Banking Crisis in Japan

Introduction

For more than a decade since 1990, the Japanese banking industry has been plagued with bad loans and fast deteriorating value of its assets. The Japanese banks played a major role in the economic development of Japan during the post-war period between 1945 and 1973. In this period, the Japanese banks financed new corporations. Since all the savings were channeled into banks during this period, banks had enough cash to lend and restrictions on other options of financing turned these banks into prime financiers. This started to change in the 1970s when reforms in the financial sector began to take place. As part of the reform process, financial markets were deregulated and restrictions on the issuance of equities and bonds were eased to an extent. As the markets opened up, major corporations in Japan, which till then depended on bank finance, shifted their focus to cheaper financing in the form of bonds and equity. This greatly reduced their dependence on banks to meet their financial needs. Initially, companies had to seek the permission of the Bond Issuance Committee to issue bonds, and the rules relating to bond issue were very tight and strict. They were required to have a collateral for every bond issued. However, in 1975[1] , Bond markets were further liberalized and collateral requirements relaxed, which led to a spurt in bond market activity (Annexure 1(a)) and companies began to source their finances from the markets. This led to a further reduction in the role of banks as a prime financier. Liberalization continued, and in the late 1970s, secondary market for government bonds was also opened. This gave the Japanese an opportunity to channel their savings into lucrative bond markets, instead of banks. By the mid-1980s, all the restrictions relating to different options of finance were lifted. The changes in the financial system led to the creation of a Commercial Paper[2] market, which gave more instruments for Japanese corporations to raise money.

These developments in the financial markets offered more attractive and easier options of finance and investments for the Japanese companies and savers, due to which the banks began to lose pre-eminence they enjoyed. Japanese banking rules were left largely untouched during liberalization. This made them stick to their traditional lines of business like taking deposits and advancing loans. Since deregulation of financial markets considerably reduced the need for bank financing, they shifted their lending priorities to individuals and commercial real-estate industry that consisted mainly of small and medium enterprises, which were generally considered risky in nature. Combination of high economic growth and near zero inflation, which was a feature of Japanese economy during the mid-1980s, boosted the asset prices to unprecedented levels. It was during this period, due to intense competition, the Japanese banks began to lend aggressively in pursuit of market share. These loans were lent against collaterals consisting mainly of real estate, whose prices had increased (Annexure 1(b)) and were overvalued. This created a bubble that was often referred to as the Asset Price Bubble. In the late 1980s, Japanese banks and corporations ventured outside Japan, especially to East Asia, Europe and United States. Even in those regions lending patterns were no different than in Japan[3] . The bubble finally burst in 1989 when Nikkei 225[4] reached a peak of 38915 (Annexure 1(c)) and collapsed. It was followed by a steep decline in the real-estate prices. This drastically reduced the value of collaterals, and banks ended-up with large non-performing loans. To counter the bad loan problem, the Japanese government introduced big-bang reforms

[1] Kashyap,Anil ,Hoshi Takeo, "The Japanese Banking crisis: where did it come from and how will it end?", NBER working paper series. (www.nber.org/papers/w7250)
[2] An unsecured obligation issued by a corporation or bank to finance its short-term credit needs, such as accounts receivable and inventory. Maturities typically range from 2 to 270 days. (www.investorwords.com)
[3] Peek Joe , Rosengren Eric S." Japanese Banking Problems: Implications for Southeast Asia"
[4] Nikkei 225 is Japanese stock index

aimed at cleaning up the financial system and creating a stable financial environment. But the economic slump, which started in the end of 1989 immediately after the stock market crash, slowed down the recovery process.

The Reform Process

The main factor that affected the banks during this period was the emergence of a vibrant bond market on the both domestic and foreign fronts[5]. In 1979, unsecured straight bonds and convertible bonds were permitted. Bond issuance criterion, which until then was stringent, also was liberalized, and it was possible due to the reform in the Foreign Exchange and Trade Control Act in 1980. This allowed the Japanese firms in raising capital from the foreign markets. Foreign markets were very attractive to Japanese corporations because there was no need for any collateral to issue bonds. It also allowed the companies to bypass the strict rules of Bond Issuance Committee and it led to high issuance of bonds in the foreign markets.

