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PROBLEMS IN THE JAPANESE FINANCIAL SYSTEM* IN THE EARLY 1990s

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Abstract

The Japanese financial system is now undergoing many serious problems due to the collapse of the "speculative bubble" which occurred at the start of the 1990s. Most of these problems were caused by the excessively expansionary policy of major Japanese financial institutions during the boom period of the late 1980s as well as the expansionary monetary policy pursued during that time. This paper describes several aspects of the current problems including the recent changes in the financial system, these effects on the economy, and the relationship with the regulatory authorities. It also evaluates the soundness and competitiveness of Japan's financial system in the international context towards the future.

I. *Macro-Economic Background*

In order to understand the Japanese financial system in 1990s, it is important to be familiar with the macro-economic situation in the latter half of the 1980s, when the seeds of recent troubles were planted. As shown in Fig. 1, the 1980s were a prolonged period of low interest rates. After the Plaza Agreement in 1985, which caused a rapid and drastic appreciation of the Japanese yen exchange rate, the Japanese monetary authority adopted a policy of lowering the discount rate. Within about a year the discount rate reached at historical low of 2.5%. This lasted for another two years until the monetary authority returned to a tight monetary policy in 1989 (Fig. 2). Throughout the period, the growth rate of money supply was at a high level ranging between 10 and 12%, while the real rate of growth was between 4 and 6%.

This policy of low interest rates encouraged an expansion of capital market fund raising and a massive shift of funds into the securities and real estate markets. As shown in Figs. 2 and 3, the rates of increase in stock prices and land prices were exceptionally high during this period. These are the key figures to understand the recent experience of the Japanese financial system. The trading volume in Tokyo Stock Exchange increased 5 timesover and the total amount of funds raised by listed companies through equity financing grew more than 10 times in the five years from 1985 to 1989 (Table 1). At the end of 1989 when

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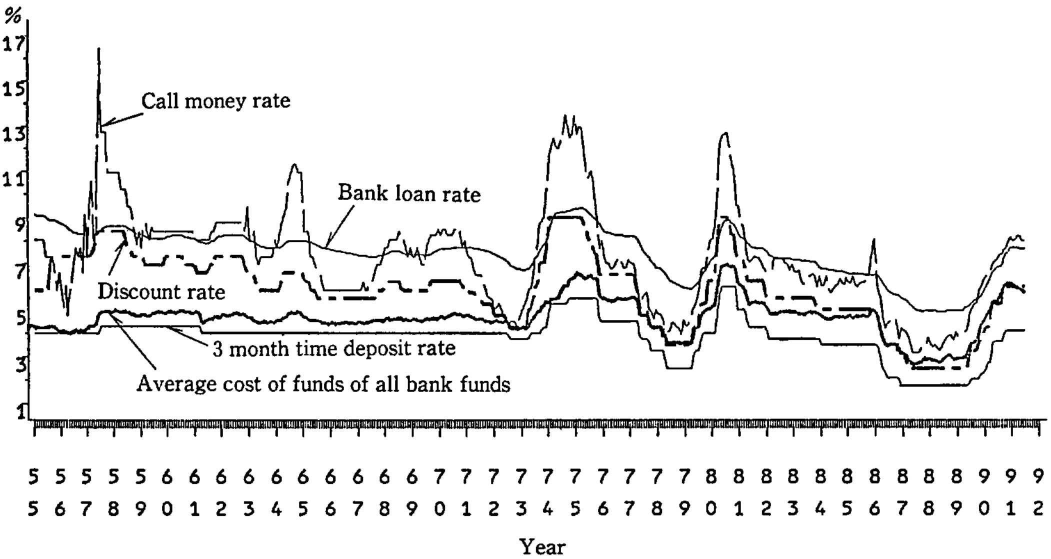
FIG. 1. INTEREST RATES AND BANK'S COST OF FUNDS

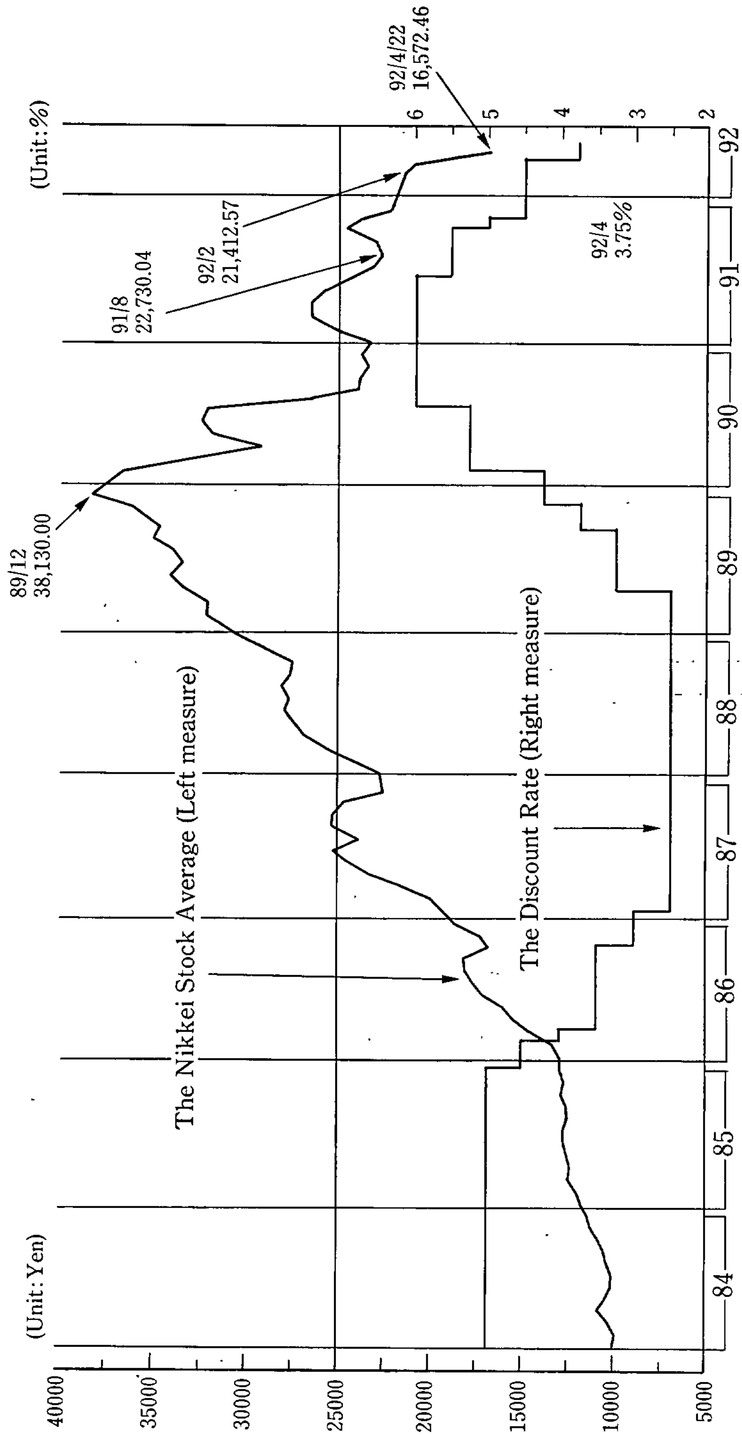


the stock prices were at their peak, the size of the Tokyo Stock Exchange was the largest in the world with an equity capitalization value of 611 trillion yen surpassing the 438 trillion yen (converted into yen at the then existing exchange rate) of the New York Stock Exchange.

Similarly, land prices started to rise rapidly from 1986 until the end of the 1990s (Fig. 3). The real estate industry was booming and high and rising land prices raised borrower's credit worthiness by increasing the value of assets pledged as collateral for loans. This asset inflation significantly distorted the resource allocation of the Japanese economy in the late 1980s, and ultimately led to many of the problems and scandals which Japanese financial institutions faced in the early 1990s.

In 1986, a schedule for deregulation of deposit interest rates was announced. Banks were in a position to reorganize their activities to cope with the expected rise in the cost of funds prompted by the planned deregulation. After the first oil crisis in 1973–75, when the Japanese economy entered into a period of lower growth, large companies reduced their demand for loans because of reduced investment opportunities. Moreover in the 1980s, industrial firms increased their direct fund raising from the capital markets which were newly opened by deregulation. High and rising stock prices encouraged them to raise long term funds through equity financing. As shown in Fig. 4, bank profit margins (yield on working assets less cost of funds) had already fallen substantially since 1975. During the period of 1986 to 1989, the cost of funds for banks was at its historically lowest level. Banks competed with each other in order to increase their loan volume. Their expansionary policy was intended not only to increase their profit, but also to enlarge their share of the loan market as they saught to survive the coming period of deregulation. If we look back at that time it is evident that competition among banks for new customers could be described as fierce and extraordinary.

