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Osaka University
The Interaction between Financial Regulation and Financial Crisis in Japan: Change in Financial Administration and Two Financial Crises from 1980 to 2010*

Ryunoshin KAMIKAWA**

ABSTRACT:

This article traces the history of the development of the Japanese financial regulatory system and explains the interaction between financial regulation and financial crisis. In the 1980s, “distorted deregulation” caused an economic bubble; financial deregulation was implemented on corporate finance, but the financial regulations on segmentation of financial services were not eased sufficiently. In the 1990s, the Ministry of Finance (MOF) hid the seriousness of a non-performing loans problem because financial deregulation was proceeding at a very slow pace and the MOF had a tight relationship with banks. It was not until 1997 that the financial crisis was perceived as serious, including by politicians. The MOF’s style of supervision and inspection of financial institutions was criticized, and more drastic financial liberalization was implemented. However, it was not until 2005 that the non-performing loans problem was finally resolved because then-Prime Minister Junichiro Koizumi, who insisted on advancing structural reforms despite a short-term economic downturn, made major banks accelerate their disposal of non-performing loans. To resolve the problem, the Financial Services Agency (FSA) inspected major banks in an arbitrary and heavy-handed manner. Therefore, the style of financial supervision did not resemble the Anglo-Saxon model completely even after the crisis was overcome. In addition, financial innovation has developed rapidly in the U.S. and Europe since the 1990s; Japanese financial institutions had to deal with the financial system instability until 2004 and could not keep up with this progress. Ironically, this has kept them from undergoing great losses since the

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global financial crisis of 2007–2008. The global financial crisis has changed the style of financial supervision by the FSA.

1. Introduction

Japan attracts broad attention from the U.S. and European countries as a precedent for a country that has experienced financial crisis. In Japan, financial instability and an economic slump continued from the 1990s to the early 2000s. However, in the global financial crisis of 2007–2008, the banking sector of Japan has not been damaged much, and the three megabanks in Japan invested in financial institutions in the U.S. and the U.K.\(^1\) Nevertheless, the Japanese economy faced a more severe downturn than the U.S. and EU economies from fall 2008 to spring 2009, as it depends heavily on exports to the U.S.

This article explains how changes in financial regulation caused Japan’s financial crisis and how two financial crises (Japan’s financial system instability from 1990 to 2003 and the global financial crisis of 2007–2008) caused change in financial regulation.

The financial system in postwar Japan was a bank-centered system. However, from the late 1970s, financial deregulation, especially relaxation of regulations regarding corporate finance, occurred. Large companies began to raise funds from stock and bond issuance and moved away from bank financing in the 1980s, leading to banks wanting to enter the securities business. However, they were hampered by the remaining financial regulations; the government delayed easing the regulations on segmentation of financial services compared to the regulations on corporate finance. Thus, banks made their way into real estate financing instead. They made real estate loans on a massive scale, and this triggered the land price bubble.

The bubble economy collapsed in the beginning of the 1990s, and banks became burdened with huge non-performing loans on account of falling real estate prices. This crisis caused changes in financial regulation. It was thought that not financial liberalization but “distorted financial liberalization” caused the financial crisis, so more drastic financial liberalization has been implemented since 1997.

However, Japanese financial institutions had to dedicate themselves to dealing with the non-performing loans problem and the financial system instability. They could not keep up with the technological innovation in finance that was advancing

\(^1\) Mitsubishi UFJ Financial Group invested in Morgan Stanley, Sumitomo Mitsui Financial Group invested in Barclays, and Mizuho Financial Group invested in Merrill Lynch.
rapidly in the U.S. and Europe. Because of this, ironically, the banking sector of Japan has not taken a huge loss in the world financial crisis of 2007–2008.

In Japan, the Ministry of Finance (MOF) had jurisdiction over both fiscal affairs (budget compilation, tax policy, and fiscal investment and loan programs) and financial affairs (supervision and inspection of financial industries, and international finance) till the late 1990s. The most important object of this financial administration by the MOF was to maintain financial system stability. The MOF restricted competition among financial institutions through strict regulations in order to prevent any financial institution failing.

Financial deregulation proceeded from the late 1970s, and regulations to restrict competition were abolished gradually. However, the MOF advanced financial deregulation at a much slower pace than the U.S. and the U.K. in the same period. Hence, the tight relationship between the MOF and financial institutions did not change. This collusive relation led to various scandals in the 1990s. Furthermore, the MOF could not prevent the financial crisis in November 1997, in which Sanyo Securities Company, Hokkaido Takushoku Bank (a city bank), and Yamaichi Securities Company (one of four major securities companies) fell into bankruptcy. The MOF’s style of supervision and inspection of financial institutions became criticized, and the financial regulatory system was changed considerably.

The policy responses to the 1997 financial crisis in Japan are usually seen as failures because the preparation of schemes for the disposal of failed banks and for injection of public funds into banks was delayed considerably. Why the financial system instability in Japan was prolonged for such a long time must be addressed. The reason the policy responses were delayed is that the collusive relationship between the MOF and banks existed until the 1990s.

Then, the question may be how the financial system instability was overcome. It is generally insisted that injection of public funds is needed to overcome a financial crisis. However, in Japan, most banks cleaned up their bad loans not by using public funds but by using funds gathered by increasing their own stocks. Therefore, in the government’s policy responses, accelerating the disposal of non-performing loans through tightening assessment of banks’ assets was more important than injecting public funds into banks.

The financial divisions were separated from the MOF, and the Financial Services Agency (FSA) was established in 2000. The government tried to transform financial administration from discretionary administration, which takes precautions in advance, into rule administration, which reviews ex post facto.