There was also a regulatory change in the rules of stock exchanges that eased the path for listing in the stock exchange, making equity issuance more attractive. These moves not only opened more options for borrowers but also the savers[6]. All this was happening when banks were still tied down with old rules that prohibited them from securitizing[7] their loans, which was not possible until 1990[8]. In fact, banks were not allowed to enter into new type of businesses like fee generating activities. Even in 1998, they were not allowed to collect fees by offering loan commitments[9]. This forced them to depend on conventional means of generating revenue such as lending loans. They were fast losing control of these lines of businesses because of the borrower's ability to obtain cheap bond financing, and saver's ability to gain more income by investing in money market mutual funds and stock markets. This also forced them to reorganize their loan portfolios, which made the banks venture into riskier segments like real estate and consumer lending.

Though they were allowed to underwrite the bond issues, and were permitted to take limited equity stakes in the lending firms[10], they were not permitted to distribute corporate securities. This did not allow them to become full-fledged universal banks like the German financial institutions. The rise of bond and stock markets reduced the dependence of the companies on Japanese banks, as they were able to give more options to the borrowers and savers, which the banks were unable to give partly due to the government restrictions placed on them.

Capital market deregulation that resulted in the lifting of prohibition on short-term euro yen loans[11] to domestic borrowers and removal of restrictions on access to corporate bond markets encouraged companies to borrow directly from the market. And the relaxation of restrictions on the activities of tightly segregated institutions such as investment banks and life insurers made it possible for different institutions to lend to those people to whom they were previously denied. It resulted in a flush of funds into the market and created intense competition among different banks that were not competitors before. Asset prices zoomed during the bubble mainly due to the near zero inflation and high economic growth rate[12], which characterized Japanese economy during that period. These two factors substantially reduced the risk premium on Japan, which made the Japanese corporations rush to the international markets for their capital expansion.

The Japanese banks preoccupation with market share led them to loosen the credit controls that resulted in reckless lending. To speed up the loan approval process, banks transferred credit appraisal and monitoring to less independent units within the banks that reported directly to sales departments in banks.

This significantly eroded the value of the collaterals on which banks lent heavily during the bubble. As the prices of properties fell by half[13], the quality of bank assets declined drastically. Slowdown in the economic growth put pressure on the loan servicing of the debtors. These circumstances led to the downgrading of the banks by the international credit rating agencies. This was a major blow to the Japanese banks, which until then enjoyed better credit rating[14]

[5] Goyal, Vidhan K, Yamada Takesh "Asset Price Bubbles, Investment, and Liquidity: Evidence from Japan "
[6] Peek Joe and Rosengren Eric S "Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan"
[7] The process of aggregating similar instruments, such as loans or mortgages, into a negotiable security. (www.investorwords.com)
[8] Kashyap ,Anil "Sorting Out Japan's Financial Crisis"
[9] Op.cit Kashyap,Anil ,Hoshi Takeo, "The Japanese Banking crisis: where did it come from and how will it end?"
[10] Ibid
[11] Loans raised in Euro zone, which are denominated in Japanese yen.
[12] Op.cit Kanaya Akihiro, Woo David "The Japanese banking crisis of the 1990's: sources and lessons"
[13] I Op.cit Kanaya Akihiro, Woo David "The Japanese banking crisis of the 1990's: sources and lessons
[14] A rating used by banks, insurance companies, mortgage companies and other financial institutions making loans which they use to judge an individual or company's credit worthiness. (www.finance-glossary.com)

than their borrowers. In addition to this, restriction on the access to domestic and foreign bond markets were also lifted. As a result, there was a significant increase in the debt borrowings by the Japanese corporations (Annexure 1(a)).