FIG. 2. THE NIKKEI STOCK AVERAGE AND THE DISCOUNT RATE



Source: *Economic Statistics Monthly*, The Bank of Japan.

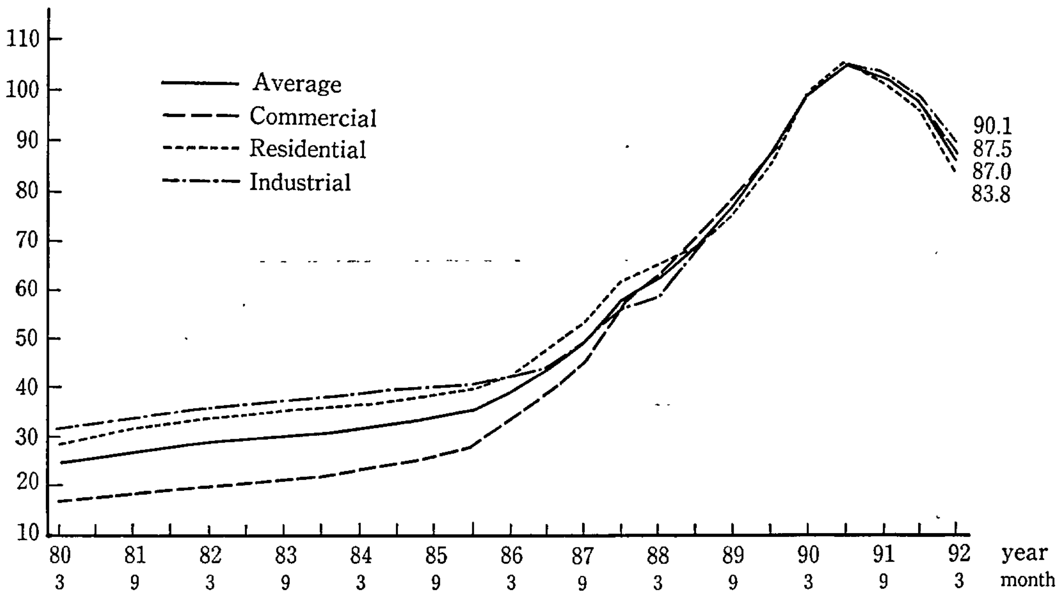
TABLE 1. VOLUME OF STOCK TRANSACTIONS AT TOKYO STOCK MARKET FIRST SECTION

(100 Million yen)

	Value of Dealing Average per Day	Amount Raised through Stocks by Listed Companies
1983	1,778	8,017
1984	2,213	10,431
1985	2,647	8,591
1986	5,587	8,725
1987	8,962	30,130
1988	10,246	47,823
1989	13,085	88,486
1990	7,167	37,924
1991	4,354	7,510

Source: *Economic Statistics Annual*, The Bank of Japan.

FIG. 3. LAND PRICE INDICES OF 6 LARGEST CITIES



Source: *Land Indices of Urban Districts*, The Japan Real Estate Institute.

II. *Bank's Lending Behavior*

In the circumstances stated above, there were five loan markets where most banks increased loan activity 1) small and medium sized firms, 2) individuals, 3) the real estate industry, 4) the finance industry, and 5) overseas investment. The changes in market shares in these loan markets by major classes of Japanese banks during the last 16 years are shown in Fig. 5 through Fig. 9. As will be explained later, aggressive expansion to these loan

FIG. 4. RATIO OF PROFIT MARGINS
(Yield on Working Assets Less Cost of Funds)

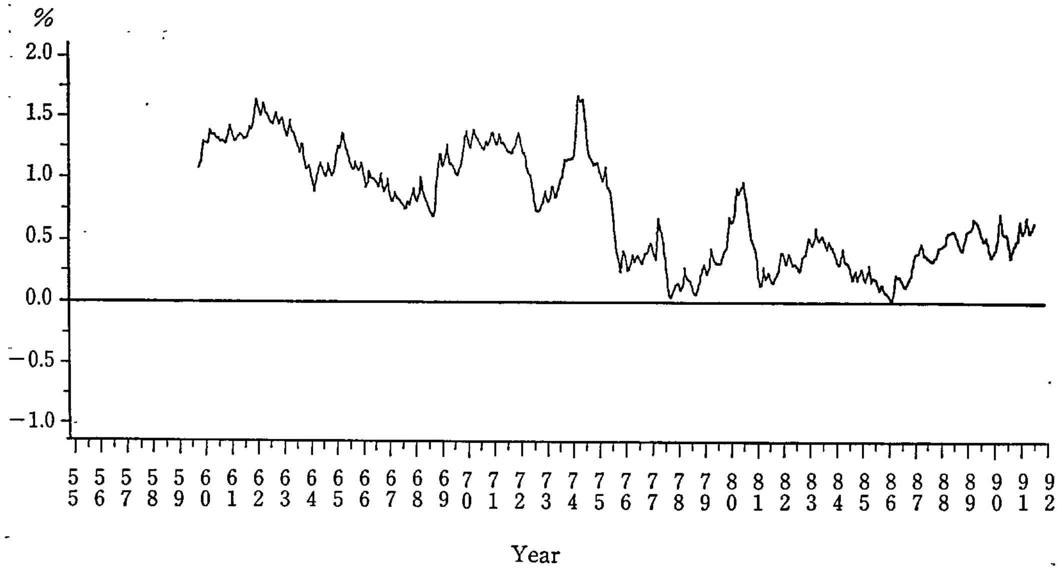
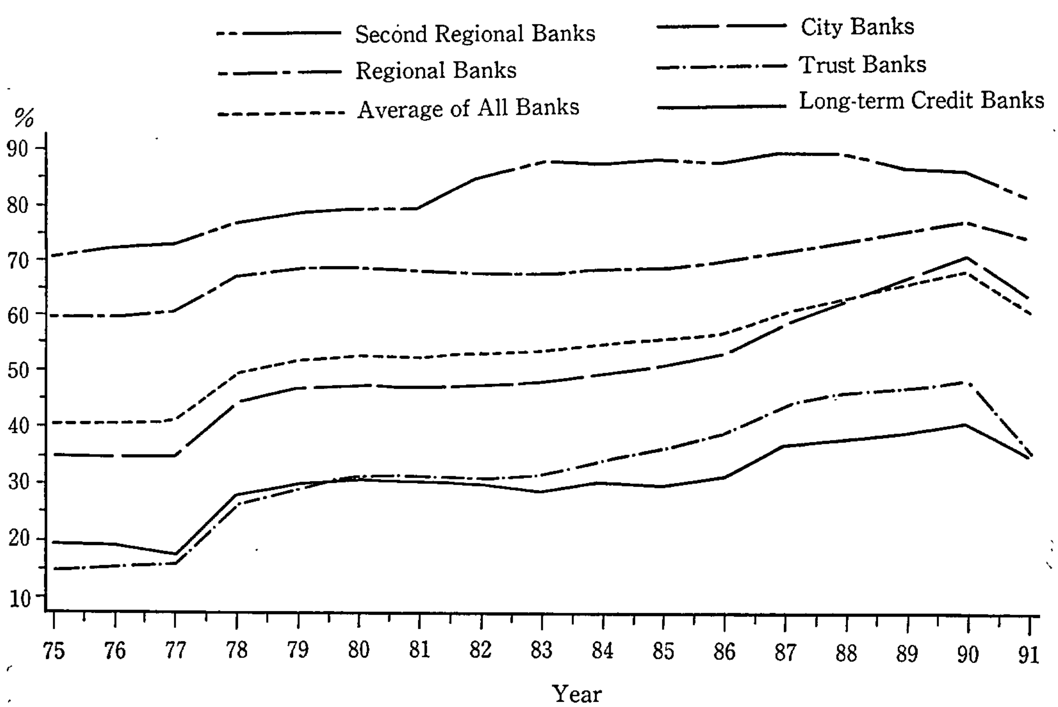


FIG. 5. PROPORTION OF LOAN PORTPOLIO GOING TO MEDIUM AND SMALL SIZE FIRMS



markets was a major source of problems in the early 1990s.

There are five classes of banks in Japan: a) long-term credit banks (3 banks), b) trust banks (7), c) city banks (11), d) regional banks (64), e) member banks of the second association of regional banks (68). Long-term credit banks and trust banks traditionally made long-term loans, mostly to large industrial firms. Manufacturing firms accounted for the largest share of loans during the high growth period preceding 1975. After the shift in the economy to a lower growth, these faced reduced demand for long-term loans by then traditional borrowers, i.e., large manufacturing firms. Under the traditional regime of the separation of business fields and regulated interest rates, long-term credit banks were exclusively licensed to issue bank debentures as a source of long-term funds. Likewise, only trust banks were allowed to offer trust services. Because of the ongoing deregulation of traditionally competitive barriers, these banks were forced to reorganize their loan policies to weather the adjustment to a deregulated climate.