However, the financial regulatory system in Japan has not been completely
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transformed into the Anglo-Saxon model, which respects the freedom of business as much as possible. The FSA has placed more emphasis on consumer protection than on encouraging financial institutions in operating activities. The regulations on segmentation between banking and securities businesses are still stricter than those in the U.S. and European countries.

This article traces the history of the development of the Japanese financial regulatory system and explains the interaction between financial regulation and financial crisis. This article is organized as follows. In the second section, it is described that the financial system in postwar Japan was a bank-centered one and the MOF had restricted competition among financial institutions. In the third section, it is argued that the deregulation of corporate finance advanced from the late 1970s but that the regulations on segmentation of financial services were not eased as quickly as those on corporate finance. In the fourth section, it is explained that this “distorted deregulation” contributed to the bubble in the late 1980s. In the fifth section, it is explained why the financial system instability in Japan was prolonged in the 1990s. This section also argues that this financial crisis caused drastic financial liberalization since 1997. In the sixth section, it is explained how this crisis was resolved under the Koizumi Administration in the early 2000s. In the seventh section, it is argued that the style of financial supervision changed after the financial crisis in Japan and that the global financial crisis of 2007-2008 changed the style of it again. In the eighth section, I close the argument by summarizing this article.

2. The Financial System in Postwar Japan

The financial system in postwar Japan was a bank-centered one. Most firms relied on bank borrowing for their funds; stock and bond financing were limited because of strict regulations. Primary household assets were held as bank deposits, and securities holdings were quite limited. A large proportion of the shares of publicly traded Japanese corporations were held by banks and companies within the same corporate groups (called “cross-shareholding.”)

The most important object of financial administration in postwar Japan was to maintain the stability of this bank-centered system. The MOF, which was in charge of financial administration, restricted competition among financial institutions to prevent any such institution whose management base was weak from failing.

There were many regulations to restrict competition. First, the classification of business categories and the scope of business for financial institutions were regulated strictly (segmentation of financial services). Following the U.S. approach,
banks were prohibited from engaging in the securities business. The insurance business was also separated from the banking business and securities business. Within the banking business, ordinary banks and trust banks were separated, and only trust banks operated in the trust business\(^2\). Moreover, ordinary banks were specialized according to their type of lending. City banks (nation-wide commercial banks) specialized in short-term lending to provide large firms with operating funds, and long-term credit banks specialized in long-term lending to provide large firms with large-scale investment funds. Small and medium-sized enterprises (SMEs) borrowed funds from regional banks, mutual banks (regional II banks since 1989), *shinkin* banks (cooperative associations), and credit unions.

Second, to ensure all financial institutions made sufficient profits, deposit interest rates were controlled by the government and lending rates were cartelized practically. Due to this, banks did not have to compete for depositors by offering higher deposit interest rates or for borrowers by offering lower interest rates. Thus, even financial institutions whose management bases were weak could attain high enough profit margins. Similarly, in the securities business, stock trading commissions were regulated.

Third, the setting up of new branches required MOF approval. As the kinds and prices of financial products were regulated strictly, expansion of scale led to profits increasing. Thus, city banks wanted to set up more branches in order to obtain more deposits and provide more loans. However, to protect small and medium-sized financial institutions, the MOF severely limited the establishment of new branches of city banks.

Fourth, the market entry and exit of financial institutions were highly restricted. To limit competition among such institutions, the market entry of new financial institutions was controlled. On the other hand, the MOF took an unbending stance of preventing any bank from going under at any cost in order to maintain financial system stability. Although sufficient profits were ensured by the government regulations, some banks faced financial difficulties owing to irresponsible management. In these cases, the MOF had other financial institutions merge with failed financial institutions as a bailout, without disposing of the failed institution. The acquiring institutions were willing to incur the cost of merging with failed institutions because they could increase their number of branches rapidly.

The MOF way of supervising financial institutions is called the “convoy system.” This term comes from the fact that in convoys, all vehicles have to match

\(^2\) Only Daiwa Bank, a city bank, rejected this regulation and operated in the trust business.
The speed of the slowest vehicle in order to protect it (Ito 2004).

3. Distorted Deregulation: late 1970s to early 1980s

Financial deregulation, especially deregulation of corporate finance, has been advancing since the late 1970s because a huge amount of government bonds was issued at that time. However, as Takeo Hoshi and Anil Kashyap (2001) and Tetsuji Okazaki and Takeo Hoshi (2002) argue, the regulations on segmentation of financial services were not eased as quickly as those on corporate finance. This “distorted deregulation” motivated banks to expand their business to real estate loans and contributed to the land price bubble.

The MOF advanced financial deregulation at a much slower pace than the U.S. and the U.K, where financial deregulation proceeded rapidly in the same period. For instance, the MOF took a step-by-step approach to liberalizing interest rates, starting with larger fixed deposits. This interest rate liberalization was finally completed in 1994. The regulations on segmentation of financial services were eased at a much slower pace. It was not until 1999 that banks, trust banks, and securities companies were allowed to enter each other’s markets.

The MOF took control of financial deregulation and advanced it very slowly. Its influence over financial institutions remained strong, and its style of supervision and regulation remained almost unchanged.

On the other hand, financial deregulation regarding corporate finance proceeded more rapidly. As a result, banks suffered from lost borrowers and narrowing profit margins. Large business firms began to raise funds through issuing corporate bonds and new stocks and became less dependent on bank financing. Banks also started to sell high interest rate CDs (negotiable certificates of deposit) due to interest rate deregulation, and this decreased profit margins, which were their prime source of earnings.

Facing this change of business environment, most city banks and long-term credit banks aspired to become universal banking businesses, modeling themselves on banks in Western Europe, which were in the securities business (Okazaki and Hoshi 2002).

However, the strategy of banks to enter the securities business could not be

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3) The interpretation in this section originated with Hoshi and Kashyap (2001) and Okazaki and Hoshi (2002).

