Restructuring the Japanese banking system
Has Japan gone far enough?
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Abstract

The resolution of the Japanese banking crisis has been identified as a critical factor affecting the health of the global economy. Massive restructuring must be undertaken to improve the health of Japanese financial system. We provide evidence that the Japanese banking system has begun to restructure in light of recent financial deregulation. In particular, failures, mergers and other forms of restructuring are now underway. However, Japanese banks still must overcome serious obstacles to regain their place among the world’s best financial institutions.

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... the health of Asia and indeed the world depends upon Japan—President Clinton in his opening address to the IMF/World Bank, November 1998.

The IMF, on September 21, 1998, defined the largest risk to the health of the world economy as Japan refusing to “address its financial-sector problems while ensuring adequate domestic demand.”

1. Introduction

Reviving the Japanese banking system is a key element in improving the health of the global economy. The extent of the bad loan problem for Japanese banks has been estimated at US$1.2 trillion, or about 7% of the GDP of Japan (Hoshi & Kashyap,
However, as recently as mid-1998, the Japanese government attempted to avoid the issue entirely. Keizo Obuchi replaced Ryutaro Hashimoto as prime minister of Japan in July 1998 and promptly vowed that none of the 19 largest Japanese banks would be allowed to fail, for example (Economist, September 12, 1998). The government even circulated rumors that the failure of just one top bank would lead to a global financial upheaval. Moreover, until quite recently the banks themselves were content to mask the extent of the bad-loan problem and hope that the economy reversed course. The Japanese government and banks have begun to change their ways, however, as failures, mergers, and other forms of restructuring have begun in apparent earnest.

This study describes the current state of the restructuring of Japanese banks, focusing on the largest Japanese banks per conventions in the business press. First, we discuss the extent of the banking crisis, the events that led to the present situation, and relevant research regarding the functioning of Japanese banks. Next, we examine current restructuring measures taken by the Japanese government and individual banks in response to the crisis. Specifically, financial deregulation and subsequent mergers and bank failures are analyzed in detail. Finally, we assess the remaining obstacles and future issues faced by the Japanese banking industry.

2. Extent of the problem

Deregulation of the Japanese banking system will be complete by 2001 and, ideally, unfettered competition will take place among banks, insurance companies and securities firms. Hoshi and Kashyap (1999) suggested that deregulation proceeded at different paces for borrowers, savers and intermediaries. These differences exacerbated the Japanese banking crisis. Specifically, large Japanese firms greatly reduced their reliance on banks as bond markets became accessible in the 1980s (Anderson & Makhija, 1999). Japanese consumers, however, continued to invest most of their wealth in bank deposits rather than the capital markets. This created an asset/liability mismatch for the banks as their funding base remained relatively constant, but they had to search out new borrowers. These new loans were largely to smaller companies that relied heavily on real-estate collateral. These loans performed poorly due to the collapse of the real-estate market in the early 1990s.

The Banker allocated a significant portion of its July 1998 “Top 1000 Banks” special issue to Japanese banks. The Bank of Tokyo–Mitsubishi, thought to be one of the healthiest Japanese banks, reported a pre-tax loss of US$6.2 billion, the second largest pre-tax loss of any bank in the world for that year. In addition, although 118 Japanese banks made the list of 1000 largest banks, 38 reported losses. The article stated that if the banks revealed the extent of their bad loans very few would have reported a profit. This stands in stark contrast to 3 years earlier when Japanese banks dominated the top of the list. In fact, most banks currently carry real-estate–backed loans on their books at 70% of peak value. However, land prices have dropped for 6 straight years to about 50% of peak value in 1992 requiring at least a one-third increase in
bad-loan provisions (Economist, August 22, 1998). The Banker indicated that the solution to the crisis involves a major consolidation in the banking sector.

Hoshi and Kashyap (1999) estimated bad loans for Japanese banks at 7% of Japan’s 1998 GDP. This measure puts the Japanese banking crisis at three to four times larger than the U.S. S&L crisis, which saw the closing of 1142 S&L institutions and 1395 banks in the 1980s and early 1990s. Hoshi and Kashyap estimated that the Japanese banking sector will have to shrink dramatically as deregulation changes the face of the playing field. By their most conservative estimates, 45 of poorest performing banks, out of a total sample of 142 banks (32%), face elimination. Under more realistic scenarios, the banking sector would have to shrink by about 50%. They concluded that the Japanese banking industry will closely resemble the U.S. banking industry within the 10 years.

