

Japanese Banking Regulations and SME Finance under the Global

Financial Crisis

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ABSTRACT

This paper discusses important policy actions in Japanese banking regulation under the global financial crisis, which seriously damaged the Japanese economy. First, the state of Japan's banking industry and an outline of Japan's banking regulations are discussed. Second, we explain the impacts of the global financial crisis on the Japanese economy and Japanese banks. Then we explain various responses of the small-and-medium-sized enterprise (SME) financing support program and banking regulations against the global financial crisis, including reintroduction of the public fund injection scheme, revision of capital adequacy regulation, and establishment of the Act to Facilitate Financing for SMEs. The measures taken by the Financial Services Agency (FSA) were effective in terms of preventing the shocks from resulting in "the greatest crisis of the century." However, these measures are temporary ways to avoid exacerbation of the problems; they are not remedies for the structural issues facing the Japanese economy, SMEs, and financial institutions.

Keywords: Banking Regulation, Global Financial Crisis, Japanese Banks, Bank Supervision.

JEL Classification: G21, G28.

1. Introduction

In the 1980s, Japanese financial institutions increased their presence in Western financial markets. Japanese financial institutions had close business relationships with large Japanese corporations (interlocking *keiretsu* business relationships) and suffered few non-performing loans because of the country's steady economic development, making them the soundest financial institutions in the world. Table 1 shows the transition in the credit ratings of major Japanese financial institutions and demonstrates that in 1988, many Japanese financial institutions were given a top credit rating.

However, in the 1990s, the financial condition of Japanese financial institutions deteriorated rapidly as a result of an increase in non-performing loans brought on by an economic slump. For example, Figure 1 shows the changes in the balance of non-performing loans that Japanese banks held. At its peak at March 2002 (i.e., the end of FY 2001), this level exceeded ¥40 trillion. Figure 2 clearly indicates the severity of the problem, and Figures 1 and 2 show that, despite disposing of non-performing loans exceeding ¥10 trillion several years in the late 1990s, the balance of non-performing loans still increased.

In 1997, the financial condition of major banks grew severe, as evidenced by the failure of institutions such as Hokkaido Takushoku Bank, which had a significant standing among major commercial banks, and Yamaichi Securities, one of the four major security corporations. Many financial institutions that survived with government assistance barely escaped bankruptcy.

In the past, Japanese banks were subjugated under extremely strict regulations implemented by the Ministry of Finance. In the 1980s, however, financial globalization progressed, increasing the concern that if the regulations did not change, they may promote the hollowing out of domestic markets. Beginning in 1996, the Japanese government advocated Japanese "Big Bang" financial reforms and fundamentally restructured the regulations. These reforms could have been viewed as a "constructive" approach to financial regulations for a new economic environment.

On the other hand, the deterioration of the business conditions of financial institutions progressed at a speed and scale greater than what was anticipated. Because the laws that

addressed such a situation were inadequate, financial regulators were forced to respond in an ad hoc manner, tackling each financial problem encountered by the major financial institutions as it occurred. After this trial-and-error approach of ten or more years, restructuring of the regulations was almost completed by around 2005.

The financial regulation reforms, aimed at dealing with the financial crises in Japan that took place after the bubble economy collapsed (the Post-Bubble Financial Crisis, for simplicity), initially were passive in nature. However, these reforms enhanced the crisis-response capabilities of Japan's financial system.

During the global financial crises that plagued the entire world from 2007 onward, Japan's financial system did not encounter major problems, and the distrust in the soundness of financial institutions did not intensify among the general public. Certainly, the Japanese economy was confronted with severe economic afflictions resulting from a major decline in exports. Nonetheless, unlike in the Post-Bubble Financial Crisis, the economic difficulties were not attributable to the financial system. In this sense, Japan's financial system had become equipped with crisis-response capabilities.

However, real economic damages due to the global financial crisis seemed unprecedented. As shown in Figure 3, real GDP growth rates were -3.2% for the fourth quarter of 2008 and -4.0% for the first quarter of 2009. The Japanese government and the Bank of Japan tried to protect the Japanese economy from failing into "the greatest crisis in the century." Regarding banking policy, several important measures, including reintroduction of the public capital injection scheme, were taken.

In this paper, we discuss details of and issues regarding these measures that evolved during the global financial crisis.¹ First, the state of Japan's banking industry is discussed in section 2. In section 3, an outline of Japan's banking regulations is provided. Then, in section 4, we explain actions regarding banking policy that responded to the global financial crisis. Finally, section 5 presents the conclusion.

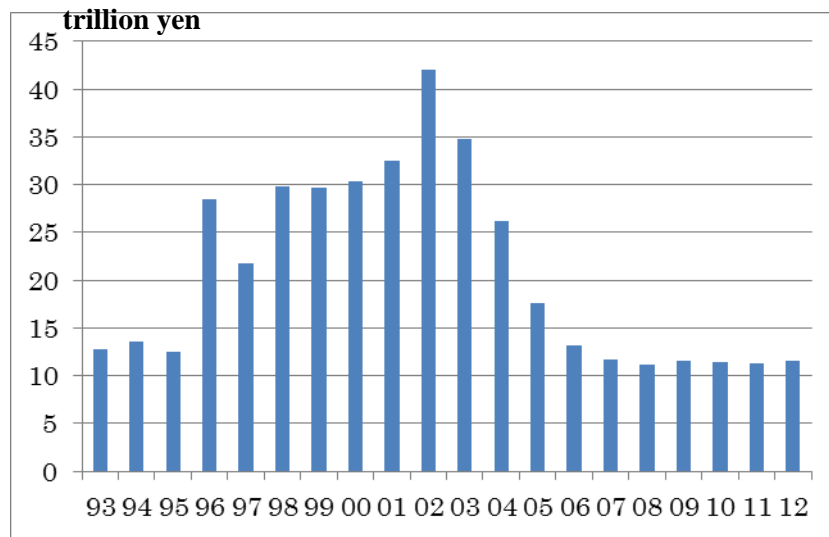
Table 1
Japanese Banks' Credit Ratings (Moody's Credit Rating)

	1988	1993	1998	2006	2013
Aaa	Dai-Ichi Kangyo, Sumitomo, Fuji, Mitsubishi, IBJ, Norinchukin			Shoko Chukin	
Aa1	Sanwa, Mitsubishi Trust, Sumitomo Trust				
Aa2	Tokai, Tokyo, LTCB, Mitsui Trust				
Aa3	Yasuda Trust, Toyo Trust, Yokohama, Shizuoka	Mitsubishi, Sanwa, Tokyo, IBJ, Shoko Chukin, Shizuoka	Shizuoka, Shoko Chukin		Shizuoka, Shoko Chukin, Chugoku, Sumitomo Mitsui, Mitsubishi UFJ Trust, Tokyo-Mitsubishi UFJ
A1		Dai-Ichi Kangyo, Sumitomo, Fuji, Norinchukin	Sanwa, Tokyo Mitsubishi, Norinchukin	Norinchukin, Tokyo-Mitsubishi UFJ, Sumitomo Mitsui, Shizuoka, Mizuho Corporate, Chuo Trust	Shinkin Central, Chiba, Norinchukin, Higo, Mizuho Corporate, Mizuho, Mizuho Trust, Trust and Custody Services, Sumitomo Mitsui Trust, Japan Trustee Services, Yokohama
A2		Sakura, Tokai, Asahi	Sumitomo, Nippon Trust	Higo, Sumitomo Trust	Gunma, Joyo, Resona, Minato, Kinki Osaka, Saitama Resona
A3		Daiwa, LTCB, Yokohama	Dai-Ichi Kangyo, IBJ, Yokohama	Shinsei, Resona, Chuo Mitsui Trust, Mitsui Asset Trust, Yokohama	San-In Godo, Daishi, Hyakujushi, Kansai Urban
Baa1		Mitsubishi Trust, Sumitomo Trust, Toyo Trust	Sakura, Fuji, Toyo Trust, Sumitomo Trust, Asahi, Tokai	Aozora, Suruga, Hiroshima, San-In Godo	Ogaki Kyoritsu, Citibank, Suruga, Hiroshima, Fukuoka
Baa2		Hokkaido Takushoku (Takugin), Nippon Credit, Mitsui Trust, Yasuda Trust, Chuo Trust, Nippon Trust	Mitsui Credit	Nishi-Nippon City, Ogaki Kyoritsu, Kiyo, Hokuriku, Hokkaido, North Pacific	Aozora
Baa3			Nippon Credit, Hokkaido Takushoku, Chuo Trust, Yasuda Trust, Daiwa, LTCB	Ashikaga	
Ba1					Shinsei

(Source) Moody's.