City banks are based in the large cities of Tokyo, Osaka, and Nagoya, and their branches cover the whole area of Japan. They have many large firms as their customers and make both long-term and short-term loans. These banks have also actively changed their loan patterns in order to ensure adequate profit margins in the face of higher costs of funds resulting from deregulated interest rates. In the late 1980s, they sought to obtain new customers and larger shares of major loan markets.

Regional banks and second regional banks are based on each prefecture and their branches cover contiguous areas. Their main customers are small and medium sized firms. The member banks of the second association of regional banks were converted to ordinary banks from specialized banks to small and medium sized firms a few years ago.

In Fig. 5, it is clear that all types of banks have been increasing loans to small and medium sized firms and individuals. This is the area where banks could expect higher profit margins compared with loans to large firms. Especially during the years between 1986 and 1990, the shares increased rapidly for city banks, trust banks and long-term credit banks as a result of their loan policy to expand into new loan markets with higher returns. The rise in the proportion of loans of regional banks and member banks of the second association of regional banks going to these borrowers was less dramatic, in part because their loans to this borrower group were already high. These banks were in the position to defend their traditional loan markets. (In 1977, the definition of small and medium sized firms was enlarged to cover a larger number of firms.)

Fig. 6 shows the proportion of residential mortage loans to individuals. City banks most active in increasing this type of loan which was collateralized by the increased land prices in large cities. In 1990, residential mortgage loans alone were proportionly as large as loans to the manufacturing industry in total city bank loan portfolios. City banks had advantages in this loan market over regional banks, due to the higher rate of increase in land prices in large cities.

Fig. 7 shows the proportion of loans to the real estate industry. All types of banks increased loans to this industry markedly during the late 1980s. The rate of increases by large banks such as long-term credit banks, trust banks and city banks are especially noteworthy. However, the decreases in the proportions of real estate industry loans by bank classes in 1991 are correspondingly larger than the increases in the late 1980s. Needless to say, large amounts of loans extended to this industry in the late 1980s is a continuing source