In late 1998, Japanese banks’ credit risk was so high that they were forced to pay 100 basis points more than Western banks to borrow dollars globally, a so-called Japan premium. Standard and Poor’s placed the credit ratings of nine large Japanese banks under negative credit watch (Reuters, November 24, 1998). The nine banks were Asahi Bank, Dai-Ichi Kangyo Bank, Daiwa Bank, Fuji Bank, Industrial Bank of Japan, Sumitomo Bank, Sanwa Bank, Sakura Bank and Tokai Bank. Interestingly, seven of these banks announced mergers in 1999, and the other two have not ruled out mergers.

3. Sources of the banks’ problems

The Japanese economy looked like a world-beater in the 1980s and early 1990s. As a result, Japanese companies indulged in heavy spending on plant and equipment, which led to overcapacity. The chief economist for Deutsche Bank in Tokyo, “estimates that between 1988 and 1992 Japan added the productive equivalent of France to its economy” (Economist, September 26, 1999). The overinvestment reduced Japan’s return on capital, and large firms have been reluctant to borrow further given their debt levels are already extremely high. In fact, the return on equity of exchange listed firms in Tokyo fell to 3.5% in 1998 compared to 27% for S&P 500 firms in the U.S. during the same period (Economist, August 29, 1998). In addition, given the extent of bad loans, banks have begun to turn away small- and medium-size companies.

In the past, the Ministry of Finance (MOF) and large banks engaged in a discreet arrangement in which the banks would offer cheap loans to the MOF’s preferred firms and, in return, the MOF would tacitly agree to bail out the banks in troubled times. This system worked well while the stock market and land prices were soaring. However, several key developments have soured this relationship. First, in the 1990s both stock and land prices plummeted. This eliminated bank reserves based on stock ownership in other companies and increased the need for provisions of bad loans backed by real estate. Second, the MOF no longer oversees the banks as that job was turned over to the Financial Supervisory Agency (FSA) in 1998. The FSA has proven to be a tough regulator, forcing banks to begin to reflect accurately the extent of the bad loans. Third, the MOF runs the Postal Savings Service, which at US$2 trillion in
deposits, competes directly with the banks. The banking industry has recently begun to lobby the government to privatize the postal bank to strip the MOF of its influence in the banking industry.

The MOF also forced Japanese banks to employ the “convoy system” to support poorly performing banks. Under this arrangement, the healthy banks helped the unhealthy banks and the banking system restructured at a slower pace as the better banks diverted time and resources to unprofitable banks. As recently as 1997, Bank of Tokyo–Mitsubishi and Industrial Bank of Japan were forced to provide Nippon Credit Bank with cash infusions. However, the regulatory watchdogs seem to have abandoned that system as large Japanese banks have been allowed to fail. One likely implication is that the quality difference between healthy and unhealthy banks will widen as funds are moved to the healthy banks (Economist, November 22, 1997).

The banking industry also utilized a powerful lobby to prevent competition. Morck and Nakamura (1999) pointed out that bank lobbying delayed the formation of a bond market and issuing of bonds abroad in the 1970s and 1980s. These efforts hindered global competitiveness but ensured that Japanese banks were locally powerful.

4. Literature review on Japanese banks

As corporate control activity in Japan is relatively nonexistent, there are few investigations of Japanese mergers and acquisitions. Large mergers rarely occurred in Japan through the early 1990s. Kang et al. (1999) analyzed 154 mergers for nonfinancial firms from 1977 to 1993. Curiously, Kang et al. found that over two thirds of the mergers involved privately held target firms. Over a 15-year period, only 46 mergers occurred in which both the bidder and target were publicly traded. The pace of mergers and acquisitions in Japan picked up, however. In 1998, Japanese firms engaged in over 900 mergers and acquisitions, a 35% increase from 1997 (Economist, April 3, 1999). Over half of the deals, in value, have involved foreign firms. A number of high-profile mergers occurred in 1999, involving some of the largest Japanese corporations. However, merger activity in Japan, in terms of number of deals or value transacted, is a small fraction of that of the U.S. over the same time period.

A bank-centered economy like Japan’s significantly affects the corporate governance of firms. Kang and Stulz (1999) conjecture that bank-centered corporate governance arrangements better address agency problems as the bank may closely monitor the borrowing firm. Kang et al. (1999), in their examination of domestic mergers from 1977 to 1993, concluded that Japanese banks with strong relations with merging firms monitor investment decisions and improve firm performance. Specifically, acquisition announcement returns for the acquirer are positively related to the degree of bank relationship and benefits are greater for firms with poor investment opportunities. However, Kang and Stulz (1999) also pointed out that this relationship limits a firm’s ability to raise funds through means other than the main bank. They demonstrated the “dark side” of banking relationships by examining how shocks to the Japanese banking sector affect borrowers. Specifically, Kang and Stulz (1999) showed firms
that are more bank-dependent had dramatically lower stock returns and significantly lower investment spending during the Japanese stock market collapse relative to firms relying on alternative methods of financing.