Figure 1

Changes in the Balance of Non-Performing Loans



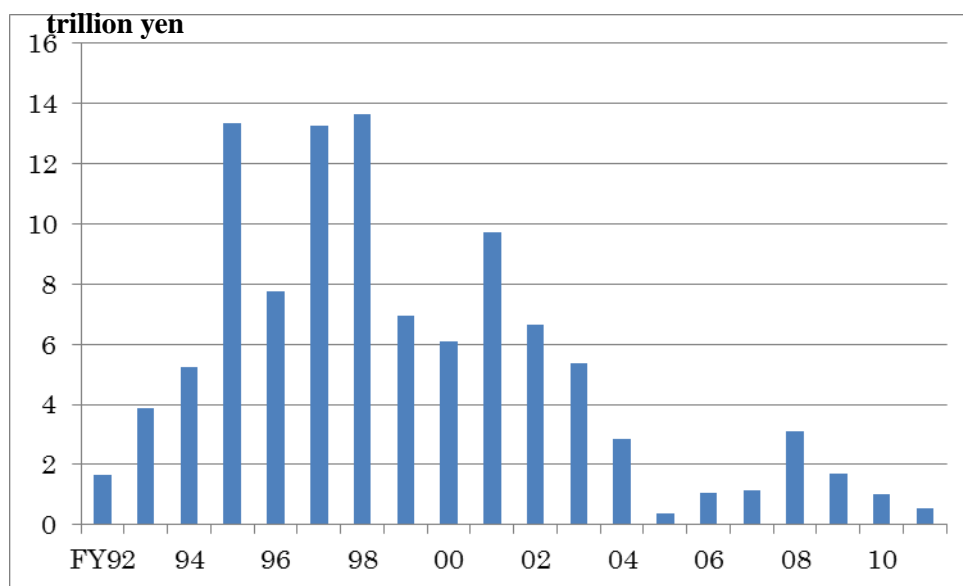
(Note) The figure shows the risk management loans of banks at the end of March of each year.

The statistics coverage has expanded in 1995 and 1997.

(Source) Financial Services Agency.

Figure 2

Changes in the Total Losses on Disposal of Non-Performing Loans



(Source) Financial Services Agency.

Figure 3
Real GDP Growth Rate



(Source) Cabinet Office, Government of Japan.

2. Overview of the Banking Industry in Japan²

2.1. Industrial Structure of the Japanese Banking Industry

Figure 4 shows the basic structure of the banking industry in Japan.

Private banks can be divided into several categories based on such factors as business functions or historical background. The distinction among city banks, regional banks, and member banks of the Second Association of Regional Banks (regional banks II) is not a legal one but rather is a customary classification for the purposes of administration and statistics. City banks are large in size, with headquarters in major cities and branches in Tokyo, Osaka, other major cities, and their immediate suburbs. Regional banks are usually based in the principal city of a prefecture, conduct the majority of their operations within that prefecture, and have strong ties with local enterprises and local governments. Like traditional regional banks, regional banks II serve smaller companies and individuals within their home regions. Most of these banks converted the legal status from mutual savings banks into ordinary commercial banks in 1989.

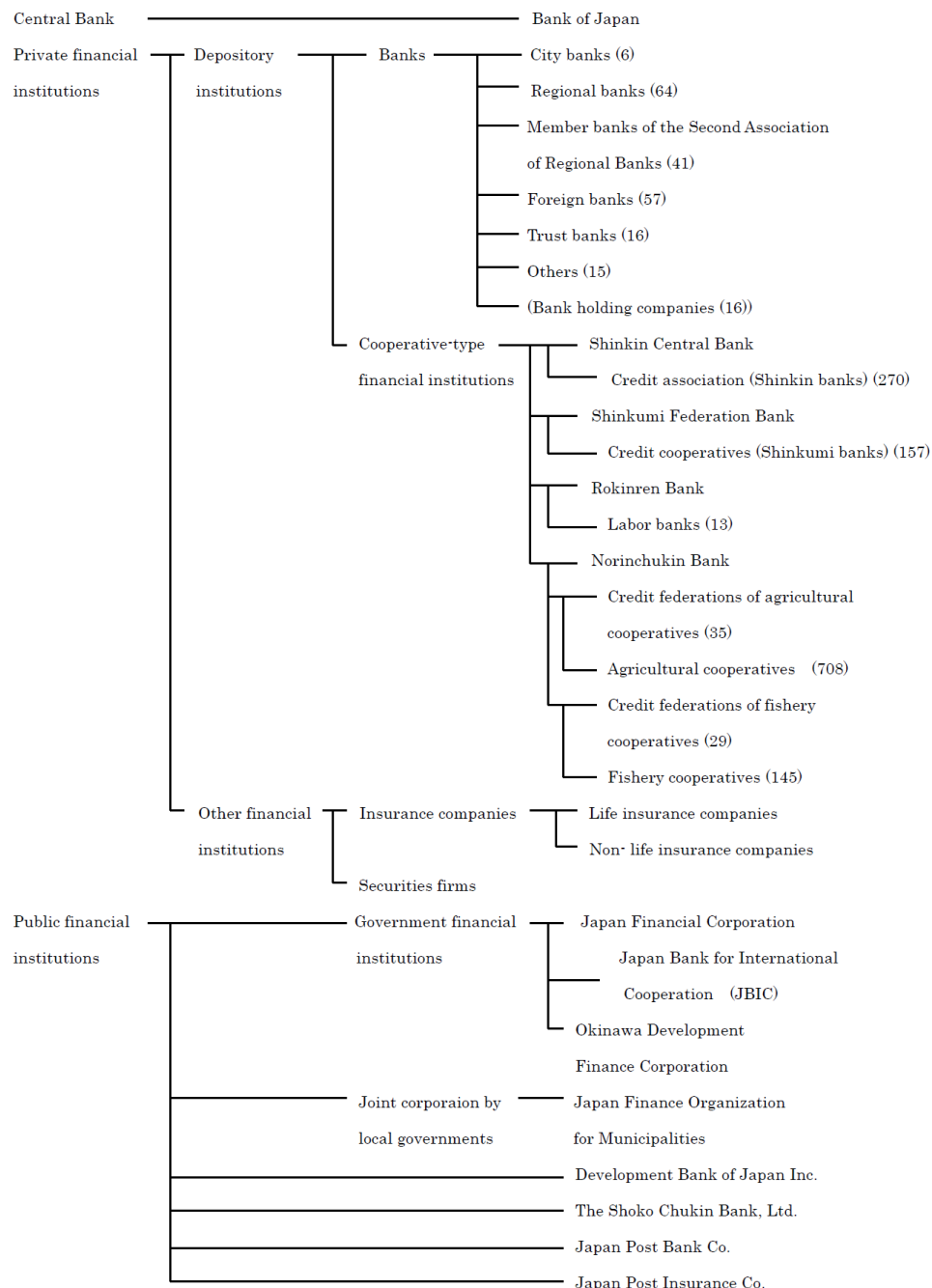
In addition to these commercial banks, there are cooperative financial institutions, including credit associations (Shinkin banks), credit cooperatives (Shinkumi banks), and agricultural

cooperatives (JA banks). These financial institutions are established to serve certain sectors. For example, Shinkin banks mainly engage in providing loans to small and medium-sized enterprises (SMEs), and agricultural cooperatives serve farmers.