FIG. 6. PROPORTION OF LOAN PORTFOLIO GOING TO RESIDENTIAL MORTGAGE

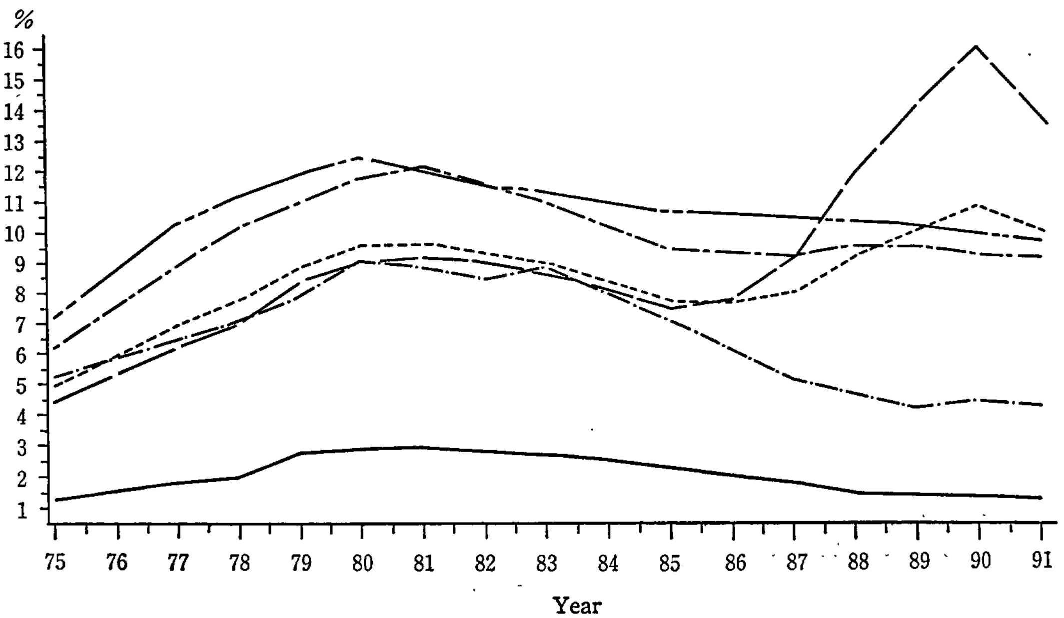


FIG. 7. PROPORTION OF LOANS PORTFOLIO GOING TO REAL ESTATE IDUSTRY

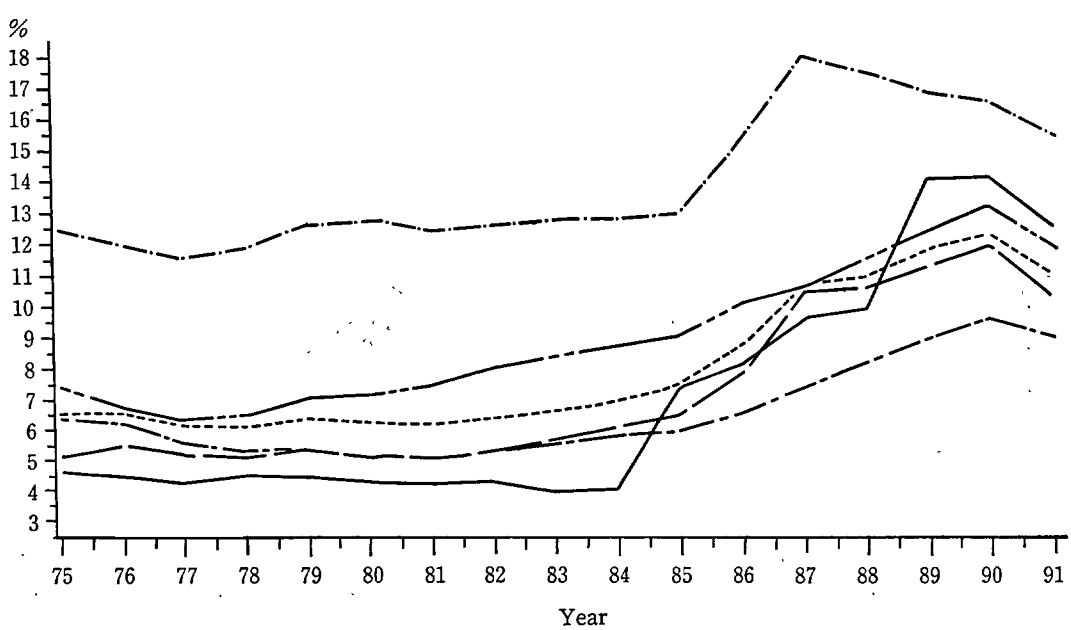


FIG. 8. PROPORTION OF LOAN PORTFOLIO GOING TO FINANCE AND INSURANCE INDUSTRY

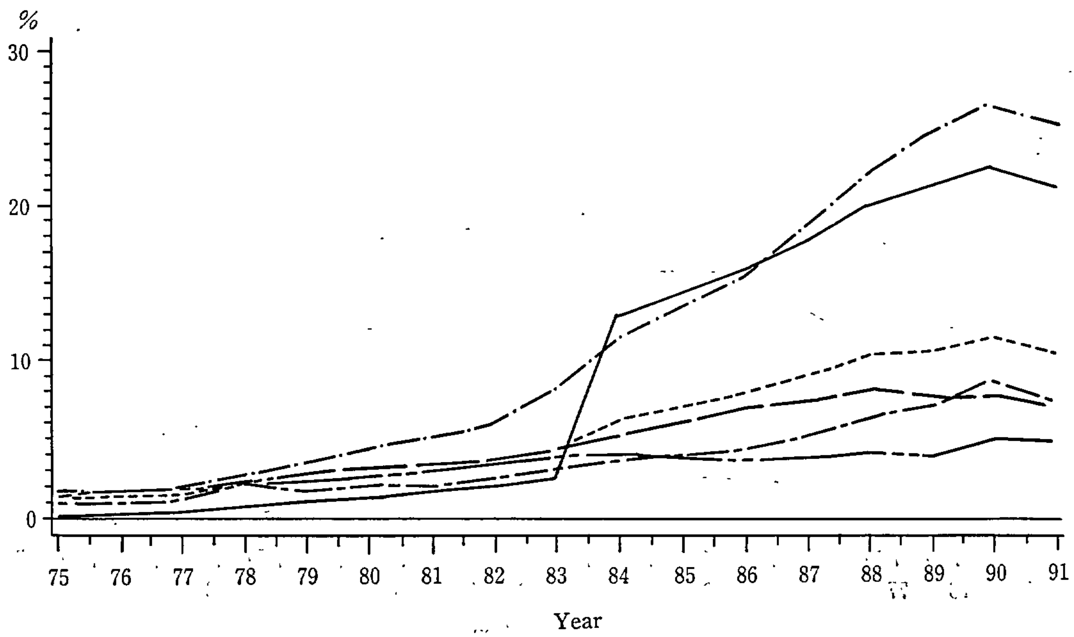
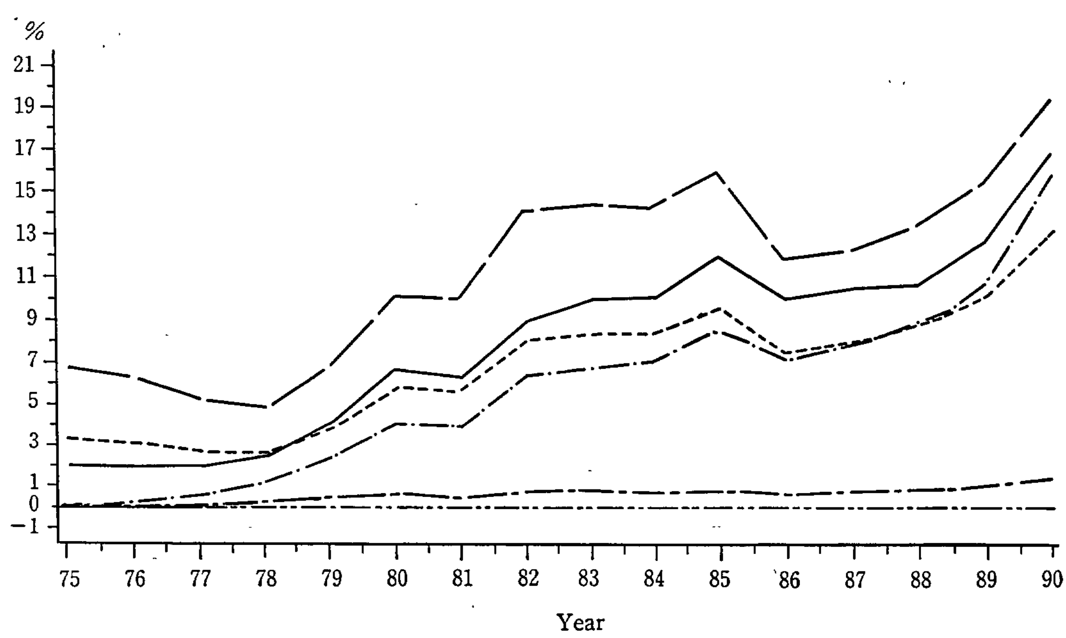


FIG. 9. PROPORTION OF LOAN PORTFOLIO GOING TO OVERSEAS



of serious difficulties for Japanese banks in the 1990s.

The proportion of bank loan portfolios in the finance and insurance industries is shown in Fig. 8. This reflects the fact that all classes of banks increased loans to non-bank financial institutions. These non-banks, in turn, made large numbers of loans collateralized by the high and rising prices of real estate, such as loans to the real estate industry and residential mortgage loans. The rate of increases by the long-term credit banks and trust banks is extraordinarily high relative to other classes of banks, because these banks have far fewer branches compared with ordinary banks and less direct access to retail area of loans. In order to offset this weakness as well as to secure a new loan market in the wholesale banking area so as to compensate for reduced loan demand by large firms, they increased loans to non-bank financial institutions. The demand for loans by non-bank financial institutions was also increased because of the rising land and stock prices. However, loans to this industry have fallen in 1991.

Fig. 9 shows the proportion of loans going overseas. This is another new loan market that large banks such as long-term credit banks, trust banks, and city banks have been pursuing throughout the 1980s. While the proportions of these loans fell in 1986 due to the large appreciation of Japanese yen, the loan amounts in dollars kept rising throughout the 1980s. This activity has dramatically increased the international presence of Japanese banks in the world loan markets. In the late 1980s, the world's ten largest banks were primarily Japanese banks, which was one motivation for the BIS agreement to raise bank equity capital requirements.

III. *Key Factor of Land and Stock Prices*

All these increased loans to the above mentioned fields were basically made possible by the increased borrower's credit worthiness due to the rise in land and stock prices. Traditionally and even now, Japanese banks extend loans only on a secured basis backed by some kind of collateral. The monetary authority also encourages banks to stick to the collateralization principle through periodic bank examinations. This principle is regarded as a base for stability in the Japanese financial system.

All loans can be classified into three categories: loans with collateral, with third party guarantees, and unsecured loans. Fig. 10 shows the proportion of loans secured by collateral in bank loan portfolio. This proportion is especially high for long-term credit banks and member banks of the second association of regional banks due to the higher credit risks associated with long-term loans and loans to smaller firms. Fig. 11 is the proportion of loans with a third party's guarantee, such as credit guarantee organizations. Consequently, the proportion of unsecured loans shown in Fig. 12 ranging from 20 to 40% for ordinary banks (commercial banks) and 40 to 50% for trust banks. Taking into account the fact that total loans include overse) as loans usually made on an unsecured basis (as shown in Fig. 9), unsecured loans in the domestic market are much smaller proportion for larger banks.

The most important asset used as a collateral is land. Fig. 13 shows that real estate is the dominant source of collateral and Fig. 14 shows the proportion of total loans secured by real estates. A rapid fall of these proportions in the case of long-term credit banks and trust banks reflects their declining competitive position in supplying capital to large