Corporate governance of Japanese banks has also been extremely poor. Anderson and Campbell (1999) examined both internal and external corporate governance mechanisms for Japanese banks from 1976 to 1996. They found no correlation between firm performance and top executive turnover until the 1990s. In addition, they documented only three mergers between banks and two bank failures over the 20-year period. Finally, Anderson and Campbell found no evidence of changes in ownership concentration or shifts in control in spite of the recent crisis. They concluded that ineffective governance exacerbated the onset of the banking crisis. These findings run counter to evidence that Japanese industrial firms have strong internal governance (Kaplan, 1994, 1997; Kaplan & Minton, 1994; Kang & Shivdasani, 1995).

Japanese banks were adversely affected by the collapse of the real estate and stock markets in the early 1990s, and the magnitude of the bad-loan problem was more severe than the U.S. S&L crisis. The government, regulators and the banks themselves have at times exacerbated the situation. The following subsections outline how Japan has addressed the problem to date and the key issues Japan faces in the future.

5. How is Japan tackling the problem?

Japan has finally acknowledged the extent of the problems with the Japanese banks and has begun to restructure accordingly. First, the government created new agencies to better monitor the banks. Second, the banking industry is undergoing deregulation, designed to increase transparency and competition. Third, merger activity among the largest Japanese banks has begun to occur at an accelerated pace.

5.1. Agencies to monitor banks

The seeming lack of oversight by regulators forced the government to create new regulatory agencies to oversee financial institutions. The first new agency is the Financial Supervisory Agency (FSA), established in July 1998. The FSA took over regulatory responsibilities of the banks and securities firms when it was spun off from the Ministry of Finance in June 1998. Once thought to be a puppet for the MOF, the FSA has proven to be far tougher in forcing financial institutions to correct problems. For example, the FSA forced the nationalization of both Long-Term Credit Bank and Nippon Credit Bank and finalized the January 1999 Mitsui Trust and Chuo Trust merger in 3 weeks (Wall Street Journal, February 8, 1999). This merger was accomplished much faster than the 1996 Bank of Tokyo–Mitsubishi merger, which took over a year to work out.

The FSA reports directly to the Financial Reconstruction Committee (FRC), another newly formed regulatory body. The FRC is managed by five government-appointed members and has been given the responsibilities of monitoring banks and parceling out funds. The FRC also reports directly to the Prime Minister in an attempt
to eliminate bureaucratic red tape. Prime Minister Obuchi named Hakuo Yanagisawa, a former prosecutor who has been extremely tough on the banks, the head of the FRC in December 1998. The FRC has since embraced the recent consolidation and has nationalized two credit banks and forced four regional banks to shut down. The FRC envisions a group of four or five very large financial institutions better able to compete globally.

5.2. “Big Bang”

In late 1996, Japanese Prime Minister Ryutaro Hashimoto revealed a plan to reform Japanese financial markets and institutions, creating a free, fair and global system by 2001. This sweeping set of reforms has been termed the “Big Bang” due to the similarities with Great Britain’s efforts to reform its markets and institutions in the 1980s. These reforms will allow competition through financial holding companies and will allow foreign firms liberalized access. The “Big Bang” consists of four major changes:

1. Securities firms entered the insurance industry beginning December 1998.
2. Insurance firms can enter the banking, trust and securities sectors through subsidiaries beginning April 2000.
3. Banks can enter the insurance industry beginning April 2001.
4. Competition without the need for the holding companies will be decided at a later date.

Several other reforms important for Japanese banks include the ability to trade in over-the-counter derivatives and asset-backed securities. Furthermore, the Foreign Exchange and Foreign Trade Control Act was amended in 1998 breaking the monopoly banks and securities firms had on the foreign exchange market.

Other reforms involve transparency and accountability for Japanese banks. The lack of transparency helped hide the extent of bad loans for Japanese banks. The banks are now forced to classify loans into four categories based on the health of the loans. The reforms also called for banks to establish loss reserves and a schedule to write off bad loans. Also, to enhance transparency the consolidated accounting method will replace the parent-only system beginning in 1999. Plans are also in place to conform accounting standards to those dictated by the International Accounting Standards Committee (IASC).