Japanese banks made lesser provisions for losses, and they were suitably aided by the lax accounting norms. It resulted in creating very little provisions against possible non-performing assets. This proved to be a major detriment for them after the bubble burst. As the asset prices increased, banks earned massive profits and so did real estate developers, brokers[15] and other clandestine groups such as Yakuza[16].

The expectations that the Japanese stock exchange would bounce back were further diminished when the gulf war broke out in 1990. These events caught financial institutions and banks unaware, and it demanded a comprehensive and coordinated effort on the part of the government and financial institutions, which did not happen. This added further chaos in the already troubled Japanese banking system.

Three-Step Plan

In response to this, the Ministry of Finance in the early 1990s came out with a three-step plan to deal with the situation. First, funds amounting to 60 trillion yen were set aside for banking sector, which roughly formed 12% of GDP[17]. Out of which, 25 trillion yen were set aside for recapitalizing the weak banks, 18 trillion yen for dealing with insolvent banks, and 17 trillion yen for deposit protection. The Japanese government tried to inject this money into the system to keep the banks afloat, and these funds were earmarked to bail out the banking sector from cash crunch that it was facing.

The second step was to accelerate disposal of non-performing loans and the third was to sell the restructured loans. To achieve the second and third objectives, in 1992, the Cooperative Credit Purchasing Company was set up to buy all the real estate loans from financial institutions and sell it on behalf of the banks. A new supervisory agency called Financial Supervisory Agency (FSA) was also set up with the purpose of monitoring the performance of the banks and financial institutions. It was also allowed to supervise the asset disposals to the Cooperative Credit Purchasing Company, and monitor the recovery process.

The Jusen Companies

The emergence of Jusen[18] companies, which had strong links with Japanese mafia, otherwise known as Yakuza[19], proved to be one of the major hurdles in the Japanese banking reforms. The Jusen problem exposed the nexus between banks, Ministry of Finance and Yakuza. Their involvement in the Japanese financial system was a cause of concern in a system that was considered relatively sophisticated. According to experts, as much as 40% of the bad loans were tied up with firms involved in organized crime representing $26.3 trillion yen[20] as of mid-1990s. And this complicated the loan recovery process that was set in motion by the Ministry of Finance.

Though in 1993 the Ministry of Finance identified two credit co-operatives on the verge of bankruptcy, new loans to highly risky projects continued to flow from these banks to Jusen companies, which ultimately resisted the repayment of debt[21]. Special examination revealed that there were 13 trillion yen worth of Jusen assets, of which 9.6 trillion yen worth of assets were considered unrecoverable. Attempts to recover these loans met with strong resistance. Later, it was also revealed that some officials in the Ministry of Finance had strong links with Yakuza[22].

To overcome this cash crunch, banks took shelter in the Deposit Insurance Corporation[23] (DIC) that pumped considerable amount of money into the banks. But given the magnitude of the banking crisis, even the DIC's resources were stretched to the limit. As a result, it started borrowing heavily from the Bank of Japan. Even after setting up

[15] As the asset prices increased developers invested heavily and this meant more loans at a premium from banks for funding their activities.
[16] Yakuza is the Japanese version of Mafia.
[17] Op.cit Kanaya Akihiro, Woo David "The Japanese banking crisis of the 1990's: sources and lessons"
[18] Jusen companies are those companies which have strong links to Japanese mafia or Yakuza.
[19] Yakuza is the Japanese version of mafia.
[20] Kaplan, David, E. "Yakuza Inc." *US News and World Report*, Washington, April 13, 1998
[21] Cigdem Akin "Japanese banking crises in comparative perspective" Thesis submitted to international university of Japan
[22] Op.cit Cigdem Akin "Japanese banking crises in comparative perspective" Thesis submitted to international university of Japan
[23] Deposit Insurance Corporation is a federal agency that insures deposits in member banks.(www.investorwords.com)

Resolution and Collection Bank[24] , in order to facilitate asset disposals, the Japanese government found that the problem was simply too large to deal with. This became even more complicated when lax accounting standards led to the wrong estimation of non-performing loans.