FIG. 10. PROPORTION OF LOAN PORTFOLIO SECURED BY COLLATERAL

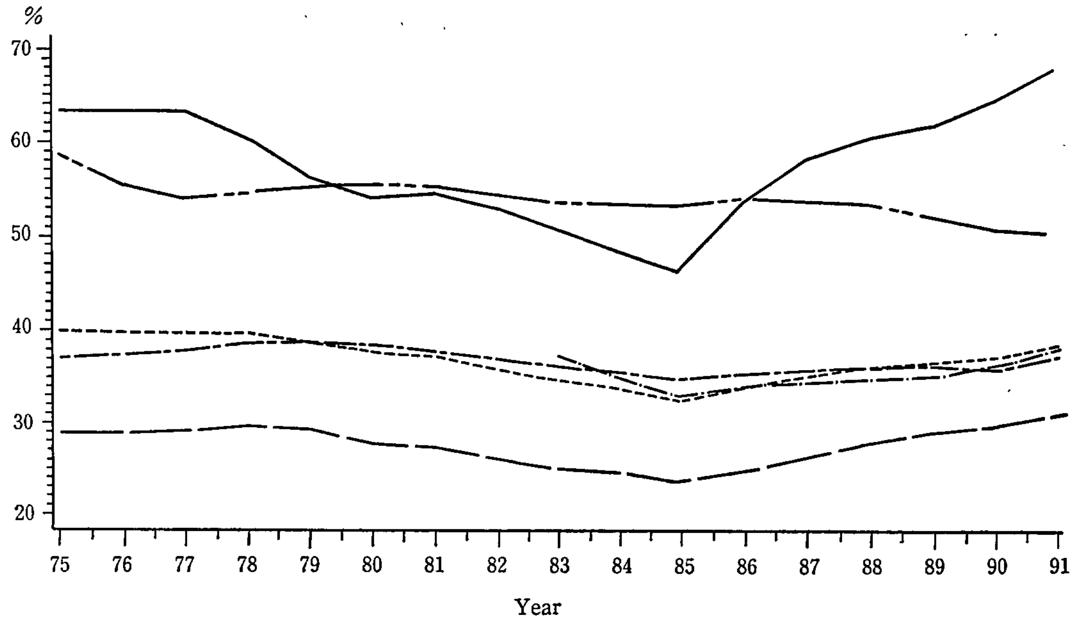


FIG. 11. PROPORTION OF LOAN PORTFOLIO WITH THIRD PARTY'S GUARANTEE

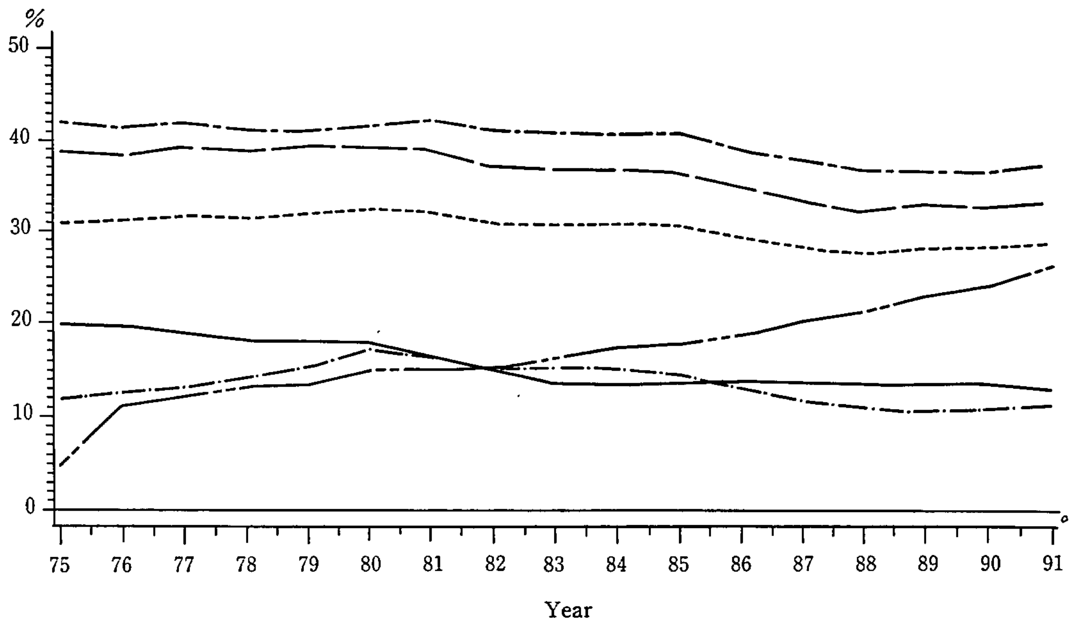


FIG. 12. PROPORTION OF UNSECURED LOAN PORTFOLIO

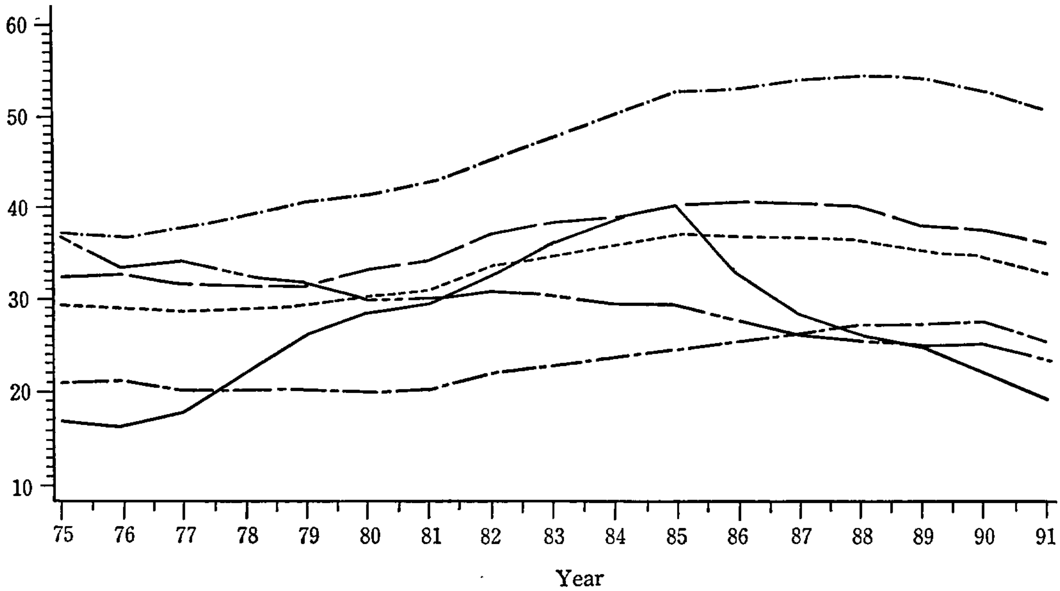


FIG. 13. PROPORTION OF LOAN PORTFOLIO SECURED BY REAL ESTATE IN THE TOTAL SECURED LOANS

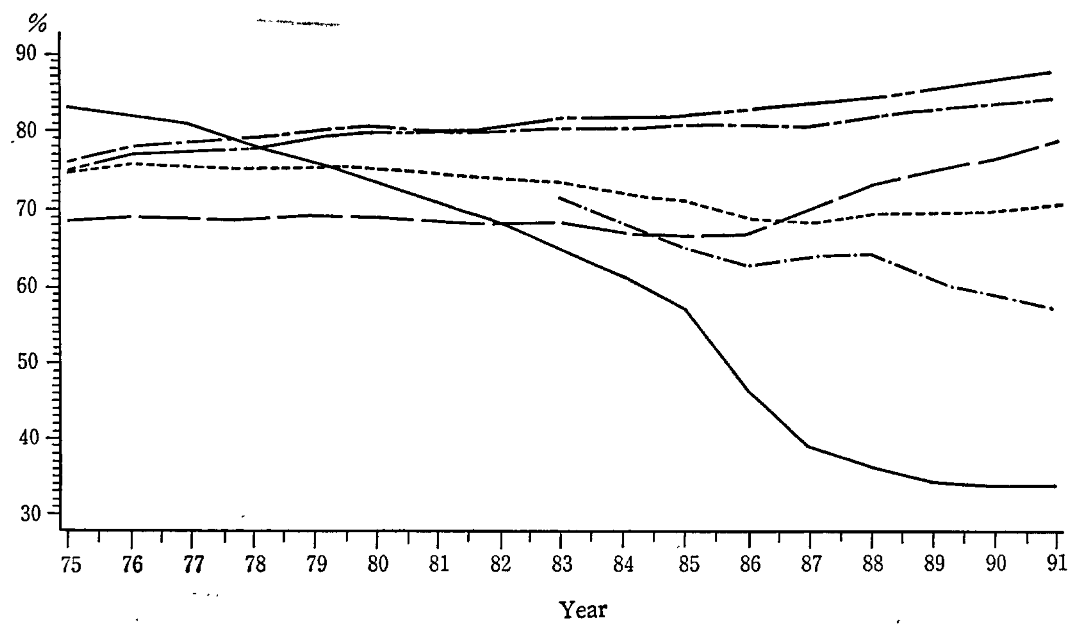
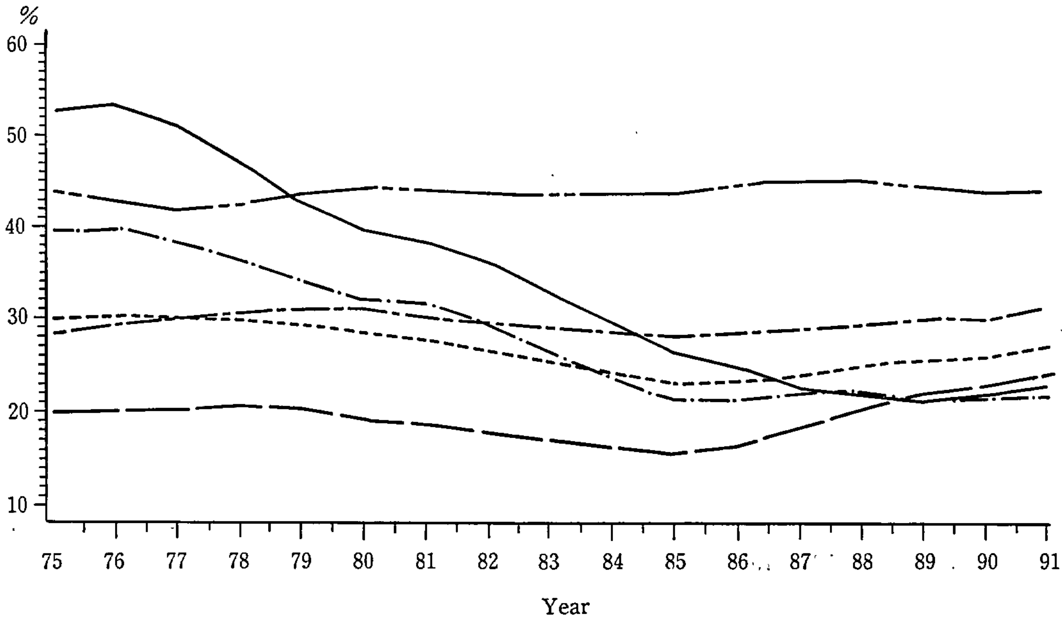