5.3. Recent restructuring activity

Hoshi and Kashyap (1999) listed 60 announced mergers and alliances among financial firms during 1998 and early 1999. They noted, however, that “... the recent mergers and closures that have occurred thus far have not reduced capacity in the industry” (p. 3). Noticeable among the list of mergers and alliances is the number of non-Japanese firms making inroads into a once domestically dominated industry. In fact, the recently nationalized Long-Term Credit Bank is being sold to a group of investors headed by Ripplewood Holding LLC of New York (Wall Street Journal, September 29, 1999). Other foreign investors investing in Japanese financial services include Fidelity Investments, GE Capital Services and Goldman Sachs. Sibbitt (1998) argued
that until quite recently regulation impaired Japanese banks' ability to engage in mergers and acquisitions. Sibbitt further argued that the combination of deregulation and foreign competition will significantly increase the merger activity in the banking industry. Finally, large financial services firms, such as Yamaichi Securities, Nissan Mutual Life Insurance and Toho Mutual Life Insurance, have recently collapsed (Business Week, September 6, 1999).

Before 1998, only three mergers involving large Japanese banks occurred. Two mergers in the early 1990s, Taiyo Kobe–Mitsui and Saitama-Kyowa, were not immediately followed by cuts in either staffing or branches. Restructuring immediately followed the Bank of Tokyo and Mitsubishi Bank merger in 1996, however. Anderson and Campbell (1999) concluded that, for mergers prior to the mid-1990s, restructuring can best be characterized as gradual or delayed. Figures 1, 2 and 3 illustrate the pre- and postmerger structure, ownership, and management of these early mergers.

This subsection focuses on recent restructuring activities as they are most likely to be in response to the recent banking crisis. The common themes of the restructuring are the large planned layoffs for the most recent mergers. Also, the consolidation among the largest banks has increased dramatically in the last 2 years. These mergers also point to an increased sense of urgency among the top banks to return to profitability. Table 1 and Figure 4 demonstrate the recent consolidation and restructuring plans of the Japanese banking industry. Table 1 examines the proposed restructuring of the most recent relevant announcements. Figure 4 begins with the largest 23 Japanese banks per convention in the business press and tracks the control changes to date. Each restructuring event affecting large Japanese banks examined.

5.3.1. Chuo Trust and Mitsui Trust merger

Mitsui Trust and Chuo Trust revealed merger plans on January 19, 1999 (Economist, January 23, 1999). The FSA, the new bank regulator, was seen as the catalyst behind the merger due to its desire to clean up the banking sector. Mitsui and Chuo will receive between ¥230 billion and may provide another ¥1 trillion in public funds to completely clean up the two banks.

Mitsui and Chuo also announced future restructuring plans. The combined entity will cut 35 of 120 branches and cut 2000 out of 10,000 jobs within the next 5 years. This also marks a change in strategy for large banks. Traditionally, banks would partner with insurance and investment banking companies within a keiretsu, allowing the banks to resemble the European universal-banking financial institutions. However, Mitsui Trust has chosen to leave its keiretsu and team with Chuo Trust in creating a more focused strategy. Figure 5 illustrates the premerger ownership structure and postmerger restructuring plans of the Mitsui-Chuo merger.

5.3.2. Industrial Bank of Japan, Fuji Bank and Dai-Ichi Kangyo Bank merger

On August 19, 1999, the Industrial Bank of Japan (IBJ), Dai-Ichi Kangyo Bank (DKB) and Fuji Bank announced a consolidation that would create the world's largest bank at US$1.27 billion in assets (Economist, August 28, 1999). The combined entity would be responsible for 30% of all Japanese corporate lending and have assets rivaling the GDP of France (Business Week, September 6, 1999; Economist, November
Fig. 1. (a) Premerger ownership structure of Mitsui Bank and Taiyo Kobe Bank, March 1989. (b) Postmerger ownership structure of Mitsui Taiyo Kobe Bank (later renamed Sakura Bank), March 1990.

6, 1999). Prices of Japanese bank stocks increased by 20% during the week after the merger announcement.

Combined this trio has US$45 billion of bad debts on the books and incurred a loss of $8.5 billion in 1998. The three banks have announced restructuring plans that include elimination of 25% of the combined 645 branches and a cut in the total number of employees from 34,000 to 28,000. The goal is to lower expenses by ¥100 billion per year. However, the implementation of this consolidation will be extremely slow. The branch and employee cuts are going to be conducted over a 5-year period (Economist, November 6, 1999). In fact, the three banks will continue functioning independently until 2002. The current presidents of IBJ and Fuji Bank will serve as co-chairmen, and the president of DKB will serve as president when the banks combine. Figure 6 illustrates the premerger ownership structure and postmerger restructuring plans of the combined merger.

