

Legal Aspects of the Japanese Corporate System

and its Financial Institutions

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Introduction

In '80, Japan was an economic superpower . Many countries admired and emulated

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the Japanese company system. At the same time ,many Japanese Financial Institutions such as banks ,securities companies², and insurance companies ranked among the world's biggest Financial Institutions .

But now we are in a long recession and as Japanese economic power decreases, no other countries even pay attention to Japan. The '80 were only ten years ago. What made Japan change ? Why are the Japanese economy and Japanese company system now so weak ?

It is said in some cases that an existing system will already have become old-fashioned , 50 years after it has been established. This can be shown when one considers the many distortions of the Japanese system, for example : scandals concerning company directors and illegal lobbyists³, or the credit risk of the whole Japanese Financial system.

In this paper, I will discuss the questions⁴ mentioned above, focusing on the Japanese Corporation system and Financial Institutions. I will try to explain the facts objectively, and answer those questions according to my opinion.

I、 The Japanese Corporate System and Corporate Governance

1, Legal Feature of the Japanese Corporation

Japanese Corporations find their legal basis in *the Law of Commerce* ⁵.There are

² In Japan, Securities Company deals with bonds and stocks of the companies. But they are prohibited to deal with deposit ,loan ,and to transfer money by Law.

³ They are called "Sohkaiya" in Japanese. Some of them have connections with the Japanese Mafia. Company directors took advantage them in order to hide some information in the shareholders meeting.

⁴ What made Japan change ? Why do the Japanese economy and Japanese company system become so weak ?

⁵ It is called as "*Shoho*" in Japanese and prescribes 3 kinds of corporation. Article52 to 500 is

four kinds of corporations: Kabusikikaisha(the joint stock company), Yugenkaisha(the limited liability company) ,Gomeikaisha(the limited partnership), and Goshikaisha (the unlimited partnership). All corporations except a limited liability company are based on commercial law ,but a limited liability company is based on *The Act of limited company*⁶. The joint stock company is the most important type of business organization, and there are more than 1 million joint stock companies⁷ in Japan. But less than 3000 companies⁸ offer their shares to the public.

In order to establish a company, promoters must collect at least ten-million yen⁹as capital. The issued shares have to be accepted or underwritten. A promoter or promoters must settle *Teikan*(the Articles of Association) at first. The Articles of Association comprises the constitution of the company later on. The Articles contain the name of the company, address of the company, and kind of business that is managed by the company etc. Then a promoter or promoters go to the registration office and register a company. After that , legally that union can be a company or legal person ,so that the company itself may possess real estate or property in its name. At the same time ,promoters have to organize the first shareholders' meeting ,then in many cases, the promoters become the directors by election of shareholders .

In Japanese companies, the shareholders' meeting is the highest organization. It is like Congress or Parliament in the country. Shareholders gather and hold the meeting,

called *corporate law* in Japan . In some other parts, it prescribes insurance and merchants. I will use the term *corporate law* as Shoho in this paper from now on.

⁶ *the Act of limited responsibility company* is called as *Yugenkaishaho*.

⁷ In this paper after this, I will use "*company*" as a joint stock company.

⁸Cf. Masao Kishida "Kaishahounyumon"(nikkei-shinbun press, 1994)p23. ff.

and check the most important and basic things in the company. Shareholders meetings can select a member of the board directors, approve the settlement of account, and even fire directors and auditors in the middle of their term ,if a quorum of more than half of the share attends the meeting ,and two-thirds of share approves¹⁰. Usually, private companies are managed by shareholders who are also directors of the company. But in public companies¹¹, shareholders do not understand the management of the company in detail, so the principal of separation between management and possession works. In short , there are two kinds of companies in Japan: public companies and private companies.

Japanese companies must have a quorum of at least three directors in order to organize a meeting of the directors , or board of directors. Directors meetings select a representative of the directors or CEO. Directors meetings deal with important business transactions such as issuing more shares to get more capital ,and the other financing matters. Some companies have more than 60 directors as members of directors meeting. In this kind of case, they have an additional board of directors¹² . A representative Director has very wide and great power in the company. A representative Director can deal with almost every kind of daily job . A representative Director can represent a company ,when the company does business or undertakes legal action . Japanese CEOs¹³ deal with daily business. The CEO has very strong power in the company, although a representative of directors or CEO has to obey the

⁹ About ten thousand US dollars.

¹⁰ sec.257paragraph 1 ,corporate law

¹¹"public company" means that the company whose shares are open to the public.

¹² This board is called "Jomukai"(supreme business committee).Corporate law doesn't mention about it.

decision of the directors' meeting.

Auditors audit company accounts. In the *big company*¹⁴, at least three auditors are needed in order to establish Kansayakukai (an auditors meeting). But in this case, each auditor still has the right to represent the company. In *the big and middle company*, an auditor can audit not only accounts, but also business transactions decided by the directors meeting. But in the small company, an auditor can only audit accounts. According to corporate law, auditors have a very strong power which is the same as directors, or even stronger. Big companies, in order to audit correctly, are required to ask CPA's to audit their accounts.

In this way, Japanese company have some important organizations to control the company. Those organizations exist to check and balance each other.

2, Mutual Holding of Corporate Stocks and Corporate Governance

After the burst of the *bubble economy*¹⁵, a lot of scandals concerning companies have been happening. One of the reasons for this is that the limit of contemporary social and corporate system, which was built in 1940', has appeared in many situations. The contemporary system was established during World War II¹⁶. So in this paper, I want

¹³ Japanese CEO is called "Shacho" or "Kaicho".

¹⁴ According to the corporate law, Japanese companies are divided into three kinds of companies. The *big company* is a company which has more than 500 million yen as a capital or more than 20 billion total debt. The *small company* is a company which has less than 100 million yen as a capital and less than 20 billion total debt. The *middle company* is a company which belongs neither the big company nor the small company.

