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Acute Symptoms of Chronic Problems: Japan's Procrastination in Solving Its Banking Crisis, the Current Situation and a Future Perspective

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INTRODUCTION

Media coverage of the Japanese banking problem in late 1998 reached amazing proportions. The *Wall Street Journal*, the *New York Times* and other major publications all carried numerous articles dealing with the topic. Japan became the focus of the world, not because of its miraculously successful economy, but rather because of the threat it posed of precipitating a world recession.¹ In the wake of this threat, the sentiment, "if only Japan would listen," has become common among foreign governments, executives, and commentators.² Despite the variety of suggestions, there seems to be a consensus that Japan should reform its banking system, close hopeless banks and inject public funds into the "ailing but viable banks." It has also been suggested that Japan follow accepted international standards of practice, update its banking laws and practice stricter banking supervision and regulation. Critics say that as long as Japan follows their advice, it can escape the Asian Financial Crisis and prosper again. Unfortunately, reform suggestions are more easily given than followed. The ramifications of banking reform necessarily make such reform difficult to carry out.

The objective of this Note is to provide a comprehensive background of the Japanese banking reform and analyze why the nature of any reform will be a long-term project instead of the quick rescue to the Japanese economy that a lot of people expect. Part I details the background of the Japanese banking reform, including the burst of the bubble economy in the early 90's; existing banking laws; the roles of the Ministry of Finance (MOF), the Bank of Japan (BOJ) and the Financial Supervisory Agency (FSA); and the recent steps taken to tackle the banking

1. See Brian Bremner, *Until its Hidden Debt Mess is Cleared Up, No Recovery is Possible*, BUS. WK., May 8, 1998, at 136.

2. See *id.*

problems in Japan. Part II analyzes the difficulties of implementing the banking reforms given such a background. Part III makes some suggestions as to what Japan can do in the short-term, as well as in the long-term, to revive its banking system. This Note concludes that the policymakers around the world should face the reality that it will take years for Japan to clean up its troubled banking system, and the success of the reform requires the determination to act and the flexibility to respond to changing circumstances.

I. BACKGROUND OF THE CURRENT BANKING REFORM

A. THE BUBBLE ECONOMY AND THE SPECULATIVE BEHAVIOR OF THE BANKING SYSTEM

People like to refer to the Japanese speculative boom in the 1980's as the Bubble Economy.³ The Bubble Economy in Japan had its origin in the 1985 Plaza Accord that was designed for economic policy coordination among the major industrialized nations.⁴ Under the agreement, Japan would enhance domestic demand and reduce its trade surplus.⁵ To fulfill its commitments, Japan adopted fiscal stimulation measures⁶, reduced the official discount rate⁷ and conducted a lenient monetary policy.⁸ The BOJ reduced the official discount rate five times between January, 1986 and February, 1987, leaving it finally at 2.5 percent.⁹ As a result, the money supply outpaced the growth of the gross domestic product (GDP), inflation was virtually nil, and "the Japanese stock market responded with a massive rally."¹⁰ From 1980 to the beginning of 1989, Japanese stock markets rose from accounting for only fifteen percent of the value of all markets worldwide to more than forty-two percent.¹¹

The boom was not limited to the stock market, however. The real estate market simultaneously skyrocketed.¹² In Tokyo, residential prices rose annually by approximately seventy percent, while commercial real estate rose by about eighty per-

3. See CHRISTOPHER WOOD, *THE BUBBLE ECONOMY 2* (1992).

4. See Geoffrey P. Miller, *The Role of a Central Bank in a Bubble Economy*, 18 CARDOZO L. REV. 1053, 1058 (1996).

5. See *id.*

6. See *id.* at 1058.

7. See *id.* at 1060.

8. See *id.* at 1061.

9. See *id.* at 1060.

10. *Id.* at 1061.

11. See *id.*

12. See *id.* at 1062.

cent.¹³ Japan's real estate market at the end of 1989 was believed to be worth over ¥2,000 trillion (\$18 trillion), four times the estimated ¥500 trillion (\$4.5 trillion) value of the American real estate market.¹⁴ The banking industry played an important role behind these seemingly unbelievable expansions.

Japan's banks lent heavily against both property and shares.¹⁵ At the end of June 1991, Japan's banks had lent a total of ¥116 trillion (\$1 trillion) directly to the property and construction sectors.¹⁶ The outstanding domestic loans of city banks stood at about fifty percent of Japan's GNP.¹⁷ As the real estate and share prices went up, however, the banking industry was losing market share to securities markets, as many of the banks' best customers substituted equity financing for bank loans.¹⁸ To compensate for such losses, the banks increased financing for real estate-based loans, increasing the demand for real estate and driving up the prices even further.¹⁹

Worried about overheating the market and sparking inflation, the BOJ adopted a policy of raising interest rates.²⁰ The BOJ raised the official discount rate five times between May, 1989 and August, 1990.²¹ Despite the rising interest rate, the market kept stable at near-record levels.²² By the end of 1989, Japan appeared to have achieved the impossible: it was sustaining full employment, low inflation, high economic growth, a large trade surplus, and enormous rises in property and stock values.²³ The conditions were so good that a measure of economic performance that counseled caution was nonexistent.²⁴

The Bubble Economy did not last long, however. Beginning in 1990, stock and land prices fell sharply.²⁵ In 1992, Japanese

13. *See id.*

14. *See* WOOD, *supra* note 3, at 50. This ratio was amazing because America is twenty-five times larger than Japan in terms of its physical area. *See id.*

15. *See id.* at 22.

16. *See id.*

17. *See id.*

18. *See* Miller, *supra* note 4, at 1063.

19. *See id.* at 1064.

20. *See* THE STRUCTURE OF THE JAPANESE ECONOMY 243 (Mitsuaki Okabe ed., 1995).

21. *See id.* ("Within fifteen months the rate went up from 2.5 percent to 6.2 percent, representing an increase of 140 percent.")

22. *See* Miller, *supra* note 4, at 1064.

23. *See id.* at 1065.

24. *See id.*

25. *See* Okabe, *supra* note 20, at 236.

stock prices experienced the heaviest fall in post-war history.²⁶ The Nikkei Average plunged 63.2 percent from its all-time high of 38,915 points, reached in December of 1989, to 14,309 points in August 1992.²⁷ The resurgence of the yen against the dollar and other major currencies from 1990 to 1995 aggravated Japan's deteriorating economy that is heavily export-driven.²⁸ Commercial banks that had extended large amounts of real estate financing or that had speculated in the stock market boom were among the hardest hit by the collapse of the Bubble Economy.²⁹ Since then, the banking industry has struggled with mountains of bad loans, reportedly at \$600 billion today.³⁰ The Japanese economy, the second largest in the world, is currently shrinking at five percent per year.³¹ Over the past eight years, the stock market has fallen sixty percent, and since the currency's high in 1995, it has plummeted forty-three percent.³² Properties are worth about ten percent of their peak value.³³ The Japanese economy has slid into a recession.³⁴

B. BANK SUPERVISION AND REGULATION IN JAPAN

1. *The Financial Structure During the "Period of Rapid Growth" (1950-1973)*

From 1950 to 1973, "the policy goal of the Japanese government was to foster economic development."³⁵ To achieve this objective, the government tried to channel low-cost funds from individual depositors to "designated" industries by inducing policy-conforming bank behavior.³⁶ "Regulated interest rates," "indirect financing," "window guidance and administrative guidance" and "segmentation and strict demarcation of business areas" were the major features of the financial structure.³⁷

26. *See id.*

27. *See id.*

28. *See* Miller, *supra* note 4, at 1067.

29. *See id.*

30. *See* Fareed Zakaria, *Japan's America Problem*, NEWSWEEK, Aug. 3, 1998, at 39.