5.3.3. Sumitomo Bank and Sakura Bank merger

On October 14, 1999, Sumitomo Bank and Sakura Bank announced a merger beginning with a capital tie-up in which each bank buys shares of the other (Wall
Street Journal, October 14, 1999). Operations would then be merged and systems integrated. Restructuring efforts such as layoffs and branch closings would be the responsibility of the individual banks prior to the official merger by April 2002. This merger would create the world’s second largest financial institution at US$935 billion in assets, trailing only the recently announced merger of IBJ, Fuji Bank and DKB.

Investors, analysts and government officials reacted positively to the merger announcement. The stock price of both banks jumped 11% on the day of the announcement. Analysts saw the merger as a continued move toward a few extremely large and competitive Japanese banks. Finance Minister Kiichi Miyazawa, touted the merger as improving the overall health of the Japanese economy. However, some analysts saw the move as a continuation of the convoy system in which a healthy bank, Sumitomo, rescued the weaker Sakura. Earlier in 1999 Sakura Bank received ¥800 billion of fresh capital to deal with bad loans. Figure 7 illustrates the premerger ownership structure and postmerger restructuring plans of the Sumitomo–Sakura merger. An interesting detail of this merger is the history of the two banks. Sumitomo Bank and Sakura Bank are the main banks for the Sumitomo and Mitsui keiretsu’s, respectively. Following the Chuo Trust and Mitsui Trust merger, this provides addi-
tional evidence of a change of strategy away from partnering with corporate groupings and toward a more Western-style, profit-oriented system.

5.3.4. Asahi Bank and Tokai Bank form joint holding company

In late September 1999, Asahi Bank and Tokai Bank agreed to set up a joint holding company by October 2002. Independent operations will be combined by function and region as of October 2001 (Yomiuri Shimbun/Daily Yomiuri, October 8, 1999). This formation will temporarily create the second largest Japanese bank, trailing only Bank of Tokyo–Mitsubishi until the IBJ–DKB–Fuji Bank merger is complete in 2002. The current presidents of Asahi and Tokai will serve as holding company chairman and president, respectively. Restructuring plans have not yet been announced for the combination. Figure 8 illustrates the premerger ownership structure and postmerger restructuring plans of the Asahi–Tokai merger. Tokai and Asahi intend to ask other regional banks and financial institutions to become members of the holding company. The goal is the create a regional financial giant. Both Daiwa
Bank and Yokohama Bank are among those rumored to be joining Tokai–Asahi in the near future.

5.3.5. Nationalized banks

Credit banks in Japan were established after World War II to finance industry. The three largest credit banks were the Industrial Bank of Japan, Long-Term Credit Bank and Nippon Credit Bank. These banks provided the majority of financing during the postwar era. However, large Japanese firms reduced their reliance on bank borrowing to fulfill their borrowing needs as bond markets in Japan became more accessible (Anderson and Makhija, 1999). Therefore, credit banks could no longer perform the service for which they were created and had to look elsewhere for borrowers. Most of these new loans were in the risky real-estate sector, and when the economy sank in the 1990s the banks were left with very large amounts of bad loans. The government nationalized both Long-Term Credit Bank and Nippon Credit Bank in 1998.

On September 28, 1999, Ripplewood Holdings, a US$430 million buyout specialist
and private equity fund, gained the sole right to bid for the assets of Long-Term Credit Bank (LTCB). Ripplewood bought the nationalized bank from the Japanese government for about US$1.2 billion. This marked the first complete foreign takeover of a Japanese bank, and the deal has some unique features (Business Week, October 11, 1999). Ripplewood cannot sell existing LTCB loans or refuse troubled borrowers for 3 years. Therefore, the ability to raise profits in the short run is severely hindered. However, the government has agreed to take over any loan that drops below 20% of book value within the next 3 years. The government will also retain a minority interest in LTCB, not to exceed 33%.

Ripplewood has set up an experienced management team to guide LTCB. Paul Volcker, former chairman of the Federal Reserve, will act as an advisor. Masamoto Yashiro, former chairman of Citibank Japan, will serve as president. The venture will be well-funded, as Ripplewood expects to inject over US$1 billion of new capital and the government is expected to provide another US$2 billion in preferred stock. The
strategy of the reformulated company is to enhance profitability by delving into areas such as credit cards, corporate pension management and the sale of mutual funds. Hakuo Yanagisawa, minister for financial reconstruction and head of the FSA, wants the new management of LTCB to utilize Western-style techniques to encourage growth in the banking sector (Wall Street Journal, September 29, 1999).