¹⁵ In Japan, the late 80's is called Bubble economy era. The Japanese Stock Market was overheated. Many people invested their money in Stock market and bought very luxurious goods etc. Japanese financial institutions were among top ten in the world. Cf. II.3. in this paper.

¹⁶ Cf. Yukio Noguchi "Saraba 1940 taisei" (Good Bye 1940 System) (Toyo Keizai Shinpou, 1995) ISBN 4492392041 p.4. ff. In this paper, I will mention about ISBN of the Japanese book in order to search easier.

to focus on the question what the Japanese company is. In order to consider this problem, we must try to argue about *Kabushikimotiai*(Mutual Holding of Corporate Stocks) and Corporate Governance .

In Japan ,till 1998, holding companies were prohibited by sec 9 of Japanese Anti-Trust Law. So Japanese companies invented another way has the same functions as holding companies. After Japan became a member of the OECD in 1964, Japanese companies had to open their shares to the foreign public. Many managers of the companies were afraid that their companies would be taken over or managers would be kicked out. After a short while, many companies purchased large mutual shares ,and became groups . As a result, many company shares were held by very stable share holders mutually: in other words whole industries were owned substantially by the companies which ran them but mutually and not directly .

By the way, at that time share prices were very cheap, the shares were valued very cheaply in the balance sheet. In Japan they do not have to book assets contemporary value. So according to the Balance Sheet, very expensive shares appear to be very cheap. Companies could took advantage of this. These types of assets are called *hidden assets*. At the bubble era, share price were very high. So companies could use this hidden asset value to attract financing from the Financial Institutions. But it helped a lot to promote bubble economy. This was one of the secrets of economic power which Japanese companies once had.

One of the bad effects of mutual share holding is that shareholders meetings become merely ceremonies. According to the corporate law , shareholders meetings should be a supreme organization in the company. But , because of mutual holdings,

shareholders meetings exist only to follow directors' decisions. One company doesn't harm an other company's business. It is considered that the shorter shareholders meeting lasts, the better company people judge. As a result, decision making should be held at directors meeting.

But in Japan many people ,even now, continue to work in the same company which the person got position after graduation from school. And this is considered to be a good tendency widely. So the position of a director is a ideal goal for every employee. This system is the origin of Japanese big company and employees' loyalty toward the company. Even if the employee can't be a director, still company guarantees the lifetime employment¹⁷. They say that *lifetime employment* , *individual labor union*, and *raising salary every year* are the three biggest secrets. This is the Japanese management that was admired ten years ago throughout the world. But they are criticized after bubble economy crashed.

Among the board of directors, a representative of directors or CEO is the oldest and the earliest to become an employee. The other directors are behind him. At the same time, a representative of directors or CEO has his coalition in the board . So he can control the board of directors. Because every other directors are usually his junior in the company. As I mentioned before, the shareholders meeting is just a ceremony, so if the company suggests some proceeding, everything will be approved. Because big companies' shares are held mutually, almost all the share will approve the company's decision. This is how a representative of directors or CEO can control or dictate to the

¹⁷ if an employee continued to work in one company 25years , he could get company pension besides public pension. In this way a retired business man(called *salary man* in Japanese)can lead a better life than non-business man.

company¹⁸. Usually, CEO's successor is chosen by current CEO's own decision in Japan.

I will give you an example of how Japanese companies are different from others. There is a labor union in Japan. In many big companies, union shop system is chosen. So every one becomes a union member . In Japan, to be a leader of the union is the one of the quickest way to be directors . Many directors are chosen from union leaders. There have been not so many severe labor dispute in Japan after world War II. In Japan labor unions work for the company, but in other countries they work against the company. By this example you can understand that the Japanese companies are an unity.

According to company law, directors meetings should decide the business matters. But a representative of directors or CEO can control the company , not directors meeting or shareholders meeting. Mutual holding of shares allows this situation to happen. In this way, companies are managed by one president alone in Japan.

Of course, auditors can check business judgements and book keeping. And they are given very strong power. But usually, auditors were once directors of the company or employees who did not have the opportunity to be directors of the company. They are juniors of the company presidents or CEO. They believe that the best way to manage the company is to obey the company or CEO's decision. If they don't follow the CEO's decision, they might be kicked out of the company in the next share holders meeting.

In this way, many Japanese companies are controlled by a president or CEO, not

¹⁸ Cf. Yasuhiro Kojima "Kaishahoukaiseisagyonokakushin(The point of revision of the corporate law)" 'Hogakuseminaru:ISSN 0439-3235' Dec.1997 p.44-46.

shareholders ,or board of directors, or auditors.

3,Shareholders Lawsuits and Bribes concerning the Exercise of Shareholder Rights

In Japan, as I mentioned before, the shareholders meeting is only a ceremony in many cases. Directors of the company hope shareholders meeting ends in peace and quite. They are sometimes too afraid that shareholders meetings will last long . So some Japanese *professional share holders* take advantage of this situation. When they find some important information, but if it not important information ,such as small rumor or even scandals about the director ,it still works, and they threaten company. Although they only have a small amount of shares , they attend shareholders meeting , and pose many questions to obstruct the proceedings. Sometimes the company overreacts and give extortionists money or goods. It is clearly prohibited to give shareholders money and goods relating to the exercise of shareholder rights¹⁹. If somebody breaks the law , that person can be sued ,and might be sent to jail , bribers and bribe takers alike.

Even very famous Japanese companies have been continuing their relationship with special shareholders . Recently these kinds of scandals have been make public. Only one middle aged professional shareholder threatened many famous financial institutions , such as Nomura –Securities ,Nikko-Securities, Daiichi-Kangyou-bank, etc. This relationship remained top secret among executive directors. Some former directors were arrested and were found guilty in 1997.