Finally, Japan Post Bank is a unique financial institution. The government ran the postal savings system until 2007, when Japan Post Bank was established as a private stock company. However, the government still fully owns the stock of Japan Post Bank,³ and most Japanese depositors regard Japan Post Bank as a publicly supported institution. Furthermore, because of the regulations, Japan Post Bank cannot extend SMEs and residential loans.

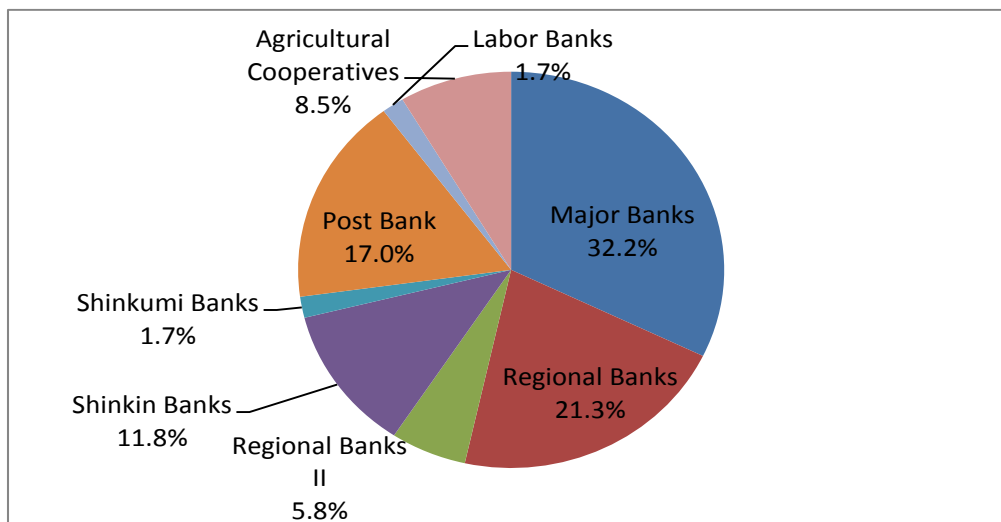
Figure 5 depicts the market shares of each of the categories of financial institutions in the Japanese deposit market. Major banks, including city banks and trust banks, have ¥332.8 trillion in deposits. Regional banks have the second largest shares, followed by Japan Post Bank and Shinkin banks.

Figure 4
Banking Industry Structure in Japan



Note: Based on the Japanese Bankers Association’s homepage data, we updated the figures in parentheses, which represent the number of financial institutions in each category at various points in time from March 2011 to January 2013. The data sources are the FSA, Nikkin (a business journal publisher), and Fisheries Agency.

Figure 5
Deposits Markets in Japan



(Note) Total deposits amount to ¥1,035 trillion at the end of March 2012.

(Source) Bank of Japan and business associations of these institutions.

2.2. Banking Regulation and Supervision Before the Global Financial Crisis

Japan's financial administration has gone through major changes since 1990. We discuss the transition of Japan's financial administration here by categorizing these changes into three stages.

The first stage occurred approximately between 1997 and 2002, when the administration was pressured to address difficulties in the financial system. In 1997, Hokkaido Takushoku Bank and Yamaichi Securities went bankrupt, followed by the collapse of Long-Term Credit Bank of Japan (LTCB) and Nippon Credit Bank (NCB) in 1998. Despite the government's ¥10 trillion capital injection and providing full protection on bank deposits, which was called the freeze on the "payoff system" in Japan, concerns regarding the soundness of major commercial banks spread in an unprecedented manner during this time.

Responding to these concerns, asset evaluation was tightened as the basis of the information disclosure system, and a system of prompt corrective action was introduced in order to accurately assess the state of financial institutions. In this sense, it was the period in which the

financial administration began to depart from its traditional form. Furthermore, financial legislation was being adjusted to process liquidation of insolvent financial institutions.

Until this period, the Ministry of Finance had been responsible for financial supervision in Japan. However, with growing financial turmoil in the wake of the collapse of the bubble economy, much criticism came regarding the fact that the Ministry of Finance held a dual function of financial administration and public financing. There was also an increasing criticism regarding the discretionary and obscure financial administration of the Ministry of Finance, which had led to the collapse of the bubble economy. Therefore, the function of financial supervision was removed from the Ministry of Finance. First, this function was transferred to the Financial Supervisory Agency. Later, in July 2000, the Financial Services Agency (FSA) was founded and given authority for overall financial administration. At that time, the FSA Commissioner, in a discourse on the commencement of the Financial Services Agency, promised to Japanese citizens “greater clarification of rules, prompt and stricter implementations of those rules, as well as improvements on the transparency of the policy formulation process and administrative procedures.” In other words, the implementation of a financial administration with a high transparency level, based on clarified rules, was a priority issue.

A turning point from the first stage to the second stage was the launch in October 2002 of the Financial Revitalization Program, under the Minister for Finance Services, Heizo Takenaka, as a response to an emergency of the Post-Bubble Financial Crisis. While the financial administration was severely criticized for its strong intervention in the operations of individual banks, under the Financial Revitalization Program, major banks were urged to accelerate their disposal of non-performing loans (with a balance reduction by half in three years).

The second stage, which began with the introduction of the Financial Revitalization Program, was the period approximately between 2003 and 2007. In May 2003, the financial problems of Resona Bank Group surfaced, and based on the discussions held by the Council on Financial Crisis Response, approximately ¥2 trillion of public funds were injected.⁴

In 2005, with the moderate revival of the economy, completely lifting the freeze on payoffs also

became possible. Repayments of public funds began as well. It was a period in which the stability of the financial system also began to be restored. The transition from emergency mode to ordinary mode progressed.

Simultaneously, the financial administration's focus shifted gradually from the revival of a stable financial system to user or consumer protection. Administrative measures against banks in this regard began to appear frequently.

The third stage was the period from 2007 to 2008. In December 2007, "Financial Reform Program—Challenges toward a Financial Services Nation" described the phase of the current financial system to be departing from emergency responses dealing with the non-performing loan problem and moving into a future-oriented phase aimed at creating a desirable financial system for the future. To borrow a slogan from the FSA, the system was entering a phase that saw "qualitative progress in financial regulation (better regulation)."

However, the third stage was suddenly terminated. In reality, the global financial crises directly triggered by the bankruptcy of Lehman Brothers occurred, and financial regulations to respond to the crisis had to be implemented again.