Nippon Credit Bank, forced by the FSA to acknowledge its true bad loans, tried in vain to stay solvent. First, NCB closed its nonbank affiliates to cut costs. Next, NCB closed its international operations to avoid capital standards. Then, NCB began to write off large amounts of bad loans and pursued mergers with other banks. However, in late 1998 the Japanese government forced nationalization of the bank.

On July 26, 1999, six former executives of Nippon Credit Bank were arrested for allegedly covering up the extent of losses (Wall Street Journal, July 26, 1999). The month before, former executives of LTCB were arrested for similar crimes. These incidents followed the arrests of two top executives of Hokkaido Takushoku Bank, who were charged with accepting allegedly illegal loans leading to the bank’s failure.
Table 1
Restructuring of Japanese banks

<table>
<thead>
<tr>
<th>Restructuring event</th>
<th>Pre-restructuring combined staffing</th>
<th>Proposed post-restructuring plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sumitomo Bank and Sakura Bank (October 1999)</td>
<td>800 Branches 32,531 Employees</td>
<td>650 branches 20,700 employees by 2004</td>
</tr>
<tr>
<td>Asahi Bank and Tokai Bank (September 1999) form joint holding company</td>
<td>730 Branches 24,095 Employees</td>
<td>Combine operations in 2001, form holding company in 2002</td>
</tr>
<tr>
<td>IBJ, DKB and Fuji Bank (August 1999)</td>
<td>809 Branches 36,551 Employees</td>
<td>650 branches 30,000 employees by 2004</td>
</tr>
<tr>
<td>Mitsui Trust and Chuo Trust (January 1999)</td>
<td>119 Branches 10,000 Employees</td>
<td>85 branches 8000 employees by 2004</td>
</tr>
<tr>
<td>Long-Term Credit Bank (nationalized in 1998)</td>
<td>41 Branches 3499 Employees</td>
<td>Sold to Ripplewood Holdings</td>
</tr>
<tr>
<td>Nippon Credit Bank (nationalized in 1998)</td>
<td>19 Branches 2290 Employees</td>
<td>For sale by government</td>
</tr>
<tr>
<td>Hokkaido Takushoku Bank (failed late 1997)</td>
<td>186 Branches 4717 Employees</td>
<td>Regional business sold to Hokuyo Bank, national business up for sale</td>
</tr>
</tbody>
</table>

Source: Premerger data is from the Japan Company Handbook (Autumn 1998). Postmerger data are from various Wall Street Journal articles.

Together, these incidents are seen as evidence Japanese banks have been attempting to hide the true nature of losses.

5.3.6. Bank failures

Hokkaido Takushoku, Japan’s tenth largest bank, effectively declared bankruptcy in late 1997. Its regional business was sold to Hokuyo Bank and its other business in Tokyo was put up for sale. Previously, Hokkaido Takushoku attempted to merge with Hokkaido Bank, but the proposed merger was indefinitely delayed in September 1999. The Ministry of Finance also failed to force life insurance companies to provide another US$1.2 billion in capital (Economist, November 22, 1997). This marked the largest failure in Japanese history and followed similar failures of Hyogo Bank and Hanwa Bank, two smaller regional banks.

The Bank of Japan and Ministry of Finance agreed to protect all bank deposits and senior debt (The Banker, December 1997). However, Hokkaido’s collapse adversely affected the local economy. Hokkaido was the largest bank on the northernmost Japanese island of Hokkaido and lent money to 60% of the local corporations. As a result, a majority of the 600 bankruptcies in the first half of 1998 can be attributed to Hokkaido’s failure (The Guardian, July 13, 1998).

6. Current issues

Serious obstacles remain for Japanese banks to improve their long-term health. First, Japan has only 12,000 certified public accountants (CPAs) compared with almost
Fig. 4. Corporate control changes among large Japanese banks. (Source: Anderson & Campbell [1999] and various issues of Economist and Wall Street Journal.)
Fig. 5. Premerger ownership structure and postmerger plans of Mitsui Trust and Chuo Trust, March 1998. Data taken from the *Japan Company Handbook* (1998) and various *Wall Street Journal* articles.

half a million in the U.S. (Craig, 1998). The U.S. utilizes about 7000 bank examiners, whereas Japan only has 710. Moreover, Japan has a small judiciary system to discipline wayward companies. Therefore, a majority of the responsibility regarding accountability and transparency rests on the individual banks for the time being.