At the same time , directors who did this kind of crime have to take civil responsibility

too. Sec 266 paragraph 1-2, Corporate Law regulates this. If a director or directors give money or goods to professional shareholders, that director has to compensate the company with that the same amount money. If the director doesn't pay the damage voluntarily, the company can sue this director. In this case, the representative director, who is usually CEO of the company, becomes the plaintiff representing company. But many times, directors don't sue the other directors. Instead auditors will represent the company in such cases, but this doesn't work. Because they are also members of the company. In this way, shareholders ultimately sue the offending director and represent the company.

Formerly this system didn't work well. Because shareholders had to pay some amount of money to sue. According to the former civil procedure act, shareholders had to pay a sum in proportion to how much they ask for compensation. This means that if the company had big losses, and the directors were responsible for it, shareholders would have to pay a lot of money. But in 1993 a radical change occurred. The Civil Procedure Act²⁰ was revised, so that the court fee for a law suit had become ¥8200 in any shareholder representing lawsuit cases. Now the numbers of shareholders lawsuit is increasing rapidly.

This tendency has influenced the Japanese Company System greatly. Especially, among directors this influence is very severe. In many cases, Japanese businessmen worked so hard being loyal to the company, in order to be a director. Sometimes businessmen believe that they have to hide something in order to maintain this

¹⁹ sec.294-2 paragraph 1, corporate law

²⁰ Special Law concerning the fare of Civil Procedure, Sec3

business situation. They thought they worked hard for the company, suddenly they became a defendant in a civil suit where they have never been in their lives.

In some law suits²¹, directors were ordered to pay over 2 billion yen by the court. The problem is that a regular Japanese business man, who becomes director, earns less than 500 million yen²² in his whole life. How could they have paid that much money? In Japan a CEO's income is only 20times more than company freshmen, but in the U.S., 400 times. Directors are considered the professionals of management in the States. But in Japan directors are, people think, almost the same as employees, and the goal of business men, that is how most businessmen think.

Tokyo Mitsubishi bank²³ has more than 60 directors, although corporate law requires only three. It is impossible to make every important business decision by 60 directors who are all over the world. Many big companies have established a supreme management board to make top business judgements. Normal directors board meetings are only ceremonies just like shareholders meetings.

Formerly Sony had over 50 directors, but they lost a lawsuit in the States. They reduced the numbers of directors. They have ten directors now, the others have become *Shikkoyakuin*(executive employee)²⁴. It is also impossible, as I mentioned before, for normal directors to make compensation for damages in law suits, because of the total income level of Japanese business men.

²¹ This case is known as "*Nihondenshikougyou(Japan Electronic Industry) case*". Ruled at Tokyo District Court in 20.6.1996.

²² About 4.5 million US-dollars

²³ The biggest bank in Japan and second largest bank in the world in 1997

²⁴They are called 'a director' in Japanese. But legally they are not member of directors board meeting. They are not registered in the registry book.

These days, several companies have reduced the numbers of directors²⁵. I think this tendency will continue. Directors must be the professionals of management. They should be able to earn more money than now in proportion to their duty. If present directors make a wrong business decision, they must resign or be sued by shareholders.

Company shareholders must pay attention toward dividends which comes from the possessed stocks. If they don't understand the policy of the company, they must attend shareholders meetings and pressure the company which has issued the stocks. In order to work this system in Japan, every open public company should disclose their information. Both individual and institutional investors have to pressure or monitor the company, if they have inefficient securities, investors have to pressure and monitor the company more. To carry out this purpose, I think we must enact more severe corporate law to disclose precisely or be punished, and to give duties for corporate investors including institutional investors, to report their vote.

At the same time, company directors must obey the law and if a bad custom continues, they must change. They must realize that if they do not, they can be sued and have the duty to pay compensation. We have to change this Japanese company system.

4, Public Enterprise and Japanese Corporations

Now Japan is suffering from much debts. There are 253 trillion yen in Government Bonds ²⁶still on the Market. This is equal to 49.2% of Japanese GDP. At the same time,

²⁵ For example, *Nihon Choki Shinyou Bank* (Nihon Long Term Credit Bank) has reduced from 26 to 5. You can find some examples.

²⁶ About 1.20 trillion U.S dollar. Government bond means Japanese Treasury Bond

local governments have issued a lot of bonds, too. Totally, the financial deficit of local and the central government remained 476,3 trillion yen, it is equal to 92.2% of Japanese GDP.

Every year the central government issues 25 trillion yen in government bonds, which is equal to 4.7% of Japanese GDP. In order to be a member of the European Union, a country must not issue government bonds exceeding 3% of its GDP. So Japan could not be a member, but France, Germany and even Italy have cleared this hurdle. Now Japan is in the most dangerous situation in the world and we can't avoid this problem.

If you go to the countryside in Japan far from Tokyo where very famous politician once appeared, you may be surprised by what you see the sight. You will find very big gymnasium in which more than ten thousand people can gather small towns. You will also find wide highways and Bullet train(*Shinkansen*²⁷) many places. Every year in the winter representatives from each town or city come to Tokyo to lobby members of the Diet or government employee of Ministry of Finance to ask them to make more Institutions. After the Nagano Olympic Games was over, Nagano Shinkansen and a lot of deficit remained in Nagano.

Now the Japanese Stock Market has sunk to a low level; especially Financial Institutions and Construction Companies. It is said that there are too many construction companies in Japan. They rely mainly on the governments contracts. And they say that the tender system has been not fair, companies and government employer discussed their bids in advance. Several governors, politicians and businessmen were arrested in 1997.

In Japan, recession has been the most important issue in the Economy. When the economy doesn't go well, every business leader requires a Supplementary Budget to promote public enterprise to the government easily. At the same time, the Bank of Japan was not neutral, and many politicians pressured them to make the Koteibuai (official discount rate) lower.

There are also many corporations or foundations²⁸ which have a special status. Some of their employees are from government offices. They are using very much government money every year, and having lots of deficit to compensate. But still they have their positions and salary and expensive retirements money and pension. Nobody can change this flow of money and system. Many politician tried to change it, but no one succeed. If the Japanese economy had continued to make progress forever, these kinds of problems would never have appeared.