4) In particular, long-term credit banks were expected to be endangered in the future. Large firms were less dependent on bank finance, and city banks’ lending periods were lengthened in effect.
executed. The regulations on segmentation of financial services had not been eased for a long time. It was not until 1993 that banks were allowed to form subsidiaries that could partially operate in the securities business. Moreover, the services that bank-owned security subsidiaries could offer were heavily restricted. They were not allowed to underwrite stock issues or deal in the secondary market for corporate bonds and stocks (Hoshi and Kashyap 2001, 252).

Segmentation of financial services was not deregulated rapidly for three reasons as follows. First, securities companies and trust banks strongly opposed the entry of city banks into their field. Second, the MOF was concerned that financial deregulation would increase competition among financial institutions and drive some of them into bankruptcy. Third, the MOF was concerned about the conflict of interests between the banking business and securities business, i.e., banks might make companies in financial difficulty issue corporate bonds and stocks in order to recover loans from them. Due to the third reason, some firewalls between a bank and its securities subsidiary have still been maintained, although financial deregulation was completed by the Japanese Big Bang financial reforms at the end of the 1990s.

4. Expansion of Bubble Economy: late 1980s

Financial deregulation encouraged the development of capital markets, which had been depressed by strict regulations, stimulated market trading, and raised stock prices in the 1980s. There was a boom among firms in making speculative investments on the stock exchange. This boom reached its zenith during the bubble period of the late 1980s.

On the other hand, the land prices around Tokyo started to soar in the early 1980s. This was because foreign financial institutions expanded into Tokyo due to financial internationalization and financial deregulation in Japan. This led to a shortage of available office buildings in Tokyo.

Banks suffering from lost borrowers and narrowing profit margins tried to increase their profits by increasing real estate loans because these loans were expected to bring in high profits due to the rise in land prices. Large banks, which had usually lent only to large firms, also increased loans to SMEs if they offered land as collateral. They made real estate loans on a massive scale without sufficiently considering the risk that land prices might fall. In postwar Japan, land prices had continued to rise except for in the year after the oil crisis in 1973, and the myth of ever-higher land prices prevailed. This stimulated land transactions and drove land prices up sharply.
In brief, deregulation of corporate finance was advanced, and this raised stock prices. On the other hand, the regulations on segmentation of financial services were maintained. The primary business of banks had to remain lending to firms. Then, banks found real estate financing as a new source of earnings and increased real estate loans. This drove land prices up further.

Moreover, a low interest rate policy was long maintained. In September 1985, the Plaza Accord was reached. This triggered sharp appreciation of the yen, and the Japanese economy got worse because its growth significantly depended on exports to the U.S. The U.S. government also continued to require that the Japanese government expand domestic demand, as it thought that exchange rate adjustment alone would not correct the trade imbalance. Hence, the Bank of Japan continued to lower interest rates from 1986. It also left its official discount rate unchanged at 2.5%, which was an extremely low rate for that time, from February 1987 to May 1989. This stimulated speculative investments in stocks and real estate further, and the stock and land bubble emerged.

The Japanese economy experienced an unprecedented boom in the bubble period. However, soaring land prices became a serious social issue, so policies aimed at decreasing these prices were implemented. The Bank of Japan returned to raising its official discount rate from May 1989, and the MOF directed financial institutions to restrain real estate loans.

As a result, stock prices started to fall in 1990 and land prices in 1991.

5. Financial Crisis and Japanese Financial Big Bang: 1990s

Stock and land prices continued to fall in the 1990s, even though the Bank of Japan shifted its policy to lower interest rates in July 1991. The slump was prolonged, and non-performing loans became a serious problem for banks.

In Japan, the non-performing loans problem directly forced the economy into stagnation. Almost all SMEs, which account for about 99% of Japanese companies, depend on banks for financing. To maintain the capital adequacy ratios, banks became reluctant to lend money to SMEs, whose lending risk was regarded to be high. This made it difficult for SMEs to raise funds, and their investments dropped. The business situation of many firms thus worsened further, and non-performing loans increased. Thus, a spiral emerged.

The fall in stock prices had a significant negative impact on the financial conditions of large banks. Through cross-shareholdings, some of them held a huge amount of stocks, whose value was more than the value of the bank’s capital. When the Basel Capital Accord (Basel I) was introduced in 1988, the Japanese
government claimed that banks should be allowed to include the unrealized capital gains on their stocks in their capital. After negotiations between developed countries on the accord, banks were allowed to include 45% of the unrealized capital gains on their securities in Tier 2 capital (which is composed of supplementary capital). This enabled Japanese banks whose ratios of capital to assets were low to clear the regulatory requirement. However, because of this, their capital fell and they experienced financial difficulty when stock prices fell.

Bank managers thought that the non-performing loans problem would be solved through economic recovery and rises in land prices. However, the economy remained stagnant, and land prices continued to drop sharply, even though the Bank of Japan had lowered its official discount rate several times since July 1991. The financial conditions of some banks worsened, and it became impossible for them to revive themselves.

The MOF adhered to the traditional style of administration. To maintain financial system stability, the MOF tried to have other financial institutions merge with financial institutions on the verge of collapse as a bailout without disposing of the failing institution.

However, this time, the MOF could not find financial institutions to merge with the ailing institutions. Most financial institutions had no capacity to bail out other institutions because they also had a huge amount of non-performing loans.

Accordingly, at this time, the MOF should have prepared new schemes for disposal of the failed banks. To dispose of insolvent financial institutions, financial authorities must get solvent financial institutions to assume the business of the insolvent ones in order to protect depositors and to continue to lend money to sound borrowing firms. Without a financial institution to assume this business, financial authorities have to prepare a takeover institution (bridge bank) by themselves. In both cases, the Deposit Insurance Corporation of Japan (DIC) has to provide funds for takeover institutions. However, if many financial institutions or a large financial institution collapses, the funds of the DIC would run out. Therefore, to maintain financial system stability, the injection of public funds for establishing a bridge bank and protecting depositors is required. Public funds should also be injected into financial institutions that are solvent but have financial difficulties. In the U.S. (the S&L crisis) and Northern European countries in the late 1980s and early 1990s, these measures were taken and the non-performing loans problem was resolved.