31. *See* Gary Wisby, *The Japanese Crisis: Why "Bubble Economy" Burst*, CHI. SUN-TIMES, July 19, 1998, at 27.

32. *See id.*

33. *See id.*

34. *See* Sheryl WuDunn, *Japan's Economy Appears Bleaker*, N.Y. TIMES, June 13, 1998, at A1.

35. Ulrike Schaede, *The 1995 Financial Crisis in Japan* (visited Sept. 28, 1998) <<http://brie.berkeley.edu/BRIE/pubs/wp/wp85.html>>.

36. *See id.*

37. *See id.*

Under this structure, interest rates were not responsive to supply and demand pressures, banks dominated in corporate financing, the central bank directly influenced the credit behavior of the major banks, and each bank category had special laws and regulations governance.³⁸ In principle, the banking business was separated from the securities business, deposit banking from the trust business and, within the commercial banking sector, long-term from short-term finance.³⁹ The "administrative guidance" from the MOF further separated the insurance business from banking and securities, as well as the foreign exchange business from deposit-taking.⁴⁰ In addition to the functional separations achieved by the use of the law and administrative guidance, other regulations affected most aspects of all financial intermediaries' operations.⁴¹ Banks had little discretion in responding to market changes.

2. *The MOF, the BOJ and the FSA*

Japan had a two-tier system of banking supervision: the MOF and the BOJ.⁴² "[The MOF] is generally considered to be the single most powerful entity in the national government."⁴³ It exerts influence over all other ministries to press the Cabinet's policies and initiatives.⁴⁴ More significantly, the MOF is the key to the heavily integrated relationships between the central government and the private sectors, including the banking industry.⁴⁵ It was the primary supervisory authority for banks

38. *See id.*

39. *See* MAXIMILIAN J. B. HALL, *BANKING REGULATION AND SUPERVISION* 86 (1994).

40. *See id.*

41. *See id.* at 91. Typically, restrictions would impinge on the sovereignty of a private depository institution in the following aspects: the sources and uses of funds; the terms on which they could borrow and lend; the activities in which they could engage; their branching and merging activities; and their investment decisions with respect to holdings of other companies' stock. *See id.*

42. *See id.* at 149.

43. CHARLES F. BINGMAN, *JAPANESE GOVERNMENT LEADERSHIP AND MANAGEMENT* 31 (1989).

44. *See id.*

45. *See id.* "Japan, Inc." is the term used to describe the close relationship between business and government in Japan. *See* ELLIOTT J. HAHN, *JAPANESE BUSINESS LAW AND THE LEGAL SYSTEM* 113 (1984). The Japanese business system is a hybrid of free market and government involvement that is unique to Japan in that the government's method of regulating the economy is based not on the guidance of formal laws, but rather through an informal process. *See id.* The government is composed of elected politicians, big business, and the higher elements of the bureaucracy, who work together in a consensus

and other financial firms.⁴⁶ For example, its Banking Bureau was responsible for the supervision of banks and their overseas affiliates. In addition, its Insurance Bureau supervises insurance companies and oversees the deposit insurance program, and its International Finance Bureau supervises the foreign activities of Japanese financial firms.⁴⁷ The MOF had authority not only to license and inspect the banks but also to demand the provision of business reports from any bank or a subsidiary company.⁴⁸ Finally, it had power to approve a miscellaneous set of banking matters, including the establishment or closing down of branches or other business offices, changes in bank location or type, and reductions in the level of capital held below a previously-specified minimum.⁴⁹

In contrast with the powerful MOF, the BOJ's objective is "the regulation of the currency, the control and facilitation of credit and finance, and the maintenance and fostering of the credit system, pursuant to the national policy, in order that the general economic activities of Japan might adequately be enhanced."⁵⁰ Thus, the BOJ has no major regulatory responsibilities over the financial system.⁵¹ In its missions and activities statement, the BOJ is to "maintain price stability and to ensure the stability of the financial system."⁵² Recognizing that the sound management of individual financial institutions is a prerequisite to the stable functioning of the financial system, the BOJ also closely monitors trends in the loans and deposits of financial institutions. The Bank's staff also regularly carries out "on-site examinations" to review their financial and management conditions.⁵³

Although the MOF and the BOJ usually collaborate their activities, their relations are not necessarily harmonious.⁵⁴ Conflict over policy priority is inevitable and disagreements are com-

framework in pursuit of what is commonly perceived as the good of Japan. See *id.* at 113-14.

46. See BINGMAN, *supra* note 43, at 31.

47. See *id.*

48. See *id.*

49. See *id.*

50. Bank of Japan Law, Law No. 67 of 1942, translated in 6 DHS LAW BULLETIN SERIES at AA-1 (1991).

51. See Okabe, *supra* note 20, at 378.

52. Bank of Japan, *Missions and Activities of the Bank of Japan* (visited Oct. 15, 1998) <<http://www.boj.or.jp/en/about/mission.htm>>.

53. See *id.*

54. See Geoffrey P. Miller, *Decision-Making at the Bank of Japan*, 28 LAW & POLY INT'L BUS. 1, 21 (1996).

mon because the BOJ views its primary missions to be controlling inflation, safeguarding the payments system, and facilitating the development of a strong and competitive banking system. On the other hand, the MOF is concerned more with fiscal policy and political considerations.⁵⁵ Furthermore, as opposed to other central banks that are gaining legal independence in both the developed and developing world, the BOJ is subject to the plenary control of the MOF.⁵⁶ Under the Bank of Japan Law, the BOJ has scant autonomy when its policies come into conflict with those of the MOF.⁵⁷ Article 42 provides that “[t]he Bank of Japan shall be under the supervision of the competent Minister [i.e., the Finance Minister].”⁵⁸ Article 43 provides that the Minister of Finance “may, if deemed particularly necessary for the attainment of the object of the Bank of Japan, *order* the Bank to undertake any necessary business, or *order* alterations in the By-Laws as well as other necessary actions.”⁵⁹ Although the BOJ is not officially an arm of the MOF, its decision-making is greatly influenced by the MOF.⁶⁰

As a crucial move in reforming Japan’s bureaucracy and subjecting the regulation of Japan’s financial markets to more public scrutiny, on June 16, 1997, Japan’s parliament passed a law that would shift the MOF’s powers to regulate financial markets to the FSA.⁶¹ The government established the FSA to provide “fair and independent” scrutiny of the banking system.⁶² The task of the FSA is to clean up the corruption and the mismanagement in the financial system and offer consumers better protection.⁶³ So far, most analysts applauded the creation of the agency as at least a step in the right direction to reduce the power of the MOF, which had come under fire for maintaining cozy ties with banks it supervised and allowing bad loans to fester.⁶⁴

55. *See id.*

56. *See id.* at 31.

57. *See* Bank of Japan Law, *supra* note 50.

58. *Id.*, art. 42.

59. *Id.*, art. 43 (emphasis added).

60. *See* Miller, *supra* note 54, at 5.

61. *See* Jathon Sapsford, *Japan’s Parliament Shifts Regulation of Financial Markets to a New Agency*, WALL ST. J., June 17, 1997, at A14.

62. *See* Valerie Reitman, *New Japan Bank Watchdog Faces Herculean Task*, L.A. TIMES, July 19, 1998, at A1.

63. *See* Alex Brummer, *The Japanese Economy: Banking on Disaster*, THE GUARDIAN, July 1, 1998, at 19.

64. *See* Reitman, *supra* note 62 at A8.

