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# The politics of bank bailout in Japan: a cognitive capture and leadership view

*Myung-koo Kang*

**Abstract** This article explores why the Japanese government did not decisively intervene on behalf of bank bailouts at the early stage of the banking crisis of 1997–98 and investigates the institutional and political context behind the use of fiscal money for bank bailouts in 1997–98, 1998–99, and 2001–05. In contrast with prevailing views, which emphasize the conflicts of interest or differences in policy preferences between politicians and bureaucrats and their captured nature either by bankers' special interests or political/bureaucratic interests, this article argues that Japanese policymakers shared a congruent policy preference — that is, minimizing the disruptions in the existing institutional arrangement in government-bank-firm relations and this congruence in policy preference (or 'cognitive capture') compelled the government to take a creditor-centered approach to the banking problem — i.e., letting banks resolve their own problems. It also argues that a strong political leadership that can break with the 'cognitive capture' and sustain government's resolute commitment to solving the nonperforming loan problem is an essential factor for successful bank restructuring.

**Keywords** Japan; bank bailout; cognitive capture; leadership banking crisis non-performing loan.

## 1. Introduction

Bailing out banks is a politically sensitive policy decision, because it is directly related to issues of taxes and redistribution. Moreover, using fiscal money<sup>1</sup> to rescue private financial institutions is likely to trigger public anger. An example can be found in the debates over what is 'too big to fail' (Mishkin, Stern, and Ron 2006; Stern and Feldman 2004). Many governments have often taken this option in response to a systemic banking crisis, defined here as a situation in which all or most banks experience a large number of defaults in a short period of time (Claessens, Klingebiel, and Laeven 2004; Evanoff and Kaufman 2005; Honohan and Laeven 2005; Laeven and Valencia 2008). For example, according to comparative

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research, out of 42 systemic banking crises between 1970 and 2007, national governments used fiscal money to recapitalize banks in 33 and nationalized banks in 24 (Laeven and Valencia 2008). In the Nordic banking crises of the early 1990s, the governments of Finland, Norway, and Sweden used fiscal money to help the failing banks, temporarily nationalizing major banks (Honkapohja 2009; Sandal 2004). During the Asian financial crisis of 1997–98, many Asian governments temporarily nationalized all commercial banks following injections of fiscal money (Haggard 2000; Kang 2009).

In Japan, however, the government did not nationalize banks immediately after it injected fiscal money into failing banks in 1997–1998, nor did it use fiscal money for a bank bailout in a decisive way. The Japanese government injected fiscal money three times—in 1997–1998, 1998–1999, and 2003–2004—based on five different laws. Intriguingly, each time, the Japanese government used only a small portion of the fiscal money for bank bailout that had been already approved by the Diet. For example, the Diet approved the use of ¥60 trillion<sup>2</sup> in fiscal money in 1998 and 1999, but the Japanese government used only ¥10.4 trillion (17.3%) for bank bailout. This underuse of fiscal money was repeated in 2003 when the Diet approved the use of ¥15 trillion for a bank bailout in 2002, but only about ¥2 trillion (13.3%) was used. Considering the number of non-performing loans (NPLs) which are loans that are close to or in default in the banking sector at that time, the injected amount was insufficient to solve the NPL problem in a swift manner. Japanese banks continued to provide additional loans to underperforming firms (i.e., ‘zombie lending’) (Caballero, Hoshi, and Kashyap 2008; Hoshi and Kashyap 2004), and this exacerbated the banking problem by intensifying the misallocation of credit (Peek and Rosengren 2005; Tett 2003).

Why did the Japanese government not intervene more decisively on behalf of bank bailout? It is particularly puzzling because the Japanese government much under-used fiscal money each time that had been already approved by the Diet. Extant studies have emphasized the conflicts of interests or differences in policy preferences in the legislation or policy formulation process, focusing on the phenomenon of ‘legislative gridlock’ or ‘policy gridlock,’ primarily originated from the captured nature of politicians (Pekkanen, Nyblade, and Krauss 2006; Pempel 2006; Scheiner and Muramatsu 2009) or bureaucrats (Amyx 2004; Grimes 2001; Miwa and Ramseyer 2003), either by bankers’ special interests or political/bureaucratic interests. These studies are invaluable for understanding the conservative coalition that delayed the legislation or policy formulation for resolving the banking crisis. However, these studies do not explain precisely why the Japanese government did not take a stronger position even after the legislation for bank bailouts was enacted.

In this article, in contrast with the view that highlights the conflicts of interest or differences in policy preferences, I argue that Japanese policymakers shared a congruent policy preference—one that minimized the

disruptions in the existing institutional arrangement in government-bank-firm relations in which the banking sector had relative autonomy, especially in relation to the government. The banking crisis in late 1997 in Japan was the country's worst systemic crisis since 1945, and Japanese policymakers were overwhelmed trying to find the policy tools that they needed to defuse the crisis. The uncertainty of the policy environment forced Japanese policymakers to rely on a conventional creditor (bank)-centered approach in which banks were expected to solve their own problems. This approach worked well in the long institutional tradition of the Japanese 'main bank' system. The government's under-use of fiscal money for bank bailouts and restraint in nationalizing banks strongly supports that Japanese policymakers agreed that banks should solve their own problems. I would call this shared view among policymakers 'cognitive capture,' in contrast with 'political' or 'regulatory capture'. In addition, this article argues that a strong political leadership that can break with the existing 'cognitive capture' and sustain a resolute government's commitment to solving the NPL problem is one of essential factors for successful bank restructuring by comparing the initial government responses to the banking crises of 1997–98, 1998–99 with those of the Koizumi Cabinet (2001–05).