In short, in order to change this system facing an aging society, we have to change by ourselves.

II、 Japanese Financial Institutions

1, Features of Financial Institutions in Japan

The legal feature of Japanese Financial Institutions is, in one phrase, that of a separated business area by each institutional group. We can divide Financial Institutions into banks, securities, life insurance, and damage insurance²⁹. At the

²⁷ Very fast special train, like a TGV in France.

²⁸ They are called *Tokushuhoujin* in Japanese. There are nearly 100 Tokushuhoujin in Japan. And there are nearly one thousand foundations which need permission of the government to establish. Ministries, Toshushuhoujin and foundations form the pyramid of the rights and interests.

²⁹ It is called "Sonpo" in Japanese. It includes fire damage, accident and traffic insurance.

same time , there are very big Financial Institutions in Japan. Those are managed by government. The biggest one is the Post Office³⁰. I will explain the legal features of each financial institutional group as follows.

First of all, I will focus on the separation between bank and securities firms³¹. Securities business contains brokerage, underwriting, selling and dealing ³²of securities such as bonds , stocks, CB, etc. But banks can't deal with this kind of business. Art.65 Sec.1 *Shokentorihikiho*(Securities Regulation Act) prohibits banks to deal with securities business. This law was revised after World War II. The Glass-Steagall Act³³in the U.S. gave big influence upon Japanese Securities Regulation Act. But there is a big difference between the two Acts. There are some exceptions in Japanese Securities Regulation Act, such as brokering Japanese Governmental Bonds and selling by its own account. Furthermore, banks can buy and hold shares of the companies³⁴. Banks deal with corporate bonds whose holders are less than 50 people .If there are more than 50 holders of corporate bonds, this business becomes securities business. If we judged from this situation, it has been often said that Art.65 Sec.1 Securities Regulation Act is a Japanese Glass-Steagall Act, but the purpose of the Japanese Securities Regulation Act is not only to keep banks away from risky securities business like the Glass-Steagall Act, but also to keep banks from securities

³⁰ It has more than 22trillion yen as a deposit. It is 3 times bigger than Tokyo Mitsubishi Bank, which is the biggest bank in Japan.

³¹ In Japan ,securities firms deal with bonds and stocks like in U.S.

³² Art 2 Sec 2 Sentence 8 *Shokentorihikiho*(Securities Regulation Act).This Act regulates securities business.

³³ After Great Depression in 1929, many banks failed. American government enacted new law named after senator Glass and Steagall. It prohibited banks to deal securities business. Because they believed that securities business are risky and banks mustn't do . This law still have effects, but it is considered as a symbol of Anti-Free financial business now.

³⁴ Art 11 of Anti-Trust Act prohibits banks to hold the issued shares more than 5% of whole shares

business in order to encourage securities firms. In this way, Japanese securities companies, such as Nomura, Daiwa or Nikko, had become the biggest in the world before the bubble economy crashed. To be frank, securities firms exist to get fees from customers.

Secondly, Banks deal with an ①ordinary and a fixed deposit, ②money transfer, and ③loan to both individuals and companies. In Japan the direct capital market doesn't work well, so companies rely on banks, that is, indirect finance works better than direct finance. So banks play a big role in business in one side, the cost of corporate finance is higher, and companies can't get risk money which aren't needed to pay back. The business which bank can deal is regulated by *Ginkoho* (Banking Act). The three businesses which I mentioned before are central business of the bank, but banks can deal with other business, such as dealing in governmental bonds, foreign currency exchange, dealing in certain area of derivatives, even renting safety deposit boxes for a fee. Roughly speaking, banks get profit from loan profit minus deposit interest, plus fees.

Among merchant banks, we can sort banks into four groups, City Banks, Regional Banks, Credit Associations, and Credit Cooperatives. The former two kinds of banks are based on the Banking Act. Credit Associations, and Credit Cooperatives are based on Special Acts: the *Shinyoukinkohou* (Credit Associations Act) and the *Shinyokumiaihou* (Credit Cooperative Act). There are no legal and functional distinctions between these banks. But the scale of business is very different. City banks are based on very big cities like Tokyo, or Osaka. They do business with big

which that company has issued.

companies. There are one or two Regional banks in one prefecture, which do business with local companies. Regional banks have some branches outside their own prefecture, but very few. Some regional banks have or had branches overseas as an accessory during bubble era. But they have to suffer a heavy burden to obey harder BIS regulations³⁵. They are trying to withdraw branches overseas now.

Credit Associations are specialized Financial Institutions that service medium and small companies, which are mainly based on the member system. They collect deposits from members and the general public, and provide loans for members. Credit Cooperatives are specialized financial institutions for small companies, and mainly for individual members. They are licensed by the Prefecture, not the *Okurasho*(Ministry of Finance: MOF). Both have the same problem: the number of members are decreasing in recent years.

Thirdly, there is a category of Trust Banks only in Japan, which is permitted to engage in trust business. Trust Banks are considered long term Financial Institutions³⁶, which deal with loan trusts, money trusts, investment trusts, land trusts, and pension trusts. Other major business activities include stock transfer agency services, custodial service for assets etc. Loan trusts and money trusts are almost same as deposit and loan for customers. Land trusts include real estate brokerage, so Trust Banks have been much damaged by bad debts from bubble crash. But many financial institutions, including foreign institutions, pay attention to pension business, because the amount of pension is becoming bigger, as the Japanese

³⁵ If some banks deal with international business, they have to obey 8% of the ratio of owner's equity, but if they deal with only domestic business, 4%.

³⁶ Long term means over one year in financial society, short term less than a year.

society is growing older rapidly, and pension business has been opened to other Financial Institutions.

There are three exceptional banks, called Chokishinyouginko(Long- Term Credit Bank) which can issue bank interest-bearing and discount debenture. They can loan money to big companies such as Toshiba, Hitachi ,and Sony etc on very long term ,sometimes over 10 years. Formerly these kinds of banks were considered high position bank ,but if companies can finance money from the capital market, there is no special reason to exist. Now they have a small number of branches³⁷ , they must find ways to survive after Japanese Big Bang.