However, the MOF was opposed to using public funds. It thus could not dispose of insolvent financial institutions and tried to hide the seriousness of the non-performing loans problem. It was not until April 1992 that the amount of bad debts
was made known to the public, although the estimated amount was in reality much less than the actual amount\(^5\). The MOF kept insisting that the non-performing loans problem was not serious and that financial institutions would be able to write off their bad loans by themselves. Yet, land prices kept falling and bad loans kept rising.

It was not until the end of 1994 that the actions of the MOF started to lead insolvent financial institutions into bankruptcy. In November 1994, the MOF made the Bank of Japan and all private banks in Japan provide funding to dispose of two failed credit unions. Tax money was not used at this time.

However, it was found that the executive director of one of the failed credit unions had lavished attention on some elite MOF officials. It was also made clear that these financial institutions had been insolvent before and that the MOF had estimated the amount of bad loans at less than the actual amount. Hence, the MOF was blamed for its untransparent financial supervision by the public, mass media, and politicians.

In 1995, the MOF finally determined to liquidate \textit{jusen} companies, which had been seen as the largest symbol of financial system instability since 1992. \textit{Jusen} companies were originally home mortgage lending institutions for individuals but had lent a huge amount of money to real estate companies. At the end of 1995, the MOF decided that 685 billion yen should be paid from the government’s general account for disposal of the \textit{jusen} companies. The public strongly opposed this decision and criticized the MOF because it monitored and inspected \textit{jusen} companies and its retired bureaucrats had become executives of those companies.

In the Diet’s proceedings, the New Frontier Party, the largest opposition party, strongly opposed the proposed budget and staged a sit-down to block the meeting to pass the budget. To pass the budget bill, the MOF tried to defuse the situation by explaining to politicians that all that was required to resolve the financial instability was to dispose of \textit{jusen} companies. In fact, the non-performing loans problem was

\(^5\) In December 1991, an analyst who worked at Salomon Brothers published that the bad loans of large Japanese banks were estimated at 20 trillion yen or 59 trillion yen in the worst case. In May 1991, the Financial Times reported that the bad loans of Japanese banks were estimated at 42–56 trillion yen. On the other hand, the Bank of Japan estimated them at 29 trillion yen at the end of 1991. The Bank told the MOF that they amounted to more than 40 trillion yen, and the MOF itself also estimated them at about 50 trillion yen. However, under the guidance of the MOF, 21 large banks published that their bad loans amounted to about 8 trillion yen in April 1992 and 12 trillion yen in October 1992 (Sugita 2005). Due to change in the definition of non-performing loans, the amount of bad loans that was published increased as the years went by; it amounted to 76.7 trillion yen in January 1998.
still extremely serious, and this was a false account by the MOF (Nihon Keizai Shimbunsha 2000a, 81). This conflict over the disposal of jusen companies made using public funds for the problem taboo.

The Liberal Democratic Party (LDP), the largest ruling party, faced public criticism for the non-performing loans problem and thus tried to lay the blame on the MOF. The ruling parties determined in 1997 that the divisions to supervise and inspect financial institutions should be separated from the MOF, and the Financial Supervisory Agency was founded in June 1998. The MOF remained in charge of planning and drafting matters concerning the financial system, and the Banking Bureau and the Securities Bureau were integrated into the Financial System Planning Bureau.

It was thought that the MOF had supervised and inspected banks inadequately because of the collusive ties between the MOF and financial institutions and that this was the cause of the non-performing loans problem. Therefore, public criticism mounted against the MOF’s strict regulations for financial institutions. Financial liberalization became widely supported. Because it was thought that not excessive liberalization but insufficient liberalization had caused the financial crisis, the financial crisis led to further financial liberalization.

Then, the then-Prime Minister Ryutaro Hashimoto started economic structural reforms. As part of these, he launched the Japanese Financial Big Bang, which eliminated financial regulations and liberalized the financial market comprehensively. He was afraid that financial transactions in foreign markets would increase and the Tokyo financial market would decline on account of strict regulations. Under his order, the MOF advanced a reformist policy positively. It did so to recover public support. The gradual deregulation that had started in the late 1970s was completed at last. The Japanese Big Bang included liberalization of various regulations, such as those on international capital transactions, brokerage commissions, securities derivatives (full liberalization in this case), and so on. Moreover, segmentation of financial services was relaxed rapidly. That is, banks were allowed to sell investment trusts and to issue non-structured bonds, the scope of the business services of banks' securities subsidiaries was liberalized, banks and securities companies were

6) Tetsuro Toya insists that the MOF implemented the Japanese Financial Big Bang in order to recover public support. He argues that the MOF had difficulty surviving due to losing public trust on account of both failures in ethics, such as scandals, and in policies, such as the jusen companies problem. He also claimed that the MOF put the public interest ahead of the interests of its supporters or domestic financial institutions (Toya 2006).
allowed to sell insurance products, insurance companies were allowed to enter the banking business, financial holding companies that included a bank, a securities dealer, an investment trust company, an insurance company, and a financial service firm were allowed, and so on (Hoshi and Kashyap 2001, 290–295).

Prime Minister Hashimoto also promoted fiscal structural reforms. In April 1997, the consumption tax rate was raised from 3 to 5%, special tax cuts were abolished, and medical costs and insurance premiums were raised. The government also decided to cut budget expenditure.