In the next section, we will examine the banking crisis of 1997–98 as a continuation of the end of the bubble economy in the early 1990s and in the context of traditional executive-legislature and government-bank-firm relations. We will then investigate the political dynamics regarding the three rounds of the bank bailout, focusing on how political leadership broke with 'cognitive capture': (1) the capital injection in response to the systemic banking crisis in 1997–98; 2) the capital injection following the Upper House election, focusing on the 'finance Diet' in 1998 and the nationalization of the Long-term Credit Bank (LTCB) and the Nippon Credit Bank (NCB); and (3) the capital injection between 2001 and 2005, focusing on the deferred tax asset issue. In the conclusion, we will discuss the key features of Japan's style of bank bailout and the lessons we can learn from the Japanese case.

## **2. Theoretical framework**

In a conventional banking crisis, a small number of banks go bankrupt. However, in a systemic banking crisis, due to the possible system-wide negative impacts on the economy, four main actors – debtors (firms), creditors (banks), regulators (bureaucrats), and politicians – with a range of incentives and preferences are likely to clash over which methods should be used to resolve the crisis (Claessens, Klingebiel, and Laeven 2004; Honohan and Laeven 2005) (See [Table 1](#)).

Debtors do not have any incentives to initiate an insolvency procedure early. Even when they are in financial distress, they would rather borrow

Table 1 Incentive structure and preference of actors

		Incentive Structure		Preferences
		Initiation	Implementation	
Creditors	Moderate		Moderate (depending on negotiations with other creditors)	Minimizing the loss Time/ Reputation in the markets
Debtors	Slow		Slow (delaying insolvency in hope of resurrection)	Delay tactics Resurrection
Regulators	Fast		Fast	* Financial Stability * Faster choices: liquidation, mergers, liability transfers
Politicians	Slow/Moderate (depends on political environment)		Moderate/Fast	* Maintaining or Expanding the political support base * Social Protection, Fair cost sharing

more, and they do not want to disclose their actual financial problems. Debtors also have strong incentives to delay the insolvency process in the hope of resurrection. Creditors do not have strong incentives to initiate the insolvency procedure early either, given that debtors can provide minimal profits. When creditors are optimistic about the future viability of debtors (or even when creditors are ambivalent about debtors' viability), creditors are less likely to begin insolvency procedures early. In particular, when the creditor-debtor relationship is stable and long-lasting, it is even more likely that creditors will not initiate insolvency procedures and, instead, will roll over loans or grant concessions on interest. Thus, under a systemic banking crisis, the initiative to begin an insolvency procedure will probably come from regulators or politicians (Hellmann, Murdock, and Stiglitz 2000).

Compared with the interests of debtors and creditors, regulators are more likely to initiate insolvency procedures, because regulators are more concerned about the stability of the financial system as a whole rather than with the profits of individual creditors. Once insolvency procedures have been initiated, regulators are likely to prefer fast resolution methods (e.g., liquidation, mergers, or liability transfers) because those measures are more likely to restore financial stability as quickly as possible. In particular, when certain types of insolvency problems in the banking sector can pose a systemic risk to the larger economy, regulators are more likely to prefer rapid resolution methods so as to minimize the contagious effect of ensuing bank runs or corporate bankruptcies. As a result, whether regulators or

Table 2 Two types of insolvency resolution

	Strength	Weakness
Creditor-centered	<ul style="list-style-type: none"> <li>* Information advantage</li> <li>* Strong incentives for successful reorganization</li> </ul>	Protracted negotiations
Regulator-centered	<ul style="list-style-type: none"> <li>* Speedy resolution</li> <li>* Easy liability transfer</li> </ul>	<ul style="list-style-type: none"> <li>* Poor incentives for successful reorganization</li> <li>* Information disadvantages subject to political pressures</li> </ul>

creditors take the initiative in implementing insolvency resolution will have a significant impact on the speed of the resolution (see Table 2).

However, if regulators do not have good information on the particulars of an insolvency problem – due to inadequate accounting standards or loan disclosure requirements – they cannot initiate insolvency procedures in a timely fashion (Baron and Besanko 1984; Stiglitz 2002). In reality, creditors are likely to have more specific and exact information on their debtors' assets, and they have strong incentives to hide information on their bad loans from regulators (Hellmann, Murdock, and Stiglitz 2000; Mishkin 1991). This asymmetry of information makes it difficult for regulators to detect the scale or scope of a banking problem early or to initiate insolvency procedures expeditiously. Therefore, obtaining clear information on the banking problem (e.g., the real scope of NPLs) as early as possible can be critical, not only for determining the timing of government intervention, but also for the positive policy effects of government intervention to make themselves felt.

At the same time, regulators may be slow in implementing insolvency procedures because of pressure from politicians. Politicians have conflicting incentives regarding the timing of initiating and implementing insolvency procedures. In particular, if the support base of the incumbent party (or parties) is challenged, politicians are likely to pressure regulators to slow insolvency resolution procedures. Moreover, the timing of an election can have a significant impact on fiscal policy. If the government faces an election after a systemic banking crisis, it is likely that the incumbent regime will try to manipulate short-term macroeconomic policies to appeal to voters. The 'political business cycle' perspective in general, and the 'political budget cycle' in particular (Shi and Svensson 2006), have focused either on politicians' opportunistic incentives and behaviors when running for reelection (Rogoff and Sibert 1988) or partisan cycles of political orientations (Alesina and Rosenthal 1995). The research has confirmed that governments pursue expansionary fiscal policies before elections, which often cause inflation after elections (Alesina and Roubini 1992). In

contrast, the literature makes mixed predictions about government spending *before* elections. Those models that focus on politicians' opportunistic behavior predict that government spending will increase before elections (Rogoff and Sibert 1988), whereas models emphasizing electoral accountability predict that wasteful government spending will decrease due to political checks and balances (Keefer 2001; Keefer 2007). Indeed, both are possible, and we need to investigate these possibilities empirically.