Except for banks, there is another Financial Institution to loan money ,called a *Non Bank*. Legally Non Bank is a Financial Institution which loans to both companies and individuals ,but can't collect money by deposit or debenture. They therefore have to borrow money from other Financial Institutions. The outstanding balance of all Financial Institutions' loan in 1996 was about 500 trillion yen in Japan. The outstanding loan balance of City Banks is 220trillion yen ,Regional Banks 140 trillion, Long Term Credit Bank 50 trillion , Non Bank 90 trillion. You can understand how big Non Bank is in Japan. Among Non Banks , there is a variety of Financial Institutions. Non Banks called *Shohishakinyu* (Consumer Loans) work very well these days, so even City Banks shift their main works into individual business.

The Japanese Central Bank is *Nihonginko*(Bank of Japan : BOJ) .It is a joint stock Corporation based on Bank of Japan Act, you can buy the stocks of the BOJ. The BOJ

³⁷ Among this category, Industrial Bank of Japan(IBJ)is the biggest, but it has only 25 branches in Japan, on the other hand, city banks have ten times more branches.

issues Japanese Yen. BOJ can control the official discount rate, and decide monetary policy such as open market operation and reserved account control. Formerly independence of the BOJ was not so strong, so BOJ was interfered by politicians, or the Ministry of Finance which is governing authority of the BOJ. But in 1997 Bank of Japan Act was revised to make it independent.

We must not forget to mention the Post Office among Financial Institutions. The Post Office is the biggest Financial Institution which deals with individual deposits and loans, postal life insurance, and the mail service. Its workers are government employees, and more than half of postal offices are special Post Offices, which are managed by civil managers. Managers of Special Post Office have a very strong political power. The deposits³⁸ which are collected by the Post Office are kept at Ministry of Finance, and invested managing division of Ministry of Finance. They make an investing strategy³⁹, which must be approved by the diet. Most severe critics say that Japanese Banks bad debts are 20%, but it is considered this investment has more than 30% of bad debts. The Institutions which have invested in this fiscal investment and loan program are, in many cases, corporations having special status, public corporations⁴⁰. They can't function, without this money, these kinds of Institutions are bankrupt. We must reform this system to invest and manage our 120 trillion asset better, but Managers of Postal Offices have a very strong political power

³⁸ It is said that Japanese individual have 1200 trillion yen as an asset. Post Office have more than 220 trillion yen as a deposit. Many foreign Financial Institutions eager to participate Japanese market to target individual asset.

³⁹ This way of investing is called Zaiseitouyuusikeikaku(fiscal investment and loan program). It is called second budget, and it is easier to take advantage this money by politicians than make budget.

⁴⁰ For example, *Juutakukinyuukouka*(Special bank for individual housing loan), or *Nihondourokoudan* (Public Road Service).

and can control many politicians.

At the end, we will mention insurance companies, which are divided into two categories. Those are *Seimeihoken* (life insurance) and *Songaihoken* (casualty, marine and fire insurance). Their business area had been divided by *Hokengyohou* (Insurance Act) and Commercial Law. At the same time, they are big and important Institutional Investors. They are expected to play the role of investigator of public companies, because they know how to investigate. They, especially life insurance companies, are buying many U.S. Treasury Bills. Without them, the U.S. Government would have difficulty making a Budget. When we talk about casualty, marine and fire insurance, we must remember that they play an important role in traffic accidents, which kill more than 10,000 people every year. Compensation for traffic accidents is a very important problem in Japan too. As Japanese Big Bang goes, separations between life insurance and casualty, marine and fire insurance, or insurance companies and other Financial Institutions is lower.

2, The Administration of Financial Market by the Ministry of Finance after World War II

Now we understand that the Japanese Financial System has been maintained by a kind of sectionalism of Financial Institutions. The separation system between ①banks and securities companies, ②long-term and short-term Banks, ③life and casualty, marine and fire insurance has worked well in order to finance especially important industries.

At the same time, after World War II, we had a special law to decide deposit and

loan rates of all banks. It meant that there was no competition among Financial Institutions. This means banks did not have to make an effort to make profit ignoring depositors profit, if they could get deposit, so they can find company to loan easily till the 80's. But that law was abolished, there is such severe competition between Financial Institutions that they might become bankrupt.

The administration by the MOF made this system possible. All Financial Institutions are licensed by the MOF. The administration of the MOF is called *Gososendan System* (Flagship protection system) which aims to keep pace of all Financial Institutions business according to the weakest Financial Institutions, to avoid competition so that every Financial Institution can maintain its business. Almost no bankruptcies of Financial Institutions had happened before the bubble economy burst.

Regulation of deposit and loan interest and separation of business areas are two important regulations based on the Banking Act and other written laws, but when something happened, *Tsuutatsu*(Official Notice by MOF division chief)and *Gyoseishidou*(administrative guidance) were offered by MOF. All banks and securities, insurance companies obeyed every guidance voluntarily. This attitude is called and criticized *Yokonarab*(exact same business actions done by all Financial Institutions). Some guidances were oral and unwritten, and not open, so foreign Financial Institutions don't understand this rule, for them Japanese Market and administration seemed very unclear and unfair.

The officers of MOF⁴¹ aren't specified in financing, they are also working on preparing national budget and tax problems. One Major interest of MOF officers is preparing the budget, so they don't know detailed financial business. They need to know this information in order to administer Financial Institutions, while at the same time Financial Institutions need MOF information, such as the date of investigating or permission to create new Financial goods. Financial Institutions establish special divisions to work only with MOF officers called MOF-tan (MOF co-working section). They go to MOF every day and try to get information , on the other hand, MOF officers can get information about real business. Sometimes Financial Institutions' MOF co-working sections entertain MOF officers to parties or golf to get a closer relationship. This is very important for the Financial Institutions, so the MOF co-working section in Financial Institutions is considered very important and where most able workers were collected. Many directors of Financial Institutions are from MOF co-working section. But this relationship can't be maintained in the coming Big Bang. In March of 1998, some MOF officers were arrested for bribery , and several MOF officers resigned on allegations of bribery being made.