This austere fiscal policy and the Asian financial crisis that started in the summer of 1997 deteriorated the economy. The economic downturn decreased stock prices, and financial institutions’ unrealized capital gains on their stocks were reduced. This caused financial system instability. In November 1997, Sanyo Securities Company, Hokkaido Takushoku Bank (a city bank), and Yamaichi Securities Company (one of four major securities companies) fell into bankruptcy. The MOF could not sustain the convoy system. That is, the MOF could not prevent any large bank from going under.

The chain reaction collapse of these large financial institutions caused panic, and some bank runs occurred. Owing to bank reluctance to extend loans, capital investment fell drastically. Japan plunged into a serious economic slump.

The MOF was blamed for its failure in financial administration. In fact, Prime Minister Hashimoto feared that the Financial Big Bang might bring about financial system instability through increasing competition among financial institutions. He repeatedly asked the MOF whether the non-performing loans problem could be overcome. From the MOF’s responses, he felt that that problem was not a serious concern (Nihon Keizai Shimbunsha 2000b, 254–255)7).

Thus, because the MOF covered the seriousness of the non-performing loans problem, Prime Minister Hashimoto carried out fiscal austerity programs and the Financial Big Bang without preparing schemes for disposing of failed financial institutions and injecting public funds into banks. This brought about financial panic.

The MOF was strongly blamed for covering up the actual amount of non-

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7) The MOF published that non-performing loans amounted to 21.73 trillion yen at the end of September 1997. However, it published that the non-performing loans of all financial institutions amounted to 76.708 trillion yen in January 1998, which was based on the new definition of non-performing loans. Prime Minister Hashimoto was surprised to hear this and questioned an MOF officer as to why the amount had increased so much (Nishino 2001, 91–93).
performing loans. Furthermore, some MOF officials were arrested for leaking the dates of inspections in advance or permitting a securities company to start selling a new financial product earlier than other securities companies in return for lavish entertainment.

The MOF lost its authority completely because of the failure of large financial institutions and the bribery scandal. In January 1998, the government parties decided that the planning and drafting of matters concerning the domestic financial system (the Financial System Planning Bureau), except for matters concerning financial failure resolution schemes and financial crisis management, would be transferred from the MOF to the Financial Supervisory Agency. This agency was reorganized into the Financial Services Agency (FSA), which was founded in July 2000.

A reason behind the bribery scandal is that financial deregulation proceeded at a very slow pace. Financial institutions had so-called MOF-tan, elite employees who exchanged information with MOF officials and entertained them by taking them to dinners. They obtained the dates of upcoming inspections from the MOF officials and thus could prepare for those inspections, which should be done without advance notice. In the period when regulations on selling new financial products were eased step-by-step, the MOF could decide arbitrarily which financial institutions could sell a new financial product or what kind of new financial products could be sold. Thus, through providing lavish entertainment, MOF-tan tried to obtain information about what kind of new financial products would be approved next and get authorization to start selling new financial products earlier than other financial institutions.

On the other hand, elite MOF officials also had to hold close relations with MOF-tan. In the MOF, the Budget Bureau was the mainstream of the ministry, and the financial divisions were treated as marginal. Changes of elite officials were decided centering on the Budget Bureau. An official who specialized in matters concerning budget-making and had no experience working in the financial divisions was sometimes appointed to a key post in the financial divisions because no post was suitable for him in the Budget Bureau. Then, officials who were amateurs at financial administration but who started working in the financial divisions were tutored in financial administration by MOF-tan and received their assistance when they drafted bills. Moreover, in Japan, elite bureaucrats are transferred to another department every one or two years. Consequently, the MOF officials could not become experts on financial administration. Overall, elite bureaucrats could not handle their tasks without exchanging information with MOF-tan frequently, and
they had to hold close ties with them (Muramatsu 2005). The reason that the MOF rejected using public funds and hid the seriousness of the non-performing loans problem lay in this situation. The MOF held close relationships with private financial institutions through MOF-tan and a “descent from heaven” (amakudari) system. The latter is an institutionalized system whereby senior bureaucrats in the MOF receive high-level appointments in financial institutions when they retire. Accordingly, if it was revealed that most financial institutions had financial difficulties, the MOF would be blamed more than the bank managers.

The MOF feared that it would be blamed for its failure in financial administration because this would lead to the separation of the financial divisions from the MOF. The MOF had jurisdiction over both fiscal and financial affairs. Budget preparation was considered the main function of the ministry, while supervision and inspection of financial institutions were considered secondary functions. Therefore, when the fault in financial administration became clear, it was possible for the critics against the MOF to argue for separating the financial divisions from the rest of the MOF and establishing a new supervisory body for the financial industry to develop financial policy specialists. Moreover, it was persuasively argued by the critics that the separation of fiscal divisions and financial divisions would be necessary to change the financial administration from the existing convoy system to a market-oriented policy having an objective and transparent nature.

Therefore, when the failures by the financial divisions became clear, the institutional arrangement of the MOF became an issue and made the argument for the separation of the financial divisions from the MOF more persuasive. However, the MOF resisted this separation because it would become difficult for ministry officials to find subsequent jobs in the financial sector if the financial divisions were separated from the ministry.

The MOF thought that it was critical for itself that the amakudari system leading to private financial institutions, which could pay high salaries, be maintained. The personnel management of government ministries in Japan relies on

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8) Most non-career officials stay in the same department for a long time and become experts in the area. However, low-expertise elite officials make the policies.