To confront the problems of this magnitude the Japanese government decided to introduce big-bang reforms that aimed at cleaning up the whole financial system and creating a stable financial system. It was the last phase in implementing the financial market reforms that started in the early 1970s. These reforms aimed at modernizing the Japanese financial markets[25] . It began in 1998 when all the restrictions relating to foreign exchange transactions were removed, and a wide range of reforms in the banking sector were expected under this program.

The Keiretsu[26] System

One of the major factors that resulted in the collapse of the banking sector was *keiretsu* system or industrial groupings. This was a common practice among the Japanese industries. It involved interlocking of the shares where the banks held some percentage of shares in the firms within *keiretsu*[27] and the firms own some percentage of shares in the bank. This cross holding pattern created close-knit relationships between banks and firms. This kind of grouping allowed the firms to gain easy access to bank loans and protection against hostile take-over. A large horizontal *keiretsu* had a wide span of industries like banking, steel, trading, gas and so on.

Some of the biggest names in the Japanese industry were part of this keiretsu system. They included Mitsubishi, Mitsui and Sumitomo. Large keiretsus had enormous influence on the Japanese economic and industrial policy. Keiretsus acted as entry barriers to foreign firms because of their preference to buy goods from the firms within the group, and also helped these industries in keeping the prices artificially high. They also acted as cartels that led to monopolization of the Japanese industries. The entire Japanese banking industry was dominated by six big keiretsus[28] and they were often referred to as the Big Six. Keiretsu's enormous influence over the Ministry of Finance indirectly influenced the policy outcome. Even the government officials had close links with these keiretsus, a legacy of Zaibatsus[29] . The group banks began to suffer from non-performing loans because low dividend payout and underperformance of the companies were generally tolerated.

These practices in keiretsu resulted in bad corporate governance in the Japanese banks. They often lent to the group companies without proper credit appraisal because they held some share capital in those companies. And the group companies had little incentive to adhere to corporate governance principles because they were protected by the keiretsu's political influence. Hostile take-overs and combined shareholder action were rare in Japan, a sharp contrast with other developed countries. Thus, the shareholders and their rights were neglected, which the keiretsus considered an unimportant issue.

Research showed that there was a significant difference between corporate governance principles of keiretsu and non-keiretsu firms[30] . In addition to this, it was found that keiretsu firms recorded lower profitability than their non-keiretsu counterparts. This resulted in poor returns on the equities when compared to that in USA. Lending to these Zombie firms[31] compounded the non-performing loan problem, which severely paralyzed the Japanese banks.

The Change

Shinsei, which in Japanese means a new beginning, was formerly known as Long Term Credit Bank (LTCB) that collapsed in 1998[32] . The Japanese government spent nearly seven trillion yen or $66 billion trying to restore LTCB's balance sheet[33] . Finally, it was sold to Ripplewood holdings[34] for one billion yen. Ripplewood pumped in an additional

[24] An institution set up by Japanese government to take over non-performing loans from banks and resolve them.
[25] Gibson, Michael, S "big bang " deregulation and Japanese corporate governance a survey of issues"
[26] Evolution of keiretsu and their different forms. (http://www.rotman.utoronto.ca/~evans/teach363/keiretsu/keiretsu.htm)
[27] A Japanese term describing a conglomeration of companies organized around a single bank for their mutual benefit. (www.investorwords.com)
[28] Ibid
[29] Zaibatsu is a forerunner to Keiretsu. It was also a similar grouping but it wielded more power than that of keiretsu's.
[30] Gibson Michael S "big bang " deregulation and Japanese corporate governance a survey of issues"
[31] Zombie firms are those firms, which depend heavily on bank finances for their day-to-day operations. Often these Zombies formed part of Keiretsus.
[32] "Reborn, Remade, Resold" *The Economist*, January 17th 2004.
[33] Ibid
[34] Ripplewood Holdings is a private equity firm based in New York.