C. THE FINANCIAL SYSTEM REFORM ACT OF 1992 AND THE BIG BANG FINANCIAL REFORM OF 1998

In 1992, the Japanese cabinet agreed upon a proposed financial reform bill and submitted it to the Diet (parliament).⁶⁵ The bill passed into the Financial System Reform Act that contains amendments to sixteen existing statutes, including the laws governing most types of financial institutions.⁶⁶ The Act amends the Banking Law to permit all types of banks to participate in the private placement of securities in the secondary market, and it grants the MOF the authority to establish capital-adequacy requirements and other standards for judging the financial health of banks.⁶⁷ Moreover, the Act enables banks and other depository institutions to establish securities and trust banking subsidiaries.⁶⁸ It also allows all types of depository institutions to merge or convert to a more viable format to save troubled institutions by encouraging them to merge with healthy ones.⁶⁹ In all, the Act aims at encouraging "sufficient competition between financial institutions" and enabling the financial institutions to "meet the increasingly sophisticated and diverse needs of the user."⁷⁰

In 1993, the Diet implemented a wide-ranging set of reforms to the Japanese financial system that it had adopted as the Financial System Reform Act.⁷¹ As the entity that drafted the Act, the MOF sought to diversify the activities of each bank within Japan's highly specialized banking industry to increase competition and promote efficiency.⁷² The MOF also encouraged sound management of financial institutions, including allowing financial managers increased independence, reinforcing the disclosure system, and creating provisions regulating capital adequacy.⁷³ Most significantly, the MOF relaxed the boundary between the banking and securities industries by allowing each to have a subsidiary competing in the other's market, aiming at

65. See Colin P. A. Jones, Note, *Japanese Banking Reform: A Legal Analysis of Recent Developments*, 3 DUKE J. COMP. & INT'L. L. 387, 423 (1993).

66. See *id.*

67. See *id.* at 423-24.

68. See *id.*

69. See *id.* at 425-26.

70. *Id.* at 410.

71. See Brian Arthur Pomper, *The Japanese Financial Reform of 1993: Will Reform Spark Innovation?*, 28 CORNELL INT'L L.J. 525, 525 (1995).

72. See *id.* at 527.

73. See *id.*

promoting the development of new and innovative financial products and services.⁷⁴

Contrary to what many hoped, however, the financial “reform,” has not brought with it “deregulation” or “liberalization.”⁷⁵ In effect, the MOF has expanded its authority to regulate financial institutions by interpreting the ambiguous language of the Act in its own favor.⁷⁶ Interestingly enough, nothing about the Act makes it readily apparent that its drafters were concerned with the increasing international scope of Japan’s financial markets, even though internationalization was one of the proposed purposes of the Act.⁷⁷ The Act has been implemented slowly and cautiously, as a result of the MOF’s concern for the continued health of the existing financial institutions and the general economy.⁷⁸

In November of 1996, former Prime Minister Ryutaro Hashimoto called for a “Japanese ‘Big Bang’ deregulation of financial markets.”⁷⁹ Nicknamed after similar British reforms of the 1980’s, the Japanese reform aims at contributing to the vitalization of Japan’s economy through strengthening the competitiveness of the financial institutions.⁸⁰ In its report, the Financial System Research Council (“the Council”) to the MOF provided the basic agenda for the “Big Bang.” With the ultimate purpose of creating a market that clearly reflects users’ choice, the Council made the following recommendations: (1) liberate and diversify products, business and organizational structure; (2) prepare the infrastructure and rules for markets and transactions; and (3) secure the financial system’s soundness.⁸¹ Within each of these recommendations, the report detailed the specific reform items, including utilizing a holding company system and transforming loans and other assets into liquid forms through the issuance of asset-backed securities, etc.⁸²

In hopes of bolstering global confidence in Japan and setting its economy on track for growth, the Japanese government an-

74. *See id.*

75. *See Jones, supra* note 65, at 427.

76. *See id.*

77. *See id.* at 435.

78. *See id.*

79. Edward J. Lincoln, *Evaluating Japan’s “Big Bang” Financial Deregulation*, prepared for the Trilateral Forum on U.S.-Japan-China Cooperation in the Asia Pacific Region.

80. *See* The Financial System Research Council, *Regarding the Reform of the Japanese Financial System*, June 13, 1997.

81. *See id.*

82. *See id.*

nounced a long-awaited "Total Plan" to clear away the nation's pile of bad debt.⁸³ Under the Total Plan, "the government would shut down insolvent institutions and turn over their clients to government-run 'bridge banks.'"⁸⁴ It would also accelerate sales of the land held as security for the loans.⁸⁵ Furthermore, the plan aims to bring a more open financial system by increasing disclosure and imposing rigorous inspection standards and controls.⁸⁶ In summary, the central scheme is the disposal of bad loans through the establishment of a public bridge bank.⁸⁷ With this plan, the government hoped to facilitate a rebirth of the financial system.⁸⁸

D. THE FOCUS ON JAPAN

It was not long ago that Japan's "economic miracle" was the wonder of the world.⁸⁹ Japan's cars set off the alarms of car producers in Detroit.⁹⁰ The average Japanese household had savings of \$100,000.⁹¹ However, that era became a sweet memory since the outbreak of the Asian financial crisis in July 1997.⁹² On July 2, 1997, the Bank of Thailand announced a managed float of the baht and called on the International Monetary Fund (IMF) for "technical assistance."⁹³ The announcement effectively devalued the baht by between fifteen and twenty percent.⁹⁴

The devaluation of the Thai currency caused a series of devaluations by other Asian countries, especially Indonesia, Korea and Malaysia.⁹⁵ The currency crisis sent a shock wave through

83. See Sheryl WuDunn, *Japan Announces a Plan to Tackle Mountain of Debt*, N.Y. TIMES, July 3, 1998, at A1.

84. *Id.*

85. *See id.*

86. *See id.*

87. *See* Goldman Sachs, *Total Plan Implications and Scenarios*, July 14, 1998. The bridge bank will proceed in two stages. First, the bank will take over ordinary debts and somewhat uncertain debts from financial institutions that are deemed insolvent and maintain lines of credit under supervision by the FSA. Second, if an insolvent financial institution cannot be sold off, the Deposit Insurance Corporation will nationalize it. *See id.*

88. *See* WuDunn, *supra* note 83.

89. *See* Wisby, *supra* note 31, at 27.

90. *See id.*

91. *See id.*

92. *See* *Chronology of the Asian Currency Crisis and its Global Contagion* (visited Feb. 4, 1998) <<http://www.stern.nyu.edu/~nroubini/asia/AsiaChronology1.html>>. This triggered the East Asian Crisis. *See id.*

93. This triggered the East Asian Crisis. *See id.*

94. *See id.*

95. *See id.*

the stock markets in Asia.⁹⁶ Japan was not an exception.⁹⁷ The Tokyo stock market fluctuated with the trends of other Asian markets.⁹⁸ When Prime Minister Keizo Obuchi took office at the end of July 1998, he vowed to move swiftly to address Japan's economic problems.⁹⁹ He designated his Cabinet as a "Cabinet for Economic Revival" and proposed banking and other structural reforms to restore the Japanese economy.¹⁰⁰ Unfortunately, more than one year after the outbreak of the Crisis, there is still little hope of recovery.¹⁰¹ On September 21, 1998, the IMF declared that the main risk to the world economy was that Japan would not "address its financial-sector problems while ensuring adequate domestic demand."¹⁰² Adding to the bleak picture of the future, the Japanese GDP contracted 1.8 percent for the fiscal year ending in March of 1999, a sharp reversal of its previous, much-maligned claim that the economy would grow 1.9 percent.¹⁰³ The Japanese problems have now become international problems.¹⁰⁴

96. See *id.*

97. See *id.*

98. See *Chronology of the Asian Currency Crisis and its Global Contagion* (visited Feb. 4, 1998) <<http://www.stern.nyu.edu/~nroubini/asia/AsiaChronology1.html>>.

99. See Stephanie Strom, *Japan's New Chief Vows to Act on Economy* (visited Oct. 5, 1998) <<http://www.nytimes.com/library/world/asia/080198japan-obuchi.html>>.