In short, if regulators lack independence or are vulnerable to pressure from politicians – who are, in turn, supported by their politically well-connected debtors and creditors – the speed at which regulators implement changes can be delayed (Banks and Weingast 1992; Bendor, Taylor, and Van Gaalen 1987). Thus, strong political leadership that can insulate regulators from debtors or creditors is an important factor in the rapid resolution of a systemic insolvency problem.

### **3. The inherited institutional setting**

#### ***The crisis of 1997–1998 in a nutshell***

Japan's systemic banking crisis in 1997–98 was a continuation of the burst of the bubble economy in 1991. Land and stock prices plunged through the 1990s. The stock market fell from its peak of just below 40,000 on the last day of December 1989 to 14,000 in 1993. Land prices plummeted by more than 60 percent; in central Tokyo's commercial district, prices in 1998 stood at only 20 percent of their 1990 peaks. Both financial institutions and nonfinancial corporations suffered huge losses resulting from the falling value of equities and land. This situation continued until 1997, when major financial institutions collapsed.

Several financial institutions collapsed in the autumn of 1997, and the situation quickly worsened into a systemic financial crisis. Financial institutions began to go bankrupt in November 1997: first, Sanyo Securities, then Hokkaido Takushoku Bank, and then, a week later, Yamaichi Securities went under. For the first time in Japan's history, a major bank (the tenth largest in the country) and a major securities company (the fourth largest) went bankrupt. Hokkaido Takushoku Bank was one of those important banks that the government had promised to protect from bankruptcy. This promise had been a response to public fears for the stability of Japan's financial system after the bursting of the bubble. The collapse of these financial institutions pushed the economy, which was slightly recovering from 1996, into another recession, and the banks became more vulnerable to deteriorating economic conditions (Hoshi and Patrick 2000; Hutchison and Westermann 2006). These financial failures had an immediate and dramatic effect on the perception of international investors of the risks inherent in Japan's financial markets. As a result, by late November 1997, about 1 percent of the 'Japan premium' (Peek and Rosengren 2001) – the extra

amount that Japanese borrowers, mostly banks, had to pay over the market rate for short-term loans – was charged for international borrowing by Japanese banks, and many international banks reduced their credit lines to Japanese banks (OECD 1998).

### ***The legislature-executive relations***

The Liberal Democratic Party (LDP) dominated Japanese party politics from 1955 to 2009; these years are termed the ‘55 regime’ (Pempel 1998) – except for a ten-month period in 1993–94. The LDP was a multi-factional organization in which key party posts such as Secretary General, Councilors Leader and Representatives Leader were distributed among different factions. The number and size of factions has ranged from six to 13, with as few as four members and as many as 120. In most cases, five major factions compete within the LDP to nominate the Prime Minister and other key posts in the party and the Cabinet (Hrebienar 2000; Curtis 1999). Factional leaders helped their followers secure key posts in the party and government. They also provided campaign funds for their followers and wielded power in official party nominations for electoral candidates. In return for providing money, party nominations and posts, factional bosses received their followers’ support in the competition for the LDP presidency, which virtually meant the presidency of the country (Curtis 1999; Krauss and Pekkanen 2011).

Under such a long dominance, incumbent politicians were usually reelected and they acquired expertise and experience in their specialized policy area, *zoku* (policy ‘tribes’) in the Diet. For example, in the Diet elections between 1946 and 1990, only 23 percent of new members were elected. Except for the short period after World War II, the comparable figure was less than 20 percent in most elections. Even after the breakup of the LDP in 1993, with the exception of about ten months, the LDP has maintained the ruling party position without any substantial challenges. Between the 22nd Diet election in 1946 and the 39th in 1990, 8,760 Diet members were elected, 2,033 of whom were first termers (Ramsdell 1992, appendix table A-4). Under these circumstances, legislative-executive relations were consolidated for preserving a status quo, while minimizing any abrupt policy changes or disruptions.

### ***Government-bank-firm relations***

Japan has consolidated a bank-centered financial system in which the government played a pivotal role in funneling bank loans to develop strategic industrial sectors during the years of high economic growth (Hoshi and Kashyap 2001; Tamaki 1995). The Japanese government allocated bank loans with the intent of developing strategic industrial sectors. For this



purpose, the government attempted to extend favorable policy loans to economic actors who were developing strategic industrial sectors, as well as putting such actors under the guidance of the government's industrial policies. However, the Japanese government's intervention style was a kind of 'cooperation model,' based on indirect and implicit inducement, and reflected in risk-sharing pattern among the government, banks, and firms.

The Japanese government also played a directive role in credit allocation, but this role was more implicit and indirect. The Ministry of Finance (MOF) of Japan and the Bank of Japan (BOJ) were more concerned with the solvency of the private banks, rather than with their portfolios (Calder 1993: 130). The Ministry of International Trade and Industry (MITI) was in charge of industrial financing to develop strategic industrial sectors during the late 1950s and the 1960s, by issuing guidelines regarding credit allocation in key industries. However, MITI did not have full control over the credit allocation process. The explicit allocation guidelines continued for less than a decade, and 'the attempts of MITI to control the private sector were limited to the *suppression* of what MITI believed was excessive capital spending. MITI apparently did *not* explicitly encourage *additional spending* in areas of special promise' (Calder 1993: 130. emphasis original). Rather, within major sectors, MITI attempted to curb 'excessive competition' (*katoukyouso*), while trying to inhibit the entry of newcomers into the industrial sector. The role of MITI with respect to industrial credit, was not direct and comprehensive; MITI was concerned with stability – both within and between sectors (Calder 1993: 131–2).