3. Japanese Economy and Financial Institutions under the Global Financial Crisis

3.1. Macroeconomic Impacts of the Global Financial Crisis

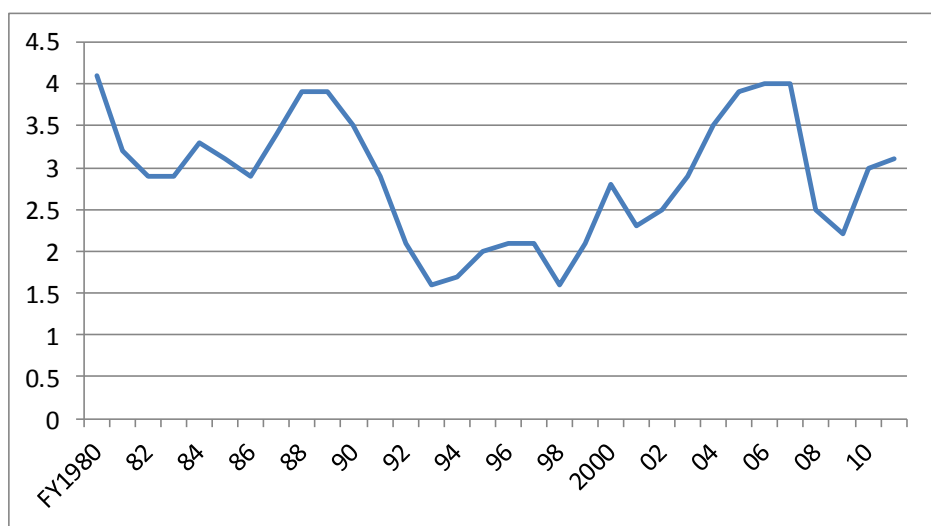
As shown in Figure 3, real GDP growth rate for the fourth quarter of 2008 was negative. Naturally, Japanese corporate performance deteriorated. As shown in Figure 6, the average return on assets (ROA) sharply declined by 1.5%, from 4.0% for 2007 to 2.5% for 2008.

It is natural to expect that these sharp declines in economic activity would lead to a substantial increase in corporate bankruptcies. The number of corporate bankruptcies is shown in Figure 7. Although the number increased by 1,500 in 2008 from the previous year, it is considerably smaller than it was around 2001, when the figure reached over 19,000. That is, measured in corporate bankruptcies, the effect of the global financial crisis was not unprecedented.

A direct reason for this unexpected result is that firms could borrow new money and obtain

various supports from financial institutions, including an exemption from the interest rate payment, a grace period for payment of the interest, a grace period for reimbursement of the principal, and a waiver of the claim. Therefore, in spite of the sharp deterioration in business conditions, funding difficulties for average firms only moderately worsened (See Figure 8).

Figure 6
Return on Assets (ROA) of Japanese Corporations (%)

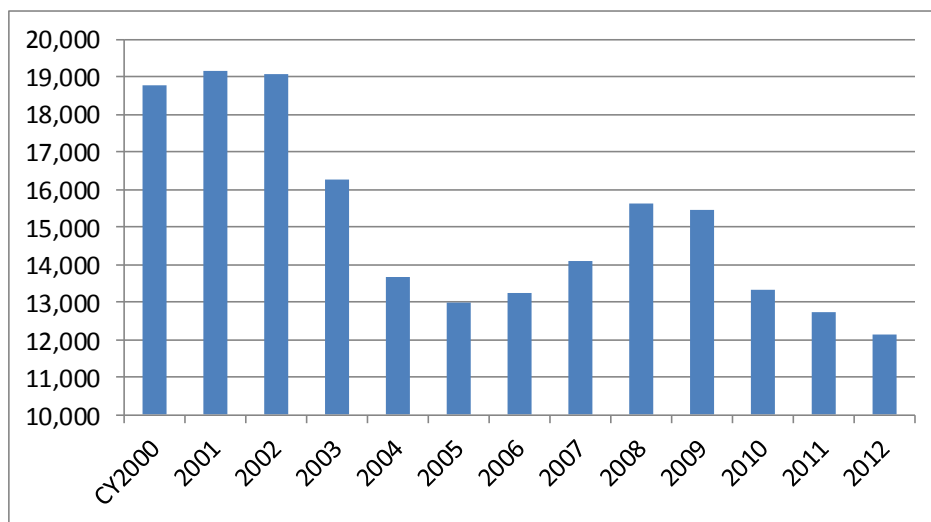


(Note 1) Here the ratio is defined as ordinary profit / total assets.

(Note 2) This figure is based on the whole sample, including small and large firms, and both manufacturing and non-manufacturing firms.

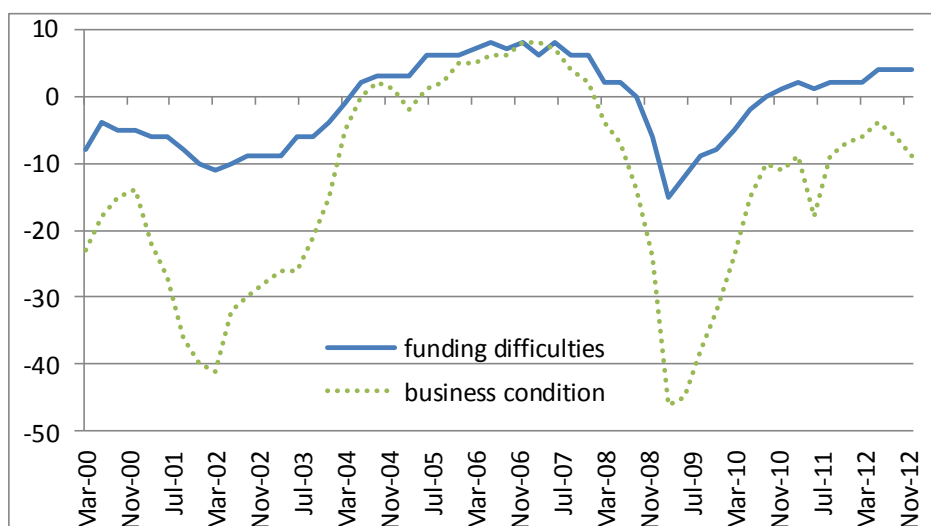
(Source) Ministry of Finance, Statistics of Financial Statements of Incorporated Businesses.

Figure 7
Number of Corporate Bankruptcies



(Source) Tokyo Shoko Research.

Figure 8
Business Sentiments



(Note) Results for all industries and all firms except the financial industry.

(Source) Bank of Japan's quarterly short-term economic survey (Tankan).

3.2. Bank Loans

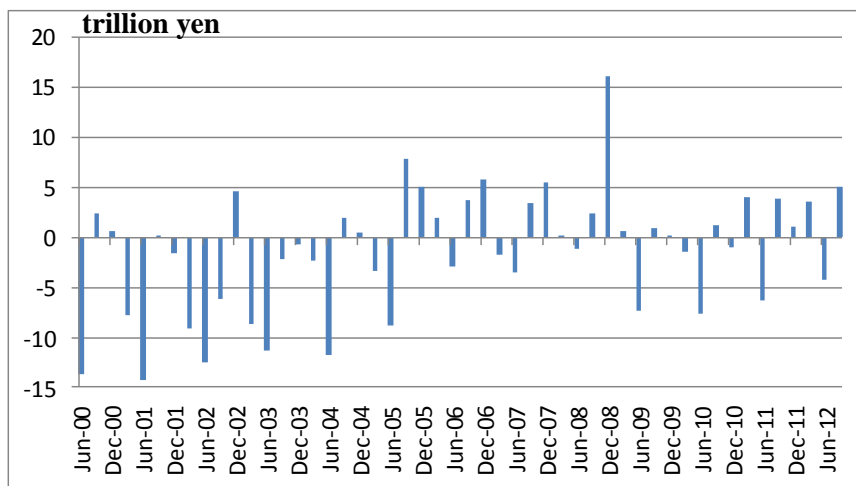
Figure 9 shows changes in loans extended by Japanese domestic banks and Shinkin banks. The fourth quarter of 2008, when the Lehman shock hit Japan, saw the largest increase in bank loans. Without this increase, the financing difficulties of Japanese firms might have been severer than what Figure 8 shows.