FIG. 14. PROPORTION OF LOAN PORTFOLIO SECURED BY REAL ESTATE

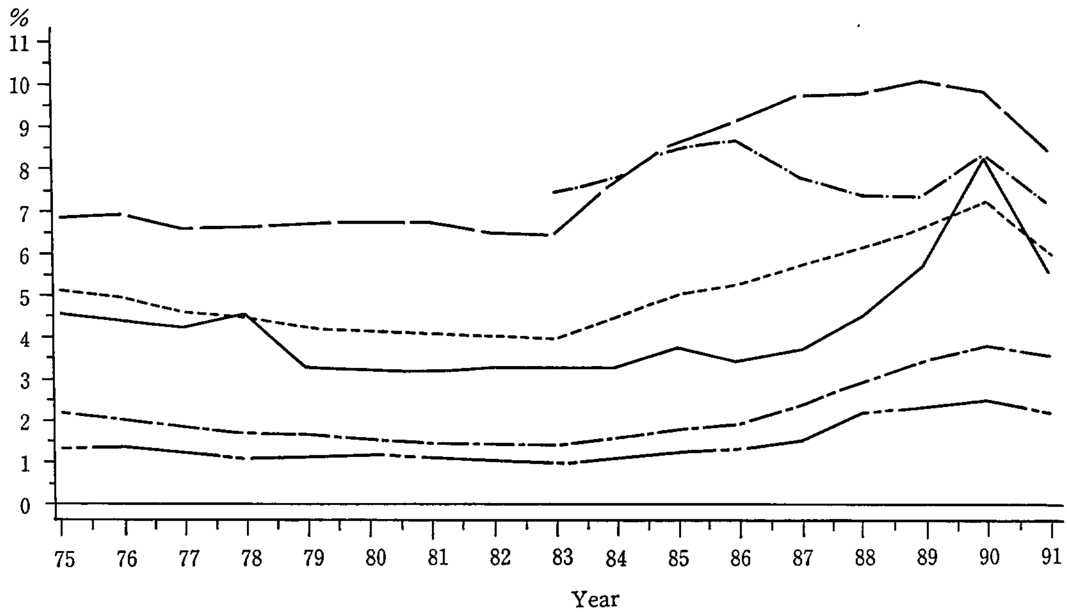


firms. This created a strong incentive for these banks to enter new loan markets as was mentioned in the previous section.

Land prices in Japan have consistently risen after World War II with only two exceptions, the year after the first oil shock in 1975 and as of 1991. Land was widely believed to be the most profitable and safest asset to hold over the long run. As already shown in Fig. 3 in section 1, the rise in land prices was exceptionally high during the 1986–1989 period. The increased value of land, which could be used as collateral, raised the credit worthiness of many borrowers such as small and medium sized firms, individuals, the real estate industry, and non-bank financial institutions which in turn made further loans to the real estate industry and expanded residential mortgage loans. This is the basic reason why all classes of banks could have expanded their relative exposure to the loan markets mentioned in the previous section.

With severe competition in the loan markets in the late 1980s, the collateralization principle designed to minimize credit risks worked perversely to encourage an attitude among lenders to make loans whenever there was sufficient land available to serve as a collateral; a policy based on the so-called "Myth of land"—a belief that land prices never fall. Until the early 1980s, it was standard practice for banks to lend only 60 to 70% of the market price of the land serving as collateral. In the late 1980s, however, when most people believed that further rises in land prices were inevitable, it became a common practice for lenders to make loans equal to 100% of the market price of the land. This was apparently a very risky way to make a loan. Since accurate appraisals of market prices for real estate are hard to come before a transaction is actually completed, especially when prices are rising rapidly. Nevertheless, competition among lenders forced most lenders to follow

FIG. 15. PROPORTION OF LOAN PORTFOLIO SECURED BY STOCKS & BONDS IN THE TOTAL SECURED LOANS



the same procedure in making loans.[1] Since land serves as such an important source of collateral for loans and is deeply embedded in the bank loan market as an anchor of financial market stability, the sharp unexpected fall in land prices in the early 1990s naturally has resulted in major damage to the financial system. This is certainly the most important factor threatening Japan's current financial system.

The stock price plunge naturally caused serious problems to securities companies and firms that were active in stock market trading in the late 1980s. However, compared with the damage caused by the fall in land prices, however, the damage caused by the fall in stock prices has less serious implications for the financial system as a whole, given the smaller role stocks play as a source of collateral compared to land (as shown in Fig. 15). Nevertheless, a stock price plunge could seriously affect the financial system through two routes, i.e., first, a large scale failure of securities companies, and second, its effect on the Japanese bank's ability to meet the BIS mandated equity capital requirement, a topic which will be discussed later.

IV. *Troubles Following the Burst of the Bubble*

In 1989, the Bank of Japan started to pursue a restrictive monetary policy, forced partly

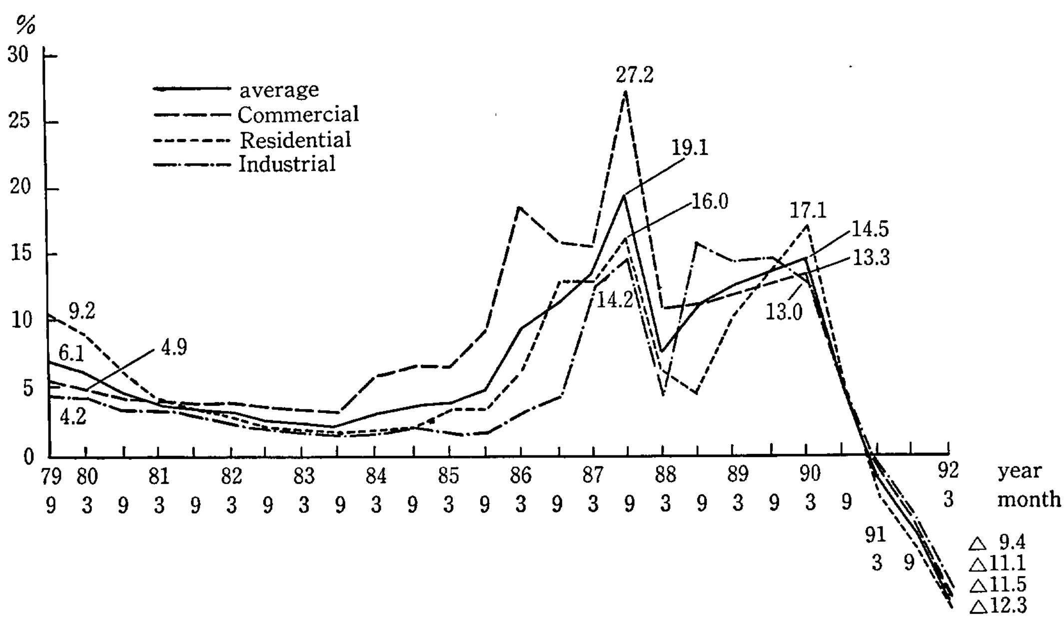
[1] A similar phenomenon was observed in the U.S. when Savings & Loans were allowed to compete against commercial banks.

by a social criticism over the rapid rise in land prices that destroyed people's hope to purchase their own houses. The monetary authorities raised the discount rate five times from 2.5% to 6% within about one year (Fig. 1) and imposed a restraint on loans related to real estate transactions. A new tax law for large scale land holding was legislated, intended to discourage land holdings held for speculative purposes. As a result, the annualized money (M2+CD) growth rate dropped to 2.1% by October 1991. Stock prices started to plunge as of the beginning of 1990. As shown in Fig. 1, they have continued on a downward trend at least through the middle of August 1992 (when this paper was written). The Nikkei Stock Average Index fell 57% from its high value of 38,915.87 yen on 12/28/89 to 16,572.46 on 4/22/92 (Fig. 2), and further to a low of 14,822.56 yen on 8/11/92 by 62%.

Land prices also stopped rising and soon started to fall in 1990 (Fig. 16). The actual situation in the real estate markets seems to be much worse than is shown in the land price statistics. The number of real estate transactions has dropped drastically due to a lack of buyers. Thus, there is so much real estate that cannot be liquidated even at largely reduced prices. As a consequence, huge loan amounts made to the real estate industry and collateralized with land, are currently locked in for both borrowers and lenders.

Among the numerous problems occurring since the asset market plunge, is the largest single default by a woman, Nui Onoue, who was a owner of a restaurant and was a very active trader in the stock market in the late 1980s. She went bankrupt with a debt of 430 billion yen. The most important lender to her was the largest long-term bank, Industrial Bank of Japan, which traditionally made loans only to large firms and had the highest reputa-

FIG. 16. PERCENTAGE CHANGES OVER 6 MONTHS IN LAND PRICE INDICES OF 6 LARGEST CITIES



Source: Land Price Indices of Urban Districts, The Japan Real Estate Institute.

tion in the banking industry. When it was revealed, the fact itself that this bank had made such a large loan to a single individual was a big surprise for all people who knew the history of loan policy of this bank. The deep involvement of the bank in this case symbolizes the policy shift of long-term credit banks to enter into the new area of individual loans seeking higher returns. Because of the high credibility of that bank in examining credit worthiness of borrowers, many other financial institutions also extended huge amounts of loans to her. She was able to borrow huge amount of money from the bank because she offered an equal amount of debentures issued by the bank as a collateral, in which case there seems to be no risk for the bank. Actually, she was the biggest single buyer of debentures issued by that bank. Her close relationship with the bank and the large amount of loans made by that bank were regarded by other lenders as a very reliable sign of her credit worthiness. Other lenders rushed to her to give loans in the late 1980s when stock prices were continuously rising.