Meanwhile, Japanese banks kept stable and longer-term relationships with their customer firms. In the Japanese 'main bank' tradition (Aoki and Patrick 1994; Hoshi and Kashyap 2001), banks preserved a relationship with firms, on average, for more than 30 years; larger firms maintained even longer relationship with banks (see Figure 1). This highlights a collective effort to share both gains and risks in bank-firm relations.

In sum, policy coordination between Japan's government and banks was deliberative. Consensus-building usually preceded actual intervention, and the minimization of the number of economic losers was consolidated in the policy community as a kind of anchor-like cognitive map. Paradoxically, however, this inherited institutional setting worked against decisive government intervention for bank bailout under a systemic financial crisis in 1997–98.

#### 4. The politics behind the three rounds of bank bailouts

When the systemic banking crisis of 1997–98 erupted, Japan's political environment was not conducive to a government bailout of the banks. Political support for the incumbent LDP plummeted immediately after the

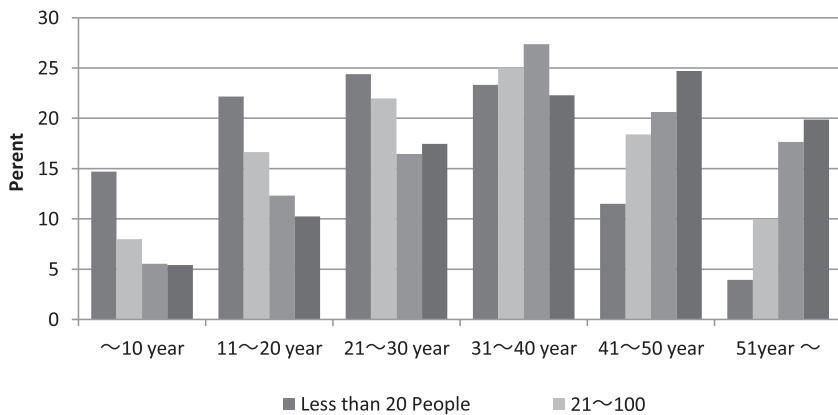


Figure 1 The business years of Japanese firms with banks. Source: Small and Medium Enterprise Agency of Japan (Dec. 2003)

crisis, and opposition parties united to block the injection of fiscal money for bank bailout, and the establishment of a new supervisory organization to handle the bank restructuring and fiscal money injection was delayed, primarily because of resistance from the MOF. Meanwhile, the banks had little incentive to request a bank bailout, as they were concerned more about their reputation in the markets. If they received the fiscal money, the markets might have inferred that they were in trouble and their real scale of NPLs could be fully exposed to regulators. Under these circumstances, the banks aligned with the LDP to delay the necessary institutional reform for detecting the actual scale of NPL in particular, and the banking problem in general. Consequently, the Japanese government injected fiscal money intermittently in 1997–98, 1998–99, and 2001–2005 – based on five laws – the Financial Function Stabilization Law (February 1998), the Early Strengthening Law (October 1998), the revised Insurance Deposit Law (2003), the Organizational Restructuring Law (September 2003), and the Act on Strengthening Financial Functions (2006).

### *The declining leadership of the LDP*

Party politics in Japan became much more fluid in the 1990s. The decades of dominance of the LDP temporarily ended in 1993, after a number of politicians left the party and created a new party (Curtis 1999; Kato 1998; Schlesinger 1997). After short-term turmoil in 1993–94, the LDP recovered its dominance in party politics, but it had to align with other minor parties to form a government. For example, during the Murayama Cabinet (June 1994 – January 1996), the LDP had to form a coalition government with the Japan Socialist Party and New Party Harbinger (*Sakigake*); this coalition lasted into the first period of the Hashimoto Cabinet (January–

November 1996). In the three elections to the Lower House in 1996, 2000, and 2003, the LDP never gained a majority, and had to form a coalition government with the Liberal Party (January 1999–April 2000) and the Clean Government Party (*Komeitō*, October 1999–August 2009). Compared to the stable dominance pattern from 1955 to 1992, this was a serious political setback for the LDP. In addition, the Cabinet frequently changed so it was difficult to pursue structural reforms (Hiwatari and Miura 2002). For instance, from 1945 to 1992, there were 20 prime ministers whose average term was 26.4 months. However, from August 1993 to April 2001, before the Koizumi Cabinet (April 2001–September 2006), seven Cabinets<sup>3</sup> were established and seven coalition governments were formed (Carlson 2007: 161).

Notably, due to the electoral and political fund reforms, the traditional ‘pork-barrel’ politics, in which the LDP maintains conservative coalitions with its supporting constituents, was briefly strengthened (Saito 2009; Horiuchi and Saito 2003). After the breakup of the LDP in 1993, Japan attempted various political reforms such as revising the political fund-raising law and adopting single-district membership. As a result, there have been several mergers and splits, and politicians switched parties without forming policy- or ideology-oriented coalitions. The single-seat electoral system made intra-party competition for nomination fiercer; politicians wanted to secure more stable support bases and wanted to reinforce their traditional coalition with protected industries (Cox, Rosenbluth, and Thies 1999; Rosenbluth and Thies 2010). Specifically, in regards to the NPL problem, LDP politicians tried to continue support for the three industrial sectors – real estate, construction, and wholesale and retail sectors – by providing additional loans or government subsidies. These three sectors were hit heavily by declining land prices after the bursting of the bubble, and since the banking crisis in 1997–98, corporate profits of these three sectors declined further. Nearly all the firms in these three sectors were virtually bankrupt and these three sectors came to account for about 54 percent of all NPLs in the banking sector as of 2001. Under the circumstances, LDP politicians tried to continue to protect these three sectors, which had been important sources of both political funding and voting base, as they did in the past.