Figure 10 shows borrowers' side data. This figure shows that large firms borrowed substantial money from banks during the peak of the global financial crisis, but small- and medium-sized firms (SMEs) did not increase borrowing at the same time. However, it is notable that SMEs paid back lower amounts than before the crisis. Banks might support SMEs by giving SMEs a period of grace.

Why did banks extend more loans to borrowers who had become riskier due to the global financial crisis? When banks conduct a business model, called transaction banking, banks evaluate credit risks of borrowers on a timely manner. It was natural that banks downgraded credit evaluation of most borrowers during the global financial crisis. If so, bank loans might have decreased. In reality, bank loans increased. Most of Japanese banks perform the relationship banking business model, where banks and borrowers have long-term relationship, which mitigates information asymmetry. Banks can support firms who face temporal difficulties because the banks believe that firms will become profitable after the crisis ends. Therefore, it is natural that banks performing relationship banking tend to increase loans to long-term customer during the crisis. This might be the case for Japan.

However, the government was worried about whether voluntary supports provided by banks were enough to keep SMEs afloat. Rather, the government was afraid that banks might overestimate borrowers' risks and hesitate to extend supportive loans. The Japanese economy experienced such situations during the financial system crisis in the late 1990s and early 2000s. Therefore, the government decided to introduce various measures to protect the shocks from resulting in the greatest crisis in the century. We discuss these measures in the following parts of this paper.

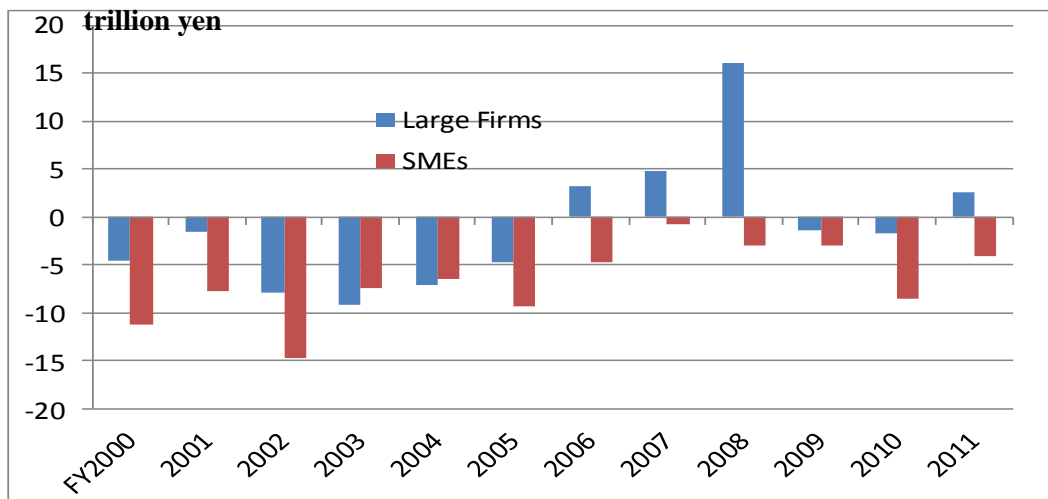
Figure 9
Bank Loan Changes (from the previous quarter)



(Note) This graph shows the changes in loans of domestic banks and Shinkin banks, including trust accounts.

(Source) Bank of Japan.

Figure 10
Corporate Borrowing from Financial Institutions



(Note) This graph shows sums of long-term and short-term fund-raisings from financial institutions for each fiscal year. Here large firms are defined as firms with ¥1 billion or more in capital. SMEs are firms except for large firms.

(Source) Ministry of Finance, Statistics of Financial Statements of Incorporated Businesses.

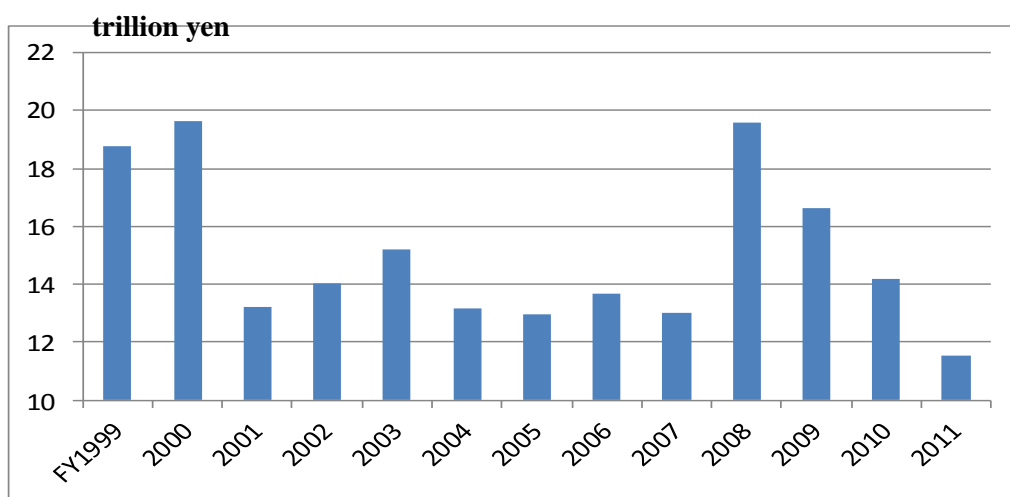
3.3. Public Guarantee Scheme

Japanese government, which was not sure the relationship banking response was substantial enough, decided to establish a new loan guarantee scheme, called “emergency guarantee” in 2008.

In Japan, there are loan guarantee schemes in which public corporations (Shinyo Hosho Kyoukai) guarantee bank loans. Under the general guarantee schemes, when borrowers fail to pay back loans, banks that extended loans to the bankrupt borrowers absorb 20% of the losses, and public guarantee corporations absorb the remaining 80%. However, under the emergency guarantee scheme, banks shoulder no burden of the losses, and the public guarantee corporations absorb all losses. Furthermore, the rates of guarantee charges that firms should pay to public guarantee corporations were set at a level that did not reflect the actual riskiness of the borrowers. Namely, implicit subsidy was provided to risky borrowers.

Figure 11 shows that approval amounts of new loan guarantees sharply increased in fiscal year (FY) 2008, reaching approximately ¥20 trillion. At the end of FY 2008, the total balance of loan guarantees amounted to ¥34 trillion⁵.

Figure 11
Approval Amounts of New Loan Guarantees



(Source) National Federation of Credit Guarantee Corporations.