100. See *Policy Speech by Prime Minister Keizo Obuchi to the 143rd Session of the Diet* (visited Sept. 20, 1998) <<http://www.kantei.go.jp/foreign/980810-143diet.html>>.

101. The stock market has continued to fall. On September 30, 1998, Japan's stock market fell to a 12-year low, with the benchmark Nikkei 225 index shedding 415 points, or 3%, to close at 13406. See Bill Spindle et al, *Bleak Economy Emerges from Japanese Survey*, WALL ST. J., Oct. 1, 1998, at A16. This is the lowest level since February 1986. See *id.*

102. See *Time to Wake Up*, ECONOMIST, Sept. 26, 1998, at 21.

103. See *Inside China Today, Japanese Government Predicts GDP to Contract 1.8 Percent* (visited Oct. 7, 1998) <<http://www.insidechina.com/china/aroundasia/news/03.html>>.

104. See David E. Sanger, *Clinton and Obuchi Break the Ice, but Solve No Economic Problems* (visited Oct. 5, 1998) <<http://www.nytimes.com/library/world/asia/092398japan-us.html>>. Talking about the financial reform in Japan, Prime Minister Obuchi said that "this is not only an issue for Japan, but something that has major implications on economies of Asia as well as the whole world." See *id.*

II. THE NATURE OF THE REFORM AND ITS CURRENT SITUATION

A. THE DEPTH OF THE BANKING PROBLEMS DETERMINE THE LONG-TERM NATURE OF THE REFORMS

For months, American officials have become increasingly specific about what they believe Japan must do. In April 1998, President Clinton warned in "unusually explicit terms" that Japan must change course if it wishes to rescue its economy from a long-term decline.¹⁰⁵ His comment intensified the pressure by the leaders of several of the world's strongest economic powers, who have reiterated that Japan's economic decline and its inability to absorb imports from its Asian neighbors threaten that constituent's economic recovery.¹⁰⁶ But Asia may not be the only area affected by Japan's failures. Indeed, American officials have a legitimate concern that the collapse of more Japanese banks and securities dealers could imperil Wall Street and, thus, the United States economy. The problem, however, is that the world leaders' statements and warnings may cause the public to mistakenly believe that it is the inaction of Japan, instead of the economic trouble itself, that is endangering the world economy.

In fact, the world already views Japan with a mixture of pity and contempt.¹⁰⁷ If Japan fails to deal with its banking crisis swiftly as a crucial first step to revitalizing its debilitated economy, it will be branded a pariah.¹⁰⁸ Is that fair? The country's real GDP contracted at an annual rate of 3.3 percent during the April-June quarter of 1998, the third consecutive quarterly decline.¹⁰⁹ Bad debt in Japan's banks amounts to perhaps thirty percent of the GDP.¹¹⁰ Of course, one can join Prime Minister Keizo Obuchi in blaming the Japanese political leaders, the powerful MOF and the heads of the country's huge financial institutions for wasting years before facing up to the crippling banking crisis.¹¹¹ Accusations cannot solve the problem, however, and one must fully understand a problem before taking steps to alleviate it.

105. See David E. Sanger, *Clinton Warns Japan: Fire up the Economy to Stem a Decline*, N.Y. TIMES, April 4, 1998, at A1.

106. See *id.*

107. See *Time to Wake Up*, *supra* note 102, at 21.

108. See *id.*

109. See *id.*

110. See *id.*

111. See David E. Sanger, *Tokyo Leader Blames Many for Banks' Crisis*, N.Y. TIMES, Sept. 22, 1998, at A13.

The banking crisis was directly related to the burst of the Bubble Economy. The BOJ's lowering of the official discount rate made bank loans virtually interest-free in Japan.¹¹² The banks used a rising stock market to create bank capital and boost their lending.¹¹³ By funneling the loans back into the stocks and property markets, the banks boosted the value of collateral (stocks and property) against which to lend even more money.¹¹⁴ In this case, the effects of regulated interest rates were obvious. For financial institutions, profit margins were high and predictable, and there was little pressure to cut costs and increase efficiency. The government's limitation on the role of the capital markets supported the bank dominance in corporate funding that also insured a sustainable high interest rate margin.¹¹⁵

The burst of the Bubble Economy eroded two important cushions protecting financial institutions from bad debts: collateral and owned capital.¹¹⁶ Not only has the burst reduced prices for the shares and land used to collateralize loans, but it has also erased many of the unrealized gains on stock portfolios that make up a large part of the capital claimed by Japanese financial institutions.¹¹⁷ The reversed conditions that let the banks boost their lending so dramatically during the bubble years were the cause of the banking problems.¹¹⁸ First, banks can no longer count on lending to cash-rich companies because those companies can raise money less expensively by selling securities in the international markets.¹¹⁹ To counter this problem in the past, banks increased the number of asset-backed loans to medium and small-sized companies and to consumers.¹²⁰ When the property prices collapsed, such counter measures failed and the collateral cushion protecting banks from bad debts was taken away. The second change in conditions was precipitated by the deregulation of interest rates.¹²¹ The BOJ could no longer absorb all the government bonds issued and it was impossible to force the public to increase savings for the purpose of purchasing

112. See WOOD, *supra* note 3, at 12.

113. See *id.*

114. See *id.*

115. See Schaede, *supra* note 35.

116. See RYUICHIRO TACHI, *THE CONTEMPORARY JAPANESE ECONOMY* 203 (Richard Walker trans., Univ. of Tokyo Press 1993).

117. See *id.*

118. See WOOD, *supra* note 3, at 22.

119. See *id.* at 23.

120. See *id.*

121. See *id.*

bonds.¹²² In April 1991, all deposits over ¥500,000 began to earn money market rates.¹²³ Instead of responding to the increase in their funding costs by passing on the cost to borrowers, the banks kept pursuing asset growth in order to boost their share of the market.¹²⁴ Indeed, the buoyant Tokyo stock market helped the banks to fill the operating loss with capital gains from the sales of stocks held in their huge portfolios.¹²⁵ Unfortunately, as the stock market fell, the banks' safety net of owned capital was stripped away and the bad debts mounted dramatically.

In 1993, the MOF and the BOJ engaged in an open debate over the appropriate response to the deterioration of the banks' loan portfolios.¹²⁶ The MOF argued that in the interest of financial stability, only a gradual adjustment to the banks' published accounts was desirable, while the BOJ advocated immediate large-scale write-offs.¹²⁷ The MOF prevailed and adopted a policy of forbearance, which allowed banks to understate the scale of their problem loans in the hope that the passage of time would eventually alleviate the situation.¹²⁸ This approach constituted a carefully formulated scheme to enable Japanese banks to mask the large-scale deterioration in their balance sheets at a dangerous time in the life of the financial system.¹²⁹ The result is the current critical situation in the banking system.

Banking crises, however, do not happen only in Japan. The U.S. Savings and Loan (S&L) crisis in the 1980s was similar to the current Japanese banking crisis.¹³⁰ By 1989, the S&L industry nearly collapsed due to fundamental flaws in the system's structure, changing economic conditions, deregulation and fraud.¹³¹ The crisis took six years and \$125 billion in taxpayer money to resolve, and resulted in the closure of nearly seventy-

122. See THE JAPANESE MAIN BANK SYSTEM 105 (Masahiko Aoki & Hugh Patrick eds., Oxford Univ. Press 1994).

123. See WOOD, *supra* note 3, at 23.

124. See *id.*

125. See *id.*

126. See VIVIEN A. BEATTIE ET AL., BANKS AND BAD DEBTS 125 (1995).

127. See *id.*

128. See *id.*

129. See *id.* at 127.

130. See generally Wayne M. Josel, *The Resolution Trust Corporation: Waste Management and the S&L Crisis*, 59 FORDHAM L. REV. S339, S339 (1991).