Because of the collateralization principle of Japan's financial system, it is easy to borrow money if only one has very safe collateral. She also borrowed money from many other smaller banks, credit unions, and non-bank financial institutions, offering fake certificates of deposit at a credit bank, Tohyo Shinyo Kinko, as a collateral. This was accomplished with the help of bank employees who allowed her to deposit a large amount of money at that credit bank and cancelled the deposit within the same day after a certificate of deposits was issued. Even though the certificates were created based on a imaginary deposits, it was officially issued by the credit bank using a genuine deed. The certificates which should have been cancelled were kept by a collaborating employee of the bank and presented to many non-bank financial institutions as collateral for the loans to the woman. The motive for this operation appears to be obtaining short time bridge financing, where the woman expected that stock prices would rise further or start rising again after the plunge. But they kept falling. Eventually, the amount of loans based on fake certificate of deposit issued by the credit bank amounted 252 billion yen. Therefore, loans made by other financial institutions based on the fake certificate also amounted to the same amount. After the scandal became clear, all the affected financial institutions asked Tohyo Shinyo Kinko to repay the defaulted loans made to the woman which were collateralized by the bank's certificates of deposit. Since the amount of fake certificates issued by that credit bank was larger than the amount of total deposits at the bank, it faced a most serious difficulty. In terms of the amount of bad loans, Tohyo Shinyo Kinko rather than Industrial Bank of Japan suffered the largest losses.

Loans associated with real estates and residential mortgage loans have suffered even more serious damage from the land price plunge. There were many large scale bankruptcies in real estate industry. There are still many real estate companies that could be declared bankrupt depending on the decision of banks. Naturally, the situation is most serious for the relatively new real estate companies that grew rapidly during the 1980s. Every financial institution has suffered more or less from the land price plunge. Especially, financial institutions that were most aggressive in expanding loans into new loan market. In the late 1980s, those aggressive banks earned larger profits and were regarded as the ideal model of banks in unregulated markets. Those banks that were regarded as timid and conservative at that time have suffered the least damage. The long-term credit banks, trust banks, and some city banks that were most aggressive in expanding to new loan markets have experienced larger amount of bad loans and non-performing loans. The higher the exposure of the bank to the real estates industry and non-bank financial institutions, the higher the amount of bad loans and write-offs. Non-bank financial institutions that have a high percentage of loans to real estate industry are in the most serious situation. The burden of these non-bank financial institution's bad loans in turn have to be borne by the banks that have made large loans to them.

There are various estimates of the amount of non-performing loans and bad loans held by Japanese banks. On April 23, 1992, the Ministry of Finance of Japan disclosed that the total amount of non-performing loans of long-term credit banks, trust banks, and city banks totaled 7 to 8 trillion yen, including bad loans of 2 to 3 trillion yen that eventually may have to be written-off. These figures represent 2.2% and 0.8% of the total loans of these banks which equal 357 trillion yen (as of Sep. 1991). According to the announcement, bad loans of the magnitude of less than 1% would not be considered a major problem for the financial system. This disclosure was intended to stress the soundness of the financial system by contradicting several higher estimates of non performing and bad loans.

A loan is defined as non-performing if the interest payment has been stopped more than 6 months. If a bank chooses to supply additional loans equal to the amount of the interest payment, the loan is still classified as a sound loan. Thus, there is some justification for more pessimistic estimates of the loan loss problem. According to a leading financial journal (*Kinyuh Business*, May 1992), the total non-performing loans of all banks and credit banks including those of affiliated non-bank financial institutions amounts to 29 trillion yen which is 5.5% of total loans outstanding. The respective amount estimated is 11 trillion yen for city banks (4.0%), 5 trillion yen for long-term credit banks (9.1%), 5 trillion yen for trust banks (15%), 4 trillion yen for regional banks (3.3%), 3 trillion yen for member banks of the second association of regional banks (6.1%), and 1 trillion yen for credit banks. Even more pessimistic estimates might be justified given limited disclosures made by the banks. Accurate figures are simply not available. Also it is easy for these estimates to change depending on the future movements of land and stock prices. Yet, it is clear that the magnitude of the losses that the banks suffered in the early 1990s are the largest they have experienced since the end of World War II.

V. *Reactions of Monetary Authority*

The case of the loans associated with fake certificates of deposit posed the most serious problem for the stability of the financial system. But, the problem of how to avoid a possible turmoil in the financial markets took a long time to settle, since many complex and conflicting interests and legally obscure factors were involved. For example, Tohyo Shinyo Kinko which issued the fake certificates of deposits has a responsibility for issuing a genuine certificate which a third party cannot identify as fake due to a poor internal management. At the same time, financial institutions that accepted the fake certificates of such a large amount as collateral were also responsible for not confirming the credibility of the certificates. Moreover, they are responsible for an "easy loan" policy to make loans with deposits at other banks as a collateral. The problem of how to share the loss has been under harsh scrutiny and negotiations among the involved institutions.

Finally, The regulatory authority has decided that Tohyo Shinyo Kinko was to be merged partly into Sanwa Bank, a large city bank in the same area that has a traditionally close relationship with Tohyo Shinyo Kino, and partly by 22 other credit banks in the same area after splitting that credit bank. Other large creditor banks, Industrial Bank of Japan and Fuji Bank have written-off 70% and non-bank financial institutions 42% of their loans. These write-offs were allowed to be tax exempt. Industrial Bank of Japan have extended financial supports to Sanwa Bank in the form of a low interest rate loan amounted to 100 billion yen for ten years. As a second case of the support and as a first case of direct gift of money, deposit insurance system has also given Sanwa Bank a financial aid equal to 20 billion yen.

This is a new method of helping a troubled bank arranged by the monetary authority in order to avoid financial market turmoil. This decision implies that even a large city bank cannot afford to help troubled smaller financial institutions without the support of many other institutions involved. This case symbolizes a model of reorganization in the financial market that the Japanese regulatory authority appear to find attractive. If it becomes necessary to deal with a large bank insolvency in the future, the outcome is likely to follow this model.

Given the history of no bank failure, and the insufficient funds and managerial capacity of the deposit insurance system to refund deposits directly to depositors, this approach could be regarded as a practical way to avoid a possible financial market termoil. However, it could cause a problem of moral hazard on the part of financial institutions and the cost have to be borne eventually by taxpayers. As the financial deregulation proceeds, the policy of "no bank failure" would have to be changed sometime in the future. This will be a very difficult decision for the government to make and the problem of how to shift to the new regime of handling troubled banks will continue to be the most serious concern for the financial authority.

VI. *Stability of the Japanese Financial System*

The losses from bad loans are certainly at a record high and are especially serious for financial instituitons that have higher exposure to the real estate sector and non-bank financial institutions. However, the estimated size of the bad loans that need to be written off is still well within the range that large banks can cover by selling their hidden assets of stocks accumulated over many years. Japanese banks can hold individual corporate stock portions representing up to 5% of the total shares of the corporation. All banks hold large amounts of stocks obtained many years ago and the book values of these stock holdings are very low even compared with current market prices. Thus, these stock holding represent a very important hidden asset for Japanese banks that reaches about 24.6 trillion yen for city banks and long-term credit banks combined as of the end of September 1991. Increasing non-performing loans and write-offs will surely reduce the bank's profitability considerably. However, given the large amount of hidden assets, there are no immediate risk to the stability of the overall financial system.

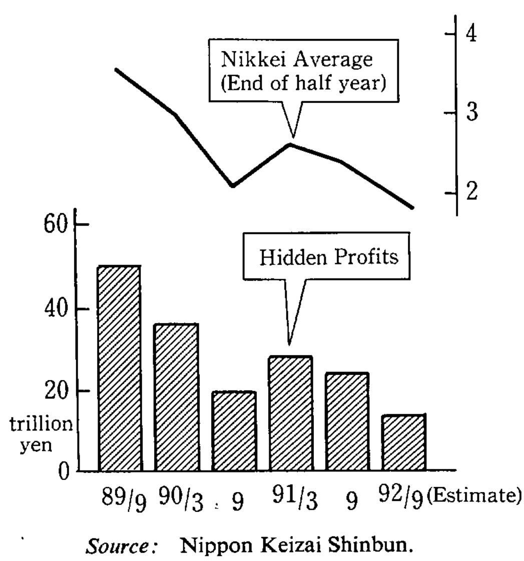
Some small banks that belong to the second association of regional banks and some credit banks are vulnerable to having larger write-offs than hidden assets. Even with these troubled banks, there seems to be no immediate effect to the overall financial system itself.