9) Sweden, facing a financial crisis at the same time, responded to it promptly and adequately. It was because financial deregulation in Sweden had already gone further and it had separated the government from bank administration (Svensson, Mabuchi, and Kamikawa, 2006).
the amakudari system. The practice of retiring career bureaucrats before they reach retirement age hastens the promotion of the younger generation and motivates them to work hard. The system presupposes that government ministries have many positions in which former staff members can be placed. Furthermore, career bureaucrats who perform well are promoted to high ranks in the government ministries and are found positions with high salaries. In short, because amakudari widens the gap between salaries, it motivates career bureaucrats to make an effort to perform well (Inatsugu 1996, 34–36, 43–45). Therefore, the MOF, which resisted dismembering, was unable to admit that it had failed in its financial administration duties. The institutional arrangement of the MOF, which had jurisdiction over both fiscal and finance divisions, fixed its strategy to hide the seriousness of the bad loans problem (Kamikawa 2005; Svensson, Mabuchi, and Kamikawa, 2006).

However, the failure of large financial institutions in 1997 made the seriousness of the non-performing loans problem clear. The MOF was blamed for the financial crisis, and the financial divisions were separated from it.

In March 1998, public funds were injected into large banks to increase their capital. Nevertheless, the non-performing loans problem was not resolved. For the injection of public funds, banks apply for injection of public capital; the amount is judged by not the government but the banks themselves. This is not forcible capital infusion, in which the government thoroughly assesses a bank’s assets and makes it set aside adequate reserves to cover its bad loans and then injects public funds to cover the capital shortage.

Banks were afraid that they would be seen as having financial difficulties, that their stocks would be sold, and that they would then run into operating difficulties, if they were willing to apply for public capital. They also feared that the mass media and the public would oppose the injection of public funds and pursue the responsibility of bank managers. Hence, no banks applied for public capital voluntarily.

Thus, the government asked some large banks that were seen as having sound financial conditions to apply for public capital in order to prevent the stocks of banks that had applied for public capital from being sold. The banks agreed, and the large banks approached applied for public capital together. The bank assets were not assessed severely. Therefore, the amount of public funds was not enough to stabilize the financial system.

In June 1998, the stock price of the Long-term Credit Bank of Japan (LTCB) dropped sharply. The LDP government decided to keep LTCB from falling into bankruptcy and instead have it merge with Sumitomo Trust & Banking, which had
proposed the merger. Sumitomo Trust & Banking insisted that it would take over only LTCB’s normal loans and that the government should inject public funds into LTCB and make it write off its bad loans.

However, the LDP was severely defeated in elections for the Upper House of the Diet in July 1998 and lost its majority in the House. Hence, the LDP government had to accept the propositions of the opposition parties, which were as follows. First, if large banks went into bankruptcy, the government would put them under “special public management” (nationalize them temporarily). Second, injection of public funds into LTCB was disallowed and so LTCB would be put under special public management. Third, the Financial Reconstruction Commission would be established in December 1998, and it, not the MOF, would resolve failed banks until December 2000.

The Financial Supervisory Agency, which was established in June 1998, assessed the assets of LTCB. In spite of the MOF’s opposition, the Agency identified LTCB as insolvent and nationalized it in October 1998. Furthermore, the bank inspectors strictly assessed the assets of the Nippon Credit Bank, which was thought to be suffering financially by the market players. They judged it to be insolvent and put it under special public management.

6. Resolution of Non-performing Loans Problem: early 2000s

Schemes for the disposal of failed banks and for the injection of public funds into banks, which had long been missing, were finally established in 1998.

However, the LDP government gave top priority to generating an economic upturn and allowed banks to postpone radical disposal of non-performing loans. The Financial Reconstruction Commission could not force a bank to declare bankruptcy and so decided to inject public funds into large banks to increase their capital, regarding all of them as financially sound. Thus, banks could not use the injected public funds to dispose of their bad loans and would have to pay the funds back to the government in years to come. The injection of public funds into large banks in 1999 appeared to settle the financial system crisis temporarily. However, it led to postponement, not acceleration, of the disposal of bad loans (Asahi Shimbun Keizaibu 2003, 259–261; Takita 2002, 40–41).

In 2001, financial system instability intensified again. In September 2002, then-Prime Minister Junichiro Koizumi, who insisted that there can be no economic

\[10\) In July 2000, the Financial System Planning Bureau of the MOF and the Financial Supervisory Agency were reorganized into the Financial Services Agency. The Financial Reconstruction Commission was abolished in December 2000.
recovery without structural reforms, had the Minister of State for Economic and Fiscal Policy, Heizo Takenaka, double as Minister for Financial Services and ordered him to resolve the non-performing loans problem.

Minister Takenaka soon formulated the “Program for Financial Revival.” It was decided that bank inspectors would tighten asset assessments of major banks and that the FSA would demand that major banks enhance their capital adequacy. He stated that he would not hesitate to inject public money into banks if necessary and that the FSA would strive to normalize the non-performing loans problem by the end of fiscal 2004 by reducing the non-performing loan ratio of major banks to about half (it was 8.4% at that time) (The Financial Services Agency 2002; Asahi Shimbun, October 25, 2002; Ono 2005, 56–57; Takenaka 2006, 70–75).

At the same time, it was decided that the Industrial Revitalization Corporation of Japan (IRCJ) would be established (it was eventually founded in April 2003), led by the MOF, which feared the negative impact of radical disposal of bad loans on the economy. The IRCJ purchased loans from banks and reconstructed and reorganized borrower firms in cooperation with their main banks and their sponsors.\(^{11}\)

Major banks were afraid of being nationalized and thus launched large-scale capital increase. Mitsubishi Tokyo Financial Group increased its common stocks through a public offering and raised 270 billion yen. Sumitomo Mitsui Financial Group issued preferred shares worth up to about 500 billion yen. Mizuho Financial Group asked loan customers, from big companies to SMEs, to take up preferred shares and succeeded in increasing its capital by 1.083 trillion yen.

On the other hand, UFJ Holdings did not increase its shares and did not advance its disposal of bad loans to large firms with excessive debts.\(^{12}\) Thus, UFJ had difficulty surviving afterward.