In response to the banking problem, LDP politicians chose to represent the interests of failing banks, rather than to impose strict and drastic reform agendas. The LDP feared that the bankruptcy of any of the major banks would generate panic and disrupt the financial order. This fear was based in part on the fact that all the large banks owned so much equity in each other; cross-shareholding practices among large banks were prevalent. Moreover, for the LDP, banks had been an important source of political funds (Carlson 2007). For instance, the political contributions made in 1999 by a single bank nearly equaled those made by all of the manufacturing associations. Of the top 20 corporate contributors of political funds in

1990, all but three were banks. Even after the revision of the political funds law in 1995, nearly 23 percent of the LDP's revenues came from the banking industry (Hrebenar 2000; Carlson 2007).

Therefore, the LDP tried to represent the interests of bankers so that the party would not lose its funding support and bankers used their network channels with ruling politicians to block both the bureaucratic imposition of stricter accounting standards and NPL classification.

### *The first round of capital injection (1997–98)*

After the financial failures in November 1997, the second Hashimoto Cabinet (November 1996–July 1998) wanted to inject fiscal money into the banking sector. It announced the Emergency Economic Package, in which the government would provide up to ¥13 trillion of fiscal money to failing banks by the end of March 1998, through the Deposit Insurance Corporation (DIC). The negotiations did not proceed smoothly. Both the public and opposition parties were against the bailout option. In particular, the bailout option was taboo in the policy community after the bailout of *jusen* (housing mortgage) companies in the summer of 1996 (Kume 2003). The Japanese government used fiscal money for bank bailout, for the first time, to resolve the problem after the special Diet session for the *jusen* problem in June 1996 (Milhaupt and Miller 1997). The injected amount reached ¥685 billion and the crisis happened a year after this *jusen* bailout, and both the public and opposition parties – the Democratic Party of Japan (DPJ), the Liberal Party, and Shinto Heiwa – adamantly opposed the use of fiscal money again for bank bailout. Under the circumstances, both the LDP and opposition parties agreed to establish the Financial Crisis Management Committee (FCMC) to handle the capital injection and passed the Financial Function Stabilization Law in February 1998. According to the law, the Hashimoto Cabinet prepared ¥30 trillion (\$240 billion), which was comprised of ¥13 trillion to recapitalize banks and ¥17 trillion to prop up the deposit insurance system, and the FCMC asked banks to apply for a share of the ¥13 trillion (Fukao 2009).

However, few banks applied for public funding, although they were on the verge of bankruptcy and the government intended to offer the fiscal money at below-market rates. The banks did not want to apply for a bailout because if they did, it could have deadly impacts on their reputation in the markets, as the bailout application might be regarded as an acknowledgement that there was a serious problem in their own business management. Therefore, banks tried to limit their exposure to this risk by not applying for the public funding.

Under these circumstances, the MOF attempted to persuade the banks not to undermine the credibility of the government's bank recapitalization endeavor. To blunt any negative impacts on banks' market reputation, interestingly, the government promised to provide the same amount of

*Table 3* Loan classification based on self-assessment (Japan, September 1997)

(Unit: billion ¥)							
	Total Credit Exposure	Of which				Total of III to IV	% of Total Exposure
		Class I	Class II	Class III	Class IV		
Major banks	431,682	377,347	45,302	6,931	2,103	9,034	2.1%
Regional banks	139,153	124,692	13,060	998	403	1,401	1.0%
Regional banks II	54,028	46,118	6,927	794	189	983	1.8%
Regional banks total	193,181	170,810	19,987	1,792	592	2,384	1.2%
Total all banks	624,863	548,157	65,289	8,723	2,695	11,418	1.8%

*Notes:* Definitions of class:

I. Credit exposures which have not been classified as Class II, III, or IV.

II. Credit exposures on which banks have judged adequate risk management on an exposure-by-exposure basis will be needed.

III. Credit exposures on which banks have serious concerns in terms of their ultimate collection and, thus, are likely to incur losses but have difficulties with rational estimation of time and extent of losses.

IV. Credit exposures which banks have judged to be non-collectable or of no value.

*Source:* Revised from OECD (1998: 105).

bailout funding for all banks. In the end, 21 institutions – 18 major and three local banks – made formal applications for the bailout in March 1998 and, notably, all financial institutions applied for ¥100 billion of public funding, regardless of their financial conditions, although many of them were on the brink of insolvency (Deposit Insurance Corporation of Japan 2008, 83, [table 3](#)). However, the total injected fiscal money was only ¥1.8 trillion (13.8%) out of the ¥13 trillion, which had been already approved by the Diet for bank bailout.

This underuse of fiscal money resulted from the information gap between bankers and MOF officials. The banks applied loose standards when they classified NPLs and there were no strong loan disclosure requirements. Consequently, it was difficult for the MOF to identify the exact amount of NPLs in the banking sector. For example, before the crisis, the MOF asked all banks to submit their own assessment of risky loans, out of outstanding loans, based on four categories by September 1997. The banks, however, submitted financial reports based on hyper-inflated expectations for their future profits.<sup>4</sup> According to the self-evaluations,

Japanese banks classified 87.7 percent of all loans as reasonably certain to be repaid, and 12.3 percent (¥76.7 trillion) as recoverable but requiring careful collection (Class II or substandard). Only 1.8 percent of loans (¥11.4 trillion), the two lowest categories (Class III & IV), was reported as bad loans (see Table 3). Contrary to the self-assessment, however, when the banks went bankrupt in 1998–99, the actual amount of NPLs of those failed banks was far larger than their original assessment.