3.4. Loans from Public Financial Institutions

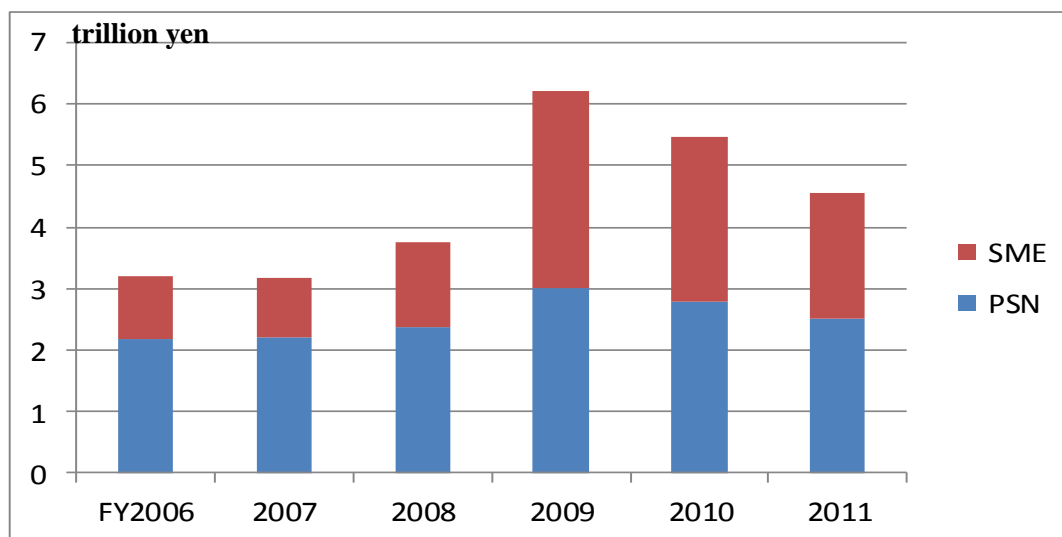
Public financial institutions had played an important role in Japanese financial markets before the Koizumi Cabinet's reform. The Koizumi Cabinet started privatization of public financial institutions because they believed that public financial institutions were inefficient and that private financial institutions were able to play the same role more efficiently.

The new laws were passed in 2007, and Development Bank of Japan (DBJ) and Shoko Chukin Bank (Central Bank for Commercial and Industrial Associations) were converted to stock companies in October 2008. At the same time, four public financial institutions, such as National Life Finance Corporation and Small Business Finance Corporation, were merged into one public institution, Japan Finance Corporation (JFC).

Ironically, just as these reforms began, the global financial crisis emerged, and the government had to use public financial institutions to tackle the crisis. The government urged JFC to provide special loans to corporate sectors. JFC provided more than ¥6 trillion to individuals and firms in 2009, which was almost twice the amount loaned in 2007, as shown in Figure 12. Furthermore, JFC started a new insurance scheme, the so-called "emergency operations." Under this scheme, DBJ and Shoko Chukin Bank could transfer loan losses to JFC. Actually, DBJ and Shoko Chukin Bank, using this scheme, provided ¥1.4 trillion in credits to private corporations for the latter half of FY 2008 and ¥3.9 trillion in credits for FY 2009.⁶

Figure 12

Loans Provided by JFC



(Note) PSN is new loans by National Life Finance Corporation and its incoming business department of JFC. SME is new loans by Small Business Finance Corporation and its incoming business department of JFC.

(Source) Japan Finance Corporation.

4. Regulatory Measures to Encourage Banks to Make Loans

Financial markets throughout the world became dysfunctional after the Lehman shock. The Japanese financial market was also exposed to a difficult situation, although not as difficult as those in Europe and the United States.⁷ A critical problem in Japan was the possible deterioration in financing for SMEs. In this section, we discuss the regulatory measures taken by the government to ensure a smooth supply of funds to SMEs during that period.⁸

4.1. Public Capital Injection

4.1.1. Brief Description of Capital Injections

Observers recognized that many Japanese banks suffered from insufficient capitals because of huge losses caused by non-performing loans and declines of assets prices. However, there were

strong political criticisms that the government intended to save guilty banks by the sacrifice of taxpayers. The government experienced bitter negotiation to provide 700 billion yen and rescue almost bankrupt housing loan companies (Jyusen) in 1996. So, although the government recognized that a scheme to inject public funds into weak but still solvent banks was necessary to protect the financial system, it hesitated to propose the scheme to the congress.

To respond to the financial crisis that was aggravated by the failure of banks such as Hokkaido Takushoku Bank in November 1997, the Financial Functions Stabilization Act was finally established. Based on the Act, the first injection of public funds into banks in Japan to increase capital occurred in March 1998. Total public funds of ¥1.8 trillion were injected into 21 banks, including large city banks. However, because the injection was small, the weak management of banks such as LTCB that received the injection remained unresolved. The reason why the injection was so small was that the government was still concerning the political criticism and that banks were afraid of the reputation risk that capital injection would be a signal of weak banks and trigger depositors' bank runs.

In summer 1998, the world financial crisis that originated in Japan was feared due to the increase in Japan premiums while international financial crises, including Asian currency crises, were expanding. Thus, the Japanese public recognized that a large-scale capital injection was necessary, and the Act on Emergency Measures for Early Strengthening of Financial Functions was enacted in October 1998. A total capital injection of ¥25 trillion was prepared based on the Act. Beginning with an injection of ¥7.5 trillion for 15 banks in March 1999, by March 2002, a total of ¥8.6 trillion was injected based on the Act.

After the bank recapitalization bill lapsed, the Financial Crisis Response ordained in the Deposit Insurance Law was the only possible scheme for further injection of public funds into banks. An amount of ¥2 trillion public funds was injected into Resona Bank in May 2003 based on this scheme. Because the scheme was supposed to be exercised only in a state of emergency, this measure is taken only after a problem has occurred.

Therefore, the Financial Function Strengthening Act was approved in 2004, which enabled the government to inject capital prophylactically into financial institutions that are solvent but that

cannot perform adequate financial functions due to insufficient capital.

4.1.2. Revised Act on Special Measures for Strengthening Financial Functions

Because banks in Japan are subject to the capital adequacy rule, they are required to hold additional equity capital to increase lending. Therefore, after the Lehman shock, the concern was that a credit crunch or credit withdrawal would be triggered regarding SMEs given this capital adequacy rule. Moreover, if many banks had weak capital adequacy ratios, the financial system would become unstable.

The Financial Function Strengthening Act, which enabled the government to inject public funds for prevention purposes based on applications from financial institutions, was implemented to strengthen the financial condition of regional financial institutions in Japan. The Act was in effect from the end of August 2004 to the end of March 2008. Unfortunately, when the Lehman shock hit Japan, the Act was not in effect. Given the seriousness of the global financial crisis, the government decided to implement a new Financial Function Strengthening Act (hereafter, the revised Act) in December 2008. The revised Act was scheduled to be in effect until March 2012.⁹

Because the old Act placed significant responsibility on the directors at banks that received public funds, bank managers hesitated to apply for such assistance. Only two banks, Kiyo Holdings, Inc. (Kiyo Bank) and Howa Bank, received public funds. Unlike the old Act, the revised Act does not impose heavy penalties on bank executives when the bank applies for a capital injection.

Table 2 lists the banks that received an injection of public funds under the revised Act.¹⁰ The table indicates that the number of banks that applied for an injection was much higher than under the old Act. On the other hand, because penalties imposed on management and shareholders were not significant under the revised Act, there was concern that a serious problem of moral hazard may occur.¹¹ Namely, the government assigned the highest priority to making banks to continue to provide loans to SMEs.

Table 2
Banks That Received a Capital Injection under the Revised Financial Function
Strengthening Act

Name of financial institutions	Date of capital injection	Amount (¥100 million)
Hokuyo Bank	March 2009	1,000
Fukuho Bank	March 2009	60
Minami Nihon Bank	March 2009	150
Michinoku Bank	September 2009	200
Kirayaka Bank	September 2009	200
Daisan Bank	September 2009	300
Shinkumi Federation Bank (Yamanashi Prefecture Shinkumi)	September 2009	450
Towa Bank	December 2009	350
Kouchi Bank	December 2009	150
Fidea Holdings (Hokuto Bank)	March 2010	100
Miyazaki Taiyo Bank	March 2010	130

(Note) The capital injection into Shinkumi Federation Bank was made through purchasing trust beneficiary rights. Other injections were made by purchasing preferred shares.

(Source) Deposit Insurance Corporation of Japan.