120 billion yen[35] to restore LTCB. This was the first time that a Japanese bank was sold to a foreign company. Shinsei bank was due for listing in February 2004, in Tokyo stock exchange, and it was expected to rake in 1.3 trillion yen to Ripplewood holdings. The revival of Shinsei bank was impressive. It reduced its bad loans to 150 billion yen by September 2003 from a peak of 2.9 trillion yen during the same period in 1998[36] . Even the capital adequacy ratio stood at 20%, more than two times the international standard of 8%[37] and the share of bad loans in total lending also dropped to 4.1%. In addition to this, Tokyo Star Bank formerly Tokyo Sowa Bank, which almost collapsed in May 2000, also rebounded to earn a $107 million profit in March 2003[38] an improvement over $2 billion loss it made two years before[39] . Many in the Japanese media and financial circles generally considered these banks as the shining stars of the successful Japanese banking reforms. But it might not be the blue print of the reforms that had taken place. Many banks were keeping the zombie firms alive by ever greening the loans [40] , even though they were showing signs of depressed job creation, lower productivity and excess capacity.

The Japanese economy had been stagnant since 1990, when real Gross Domestic Product (GDP) grew at an average of just 1.2%[41] . Since 1995, growth was extremely slow averaging less than 0.7% on year-to-year basis[42] . But in the last quarter of 2003, the GDP grew by 7% (Annexure 2), the fastest since 1990, recording growth rate of 2.7%, for the year as a whole[43] . But this growth rate was seen in the last quarter of 2003, which some economists argued that it did not represent a full economic recovery. Many in the Japanese financial and economic circles believed that the growth was a short-term phenomenon and was not sustainable on a long-term basis.

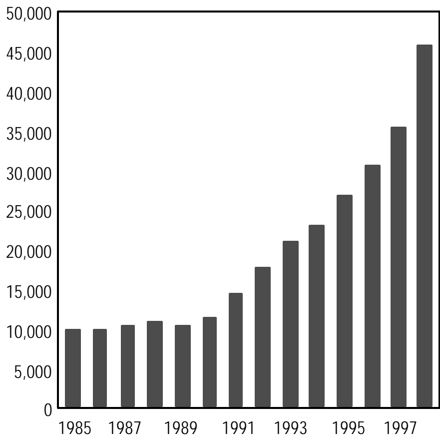
In September 2003, Japanese banks still had large amounts of non-performing loans (Annexure 3). One estimate put the figure at 21.5 trillion yen[44] for which Japanese banks did not make any provision[45]. The percentage of non-performing loans to the total loans, stood at 7.2% (Annexure 4) for the major banks and 7.8%[46] for the whole banking sector, which was high, compared to international standards. In addition to this, many banks were still part of keiretsus, whose domination though diminishing, had a considerable clout in the Japanese industry. The problem of Jusen companies could not be simply wished away as large part of the non-performing loans had to be recovered from these companies. The yakuza plays an important role in the Japanese financial system even today, thanks to the involvement of banks in the real-estate sector during the bubble period. These problems continued to haunt the Japanese banking sector and some believe that it was more of a socio-cultural problem than purely an economic one, which pervaded in the Japanese society and had to be addressed at a different level altogether.

[35] Op.cit "Reborn, Remade, Resold"
[36] "Shinsei banks impressive revival" *The Japan Times*, February 21, 2004.
[37] Ibid
[38] "Tokyo Star Bank is on rise" *BusinessWeek*, February 23, 2004.
[39] Ibid
[40] Renewing the loans to avoid classifying them as NPLs
[41] Hoshi, Takeo and Kashyap Anil K "Japans economic and financial crisis" (http://gsbwww.uchicago.edu/fac/anil.kashyap/research/#Japanese)
[42] Ibid
[43] "Surprise, Surprise" *The Economist*, February 19, 2004.
[44] "A yen for Japanese Banks" *The Economist*, October 7, 2003.
[45] Ibid
[46] Ibid