This initial infusion of fiscal money (¥1.8 trillion) was insufficient to stabilize the market. Many banks were indeed on the verge of bankruptcy and financial turmoil continued in the banking sector. In particular, the Long Term Credit Bank (LTCB) of Japan and Nippon Credit Bank (NCB) received only part of the public funding for which they applied – ¥130.0 billion and ¥60 billion, respectively (Deposit Insurance Corporation of Japan 2000: 66, table 2). This injection failed to rescue these two banks and it originated from the lack of clear information that could detect the real scale and scope of the NPL problem of these two banks. This proved to be a reality after these two banks were nationalized at the end of 1998.

### ***The second round: the election and the ‘Finance Diet’ (1998–99)***

The Japanese government had to inject more fiscal money at the end of 1998 due to the aggravating banking problem, even after the initial infusion of capital. But, the second round of capital injection proceeded under a very different political environment. Popular support for the Hashimoto Cabinet plummeted, due to the massive bank failures and the following turmoil in the financial markets. In April 1998, in the middle of pushing a bailout plan, popular support for the Cabinet dropped below 30 percent (*The Asahi Shimbun*, 27 April, 1998). In the meantime, financial problems of LTCB reached the public in the summer of 1998. The quickly weakening bank provoked a political debate on the issue of whether it was better to allow weak but solvent banks to continue operating by injecting fiscal money or to let them fail (Suda 1998). The LDP feared that the bankruptcy of LTCB or any major banks would generate panic and financial chaos.

Coincidentally, the LDP was defeated in the House of Councilors (Upper House) election in July 1998 – winning only 102 of 252 seats. In the election, the DPJ, founded by the merger of several opposition parties immediately after the crisis in January 1998, gained 47 seats. After the election, a special autumn Diet session (‘finance Diet’) was convened to discuss a stronger bank bailout option. However, as the LDP was not a majority in the House of Councilors, it had to make concessions to the opposition (Takinami 2010). Opposition parties demanded that fiscal money – if committed – be injected and managed transparently. For this purpose, they demanded that an organization other than the MOF administer the bailout process (*Japan Times*, 21 August 1998).

Immediately after this special session, LTCB went bankrupt on 23 October 1998, and NCB on 13 December 1998. LTCB's bankruptcy was a particularly serious blow to the traditional convoy system because the LTCB failure was not only the biggest bank failure in postwar Japan – it was the biggest in the world. More significantly, LTCB was a symbol of the successful, long-term oriented Japanese banking system. In the end, both banks were nationalized and due to the continued instability in the banking sector, the Obuchi Cabinet had to inject ¥6.7 trillion to 15 banks in March 1999 (Fukao 2009).

After nationalization, the Financial Supervisory Agency discovered a huge gap between the initially reported amount of NPLs by these two banks and the actual amount of NPLs. Initially, the capital deficit of LTCB was estimated at ¥340 billion, but after the investigation by the Financial Supervisory Agency, it swelled by more than 7.5 times to an estimated ¥2.65 trillion (Gyodou News Communication Company 1999). Ultimately, ten months after nationalization, in August 1999, the estimated capital deficit rose to ¥3.5 trillion (OECD 1999: 78). It was ten times larger than the initial estimate. The NCB bailout demonstrated a similar problem. At first, NCB's capital deficit was estimated at ¥94.4 billion, but upon closer inspection after nationalization, this figure soared to around ¥3 trillion (OECD 1999: 79).

'This huge gap between self-assessed and actual NPL amount was not confined to these two banks (Hall 2000). Indeed, the actual amount of NPLs of failed banks was far larger than their original self-assessment. Accordingly, the government had to inject more fiscal money into failed or failing banks – literally into all banks – to prevent bank failures from spiraling out of control. Consequently, the government made more public funds available with the approval of the Diet, totaling ¥60 trillion: ¥17 trillion for the protection of the deposits of failed financial institutions; ¥18 trillion for banks under special public management as well as bridge banks; and ¥25 trillion for the recapitalization of financial institutions. In particular, the funds for bank recapitalization increased from ¥13 trillion in March 1998 to ¥25 trillion in a year. Then, ¥7.5 trillion was injected again into failing banks. As a result of these recapitalization efforts, the ratio of injected fiscal money to equity in those banks receiving fiscal money reached about 40.5 percent, and these banks came under the virtual control of the Japanese government (Deposit Insurance Corporation of Japan 2008).

Meanwhile, notably enough, during the 'finance Diet' in October 1998, the LDP agreed to the demand from opposition parties to set up an organization, separate from the MOF, to administer the bailout transparently, in return for getting the cooperation to pass the bill for bank bailout. Accordingly, the Financial Supervisory Agency was established in June 1998, as an external organ of the Prime Minister's office. However, from the beginning, the independence and abilities of the Financial Supervisory Agency were under suspicion because most of its staff was recruited from the Banking and



Securities Bureaus of the MOF. There were only 26 new hires, and the staff of the Financial Supervisory Agency, above director-level, could go back to the MOF. Moreover, in times of financial crisis, the commissioner of the agency was obliged to consult with the MOF over the course of action.