For directors in Financial Institutions in Japan, the most important way to manage banks has been to know the MOF's decision, so they didn't have to make their own business decisions. But from now they have to make their own business decisions as other companies. If they failed to manage , the Shareholders Lawsuits

⁴¹ In Japan, to graduate from Law faculty of Tokyo University , to pass in a very difficult exam to be government employee, and to work in MOF is considered to be one of the best job. After becoming officers of MOF, severe survival competition goes on till one of the same generation members becomes an administrative vice minister. After retirement of MOF, all members who passed the most difficult exam can get a good job in Financial Institutions, and get good salary.

would be waiting.

3, Bursting of the Bubble Economy and background of Crime in the Financial Markets

As the President of U.S. R.Reagan's economic policy, called *Reaganomix*, caused a lot of trade and budget Deficit , so they have had to change their policy in order to improve this situation . They were trying to make the U.S Dollar cheaper to promote U.S. exports . The Secretary of U. S.,James Baker held the G5 meeting at the Plaza Hotel in New York in 1985. They decided to intervene in the Foreign Exchange Market. One U.S dollar cost 240yen in 1985, became 160yen in 1986, 79 yen in 1995. Generally speaking, Japanese economy mainly has depended upon exports, so many people thought this was a very severe problem. At that time, this was called *Strong Yen Recession*. Many business people , especially exporting companies managers, requested a supplementary budget to overcome this recession. Though the U.S. dollar became weak, the trade deficit didn't decrease. So, in order to reduce the trade deficit, the U.S. government pressured the Japanese government to take measures to expand domestic demand ⁴².Japanese government couldn't say "No", because Japanese government wanted to stop the strong yen tendency. They had to ask the U.S. government to intervene in the Foreign Exchange together. Under domestic and international pressure, the Japanese government drew up the biggest ever supplementary budget .At the same time the BOJ lowered the official discount rate (2.5%), the lowest at that time. Though, according to official economic indicators , the

⁴² U.S. government insisted that there were many unfair trade practices in Japan, which interfered free trade and U.S. export toward Japan as a trade barrier. They also pressured Japanese government to establish SII(structural impediments initiative) , which is a bilateral conference to

recession had passed the bottom , and many Japanese exporting company had prepared countermeasures against a strong yen. This was how over floating capital or money appeared. These money headed for Stock Market and land.

The biggest problem of the bubble economy was skyrocketing of the land price, which became 300% more expensive than 8 years ago. The *Nikkei Average*(Japanese Dow Jones)of Tokyo stock market also jumped up. The stock of NTT⁴³ played a big part, and the Japanese Dow Jones average had become 38 thousand ,which nearly tripled in 5 years. Many people believed this boom would continue for a long time and land price would go up forever.

But, after 1989, the Japanese government changed its policy toward the bubble economy. The BOJ raised the official discount rate three times. Solomon Brothers, which is a very big American securities company, dissolved very large arbitrage transaction. This caused a lot of selling, and a Stock Market crash, whose Japanese Dow Jones Average is 15 thousand now(May '98) .

During this process, various scandals of Financial Institutions appeared to the public. If bubble economy had continued, these scandals would never have appeared. I think these scandals show the characteristics of Japanese financial market and Financial Institutions well. Let's examine some examples as follows in order to understand Japanese problems in the financial market.

get rid of unfair trade practices in Japan in 1994.

⁴³ NTT is the biggest telephone and multimedia company in Japan, which was a former public corporation and became a private company. Japanese government was shareholder and sold its shares to finance. NTT shares became a boom and 1.19 million became 3.20 million in 6 month. Even no-experienced individual investors bought NTT shares, they believed Japanese assured NTT shares. But now it costs 1.1 million, many individual investors were ,they felt, distrusted Stock Market and shares, and this makes more difficult for companies to finance through capital market.

In 1991, incredible fraud cases happened. Bank officers forged certificates of deposit, and borrowed money from other Financial Institutions using those certificates of deposit as collateral. This kind of fraud happened in *Fuji Bank*, *Tokai Bank* and *IBJ*⁴⁴. In the case of Fuji Bank, a very work eager branch section chief forged total 250 billion⁴⁵ certificates of deposit in his branch. He abused the bank operation system, and brought the certificates to Non Bank to borrow money. His aim was to increase his loan and deposit sales, but after a while he began to trade with a real estate swindler and got some kickback. In the Tokai Bank, the story was about same. In IBJ, a middle aged woman played a main role. She managed a Japanese style luxurious restaurant. She invested a lot of money in the Stock Market without reasonable basis or theory. So she had difficulty in financing her investment. So branch chief of *Toyo Shinkin*⁴⁶ helped her and forged a total of 350 billion certificates of deposit of Toyo Shinkin. The IBJ accepted this certificate as collateral and guaranteed of her transaction, a kind of money laundering. Some people were arrested, the CEOs of these banks were fired and were summoned to the Diet. By these cases we can learn the lesson that during the bubble era, how powerless the internal checking system was, if there is a profit, everybody forgot the basic rule of Financial Institutions and society: to get collateral and behave legally.

The Next problem was the crime of all Japanese business society. From late '80 till

⁴⁴ Fuji Bank was a former top bank in Japan in '60. Tokai Bank is a top bank in Nagoya district, which is the third largest city in Japan. IBJ (Industrial Bank of Japan) is considered special bank to loan very good companies in Japan, and well known as IBJ in overseas Financial Market.

⁴⁵ Cf. *Nihonkeizaisinbun* (Japan Economic Newspaper) 13.9.1991.