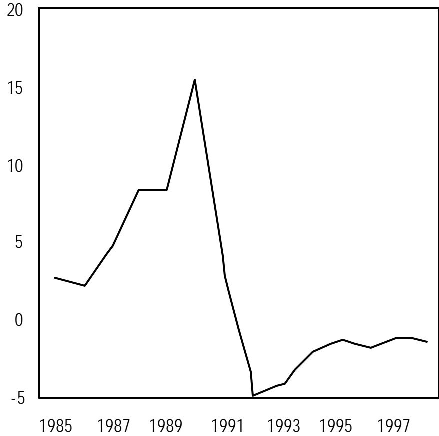
Annexure 1

Nikkei 225; Growth in Residential Land Prices and Outstanding Corporate Bonds

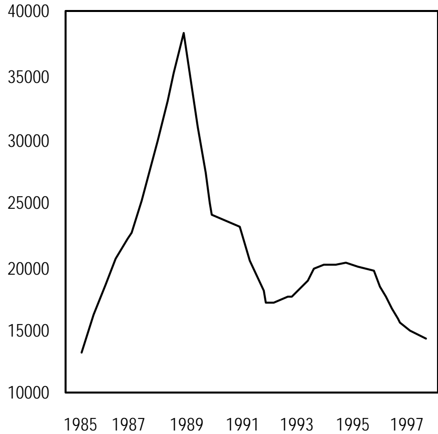
1a. Outstanding Corporate Bonds (in billions of yen)



1b. Growth in Residential Land Prices



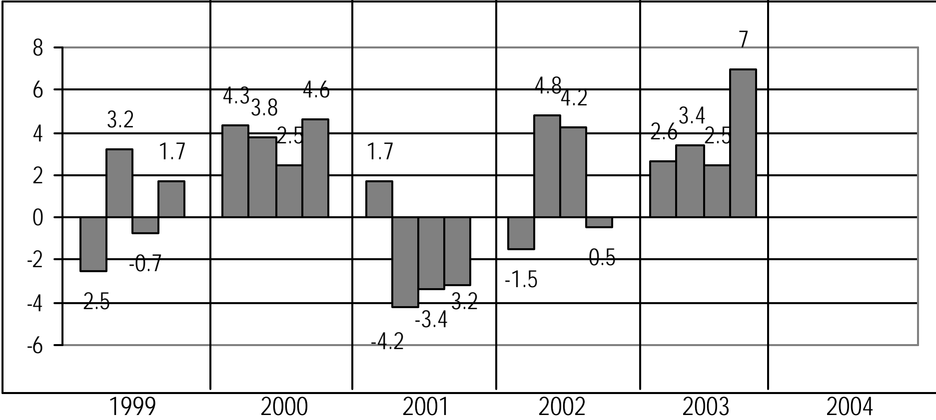
1c. Nikkei 225



Source: [1] The Japanese banking crisis of the 1990's: sources and lessons: - Prepared by Akihiro Kanaya and David Woo for IMF in 2000.

Annexure 2
Growth Rate of GDP in Japan

GDP Growth
Annualized Percentage Change (JP. OUT. ANNGDP.Q)



Source: www.newyorkfed.org

Annexure 3
Table-1 The Status of Non-Performing Loans Held by all Banks (as of end-September 2003)