Under the circumstances, opposition parties insisted on the complete separation of the financial supervisory functions from the MOF. One result was a temporary measure of creating the Financial Reconstruction Commission (FRC). The FRC was established for policing the infusion of fiscal money and directing the functions of the Financial Supervisory Agency. Then, in July 2000, the Financial Services Agency (FSA) was established within the FRC through a reorganization of the Financial Supervisory Agency. In accordance with this change, the FSA became responsible for planning the financial system – powers which had formerly belonged to the MOF. Finally, in January 2001, by reorganizing central government ministries, the FSA became an external organ of the Cabinet Office. With the concurrent abolishment of the FRC, the FSA began determining the disposition of failed financial institutions (Grimes 2001: 207–9).

This reorganizing process took more than five years since the inception of the political debate in 1996, due to the continuing resistance from the MOF and diverging preferences in regards to the functions and power of the new agency, and the delayed reorganization greatly constrained government intervention for bank restructuring in general, and for bank bailout in particular.

### ***The third round of capital injection (2001–5): the issue deferred tax asset***

The third round of capital injection corresponds with intensive government efforts to reduce the NPL ratio under the Koizumi Cabinet. After Prime Minister Koizumi was inaugurated in 2001, the Japanese government's drive for rapid NPL resolution gained political momentum. In April, the 'Two-or-Three-Year Rule' was announced in the Emergency Economic Package, which called for the major banks to remove existing NPLs within two fiscal years and new ones within three years. In his first policy speech on 7 May 2001, Koizumi declared that his Cabinet would remove NPLs from the banks within two to three years. Then, a year later, the '50 percent/80 percent Rule' was announced, which urged the major banks to remove 50 percent of NPLs within one year and most (some 80 percent) of them within two years. Then, in October 2002, the government announced the Program for Financial Revival, which aimed to halve the NPL ratio of the major banks to 4 percent by March 2005 (Cabinet Office 2003: chapter 2).

The Program for Financial Revival set out policies for the strengthening of financial administration centered on three measures: (1) tightening the assessment of assets; (2) enhancing capital adequacy; and (3) strengthening



Table 4 Status of NPL and bank performance (1998–2006)

	(Unit: trillion ¥)								
	1998 <sup>6</sup>	1999	2000	2001	2002	2003	2004	2005	2006
Total bank loans <sup>1</sup>	551.4	536.1	537.1	512.1	474.6	455.5	446.1	457.5	472.7
Total NPL <sup>2</sup>	33.9	31.8	33.6	43.2	35.3	26.6	17.9	13.4	12.0
NPL ratio	6.2	5.9	6.3	8.4	7.4	5.8	4.0	2.9	2.5
ROA <sup>3</sup>	-	-0.4	0.0	-0.6	-0.7	-0.1	0.3	0.5	-
ROE <sup>4</sup>	-	-25.1	-0.5	-12.7	-17.9	-2.9	4.3	12.6	-
GDP <sup>5</sup> (c)	504.8	497.6	503.0	497.7	491.3	490.3	498.3	501.3	507.7
% of GDP	6.7%	6.4%	6.7%	8.7%	7.2%	5.4%	3.6%	2.7%	2.4%

Notes:

1) Total loans consist of the loans provided by city banks, long-term credit banks, trust banks and regional banks.

2) The definition of non-performing loans is based on the Financial Reconstruction Law (Oct. 1998)

3) Return of Assets

4) Return of Equity

5) GDP is based on current prices in national currency.

6) Japanese figures are based on the fiscal year. For example, the figure of 1998 is actually the figure by the end of March 1999.

Source: FSA of Japan, *Status of NPL loans* (<http://www.fsa.go.jp/en/regulated/npl.html>)

governance (Cabinet Office 2004). After this announcement, the FSA conducted an investigation in March 2003 to tighten the assessment of assets. The gaps between the FSA inspections and major banks' self-assessments were disclosed to the public on an aggregate basis. The FSA then forced banks to narrow the gap. Meanwhile, to enhance capital adequacy, the BOJ purchased stocks held by the major banks, amounting to a total of approximately ¥2 trillion from November 2002 to September 2004. Moreover, external auditing of bank management was augmented, and the FSA closely supervised the realization of the restructuring plans the major banks had submitted for sound management (Cabinet Office 2003: 152). As a result of these intensified efforts, the NPL ratio of the major banks ultimately started to decrease in 2004, reaching about 2.9 percent in March 2005 after nearly eight years of muddling through (see Table 4).

Despite these achievements, however, the profitability and competitiveness of the major banks did not significantly improve. In fact, the capital base of the major banks did not improve; if anything, it worsened despite the BOJ purchasing ¥2 trillion of stocks from the major banks between 2002 and 2004. The capital adequacy of the major banks did not substantially improve because of the increasing proportion of 'deferred tax assets' – the difference between tax expense and tax payable is referred to as deferred taxes – in core capital.

Deferred tax accounting was introduced in October 1998, when the Diet passed the financial reforms bills, which became effective in April 1999. Deferred tax accounting estimates the future capital gains (taxable profits) and books them as assets (Mochizuki 2006). However, one critical problem of booking this deferred tax asset as a genuine asset lies in the calculation of the pre-adjusted taxable income based on projected future business performance: If projected taxable income fails to be achieved, there will be no tax-reducing effect, and in such a case, the deferred tax asset will disappear, thus depleting the capital base. Therefore, this accounting procedure involves subjective estimates of future capital acquisitions, and this subjective factor makes it difficult to identify the real scale of deferred tax assets (Kuroda and Hamada 2001; Skinner 2008).