4.2. Redefinition of Non-Performing Loans

In November 2008, the FSA revised several rules that defined non-performing loans. Before the revision, the regulatory rule generally classified loans to borrowers whose loan conditions, such as payment schedule and interest rates, were changed as non-performing loans. It is difficult for banks to provide new loans to such downgraded borrowers. Therefore, firms hesitated to ask banks to change loan conditions. Banks also hesitated to change loan conditions because they had to write down these condition-changed loans, resulting in lower capital ratio.

The new rules introduced wider exceptional instances under which banks were allowed not to

classify condition-changed loans as non-performing loans. For example, under the new rule, if the borrowers have a credible restructuring plan and are confidently expected to attain the normal status of borrower classification within approximately five years (within 10 years if appropriate), the borrowers whose loan's condition is changed are allowed to be classified as normal status.¹²

This revised rule had significant impacts. Figure 1 in section 1 shows that the balance of non-performing loans increased only slightly in 2008, despite the fact that the economic slowdown was significant. Regarding the FSA's report on factors in changes of non-performing loans, ¥1.4 trillion in loans originally classified as non-performing loans (i.e., loans that require monitoring) were upgraded to normal status in 2008 because a credible restructuring plan was drawn up, while the figure for 2007 (before the rules changed) was only ¥0.2 trillion. Also, the amount of loans downgraded from normal status to non-performing status in 2008 was ¥0.9 trillion, which was less than before the crisis. Namely, the figures in 2006 and 2007 were ¥1.0 trillion and ¥1.2 trillion, respectively. This suggests that many borrowers maintained normal status by drawing up credible restructuring plans amid the global financial crisis.

This regulatory measure is controversial. Downgrading likely damages borrowers and decreases the chance for them to recover. It is also reasonable that loans to borrowers with truly credible restructuring plans are classified as normal status. Owing to this measure, banks can support borrowers without worrying about loss due to the write-off. This measure enables the financial system to continue functioning smoothly.

However, this measure has a downside. Speaking in the extreme, it is always possible to draw up a 10-year plan for a borrower to revitalize. By sweeping real issues under the rug, both banks and firms might not be forced to perform painful reforms. Harada, Hoshi, Hosono, Koibuchi, and Sakuragawa (2011), among others, pointed out that this measure damages the trustworthiness of Japanese banks' disclosure because it is subjective to judge whether a restructuring plan is credible.¹³

4.3. Temporal Loosening of Capital Adequacy Ratio Regulation

The government released an Economic Policy Measure Package, named “Seikatsu Taisaku,” on October 30, 2008. As a part of this measure, the government decided to loosen the capital adequacy ratio regulation to tackle the global financial crisis. This measure was scheduled to end by March 31, 2012.¹⁴

Before the measure, banks following the domestic capital adequacy rule were forced to deduct 60% of valuation losses of “other available-for-sale securities” from capital. However, after this measure, banks were allowed not to deduct any valuation losses of “other available-for-sale securities” from the capital. As securities prices sharply decreased during the crisis, many banks suffered huge valuation losses of securities in their portfolio.¹⁵ Therefore, without this measure, the regulatory capital ratio of these banks would have fallen substantially.

The securities market did not function well during the crisis, and thus market prices of securities seemed to temporarily differ from fundamental values. In this sense, this temporal loosening may be reasonable. However, this measure also makes bank disclosure opaque.

4.4. New Measures for Financial Facilitation

“New measures for financial facilitation” were announced in March 2009 to facilitate firms’ borrowing because business conditions, not only of SMEs but also of middle-size and large firms, deteriorated remarkably during the recession after the Lehman shock. There are three main measures.

First, special off-site interviews were conducted at the end of FY 2008 to investigate whether banks were eager to supply funds to firms. Based on the results of the interviews, the operations from April to June 2009 of major banks as well as regional financial institutions that were swamped with complaints were examined.¹⁶

Second, the FSA changed the risk weight given to emergency guaranteed loans for calculating regulatory capital asset ratios. As emergency guaranteed loans were fully guaranteed by public credit guarantee corporations and banks hold no credit risk for them, the FSA decreased their risk weight from 10% to an exceptional 0%. This measure intended to decrease amounts of risk

assets, which is the denominator of the capital ratio.

Adding to the temporal loosening of capital adequacy ratio regulation discussed in 4.3, regulatory capital ratio of regional banks actually increased for FY 2008 when they recorded negative profits. Namely, average capital ratio of regional banks (including regional banks II) rose from 10.5 % (at the end of March 2008) to 10.7% (at the end of March 2009).

Third, capital injections based on the revised Act, discussed in section 4.1 in this paper, were promoted during open hearings to financial institutions by requesting that they consider a more positive use of the Act.

4.5. Act to Facilitate Financing for SMEs (Kinyu Enkatsuka Act)

An “Act on temporary measures to facilitate financing for SMEs” (hereafter, the SMEs Finance Act) was implemented in December 2009 to assist SMEs that had difficulty with management and finance as a result of the recession after the Lehman shock. The SMEs Finance Act imposes obligations on financial institutions to make efforts to respond to requests as best as they can when SMEs and mortgage borrowers apply for a softening of borrowing conditions, such as extensions of repayment deadlines.

The SMEs Finance Act could cause an increase in non-performing loans. Therefore, banks might hesitate to respond to borrowers’ requests. Thus, some additional measures were taken to promote the implementation of the Act. If a financial institution admits softening loan conditions, it does not have to classify them as non-performing loans in most cases under the Act.¹⁷ Moreover, although banks must make an effort to respond to borrower requests, a legal penalty on banks is not specified if they fail to do so. However, banks must organize their implementation system, report their implementation results to the authorities, and disclose them to the public. A legal penalty is imposed for false disclosures or reports.

Table 3 summarizes the implementation of the Act from the beginning of its enforcement to the end of September 2012. The implementation ratio is at a relatively higher level because of the supportive measures discussed above. However, from the point of view of financial stability, we are concerned that banks hold many unreported non-performing loans because substantial loans

with extended repayment periods may be classified as normal loans.

We can admit that the SMEs Finance Act has directly contributed to a decrease in the number of corporate bankruptcies. If the difficulties borrowers face are cyclical, the costs of this measure seem moderate. However, if borrowers face structural difficulties, procrastination will make issues harder to resolve. Procrastination often disinclines banks and borrowers to conduct painful restructurings. Unfortunately, Teikoku Data Bank, a Japanese major industry information provider, reports that failures of firms that obtained a softening of loan conditions under the Act are increasing.¹⁸ It suggests that the costs of procrastination will be larger.

Table 3
Implementation Rate of the Act to Facilitate SME Finance (in cases where debtors are SMEs) (until September 2012)

	1 (%)	2 (%)
Major banks (10)	97.3	92.2
Regional banks (106)	97.3	92.8
Other banks (26)	90.7	86.9
Credit associations (272)	97.6	93.5
Credit cooperatives (159)	98.1	94.3
Labor credit associations (14)	100.0	100.0
Credit federation of agricultural cooperatives and credit federation of fisheries cooperatives (67)	98.8	95.8
Total (654)	97.4	92.9

(Note 1) Column 1 displays the implementation ratio that equals the implementation number divided by both the implementation number and the rejection number.

(Note 2) Column 2 displays the implementation ratio that equals the implementation number divided by the total application number. The discrepancy between Columns 1 and 2 is due to the numbers of applications under review.

(Note 3) Saitama Resona Bank is included in the regional banks.

(Source) Financial Services Agency.