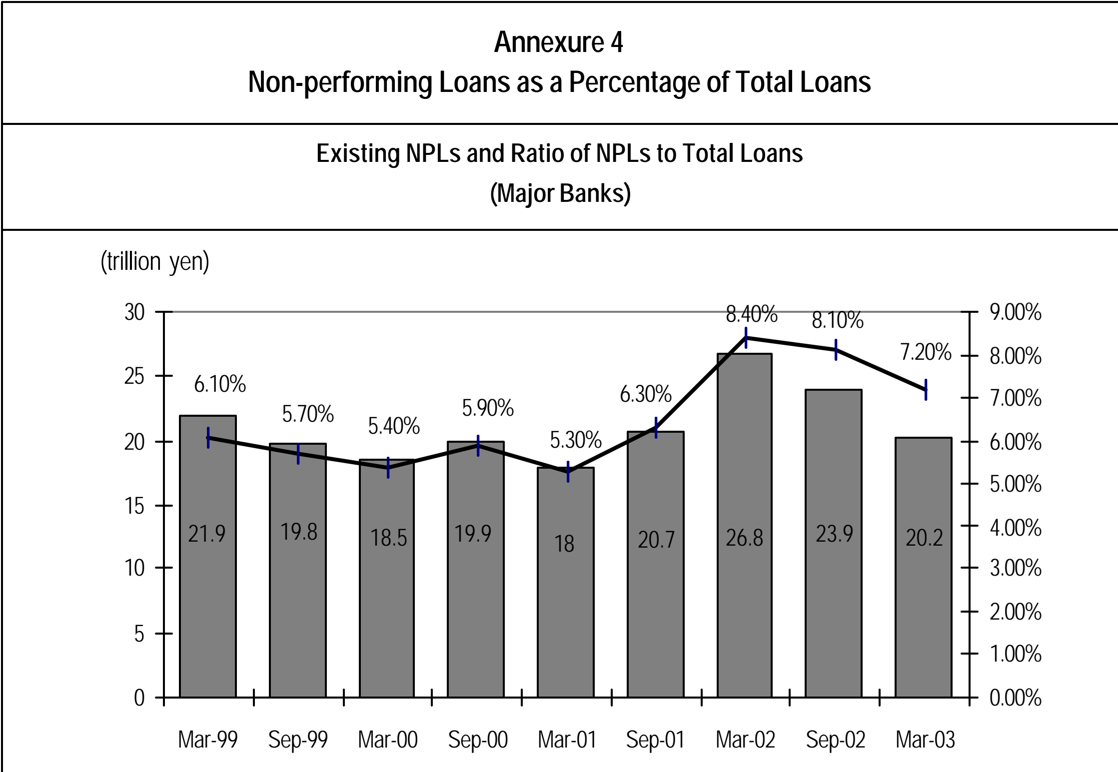
trillion yen

	Non-Perfoming Loans (NPLs) based on the Financial Reconstruction Law			Specific Provisions for Loan Losses	Total Losses on Disposal of NPLs
		Doubtful and bankrupt/*de fact* bankrupt	Special Attention		
City Banks, Long-Term Credit Banks and Trust Banks	17.7 (▲2.9)	8.6 (▲0.4)	9.2 (▲2.5)	2.5 (▲0.5)	1.7 (0.6)
Major 11 Banks	17.5 (▲2.8)	8.4 (▲0.4)	9.1 (▲2.4)	2.3 (▲0.5)	1.7 (0.6)
Regional Banks	13.9 (▲0.8)	9.4 (▲0.4)	4.5 (▲0.4)	3.0 (▲0.0)	0.8 (0.0)
Total of All Banks	31.6 (▲3.7)	17.9 (▲0.8)	13.7 (▲2.9)	5.5 (▲0.5)	2.5 (0.7)

(Note:)

1. Figures in parentheses stand for changes from end-March 2003.(Parentheses under the figures of "Total Losses on Disposal of NPLs"stand for changes from end-september 2002.)
2. Figures for "NPLs based on the Financial Reconstruction Law" are the sum of the assets classified as "bankrupt / de facto bankrupt", "doubtful", and "special attention."
3. "Major 11 banks" stand for City Banks, Long-term Credit Banks and Trust Banks excluding Shinsei Bank and Aozora Bank.
4. Figures of NPLs about Mizuho Group and UFJ Bank include those which are transferred to subsidiary companies for corporate revitalization.
5. "Regional Banks" include Saitama Resona Bank.

Source: www.fsa.go.jp



(Notes)

* "Major Banks" shows the total amount of City Banks, Long-term Credit banks and Trust Banks (excluding the Shinsei bank the Aozora Bank).
* The figures are based on the Financial Reconstruction Law.
* NPLs refer to "Special attention" or below loans.

Source: www.fsa.go.jp