Another obstacle to mergers and acquisitions in Japan is securities regulation. Currently, minority shareholders have the right to refuse a takeover bid, making it difficult for a complete takeover to occur (*The Guardian*, July 13, 1998). However, the government plans to change the law to dictate that minority shareholders must sell their shares if the bidder gains agreement for a majority of shares.

Another barrier to control changes in Japan is the cross-holding of shares. Specifically, other companies own over 40% of the shares of the average Japanese corporation. For industrial firms this offers the ability to tie themselves to friendly suppliers, customers and banks. For banks, this has created the illusion of profitability in the face of bad loans. Specifically, until recently banks were allowed to use capital gains from stock holdings of other companies to pad profits. For banks, the extended downturn in the Japanese stock market wiped out any stock gains from ownership of other companies. Therefore, the extent of bad loans became more apparent. The threat of failure as well as pressure from regulatory bodies may force banks to unwind these positions. Indeed, banks have begun dumping their cross-holdings to free up cash.
Finally, consolidation may not be as attractive as perceived by the business press. The Bank for International Settlement (BIS) published a paper examining bank consolidation and profitability in different countries (Economist, August 28, 1999). The study found that, despite increased merger activity, profitability had actually fallen in 12 countries, perhaps because bidders paid too much or trivialized organizational issues. Therefore, mergers may not be a panacea for Japanese financial institutions.

7. Future issues

Japan has taken great strides attempting to restore its financial institutions to respectability. However, several key issues need to be addressed for the Japanese banking system to continue to improve.

On October 5, 1999, Michio Ochi replaced Hakuo Yanagisawa as the head of the FSA. Yanagisawa served less than a year in this post and was believed to be responsible
Fig. 7. Premerger ownership structure and postmerger plans of Sakura Bank and Sumitomo Bank, March 1998. Data taken from the *Japan Company Handbook* (1998) and various *Wall Street Journal* articles.

For the recent restructuring in the banking industry. In fact, when Yanagisawa took over control of the financial system from the Ministry of Finance he stated, “Maybe I’m the only one who can promote restructuring in Japan’s financial industry” (*Economist*, August 28, 1999). The choice of Ochi, a former MOF official, is seen by some as a move to appease angry bank and government officials. In fact, Ochi commented that the recent purchase of LTCM by Ripplewood was a short-term maneuver to strip assets and sell quickly. Ochi also hinted that an increase in foreign capital is not the best solution for the current problems. This is in stark contrast to Yanagisawa’s policy, as foreign investment in Japan will probably total US$125 billion in 1999, three times the 1998 total. A litmus test of Ochi’s determination for reform will be the sale of Nippon Credit Bank. Potential buyers include the recently married Chuo Trust and Mitsui Trust, J.P. Morgan and Kohlberg Kravis Roberts. Ochi will be ripe for criticism if a high-quality foreign bidder is passed over for a domestic suitor.

Ochi also has several key obstacles to overcome in the near future. First, in April 2001, the government will begin to limit deposit insurance to about US$86,000 per account. This could start a run on the weaker regional banks if they have not restructured sufficiently by that time. Another problem area is in the insurance industry.

The life insurance sector will undergo deregulation beginning in 2001 and has seen the recent failure of several companies. In 1997, Nissan Mutual Life Insurance became the first life insurance firm to fail since World War II, followed closely by the failure of Toho Mutual Life Insurance. The casualty-insurance sector was recently deregulated and faces stiff foreign competition. In fact, on October 18, 1999, Mitsui Marine & Fire Insurance, Nippon Fire Insurance and Koa Fire & Marine Insurance agreed to merge, which created Japan’s largest casualty insurer (Wall Street Journal, October 18, 1999).

Individuals in Japan realize that the economy is at a crossroads. According to a recent survey, a majority of Japanese citizens would rather have a society based on increased risk and equal opportunity than the traditional Japanese egalitarian system (Business Week, October 25, 1999). This move toward a more Western-style economy is supported by the dramatic increase in entrepreneurial start-ups and risky ventures. This increase in risk-taking has led to an increase of equity investment to an all-time high of 7% of household savings. Equity investment looks to grow dramatically in the next few years, because current yields on savings deposits are near zero.