Minister Takenaka’s hard-line policies were seen to be stalled because injecting

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11) The IRCJ, the Resolution and Collection Corporation (RCC), which was established in April 1999 and which started to reconstruct borrower firms in 2002, and private corporate reconstruction funds, which became very active at that time, were useful to major banks when they disposed of bad loans (Hoshi and Kashyap 2006, 451). In the 1990s, the institutions for corporate revival, such as bankruptcy proceedings under Chapter 11 and turnaround businesses, were not developed in Japan. Keiichiro Kobayashi points out that this was one important factor that hindered the disposal of bad loans in Japan (Asahi Shimbun, August 20, 2009).

12) It established a subsidiary, in which Merrill Lynch took a 120 billion yen stake through preferred shares. It specialized in the disposal of non-performing loans, and UFJ Holdings transferred its bad SME debts to the subsidiary (Yamaguchi 2004, 161–162).
public funds seemed to be unnecessary for the time being owing to the capital expansion of major banks (*Asahi Shimbun*, April 26, 2003). He tried to achieve infusion of public funds into banks by using audit corporations.

The Chairman of the Japanese Institute of Certified Public Accountants, Akio Okuyama, who cooperated with Minister Takenaka in formulating the “Program for Financial Revival,” sent a Chairman Notice on February 24, 2003 to certified public accountants. It urged the accountants to calculate the deferred tax assets of major banks precisely, with each bank’s earnings forecast and the business environment around it in mind. If the accountants followed this notice, it was difficult for them to allow Resona Bank to claim five years of profits, which is the maximum, for it had been in the red for three accounting terms in a row (Ono 2005, 85; Yamaguchi 2004, 166–167). The auditing firm for Resona allowed Resona to claim only three years of profits. As a result, the capital adequacy ratio of Resona Bank was calculated as 2.3%, and that of Resona Holdings, which was its holding company, was calculated as 3.8%. As their capital adequacy ratios fell below the 4% required by domestic standards, the infusion of public funds was required (Japan Center for Economic Research 2003).

On May 17, 2003, a meeting of the Financial System Management Council was held, and it decided to inject 1.96 trillion yen in public capital into Resona Bank. Resona Bank was not regarded as having excessive liabilities because the auditing firm permitted estimation of deferred tax assets for a three-year period. If it had not, Resona Bank would have been judged insolvent. The government applied not Item 3, Article 102 of the Deposit Insurance Law (placing banks under special public management, or nationalizing banks), but Item 1 (restore the soundness of banks that are not insolvent by injecting public money into them) to this case. Therefore, Resona Bank did not reduce capital stock and the responsibility of the shareholders of Resona Holdings was not pursued (Yamaguchi 2004, 171).

After the injection of public money into Resona Bank, stock prices, especially those of banks, turned upward, and this rapidly enhanced the financial strength of banks. The main reason for this was that shareholders of Resona Holdings were allowed to not pay the normal penalty. Instead, they made gains as the stock price of Resona rose. Foreign investors rushed to buy the stocks of banks and the banks’ related companies because it became clear that Minister Takenaka was being unexpectedly lenient with the banks (*Asahi Shimbun*, September 19, 2003). In the end, stock prices recovered through moral hazard, i.e., the government protecting the shareholders of banks.

After that, the FSA, at the initiative of the Inspection Bureau, conducted strict
inspections of financial institutions. In November 2003, Ashikaga Bank (a regional bank), was judged insolvent because its auditors did not permit estimation of deferred tax assets. It was nationalized temporarily under Item 3, Article 102 of the Deposit Insurance Law, and the stock of Ashigin Holdings (its holding company) became almost worthless. In this case, the shareholders’ responsibility was pursued strictly.

In 2004, the FSA implemented extremely strict inspections of UFJ Bank because it had tried to thwart inspections by the FSA in the previous year. It was forced to set aside a huge amount of loan-loss reserves. To avert its bankruptcy, it was compelled to merge with Mitsubishi Tokyo Financial Group.

At the end of fiscal 2004, the target of the “Program for Financial Revival,” which was that the non-performing loan ratio of major banks should be decreased by half, was achieved and financial unrest was dispelled.

However, the fundamental disposal of non-performing loans was achieved in different ways from those first expected.

First, it had been thought that huge infusions of public funds into major banks would be required. However, many major banks increased their stocks by themselves and succeeded in clearing up their bad debts. Only Resona Bank and Ashikaga Bank applied for public fund injections.

Second, because Minister Takenaka had threatened to nationalize major banks and they made serious efforts to clear bad loans, which they had put off handling, the radical disposal of non-performing loans was achieved. Nevertheless, it should not be overlooked that the Japanese economy recovered by the good fortune that foreign demand, especially demand in China, increased. This enabled ailing companies whose debts had been classified as bad loans to turn around, and their debts were turned into normal loans. As a result, the amount of bad loans decreased rapidly.

Third, when the government injected public funds into Resona Bank, the FSA did not assess its assets and took at face value the assertion of the auditing firm that the bank was not insolvent. The shareholders’ responsibility was not pursued. Therefore, the stock prices turned sharply upward, not by proceeding with structural reforms but by moral hazard, and a financial crisis was averted. The economic recovery was also a significant factor in the increase in stock prices.

Of course, these points do not imply that the Koizumi Administration’s efforts to make major banks accelerate the disposal of non-performing loans were not significant. Rather, they should be highly regarded. This is because the financial system was stabilized through the radical disposal of bad loans, and this supported
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the economic recovery in part. That is, both the economic recovery and the radical
disposal of bad loans decreased bad loans; both the decline in bad loans and
increase in stock prices improved management of banks and stabilized the financial
system, and this caused a business upswing and an upturn in share prices.