The failure of Resona Holdings in May 2003, the fifth largest banking group of the time, exemplifies this problem. The financial statements for Resona Holdings had included large deferred tax assets as part of their capital and these assets accounted for 70 percent of Tier 1 capital according to Moody's Investor Services (Ibson, *Financial Times*, 19 May 2003). Under these circumstances, two auditing companies – Asahi & Co. and Shin Nihon – disputed the bank's profit forecasts, on which the deferred tax assets depended, and refused to give a clean audit report unless Resona cut its deferred tax assets by 40 percent. However, by April 2003, the capital adequacy ratio of Resona Bank stood at about 2 percent. This was half the required minimum of 4 percent for domestic banks, and one quarter of the minimum of 8 percent for international operations. Without including the deferred tax assets, Resona Holdings would have gone bankrupt. In the end, ¥2 trillion of fiscal money was injected as a preventive measure to stall the collapse, and the bank was nationalized. In handling the Resona Holdings case, the government revised the law regarding the injection of fiscal money. With the revision, after a long process of the muddling through, the government finally came to be able to inject fiscal money against the banks' will, not only for those failed or failing banks, but also for those sound banks when the government expects impending financial turmoil.

## 5. Conclusion

Several key elements have influenced the Japanese government's use of fiscal money for bank bailouts. First, Japan's dilemma over financial reform was predominantly political: specifically, a lack of strong leadership, which could have broken with the conventional view among LDP politicians and MOF officials. The Japanese government needed new rules for financial oversight and organizations to implement reforms in a consistent and resolute way, but the involved actors – regulators, politicians, and bankers – tried to minimize the short-term negative economic shocks to the banking and the corporate sectors, sticking to the conventional policy norm of

limiting the number of economic losers or structural adjustment costs, while preserving the institutional arrangement in government-bank-firm relations. The Japanese government's gradual and deliberative approach of allowing banks to take care of their own NPL problem, reduced political conflicts over the fiscal cost of bank bailouts. This politics of benevolence, however, resulted in higher total fiscal cost, as the banking problem became drawn out. Japan has become the most indebted country among advanced economies as of the end of 2011.

Furthermore, the case of Japan proves that in times of systemic banking crisis, a regulator-centered, a more centralized way of financial restructuring can be more effective in shortening the crisis and reducing the final fiscal cost than a creditor-centered approach. After the first and the second rounds of government bailouts (1997–98 and 1998–99), the Japanese government became the largest shareholder of almost all banks in the country. However, the Japanese government did not demand that the banks enact stricter managerial reforms. Instead, the government let banks take care of their own troubled assets and loans, while introducing the accounting gimmick of deferred tax assets. This creditor-oriented resolution can have some critical advantages over the regulator-centered resolution procedure. In the case of Japan, however, it seems that because the government did not take full responsibility for financial restructuring and NPL resolution procedures, the banking problem lasted longer and became much costlier than other systemic banking crises (Laeven and Valencia 2008). In particular, due to the insufficient institutional safeguards for accurately detecting the scale and scope of the banking problem, the Japanese government, as a financial supervisor, could not detect the hidden troubled assets and loans in the banking sector when the crisis occurred in 1997–98. Officials of the MOF relied on bankers' self-assessment of troubled assets and loans, and this made the MOF miscalculate the risks banks were actually carrying at the time of the crisis. The alarming increase of hidden NPLs after the nationalization of LTCB and NCB at the end of 1998 highlights this point.

Of course, we cannot properly estimate a counterfactual situation; whether stronger action on the part of the Japanese government would have produced better outcomes. It is that given the complementary nature of institutional arrangements in Japan's political economy, radical reforms might have been more *socially* inappropriate, although *economically* better. Which method is chosen is, in the end, within the realm of politics.

The Japanese case offers valuable lessons to the bank bailouts during the global financial crisis of 2007–09 as well. First, it is essential to reform the financial supervisory functions of the government as early in the crisis as possible. As of April 2009, most countries have used fiscal money for bank bailouts, ranging from 2.4 percent of GDP in Japan to 3.9 percent of GDP in the United States. But if we include the fiscal spending for purchasing assets and lending by the Treasury, Central Bank support for Treasury backing, and others, the amounts are much greater, reaching an average of

49.8 percent of GDP in advanced economies (IMF 2009). However, to date, financial supervisory reforms have stalled and it is difficult to estimate the real scale and scope of troubled assets and loans, at both the national and global levels, because those troubled assets and loans are intertwined through securitization and various kinds of financial derivatives. We should learn from the Japanese experience that proper supervisory reforms are essential if we are to minimize the fiscal cost and to make bank bailouts successful.

Second, the Japanese case shows that the timing and the style of government intervention do matter if the state is to resolve systemic banking crises. In terms of timing, it might be better for the government to prioritize the speed of restoring financial stability over limiting the fiscal costs or on the moral hazard of banks early in the crisis. Above all, the government needs to prevent information asymmetry between regulators and bankers. The reform of the supervisory functions of the government is a political process; to make that reform successful, decisive and resolute political leadership that can withstand political pressures is critical.

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## Notes

1. Among scholars and policymakers, public funds is a more widely used term, and government's bailout money is often funded in government securities. But if government's bailout money is not redeemed, it will end up as an increasing fiscal burden to the government. Therefore, in this article I use the term fiscal money for public funds.
2. ¥ = Japanese yen. All dollar (\$) amounts are in US dollars unless otherwise specified.
3. This figure counted the Hashimoto Cabinet as two.
4. This false report also applies to Yamaichi Securities. For example, 35 client firms helped Yamaichi hide enormous so-called *tobashi* losses off its books – *tobashi* is the practice of concealing losses by shifting them among client accounts, which is illegal. This case led to the first shareholder lawsuit against a firm's auditors in Japanese history (OECD 1998:109).

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