⁴⁶ Toyo Shinkin (the credit association) was dissolved after this case. cf. *Japan Economic Newspaper* 14.8.1991

1991, almost all Securities companies compensated only the loss of corporate clients⁴⁷. At first this compensation was not illegal, but against the Japanese Securities Association's *Jishukisei* (Industries Moral Self Imposed Rule). In 1991, the MOF issued authorities guidance, but after that many securities companies continued, so finally the Japanese Securities Regulation Act was revised to be illegal.

This compensation was to only corporate clients, not individual investors, which is unfair and nobody can understand. It harmed the fair auto mechanism of establishing price. The fact that almost all securities companies compensated and many client didn't feel guilty about this or didn't recognize the situation, shows this crime comes out of the Japanese societies traditional practice. It was a long year traditional business practice to maintain business relationship, many people took it for granted in the Japanese business world, which is never common sense outside Japan. What is most important about this case is that the impression of Japanese Financial Market is unfair is known to everywhere. Japanese Financial Market had lost many kinds of investors.

Furthermore, as I mentioned before⁴⁸, many Financial Institutions had continued to give bribes concerning the exercise of shareholders rights. These scandals show that Japanese long year traditional practice is far away from common sense in the World.

4, Bad Debts of the Banks and Bank Support Subsidy using Public Money (Tax)

Now Japanese Financial Institutions, especially banks, are suffering from very

⁴⁷ This was a scoop of Japan Economic Newspaper, after reported this news, many criticism attacked Securities Companies not only in Japan, but also all over the world

⁴⁸ See, I, 3, in this paper.

severe problem: Bad Debts⁴⁹. I will explain how this severe problem happened.

During the bubble era, almost all Banks and Non Banks loaned money to real estate broker companies. Usually, according to the loan text book, when you hold a mortgage on land, you can borrow only 80% of land price at maximum. But Japanese Banks loaned over 100% or more, because many people believed that the land price would increase forever. And over-competition among banks for loans under MOF's authority helped this situation to worsen greatly. If a borrower has land, even if it's a small, distorted, steep, or plain land, Banks would loan at that time.

There was a terrible example, called *Jiage* (eviction using force). If they can buy vast square land facing a wide road, the land price would be doubled or trebled easily. So some real estate brokers sometimes used *Yakuza* (Japanese Mafia) to do illegal evictions. Banks loaned real estate brokers much money. What is worth, banks, through Non Banks, loaned to the companies having connections with Japanese Mafia. So during bubble era, Financial Institutions, especially banks began to have relationship with Japanese Mafia, as Mafia becomes legal association on the surface. Financial Institutions tried to cut off this relationship, but this was not so easy. A Branch manager of Sumitomo Bank, which is one of the biggest banks in Japan, was shot. To collect loan from companies which have relationship with Japanese Mafia. In U.S. some critics say that this Japanese recession is called the "Yakuza Recession".

Though the bad debts of Japanese Financial Institutions were so large and risky, the MOF didn't try to solve out basically, tried to postpone them as long as possible. But

⁴⁹ It is said that among 500 trillion bank loan, officially 70 trillion is bad debts, but truly more than 100 trillion yen.

when the Daiwa Bank case ⁵⁰happened, the MOF couldn't postpone any more. In 1995, *Jusen*⁵¹ (Non Bank of Individual Housing Loan) was a symbol of Japanese bad debts. So Japanese government and the MOF tried to deal with Non Bank of Individual Housing Loan first. Non Bank of Individual Housing Loan had nearly 15 trillion claim against debtors. But as much as 13.2 trillion, almost 90% of their loan was difficult to collect. The reason why they had become like that is not so difficult to understand. Their main customers were individual persons, as banks were trying to take its place, they had to find another customers. Those were real estate broker. Though they didn't have special knowledge about real estate collateral loans, they soaked up this kind of loan. Sometimes shareholder banks introduced bad customers to collect bank's loan. This story was like Saving and Loan(S&L) in the U.S. Ultimately, they couldn't survive any longer. The problem was how to collect money to dissolve Non Banks of Individual Housing Loans. Among 13.2 trillion yen, 50% will be bought by ex-Jusenkarikiko(Housing Loan Collecting Association; but later unified to Japanese RTC) which was supposed to be established later. The other 6.2 trillion yen, banks as a shareholder gave up their claim as much as 5 trillion yen. But the Agricultural Financial Associations refused to abandon the rest. So 680 billion yen was lacking. The Japanese government had to compensate by using Budget(Tax).

⁵⁰ Ex-employee was doing illegal transaction in New York branch of Daiwa Bank, which is a middle class city bank. To be worth, it is said that Daiwa bank didn't report to FRB within a month which was regulated by banking Act in U.S., because MOF officer told them not to report at that time. As Daiwa didn't report to FRB, they were deported from U.S. Further FRB pressured Japanese government to solve Bad Debts problem as soon as possible.

⁵¹ There were seven ex-Non Bank of Individual Housing Loan. Non Bank of Individual Housing Loan was established by all Financial Institutions including banks, insurance companies. Financial Institutions were shareholders of Non Bank of Individual Housing Loan. They borrowed money from banks and *Nokyo*(Agricultural Financial Associations).

Many people got upset and said "Why do we have to pay the bad debts made by incompetent managers who made a lot of profit during the bubble era?" It was a very big confusion all over Japan. Agricultural groups have a very strong political power. This was the first time to use official money, when they would deal with bad debts of Financial Institutions.

5, Bankruptcy of Financial Institutions in Japan

Since 1994, several Financial Institutions have gone bankrupt⁵². Before that, we had a legend that Financial Institutions, especially Banks had never gone bankrupt. But that legend broke easily. I will classify a serious of Bankruptcy into three groups and explain.