131. See *id.*

five banks.¹³² One unique aspect of the Japanese banking crisis is its complex and severe nature. One can expect that its remedy will take a long time, especially in light of the structure of Japan's banking system and the mechanism of supervision.

1. *Banking Supervision and Regulation Lag Behind What is Required to Implement the Banking Reform*

On October 16, 1998, the Upper House of the Japanese parliament formally passed legislation to pump public funds into capital-starved institutions.¹³³ The passage of the bank-recapitalization bill clears the way for the government to draw money from a pool of funds totaling ¥60 trillion (\$545.5 million).¹³⁴ Although the legislation is a step toward resolving the banking crisis, by itself it is nothing more than a tool. As U.S. Treasury officials urged in Tokyo, a quick plan is needed for the implementation of the public fund injection.¹³⁵ The problem, however, is that such a quick plan is difficult to achieve because of economic and structural reasons. For bankers, accepting the government's help has serious drawbacks.¹³⁶ Any bank seeking help will alert markets to deep problems. The banks' funding costs would certainly rise, and its share prices would get hurt.¹³⁷ Admittedly, Japan could force its banks to accept public money, but there is no guarantee that the banks will lend again, which is the very goal of easing the current credit crunch.¹³⁸ More significantly, without the structural reform of the financial system, especially bank regulation and supervision, Japan cannot begin to solve the banking crisis.

As noted in the previous section, the MOF basically controls the BOJ and the operations of banks in general.¹³⁹ Banks have little discretion with regard to their ranges of operations. On the other hand, Japanese banks enjoy almost limitless discretion concerning the treatment of bad debts.¹⁴⁰ They are not re-

132. See Brian Bremner, *Last Chance for the Yen?*, BUS. WK., July 6, 1998, at 46.

133. See *Japan Adopts Banking Measures Designed to Inject Public Money*, WALL ST. J., Oct. 19, 1998, at A23.

134. See *id.*

135. See *id.*

136. See Jathon Sapsford, *Japan's Bailout Packages Raise New Questions*, WALL ST. J., Oct. 15, 1998, at A19.

137. See *id.*

138. See *id.* The BOJ reported that outstanding bank loans fell 2.7 percent in September from the year-earlier month, the biggest decline on record. See *id.*

139. See *supra* note 46-60 and accompanying text.

140. See WOOD, *supra* note 3, at 41.

quired to disclose non-performing loans, and no one in the MOF's banking bureau has the specific task of monitoring the adequacy of reserves against bad debts.¹⁴¹ Instead of the MOF enforcing prudential standards, it is up to the banks to ask the regulators for permission to reserve on a case-by-case basis.¹⁴² In the present context of mounting bad debts, this regulatory attitude has provided a convenient excuse for banks to avoid owning up to their problems.¹⁴³ Furthermore, the opaque accounting practices have masked the true size of problem loans for many years, undermining confidence among businesses and the public at large and causing deleterious effects on domestic demand.¹⁴⁴

Additionally, the regulatory authorities have tried to protect banks essentially in three ways. First, the regulatory authorities provided many forms of subsidies, including those arising from interest rate regulations, entry restrictions, and BOJ lending at the discount rate.¹⁴⁵ Second, the government bore significant portions of credit risks. The MOF and the BOJ rescued troubled banks using any possible means.¹⁴⁶ Third, the authorities controlled the flow of funds through the capital market.¹⁴⁷ The combination of the above elements has led to the current inability of banks to handle the crisis when the revival of the economy depends on the confidence of the banking system.

A sound financial system depends on a trio of crucial elements: (a) independence of the central bank from short-term political pressures; (b) enforcement of international standards on the operations of commercial banks; and (c) special rules and procedures for closing insolvent banks and restructuring weak ones.¹⁴⁸ Bank failures are natural in an economy based on private-sector activity.¹⁴⁹ However, they are different from other types of business failures in that they can infect public confidence in all banks and may cause public panic, bank runs and even a total meltdown of a financial system.¹⁵⁰ The potential

141. *See id.*

142. *See id.*

143. *See id.*

144. *See* IMF, *Japan's Economic Crisis and Policy Options* (visited Oct. 18, 1998) <<http://imfnt1x.imf.org/external/pubs/ft/weo/weo1098/pdf/part8.pdf>>.

145. *See* Aoki & Patrick, *supra* note 122, at 105.

146. *See id.*

147. *See id.*

148. *See* John W. Head, *Lessons from the Asian Financial Crisis: The Role of the IMF and the United States*, KAN.J.L. & PUB. POL'Y, Spring 1998, at 70.

149. *See id.* at 75.

150. *See id.*

risk of a systemic failure is the key reason why a country needs special rules for handling insolvent banks.¹⁵¹ Instead of recognizing the necessity of closing insolvent banks, the Japanese system has tried to avoid bank failures at all costs.¹⁵² The MOF arranges for stronger institutions to absorb insolvent institutions through what amounts to administratively orchestrated purchase and assumption transactions.¹⁵³ Because a bank's financial troubles usually stem from either bad management or inadequate governmental supervision of the financial sector, the avoidance of such bank failure leads the bank into even deeper trouble.¹⁵⁴ This is both detrimental to depositors and a risk to the financial system as a whole.¹⁵⁵

Finally, despite its claimed nature of "fairness and independence," the FSA's ability to restore international credibility to Japan's ailing banking system is far from clear. Most of its new inspectors have no financial experience and will be learning during on-the-job audits of the world's largest banks.¹⁵⁶ Moreover, most of the members of the FSA have simply been shifted from the MOF.¹⁵⁷ This casts serious doubts over the FSA's separation and independence from the influence and pressures of the MOF. Analysts believed that the FSA came up short in the real objective of improving transparency and oversight of the banking system.¹⁵⁸ Furthermore, banks are attacking the FSA and other regulating authorities for lack of knowledge of the economy and the financial industry.¹⁵⁹ Considering all of the above factors, the FSA is far from being a powerful and efficient regulatory regime capable of fully resolving the current crisis in the banking system.

151. *See id.*

152. *See* Curtis J. Milhaupt & Geoffrey P. Miller, *Cooperation, Conflict, and Convergence in Japanese Finance: Evidence from the "Jusen" Problem*, 29 *LAW & POLY INTL BUS.* 1, 8 (1997). Japanese financial regulators set policies and rules with the weakest member of the industry sector in mind. *See id.* This is commonly referred to in Japan as a "convey" system of regulation, because the group is allowed to move no faster than its slowest member. *See id.* Key aspects of the convey system are the avoidance of failure by financial institutions and the informal mechanisms utilized to avoid failure. *See id.*

153. *See id.* at 8-9.

154. *See* Head, *supra* note 148, at 75-76.

155. *See id.* at 76.

156. *See* Reitman, *supra* note 62.

157. *See id.*

158. *See id.*

159. *See* Hiroshi Ota, *Financial Authorities under Fire for Meddling More Than Helping*, *THE DAILY YOMIURI*, Feb. 17, 1999, at 7.