5. Concluding Remarks

This study explains how Japanese banks and banking regulations have responded to the global financial crisis. Although the Japanese financial system weakened significantly after the collapse of the economic bubble in the early 1990s, it had recovered stability and soundness before this global crisis occurred. Japanese financial institutions did not hold a large amount of securitized assets related to subprime loans, thus direct losses related to these assets were not large during the global financial crisis of 2008. Therefore, unlike in Europe and the United

States, there was little need for the FSA to assist damaged financial institutions. However, bank supervision regulations had to be changed in response to the financial crisis in Japan. Namely, as SMEs' business conditions deteriorated sharply, the government had to encourage banks to assist SMEs.

Historically, the main purpose of bank regulation is to keep the banking system stable and sound, but the FSA had to shift the emphasis from prudential consideration to economic activity consideration.¹⁹ Although there are some measures, such as the public capital injection scheme, that actually increase bank soundness, most measures are regarded as financial window-dressing, including the change of the definition of non-performing loans and the exclusion of valuation losses of securities from capital ratio calculations.

How should we evaluate these window-dressing measures? These measures mitigated negative shocks, limiting corporate bankruptcies. We may understand that the FSA implicitly modified pro-cyclicality, which the Basel II capital adequacy regulation is criticized as having done. During the crisis, the FSA reduced effective capital ratio while the nominal ratio of 8% remained unchanged. Without these measures, bad economic conditions might have reduced banks' capital ratios, and banks with lower capital ratios would have been forced to cut lending, deteriorating the economy further. After the crisis, many observers criticized the capital adequacy regulation for its pro-cyclical nature. In this sense, the FSA was a pioneer.

However, as pointed out before, these measures make reported figures, such as bad-loan ratios and capital ratios, opaque. It is now hard for depositors to know how much banks hold in real capital and bad loans based on the disclosure report. The true financial condition of Japanese banks may be worse than what is disclosed. Fortunately, so far, this ambiguity has not created public distrust of banks. Additionally, procrastination of problems often damages motivations of banks and borrowers to tackle difficulties, and therefore, the possibility to resolve problems likely becomes smaller.

We also note that the FSA utilized the double standard, under which different rules are applied for internationally active banks (i.e., banks having overseas subsidiaries and branches) and for domestically operating banks. For example, it is hard for the FSA to modify capital adequacy

rules for international banks, which are subject to the Basel international agreement. However, rules for domestic banks are not subject to the international agreement and the FSA can modify the rules. When crisis hit Japan, the FSA had relatively high degree of freedom for modifying regulatory rules that were only applied for domestic banks. Responding to the crisis, the FSA could flexibly modify several regulatory rules. Furthermore, domestic banks are major lenders to SMEs. Therefore, regulatory measures that mainly affected domestic banks were effective for protecting SMEs.

Recently, IMF (2012) pointed out; “for domestic and internationally active banks, different minimum capital levels and a different definition of capital are used, although a similar capital adequacy framework applies. Triggers for early intervention measures due to a shortfall in minimum capital levels are set at a too low level especially for domestic banks.” Then, IMF insisted “The authorities should seek to enhance the standards for capital adequacy, and to streamline the rules applicable for domestically and internationally operating banks.” Implicitly, IMF criticizes the double standard approach taken by the FSA. In the future, we are not sure whether the FSA’s approach is accepted by other countries²⁰.

In Sum, we have a big challenge. We have to search for a policy that has flexibility or a counter-cyclical nature to stabilize the short-term economic fluctuation but that does not hurt the credibility of bank disclosure, which is necessary condition for long-term economic stability.

Furthermore, the Japanese economy has to cope with recurring crises after the collapse of the bubble economy. The Japanese economy is still stagnant, and it is more and more necessary to stimulate the economy from the financial side. We need to search for new policy measures that encourage banks to take more risk to stimulate the economy and yet also effectively prevent banks from taking excess risk.

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NOTES

1. More technical analyses are conducted in Ogura and Yamori (2010), Yamori and Harimaya (2009, 2010a, 2010b), Yamori, Harimaya, and Asai (2006), Yamori and Okada (2007), Yamori, Tomimura, and Harimaya (2011). Also, many studies analyze Japanese banking (e.g., Hall, 1999, 2003, 2007; Honda, 2002; Uchida & Udell, 2010).
2. See Yamori and Nishigaki (2008), which describes the large changes that have occurred in the financial system since the 1990s, as well as the impacts of those changes on banks, and discusses the new challenges for Japanese banks.
3. To be more exact, the government holds 100% of the shares of the holding company, Japan Post, and the holding company holds 100% of the shares of Japan Post Bank. A part of Japan Post shares that the government holds is scheduled to be sold.
4. A detailed analysis was conducted by Yamori and Kobayashi (2007). According to the results, the market recognized that this capital infusion was a “too big to fail” type policy.
5. Japanese fiscal year starts on April 1 of each year and ends on March 31 of the following year.
6. Therefore, the government recognized the necessary role of public financial institutions. Initially, stocks of DBJ and Shoko Chukin Bank were scheduled to be sold in the market by 2015. However, while tackling the global crisis, the government changed the schedule. New laws, which put off complete privatization of DBJ to around 2022, were enacted in 2011.
7. The FSA reported that the total amount of subprime-loan-related products Japanese depository institutions held as of September 30, 2008, was ¥797 billion, while the Tier 1 capital of these institutions amounted to ¥50.1 trillion.
8. A detailed discussion of the BOJ’s policies can be found in Yamori and Kondo (2011).
9. The Act was revised in 2011 after the East-Japan Great Earthquake. The public capital injection scheme will be in effect until March 2017.
10. Under the 2011 revised Act, many banks that were seriously damaged by the East-Japan Great Earthquake obtained public funds.
11. Based on the Act, an Examination Board has been established to review the applications and monitor the performance of banks. Currently, Nobuyoshi Yamori, an author of this paper, serves as a member of this Examination Board.
12. Strictly speaking, these assets are generally classified as “other performing loans with some concerns for the future.”
13. Spiegel and Yamori (2006) find that banks with larger bad loans tended not to disclose figures of bad loan ratios when the disclosure was not compulsory. Furthermore, Kondo (2010) also showed that financial institutions with more bad loans tended to be passive

- regarding disclosure, especially if they were rated by foreign rating agencies.
14. In June 2012, the FSA decided to extend this measure until March 30, 2014. It exemplifies the difficulty in ending a “temporal” measure.
 15. According to the Japanese Bankers Association, total valuation losses of “other available-for-sale securities” amounted to ¥1.9 trillion at the end of March 2009, while banks held ¥2.5 trillion valuation profits at the end of March 2008. As Tier 1 capital of regional banks, most of which followed the domestic capital adequacy rule, was around ¥13 trillion yen at the end of March 2009, this measure had substantial impacts on their capital ratios.
 16. “One Year of the Financial Services Agency (Fiscal Year 2008)” indicates that there were no regional financial institutions that were swamped with complaints.
 17. Under the Act, the definition of non-performing loans was revised. Now, borrowers who have no restructuring plan when they request a softening of borrowing conditions but who will surely make a credible restructuring plan within one year are classified as normal status.
 18. See Teikoku Data Bank HP at <http://www.tdb.co.jp/report/watching/press/p120805.html>.
 19. Of course, in the sense that a prosperous economy reduces the possibility of corporate failures, these measures indirectly contribute to the soundness of the banking system.
 20. The FSA has already implemented Basel III regarding internationally active banks. The FSA plans to implement different capital adequacy rules for domestic banks. Regarding to IMF (2012), “The FSA expects the IMF to understand that non-internationally active banks engage in community based businesses and thus their minimum capital ratios should be set to balance the two objectives of facilitating their financial intermediary function in respective regions and ensuring safety and soundness of those banks.”

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