In 1994, two Credit Cooperatives called *Tokyokyouwashinkumi* and *Anzenshinkumi* went bankrupt, because they had too much bad debts. They were dissolved and business property was transferred to Japanese RTC(Resolution Trust Corporation) which was established from these two Credit Cooperatives by special Act. After that every Credit Cooperative which went bankrupt was dissolved and business property including bad debts was absorbed in to Japanese RTC. In order to deal with bankrupt Credit Cooperatives, a governmental official money has been used through *Yokinhokenkikou* (Deposit Insurance).

In 1996, Regional Bank called *Hanwabank* went bankrupt. This time Hanwabank was ordered to stop business by MOF. So it would disappear after paying all its

⁵² In 1994, two Credit Cooperatives had gone bankrupt. In 1995 two Credit Cooperatives and one Regional Bank, in 1996 two Credit Cooperatives and two Regional Banks. In 1997, bigger scale of Financial institutions, one Life Insurance, two Securities companies, one Regional Bank and one City

deposits off . After that ,they claimed that this administration had no reason to the authority (Ministry of Finance), not to the court, but it wasn't admitted . I think this decision was reasonable , but it wasn't so clear why only Hanwabank was ordered to stop business. There is no standard to determine when such an order should be made . The most factor in ordering closure of banks is to stop as soon as possible , or the damage or loss may skyrocket. So we must make a clear standard , for example under 2% the ratio of owner's equity, they have to stop business.

In November 1997 , a severe earthquake attacked the Japanese Credit System :This led to the Bankruptcy of Sanyo Securities Company ,Hokkaido Industry Bank and Yamaichi Securities Company. When Sanyo Securities Company went bankrupt, default of obligation happened in the call market, where Financial Institutions borrow and loan very short term money by phone. So the influence was very big, so that weak Financial Institutions according to the rumor can't borrow money from this market. So one day in November 1997, Hokkaido Industry Bank couldn't finance from the call market, it needed 200 or 300 billion yen to open a bank in a day. Finally, the board of directors decided not to open on 17th of November ,if they opened the all branches , the money would go short easily. There would be a panic. They decided to give their main branches to *Hokuyobank* , which is small regional bank in Hokkaido-region . Hokkaido Industry bank was a City Bank, the 12th largest bank in Japan. Even now this affects the Japanese Economy substantially. Soon after the Hokkaido Industry Bank went bankrupt, Yamaichi Securities, which was one of the four biggest securities companies got into danger.

Bank went bankrupt.

They were trying to hide illegal transactions ,such as bribes concerning the exercise of shareholders rights ,or illegal compensation of the loss in an offshore market. They didn't disclose the information. So investors distrusted Yamaichi Securities and sold a lot and lot of shares. So the price became as low as the standard price. At last, Yamaichi couldn't finance from the market. Yamaichi had to decide to close their business by themselves within a year. In these three categories, the reason why those Financial Institutions became bankrupt was clear: bad debts from the bubble economy .But they were gone to bankrupt by the power of the market.

Even after finishing Non Bank of Individual Housing Loan case, the risk of Japanese Financial System didn't go away. Many people said this is one of the causes of more severe recession. So the Japanese government had to get rid of the systemic risk to use more official money in 1998.The scheme was that government established a special account in Deposit Insurance to give money .The government prepared as much as 30 trillion yen from tax and borrowing from BOJ. The scheme was that banks apply for public help ,not loan voluntarily, after checking their application, government would pay money. This time government has paid 1.2 trillion yen to make the ratio of owners equity stronger and to avoid a credit crunch. But I think this method doesn't work well. If you want to stabilize the financial system, to give public money equally and settle the loan and deposit rate works more, like in the U.S. in 1929. The most serious problem of this scheme is that this promotes moral hazards for bank directors. Even if they failed to manage banks , government would help them using public money. Every director thinks government will help banks next time without

taking any responsibility. What is worth, according to the Asahi⁵³ newspaper, some politicians pressured even good banks to apply so that risky banks can apply easily. It is obviously against market rules. In this way, the crash of the bubble economy shows the weak and ugly side of our corporate and financial system. I think today's recession comes, mainly from the risks of the Financial System and Credit crunch. At the end of this paper, I will try to show my opinion to solve these severe problems.

Conclusion

As we have seen, the Japanese system was a kind of one nation system in which every Japanese person work for individual internal groups. During confusion or recovering from War , this system works very well and is effective. In this kind of society, there is not so much difference between employee and employer. Inside groups like companies or associations, people don't need clear rules or judgement. Without clear rules, people can decide things by mutual agreement in advance. This is why this system is hard to understand for outsiders. They feel Japanese society unfair and unclear, not open. But Japan has become one of the developed countries, we make our rules clear and open to outsiders. Every company must disclose its information according to the law. Companies can do anything without prohibition by the law. Every business man has to obey only written law and administrative guidance, not oral or unwritten guidance.

In the Financial Markets, the Big Bang is waiting in front of us. Big Bang means a radical change in a the Financial Market, such as the revision of the Foreign Exchange

⁵³ Asahi is one of the biggest newspapers in Japan. Asahi is considered rather liberal.

Act, the abolition of the License system of Securities business, the abolition of the Concentration in Securities Exchange. But the biggest change, I think, is the method of administration by the MOF. The Japanese government, especially the MOF, has to change its policy: from preserving and raising industry, to checking and investigating industries according to the written law. Japanese government has to establish powerful checking Institutions like SEC in order to keep the market fair. MOF must not intervene in each Financial Institution's management or control all financial business. The Big Bang deregulates the business area and makes competition harder. This means many Financial Institutions would go bankrupt in hard competition. We must make a rule to remove the lost Financial Institutions from the market as soon as possible to reduce the cost. We must change the policy from bureaucracy to Market Rule. The Market must be competitive and fair. In a deregulated market, to take our own responsibility is the most difficult things to do. Energy from privatization and is the origin of Financial Market next century facing population decreasing and highly aging society. In this way, Japan's 1940 model of society has become tired and needs to be changed.

After all, not only the Financial Market, but also all Japanese society, including individuals need the Big Bang in order to take their own responsibility for the market.

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