C. "BIG BANG" IS NOT AS DRASTIC AS IT SOUNDS

The purpose of Big Bang is to deal with a massively dysfunctional financial system that further threatens the growth of Japan's economy.¹⁶⁰ It aims to achieve heightened competitiveness of Japanese financial sectors and unleash the enormous financial assets held by Japanese households through better investment options.¹⁶¹ As former Prime Minister Ryutaro Hashimoto claimed, the "goal is to build a country in which independent individuals can sufficiently exercise their creativity and boldly face challenges to realize their dreams."¹⁶²

Not everyone is as optimistic, however. Most observers believe that the Big Bang reforms will not transform an economy that has shown scant growth for seven years and that departs from the global trend towards more open markets with borderless finance and trade.¹⁶³ Japanese financial institutions badly trail western competitors in their knowledge of risk management and in their ability to innovate with new investment.¹⁶⁴ Most importantly, the Total Plan for financial deregulation lacks the most crucial elements of debt forgiveness and liquidation of collateral real estate.¹⁶⁵ Debt forgiveness is important because if it does not occur, the massive leverage in the construction and real estate sectors would create the conditions for a deflationary spiral and a further increase in non-performing loans.¹⁶⁶ Liquidation of real estate held as collateral is one way of realizing economically significant debt forgiveness.¹⁶⁷ Unfortunately, the government downplayed the importance of bad debt forgiveness. In the original version of the Total Plan, the first specific measure was on final disposition of bad debts and the work-out process of loans, the reduction of the total debts of the real estate and construction sectors through debt forgiveness.¹⁶⁸ In the second version, although the "bridge bank" scheme and disclosure requirements were added, the Plan

160. See E. Keith Henry & Ken Okamura, *Big Bang Shaping the Future of Japan's Economy*, AM. CHAMBER OF COMMERCE IN JAPAN J., Mar. 1998, at 11.

161. See *id.*

162. See *Reforms Jolt Japan Economy "Big Bang" Begins Deregulation Today*, CIN. POST, April 2, 1998, at 6B.

163. See James Cox, *Few Laud Big Bang in Japan Critics Say "Metaphorically Challenged" Reform Plans Fall Short*, USA TODAY, April 1, 1998, at 4B.

164. See *id.*

165. See Goldman Sachs, *supra* note 87.

166. See *id.*

167. See *id.*

168. See *Comprehensive Plan for Financial Revitalization* (1st version) (visited Oct. 6, 1998) <<http://www.kantei.go.jp/foreign/980707fina-rev1.html>>.

aims at creating "a secondary market with depth through the use of such methods as bulk sales and securitization" to dispose of bad loans.¹⁶⁹ The differences in the two versions seem to suggest that if there are sufficient disclosures of the bad loans and removal of the weak banks from the financial system, both domestic and overseas confidence will improve and everything will recover. Such a way of dealing with the bad loans problems is unsound in that without the sale of collateralized real estate, the banks' capital usage will be insufficient and the banking system will not recover.¹⁷⁰ Furthermore, collateral disposition in Japan is complicated by such factors as the complexity of debt relationships and the high ratio of financing extended without collateral.¹⁷¹ This is a serious situation because inefficiency in the real estate market has a "tendency to suck everything else down with it."¹⁷² The fact that the Japanese economy has not shown signs of improvement over the past several years despite all of the economic stimulus packages and low interest rates can prove this point.¹⁷³ Analysts believed that leaving the real estate sector massively overleveraged, while reducing the number of the banks and raising the reserve ratio, would have no significant economic effect.¹⁷⁴ More importantly, banks are naturally opposed to pursuing debt forgiveness because it implies a wealth transfer from the banking sector to the real economy.¹⁷⁵ As a result, the perspective of large-scale debt forgiveness is diminished, placing a significant obstacle in the way of achieving the objective of the reform. Although regulators from the Financial Reconstruction Commission "ordered" the nation's top banks to "write off all their bad loans" by March 31, 1999, the end of the fiscal year, the success of the initiative is questionable because

169. See *Comprehensive Plan for Financial Revitalization* (2nd version) (visited Oct. 6, 1998) <<http://www.kantei.go.jp/foreign/980707fina-rev2.html>>.

170. See Goldman Sachs, *Bridge Bank Great Propaganda*, July 29, 1998, at 3.

171. See *id.*

172. *Id.*

173. See *id.*

174. See *id.*

175. See Goldman Sachs, *supra* note 87. The banks face a conundrum. For the property to be sold, the real estate companies will have to mark down the property to market value. The companies cannot afford to pay interest, let alone write down such an enormous principal loss. If the property is sold, then the value of the property should increase theoretically. The banks wish to participate in the increase of property value. However, the value of the property cannot recover unless banks agree to some sort of debt forgiveness. See *id.*

of the murky definition of bad loans, and the worsening economy.¹⁷⁶

Additionally, the Big Bang Reforms are criticized because they exclude the reform of Japan's Postal Savings System.¹⁷⁷ Because the system accounts for over one-third of all personal deposits in Japan, such a big part of the banking system appears at odds with the goal of fostering a financial system governed by market principles.¹⁷⁸ Also, the Postal Savings System "has some comparative advantages in attracting deposits, including complete government deposit guarantees," and it has the "potential to be a major destabilizing element in Japan's economy."¹⁷⁹ Since financial deregulation presupposes a population willing to take advantage of the changes, the fact that the Japanese public remains distinctively risk adverse in its investment decisions and prefers the low-risk Postal Savings System would make it difficult to achieve the reform's objective, that is, improving competitiveness through liberalization and diversification of products and business.¹⁸⁰

Finally, although the Japanese government has passed legislation to inject public funds into "ailing but viable banks,"¹⁸¹ it has not addressed the rules and procedures for handling the hopeless banks. As one commentator suggested, a legal regime which gives a regulatory authority the full power to determine the course of action when a bank is deemed insolvent is necessary.¹⁸² The authority could either choose to restore the health of the troubled bank by taking specified drastic measures to improve its operations or place the bank under a receivership for the purpose of restructuring or full liquidation.¹⁸³ This approach will protect both the financial system as a whole and the individual depositors of the troubled bank.¹⁸⁴ The establishment of the Financial Reconstruction Commission in December of 1998 seemed to create such a regulatory authority. The Com-

176. See Jathon Sapsford, *Japan Banks Feeling Push for Quick Fix*, WALL ST. J. EUR, Jan. 21, 1999, at 21.

177. See Ernest T. Patrikis, *Japan's Big Bang Financial Reforms*, 24 BROOK J. INT'L L. 577, 590 (1998).

178. See *id.*

179. Thomas F. Cargill, *Asia's Financial Crisis and Japan* (visited Sept. 28, 1998) <<http://www.nmjc.org/jiap/events/papers/carhout.html>>.

180. See Lincoln, *supra* note 79.

181. See *Japan Adopts Banking Measures*, *supra* note 133 and accompanying text.

182. See Head, *supra* note 148, at 76.

183. See *id.*

184. See *id.* at 78.

mission's ability to handle the top nineteen banks where most of the bad debts lie, however, remains uncertain because of the strong opposition from the banks¹⁸⁵ and the concerns of the systematic stability to which the political leaders are greatly attached.¹⁸⁶

III. A POTENTIAL WAY OUT OF THE BANKING CRISIS

A. REVIVE CONFIDENCE IN THE BANKING SYSTEM THROUGH FULL DISCLOSURE OF BAD DEBTS AND MAINTENANCE OF CAPITAL ADEQUACY

The first step in alleviating the crisis is to determine the actual status of the banks' financial affairs. To determine the banks' condition and the outside support required, it is vital that banks report all of their expected losses and write-offs in a prescribed uniform manner.¹⁸⁷ The importance of such a full disclosure lies in the fact that until the markets are convinced that the banks and the financial supervisory body are no longer in financial straits, they will not have confidence in the Japanese financial system.¹⁸⁸ Initially, such a disclosure was not part of the Obuchi program which was approved by Japan's parliament in October, 1998.¹⁸⁹ The Obuchi program does not require the banks to disclose the actual value of their bad assets.¹⁹⁰ With the establishment of the Financial Reconstruction Commission, Japan's banks would have to "reassess their assets and bad loans under the Commission's strict terms."¹⁹¹ It is a proper step to break away from the financial policies of the past and avoid postponing solving the banking problem, which could result in lost international credibility and a larger financial crisis from future bad loans.