Traditionally, the Japanese government has pursued the policy of not allowing any bank to go bankrupt. There is no history of any bank failures since the end of World War II. When there were troubled banks, the monetary authority arranged mergers with larger banks to help them. In 1991, a troubled mutual savings bank, Tohho Sogo Bank, was merged into a larger regional bank, Iyo Bank, which is located in the same area with the financial support of the deposit insurance system in the form of a low interest rate loan. Again, for the case of Tohyo Shinyo Kinko whcih was mentioned in the above section, the similar approach was taken. These are very clear messages from the monetary authority to declare the determined policy of ensuring the stability in the financial markets. Because of this firm commitment of the government to protect the country's financial market stability and a belief of depositors in this consistent policy, it is unlikely that the stability of the financial system would be affected.

The method of preventing financial market turmoil through mergers of troubled financial institution into larger banks, in turn, highlights the importance of the stock prices for the stability of the financial system. The average book value of stocks held by city banks and long-term credit banks altogether (14 banks) is estimated to be worth 50% of its value as of the end of September 1991. As of the end of March 1992, market value of the stocks held is estimated to have fallen to 80% of September 1991 market value. Therefore, the hidden profits of bank's stock holdings are estimated to have fallen by 43%, from 24.6 trillion yen (end of Sep. 1991) to 14.1 trillion yen (end of Mar. 1992), twice as much as the fall in stock prices, as shown in Fig. 17. This highlights that a bank's hidden profits are very susceptible to stock price fluctuations.

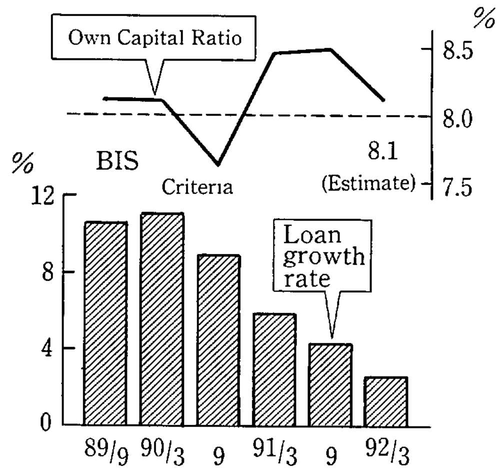
The stock price plunge posed a more serious problem to the Japanese banking system due to the BIS's mandated bank equity capital requirements. Since 45% of hidden profits

FIG. 17. NIKKEI AVERAGE AND HIDDEN PROFITS OF CITY BANKS AND LONG-TERM BANKS (14 Banks)



Source: Nippon Keizai Shinbun.

Fig. 18. OWN CAPITAL RATIO AND LOAN GROWTH RATE OF CITY BANKS AND LONG-TERM CREDIT BANKS (14 Banks)



Source: Nippon Keizai Shinbun.

of stock holdings are calculated as bank capital. the BIS ratio for Japanese banks is very susceptible to stock price fluctuations too. Fig. 18 shows the movement of the BIS ratio and the growth rate of loans outstanding for city banks and long-term credit banks combined. As of the end of September 1991, the simple average BIS ratios were 8.57 for city banks, 8.32 for long-term credit banks, and 10.28 for trust banks. The BIS ratio of city banks and long-term credit banks combined was 9.51 at the end of 1991. With reasonable assumptions of 1% increase of risk assets and an increase in bank subordinate debt (which is also treated as equity capital) of more than 1.2 trillion yen during the half year, the BIS ratio is estimated to fall to 8.1% at the end of March 1992. The minimum level of Nikkei Stock Average Index that is necessary for the banks to meet the 8% criteria with a maximum increase in bank subordinate debt is estimated to be 16,200 yen, which is exactly the range of the index level in June 1992. On August 11, the Nikkei Index fell to the year's lowest level of 14,822.56 yen.

If stock prices remained at a low level or fall further, it will be necessary for banks to reduce the growth rate of loans. The declining growth rate of loans in 1990s observed up to now primarily reflects a declined demand for loans.[2] Due to the low level of demand, it is expected that the BIS criteria can be attained during fiscal year 1992 even without reducing the loan growth rate, provided that the growth rate of loans remains around the same level as in the last fiscal year. Depending on the stock prices, however, it is still possible that banks will not be able to meet the increased loan demand and may even have to reduce the amount of outstanding loans. If this should happen, it would have an adverse effect on the current economic recovery, the future growth of the Japanese economy, and the world economy as well.

[2] An exceptions to this are real estate and stock loans which have been purposely reduced by most banks.

VII. *Financial Market Reform*

Many financial scandals have been uncovered in the stock market since the burst of the speculative bubble. Cases relating to compensation to large customers for losses sustained can be traced to regulated brokerage commission rates. In addition, unfair and unethical aspects of stock market trading have been uncovered. In fact, many other stock market scandals have their roots in the inefficient and distorting effects of old and outmoded regulations. Since the supply of equities were excessive in the late 1980s, it seems to take some time for the market balance to recover. In order to regain investors trust, several reforms of the market should be made, including the deregulation of brokerage commission. Recently, the Japanese government indirectly tried to boost stock prices, but each time the market reacted negatively. Pushing the deregulation of securities business would be the fastest way to strengthen the stock market.

All securities companies are now in very severe financial condition and most of them are running large deficits. Small and medium sized securities companies that do not have enough assets may not be able to wait until the market conditions improve. Restructuring of this business through M&A transactions is highly probable. According to the plan of new legislation for the financial market reform, banks can enter the securities business through a 100% owned newly established securities subsidiaries. But, the newly established subsidiaries are not allowed to engage in brokerage business for the time being. When the subsidiaries will be allowed to engage in the full range of business is currently left uncertain.

At least for the time being, however, the securities business has become an unprofitable business for banks to enter, given the huge cost of establishing new subsidiaries. Taking all these conditions into account, it is not surprising that the monetary authority has decided to allow banks to enter securities business through the merger or acquisition of troubled securities companies. In this case, banks should be able to start brokerage business immediately and the set up costs are substantially lower. This approach may well contradict the original idea of financial market reform and accordingly involves many subtle problems. Even though this idea is not discussed officially, it seems to be a likely scenario in the process of financial market reform.

In any case, the capacity of banks to help troubled securities companies is an important factor for avoiding a stock market turmoil. Then, the stock prices again become key elements in determining the bank's capacity to help troubled securities companies.

VIII. *Soundness and Competitiveness of Japan's Financial System*

Though the amount of bad loans that financial institutions have are not small, all of these institutions have learned valuable lessons that can help them to prepare for the days of complete deregulation and they are making efforts to reorganize their business practices. Under the regulated regime, all banks behaved as others do. The monetary authority guided them to behave in that manner. Scandals related to illegal and unethical behavior of employees are due mainly to the excessive competition caused by management policies to behave like others. It was difficult for a bank to stay out of the circle alone when all other banks were enjoying the fruits of high profits. It caused extremely severe competition among financial institutions that encouraged turning a blind eye toward unethical and illegal activities. They had forgotten the true baseline of financial institutions as organizations with a special social responsibility.

In the new regime of deregulation, financial institutions are required to behave independently, bearing responsibility for their own actions. Recent troubles in the Japanese financial system can be regarded as examples of a moral hazard problem caused by the old regime of bank protection. This occasion is a good chance to push deregulation further. The best remedy to the recent trouble is to establish the principle of individual bank responsibility in the financial system through less government intervention and more public disclosures.

After the recent troubles, the government's research committee on financial system issued a report recommending six measures for securing stability and trust in the financial system: 1) Reinforcing internal management system of financial institutions, 2) Further disclosure, 3) Raising more bank equity capital. 4) Strengthening the monitoring function of the monetary authority, 5) Appropriate use of deposit insurance system, 6) Need to increase the soundness of non-bank financial institutions. Financial institutions are required to recognize their public responsibility and to regain people's trust in the financial system. In order to promote fair and orderly competition in financial and capital markets, the government is also required to legislate new laws for financial system reform.

The Japanese industrial economy still remains strong in early 1990s and its major problems are confined to financial and real estate sectors. Many firms in other sectors made large scale real investments for the future with low costs of funds raised in the late 1980s. This is a positive aspect of the late 1980s that may facilitate a further growth of the real economy. These robust fundamentals of the economy are the essential reason why there is little fundamental risk in the stability of the Japanese financial system.

Certainly, for the time being until the problems of bad loans are resolved, Japanese banks might have to endure a period of lower profits due to non-performing loans and write-offs, but this does not directly affect the basic soundness of Japanese financial system. Although Japanese banks may not be able to expand their loans as rapidly as they did in the 1980s, it does not necessarily affect the competitiveness of Japanese financial system. In the past, there have been several similar experiences in the United States where many banks sustain significant losses due to exposure to real estate and overseas sectors. However, these cases did not necessarily lead to a loss of international competitiveness for the U.S. financial system.

Economic fluctuations are inevitable. The future of the international competitiveness of the Japanese financial system depends on whether it can learn from this troubled time and step forward to develop a new financial system in which financial institutions compete with each other under the principle of self-responsibility while serving the public needs and contributing to the further development and the increasing efficiency of the economy.

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