At least some executives in the banking industry feel a sense of urgency to restructure...
and become more competitive globally, especially with the removal of government safeguards. For instance, the new President of Sanwa Bank, Kaneo Muromachi, says, “We aren’t restructuring because MOF is telling us to, we are doing it because we need to survive” (Business Week, October 25, 1999). However, in stark contrast to South Korea’s response to the 1997 financial crisis in which over half of top executives lost their jobs, none of the top executives of Japanese banks has been ousted (Economist, November 6, 1999). The arrests of top executives at the nationalized credit banks, discussed earlier, are seen as largely token gestures.

The problem with attempting to restructure an industry without the proper infrastructure in place to monitor progress is the likely outbreak of fraud similar to the British “Big Bang” in the 1980s (Craig, 1998). The shortfall of accountants and bank examiners and lack of a proper punishment system in Japan have already led to a lack of supervision. As mentioned earlier, top executives at both Long-Term Credit and Nippon Credit bank were arrested for attempting to cover up the extent of bad loans. Further cases of fraud within the Japanese banking system seem highly likely.

Japan faces a very serious pension fund shortfall in the next few decades. The Organization for Economic Cooperation and Development (OECD) had estimated government debt caused by pensions will rise from 25% of GNP in 2000 to 300% of GDP by 2030 (Economist, June 28, 1997). Experts estimate the pension fund shortfall to be roughly the size of the current bad-loan crisis (Wall Street Journal, November 29, 1999). Japan hopes to reduce the severity of this situation by expanding the investment opportunities available to the population.

Another key area of concern is the government’s reaction to restructuring plans. Banks need to lay off thousands of employees and close hundreds of branches to remain competitive, but job security is a landmine for politicians. For example, in October 1999, Nissan Motor Co. announced a plan to lay off 21,000 employees. Both the prime minister and trade minister of Japan responded directly to Nissan by stating a desire to see as few layoffs as possible. Other large Japanese companies announcing restructuring plans include Hitachi, Sony, Mitsubishi Motors, NEC and Nippon Telephone and Telegraph. Combined with layoffs at Nissan, total layoffs will total close to 90,000 workers (Business Week, November 1, 1999). All of the recent mergers of Japanese banks call for massive layoffs in the next few years. The government’s policy stance on this issue will certainly dictate how fast the banks regain their competitiveness.

8. Conclusion

The Japanese banking system has undergone a dramatic facelift in the past year due to the poor health of Japanese banks. Deregulation and the formation of powerful regulatory agencies have forced the banking industry to undergo a massive restructuring as evidenced by mergers and failures among the largest banks. Although the banking system is taking strides in the right direction, the banks still face serious issues. How the banks deal with the remaining obstacles will determine whether the recent changes are merely token gestures or a genuine start in improving the international competitiveness of Japanese banks.
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Appendix

Timeline of events affecting the Japanese financial system.

Late 1970s  Formation of Japanese bond market.
1980s  Japanese corporations allowed to issue bonds abroad.
Early 1990s  Collapse of both real estate and stock market in Japan.
11/1996  Prime Minister Ryutaro Hashimoto announces a plan to reform Japanese financial institutions and markets. The plan is termed “Big Bang” for its similarities to similar efforts in Britain.
1997  Hokkaido Takushoku Bank fails.
1998  Long-Term Credit Bank (LTCB) and Nippon Credit Bank are nationalized.
7/1998  Keizo Obuchi is named Prime Minister of Japan replacing Ryutaro Hashimoto.
       The Financial Supervisory Agency (FSA) is spun off from the Ministry of Finance to force financial institutions to correct problems.
       The FSA reports directly to the Financial Reconstruction Committee (FRC), another newly formed regulatory body reporting directly to the prime minister.
12/1998  Prime Minister Keizo Obuchi names Hakuo Yanagisawa head of the FRC. Yanagisawa was a former prosecutor.
       Securities firms allowed to enter the insurance industry as part of “Big Bang” reform.
1999  The consolidated accounting method replaces parent-only reporting to enhance transparency.
1/1999  Merger announcement for Mitsui Trust and Chuo Trust.
8/1999  Merger announcement for Industrial Bank of Japan (IBJ), Dai-Ichi Kangyo Bank (DKB) and Fuji Bank.
9/1999  Asahi Bank and Tokai Bank announce they will form joint holding company.
       Announcement of sale of LTCB to Ripplewood Holdings.
10/1999  Hakuo Yanagisawa is abruptly replaced as head of the FRC by Michio-Ochi, a former MOF official.
       Merger announcement for Sumitomo Bank and Sakura Bank.
4/2000 Insurance firms can enter banking, trust and securities businesses through subsidiaries as part of “Big Bang.”

4/2001 Banks can enter the insurance industry.

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