In the meantime, Japan should consider closing insolvent banks and injecting public funds into "ailing but viable banks." If necessary, the viable banks should be compelled to use the public funds to maintain capital adequacy. Capital adequacy re-

185. See Goldman Sachs, *supra* note 87.

186. See Head, *supra* note 148, at 75.

187. See *The Japanese (Banking) Crisis*, DRESDNER BANK TRENDS, Nov. 13, 1998, available in 1998 WL 11117662.

188. See *id.*

189. See Peter Landers, *Japan's New Banking Bill Has Plenty of Familiar Problems*, FAR E. ECO. REV. 75 (Tokyo), Oct. 22, 1998, available in 1998 WL 13867113.

190. See *id.*

191. *Japan's Bank Must Drastically Restructure*, AGENCE FR.-PRESSE, Jan. 11, 1999, available in 1999 WL 2526496.

fers to the ability of a bank to face risks by relying on amounts that have been paid in by the shareholders, together with certain other reserves.¹⁹² Under the Basle Core Principles, banking supervisors must set prudent and appropriate minimum capital adequacy requirements that reflect the risks that banks undertake and must define the components of capital.¹⁹³ The explanatory text accompanying the principle elaborates on the importance of a bank's equity capital:

[I]t provides a permanent source of revenue for the shareholders and funding for the bank; it is available to bear risk and absorb losses; it provides a base for further growth; and it gives the shareholders reason to ensure that the bank is managed in a safe and sound manner. Minimum capital adequacy ratios are necessary to protect the interests of depositors, creditors and other stakeholders of the bank and to help supervisors pursue the overall stability of the banking industry.¹⁹⁴

In Japan, capital inadequacy has become a big problem for banks.¹⁹⁵ A senior Japanese official said that the capital reserve levels of the top nineteen banks are so low that these banks might be banned from operating internationally if the rules of capital adequacy are "vigorously pursued."¹⁹⁶ Since bolstering Japan's ravaged banking system is considered the single most important factor in quelling the global financial turmoil, meeting the capital adequacy requirement of the Basle Core Principles is the first step towards the achievement of such an objective.

As to the closing of failing banks, the nationalization of the Long-Term Credit Bank of Japan (LTCB) is a positive step towards the overhaul of the financial system.¹⁹⁷ The LTCB takeover is good news for Japan's financial system because it shows that Japan finally has a plan to handle critically disabled financial institutions efficiently.¹⁹⁸ During the nationalization of the failed banks, it is necessary to take some caution to avoid destroying bad, as well as good, institutions because of lost confidence in the system.¹⁹⁹ Admittedly, the effects of such reform in

192. See Head, *supra* note 148, at 81.

193. See Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (April 1997) (visited Oct. 2, 1998) <<http://www.bis.org/publ/index.htm>>. [hereinafter Basle Core Principles]

194. See *id.*

195. See David E. Sanger, *Japanese Tell U.S. That Their Banks Are in Big Trouble*, N.Y. TIMES, Oct. 5, 1998, at A1.

196. See *id.*

197. See Jathon Sapsford, *Japan Eases Fears in Financial System*, WALL ST. J., Oct. 26, 1998, at A19.

198. See *id.*

199. See *Time to Wake up*, *supra* note 102, at 27.

the short and medium term will result in a stream of bankruptcies of banks and the businesses to which they loaned money, a decline in stock and property markets and rising unemployment.²⁰⁰ However, given the severity of the crisis and the economic positioning of Japan vis-à-vis the rest of the world, courage and prompt action are required to carry out the long-term goal of restoring health to the whole economy. If traditional caution prevails, the country may be in for another decade of lost growth.²⁰¹

Another short-run measure would be cutting operating costs and shaking up the management team. Japan needs to reconsider its lifetime employment practice²⁰² and eliminate redundant employees to cut operating costs. Shareholders and management of the banks should not be protected.²⁰³ They should lose their interest in the bank because they undertook the risk or responsibility for the success or failure of the bank. It is only right that they bear the consequences of their own bad investment judgment or their poor performance.²⁰⁴ Because turning around a bank generally requires a new management team unburdened by responsibility for past mistakes, Japan needs to assign responsibility to bankers' bad decisions instead of just having them apologize for making bad loans.²⁰⁵ The Japanese government, however, may find this measure hard to carry out because of the close relationship between the government and business.²⁰⁶ If Japan is to solve its current banking crisis, it should be prepared to take some politically painful steps for the sake of its economy, or even the global economy.

B. LONG-TERM HEALTH OF THE BANKING SYSTEM RELIES ON FUNDAMENTAL STRUCTURAL REFORMS

Rationalizing a financial sector by liquidating the failed banks and restructuring the weak ones, however, can only correct some crucial immediate problems.²⁰⁷ The long-term health of the system relies on long-term systematic reforms. Strong

200. See Zakaria, *supra* note 30.

201. See *Time to Wake up*, *supra* note 102, at 28.

202. The number of Japanese bankers has fallen by only 6 percent from 1993 to 1998, and this was achieved largely through retirements. See Robert Zielinski, *The World Cup of Banking Reform*, TIME INT'L, Jan. 18, 1999, at 23.

203. See Head, *supra* note 148, at 75.

204. See *id.*

205. See Zielinski, *supra* note 202.

206. See *supra* note 45 and accompanying text.

207. See Head, *supra* note 148, at 80.

and effective bank supervision is indispensable.²⁰⁸ Effective supervision of banking institutions is essential to achieve a strong economic environment and financial stability.²⁰⁹ Such supervision ensures that banks operate in a safe and sound manner, such as holding capital and reserves sufficient to support the risks that arise in their business.²¹⁰ Banking supervision should “foster an efficient and competitive banking system that is responsive to the public’s need for quality financial services at a reasonable cost.”²¹¹ To achieve this objective, a supervisory agency must have operational independence, the means and powers to gather information and the authority to carry out its decision.²¹² It should encourage good corporate governance and enhance market transparency and surveillance.²¹³ In the context of the Japanese banking reform, the issues of “insider trading and connected lending” and bank transparency are particularly important.

1. *Sound Corporate Governance Requires Strict Regulations of Insider Trading and Connected Lending*

Insider trading is a situation where “a person familiar with the inner dealings of a public company executes transactions based on information prior to its public disclosure.”²¹⁴ Insider trading tends to create “competitive distortion.”²¹⁵ In Japan, insider trading was a routine part of business until the summer of 1988 when Japan’s Diet passed insider trading legislation.²¹⁶ Insider trading once encouraged growth when Japan’s market was isolated and had relatively few participants.²¹⁷ As the world’s financial markets began to converge, the effect of repelling outside participants by the insider trading practice became unacceptable.²¹⁸

“The global interest in regulating insider trading stems from the necessity of accurate risk assessments and confidence

208. *See id.*

209. *See* Basle Core Principles, *supra* note 193.

210. *See id.*

211. *See id.*

212. *See id.*

213. *See id.*

214. *See* Brian Volkman, *The Global Convergence of Bank Regulation and Standards for Compliance*, 115 *BANKING L.J.* 550, 571 (1998).

215. *See id.*

216. *See id.*

217. *See id.*

218. *See id.*

in financial markets.²¹⁹ If insiders are allowed to take advantage of their privileged information, risk assessments of the insiders and non-insiders could vary significantly and weaken the confidence of anyone not privy to the inside information.²²⁰ Although the concept of prohibiting insider trading is widely accepted, the world does not have a common standard for deterring such activity mainly because of the different definitions of insider trading.²²¹ The inconsistency of interpretation, together with the Japanese tradition of strong governmental relationship with business,²²² may deter foreign participation in the Japanese financial markets. Because of Japan's position as the world's second largest economy and its tradition of bank protection, vigorous competition from foreign banks is necessary to improve the health of the financial system when the protection is taken away. As discussed above, the first step towards fixing the banking problem is to restore confidence in the system itself. Clarification and improvement of insider trading legislation would be helpful because confidence also comes from the market participants' ability to accurately access consistent market information without the fear of being disadvantaged by privileged information to competitors.

Connected lending is "the extension of credit to individuals or firms connected to the bank through ownership or through the ability to exert direct or indirect control."²²³ Without proper regulation, connected lending could lead to significant problems because determinations regarding the creditworthiness of the borrower are not always objective.²²⁴ Unlike other typical capitalist systems where banks lend money to those companies that are likely to repay their debts on time and in full, the Japanese banks lend to companies with whom they have a cozy relationship, whether or not they are doing well.²²⁵ Because the system was so indiscriminate about distributing capital, the market did not send any signals regarding the performance of the banks.²²⁶ When the Bubble Economy burst, thousands of companies had

219. *Id.* at 572.

220. *See id.*

221. *See id.*, at 572-73.

222. *See* Bingman, *supra* note 45 and accompanying text.

223. *See Basle Core Principles*, *supra* note 193. Connected parties include a bank's parent organization, major shareholders, subsidiaries, affiliated companies, directors and officers, etc. *See id.*

224. *See id.*

225. *See* Marcus Gee, *The Real End of Japan Inc.*, THE GLOBE AND MAIL (Toronto), April 4, 1998, at D4.

226. *See id.*

trouble paying their loans, and the banks got stuck with mountains of bad debt.²²⁷

To prevent further occurrence of imprudent lending, Japan must enhance the regulation of lending practices. It should put in place a supervisory regime that can independently evaluate a bank's policies, practices and procedures "relating to the granting of loans and making of investments and ongoing management of the loan and investment."²²⁸ Supervisors need to ensure that individual banks maintain objective and prudent lending policies and make their credit decisions free of conflicting interest and inappropriate outside pressures.²²⁹ As the banks' regulator, the FSA needs to effectively monitor connected lending. It may require that "the terms and conditions of such credits not be more favorable than credits extended to non-related borrowers under similar circumstances."²³⁰ In light of the close relationship between banks and other industries²³¹ and the powerful influences from the Japanese government,²³² the need for an independent supervisory regime to effectively regulate the banks' credit and investment policies and practices becomes urgent.

2. *The Success of the Interaction of Prudential Supervision and Market Disciplines Calls for Bank Transparency*

Free markets contain mechanisms that can reinforce the efforts of supervisors by rewarding banks that manage risk effectively and penalizing those whose risk management is inept or imprudent.²³³ Market discipline, however, can only work if market participants have access to timely and reliable information that enables them to assess a bank's activities and the risks inherent in those activities.²³⁴ Moreover, for the complementary interaction of prudential supervision and market discipline to promote long-term stability of both individual institutions and

227. *See id.*

228. *See* Basle Core Principles, *supra* note 193.

229. *See id.*

230. *See id.*

231. *See* Apisit Buranakaonda, *Financial Reform in Japan: "Big Bang" No Sure Cure for the Rest of Asia*, BANKOK POST, Mar. 2, 1998, available in 1998 WL 7888358.

232. *See* Bingman, *supra* note 42 and accompanying text.

233. *See* Basle Committee on Banking Supervision, *Enhancing Bank Transparency* 1 (visited Oct. 18, 1998) <<http://www.bis.org/publ/index.htm>>.

234. *See id.*

banking systems, bank transparency is indispensable.²³⁵ Improved public disclosure not only enhances such interaction, but also strengthens market participants' ability to encourage safe and sound banking practices.²³⁶

Transparency is "public disclosure of reliable and timely information that enables the use of that information to make an accurate assessment of a bank's financial condition, performance, business activities, risk profile and risk management practice."²³⁷ In Japan, thanks to murky accounting principles and imprudent risk management, the severity of the banking crisis was covered up until early 1998.²³⁸ The banking problem is not just the reported \$600 billion in bad loans; it also involves hundreds of billions of dollars in pension liabilities.²³⁹ The lack of public disclosure effectively handicapped the abilities of the supervisory authorities and the banks to handle the problem when it finally came to light. As the Basle Committee on Banking Supervision noted, disclosure helps prevent both foreseen and unforeseen problems in banks.²⁴⁰ Enhanced public disclosure allows market discipline to work earlier and more effectively, thereby strengthening the incentives for banks to behave in a prudent and efficient manner.²⁴¹ Market discipline based on adequate public disclosure can be an effective complement to supervisory efforts to encourage banks to maintain sound risk management systems and practices.²⁴²

As to the market participants, high-quality public disclosure improves their capability to make informed decisions.²⁴³ Bank transparency allows them to more accurately assess a bank's financial strength and performance; increases the credibility of information disclosed by a bank; demonstrates a bank's ability to monitor and manage its risk exposure; and reduces market uncertainty.²⁴⁴

Disclosure alone, however, does not necessarily result in transparency. To achieve transparency, a bank must provide timely, accurate, relevant and sufficient qualitative and quanti-

235. *See id.*

236. *See id.*

237. *See id.*

238. *See* Bremner, *supra* note 132, at 137.

239. *See id.*

240. *See* Basle Committee on Banking Supervision, *supra* note 233, at 6.

241. *See id.*

242. *See id.*

243. *See* Basle Committee on Banking Supervision, *supra* note 233.

244. *See id.*

tative information that "enables users of that information to make an accurate assessment of a bank's financial condition and performance, business activities, risk profile and risk management."²⁴⁵ In its recommendations, the Basle Committee identified six broad categories of information to be addressed in clear terms and appropriate details to achieve a satisfactory level of transparency.²⁴⁶ In the current context of the banking reforms, it is necessary to emphasize the importance of disclosure of accounting policies because Japanese banks use different accounting practices and procedures.²⁴⁷ It is encouraging that the FSA set new and strict accounting rules for the financial system.²⁴⁸ It helps to determine the real size of the bad debts and lay a foundation for further structural reforms.

Admittedly, public disclosure can have potential drawbacks.²⁴⁹ In particular, when the market becomes aware of a bank's weak position, it may overreact and push the bank out of the market even though it is solvent in terms of net assets.²⁵⁰ The market's distrust in one bank may spread to other banks and lead to a systematic failure.²⁵¹ The potential drawbacks, however, should not discourage transparency of the Japanese banks. After all, banking by itself is a risky business.²⁵² The success of the reforms requires a balance of benefits and risks. Given the background of the Japanese banking crisis, its severe nature and the importance of reviving the financial system, the benefits of bank transparency significantly outweigh the potential drawbacks it might bring.

IV. CONCLUSION

Ever since the Japanese Diet approved its plan to inject public funds into the trouble-ridden banking system in 1998, one might have expected that the Japanese banking crisis would soon be over. Due to the complicated background and the depth of the banking crisis, however, any speculation of a quick cure to

245. *See id.*

246. *See id.* The six categories are: financial performance; financial position; risk management strategies and practices; risk exposures; accounting policies; and basic business, management and corporate governance information. *See id.*

247. *See* Bremner, *supra* note 132.

248. *See* Gillian Tett, *Japan's Revitalized Financial Watchdog Starts to Sharpen up Its Teeth*, FIN TIMES, Dec. 3, 1998, at 4.

249. *See* Basle Committee on Banking Supervision, *supra* note 233.

250. *See id.*

251. *See id.*

252. *See id.*

the banking system, and hence the whole economy, is unrealistic. To the contrary, in the short term, the Japanese government should take determined steps to restore confidence in the banking industry by closing insolvent banks and helping the viable ones. At the same time, as a long-term objective, the Japanese government should overhaul the structure of the banking industry and steer its way towards internationally-accepted practices. Especially in the areas of sound governance and bank transparency, the cornerstones of a sound financial system, the Japanese should exert more efforts to conform to international standards in the era of international competition. On the one hand, we expect the Japanese government to take prompt and thoughtful actions to fix the banking industry for the sake of its own economy and that of the world. On the other hand, we need to show our patience, understanding and support for the Japanese banking reform.