Two lessons can be learned from Japan’s experience. First, tightening
assessment of banks’ assets and preventing banks from deferring the disposal of
bad loans are more effective as a governmental response than injecting public funds
into banks. It is generally argued that injection of public funds into banks is
necessary to overcome a financial crisis. However, in 1998 and 1999 in Japan, such
an injection prolonged rather than accelerated the disposal of bad loans. When
major banks wrote off their bad loans under pressure from Minister Takenaka, they
did not apply for public capital but increased their capital by themselves. Of course,
the government should not hesitate to use public funds if they are needed.

Second, it is necessary not only to depend on an economic upturn but also to
advance the disposal of non-performing loans steadily in spite of a short-term
economic downturn. In Japan, the government increased public spending
enormously and the Bank of Japan eased monetary policy to extremes. Due to this,
the economy recovered temporarily in 1996 and 1999–2000. However, the amount
of bad loans did not decrease and these economic booms did not last for long\(^{13}\).

7. The Global Financial Crisis: late 2000s

The non-performing loans problem had finally been resolved for about 15 years
by the late 2000s. In this period in which all Japanese financial institutions were
concerned with dealing with bad loans, financial innovation developed rapidly in
the U.S. and Europe. Moreover, in Japan, regulations on segmentation between
banking business and securities business still remain. Banks still concentrate on
traditional banking business. Investment bank business, such as mergers and
acquisitions, liquidation of assets (securitization of real estate and loan assets), and
financial advice is conducted by securities companies. Japanese securities
companies, however, delayed launching into investment bank business and have
fallen behind the U.S. and Europe’s financial institutions. The non-performing
loans problem and financial regulations delayed financial innovation in Japan
remarkably.

However, major financial groups centering on megabanks, into which large
financial institutions had been reorganized, have launched into the investment

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\(^{13}\) This section is summarized from Kamikawa (2010).
banking business as the non-performing loans problem was resolved. In a financial group, a holding company holds stocks issued by a city bank, a trust bank, and a securities company. Mitsubishi UFJ Securities and Mizuho Securities (which are securities subsidiaries of banks) and Daiwa Securities SMBC (which was the joint venture between Daiwa Securities and Sumitomo Mitsui Financial Group) have entered the investment banking business\(^{14}\). Furthermore, the regulations on segmentation between banking and securities businesses have been eased gradually. However, the primary household savings vehicle still remains bank deposits, as public consciousness does not change immediately. The Japanese financial system still remains a bank-centered system.

On the other hand, the style of financial administration has been transformed from the MOF’s discretionary administration, which took precautions in advance, into the FSA’s rule administration, which reviews ex post facto. The FSA respects the initiative and autonomy of market players and keeps an arm’s length from financial institutions. The officials operate independently of MOF-tan when they draft bills. In any case, the scheme for resolving failed financial institutions has been completed.

However, financial institutions believe that the FSA emphasizes protecting consumers more than activating operations of financial institutions, that it has been eager to severely punish them for their wrongful acts, and that it has enhanced its power against them. To make major banks accelerate their disposal of bad loans, the FSA did in fact inspect them in an arbitrary and heavy-handed manner. Financial institutions perceive that the UFJ group was compelled to merge with Mitsubishi Tokyo Financial Group because it resisted inspection by the FSA. In addition, since 2005, the FSA has very severely punished insurance companies for non-payment of insurance claims and Sumitomo Mitsui Banking Corporation for pressuring its borrowers to buy financial products. Some financial institutions call the Financial Services Agency the “Financial Punishment Agency.”

In 2006, the Financial Instruments and Exchange Act was enacted. This act establishes rules on the sale of various financial products in order to protect consumers. It is criticized by some financial institutions for being too strict. They insist that it makes sales of financial products too difficult and that this is because the FSA drafted it without listening to their opinions. This means that the FSA

\(^{14}\) In 2009, Sumitomo Mitsui Banking Corporation acquired Nikko Cordial Securities from Citigroup and made it a wholly owned subsidiary. The joint venture between Daiwa Securities and Sumitomo Mitsui Financial Group was dissolved and Daiwa Securities acquired all of the shares of Daiwa Securities SMBC.
bureaucrats make unrealistic laws, as they become estranged from financial institutions and do not know the actual conditions of financial product sales.

However, the FSA does not necessarily try to control financial institutions on account of its desire for power. In Japan, when a particular business situation becomes a new social problem, the mass media and the public generally blame the government for its failure to act and urge it to regulate that business\(^{15}\). Therefore, the FSA tends to strictly regulate financial institutions to avoid blame from the mass media and the public.

However, it is considered to be lucky for Japan that the Japanese financial system remains a bank-centered system. Due to this, the banking sector of Japan has suffered limited impact from the global financial crisis of 2007–2008.

Moreover, in Japan, the regulations on segmentation between banking and securities businesses are still stricter than in the U.S. and European countries, though they have been eased to a considerable extent. For example, the firewalls between banks and their securities subsidiaries (such as prohibition against sharing of nonpublic information on their clients between a bank and its securities subsidiary without client consent) remained until June 2009\(^{16}\). On the other hand, it is considered that financial groups in the U.S. and European countries compounded their losses of securitized products because they integrated banking and securities activities and could not perceive the overall loss risk (Asahi Shimbun, June 4, 2009). If this view is right, financial institutions in Japan have not suffered from large losses owing to the regulations on segmentation between banking and securities businesses.

However, Japan faced a more severe economic downturn than the U.S. and many European countries from fall 2008 to spring 2009, as the Japanese economy heavily depends on exports to the U.S., whose domestic demand dropped sharply.

The Japanese government then intervened in the banking sector again. First, the government urged financial institutions to apply for public capital to prevent reluctance by banks to provide loans. Some banks applied for public capital to strengthen their capital base, and their management responsibilities have not been pursued. Second, the FSA eased its inspection standards to a large degree and asked banks to lend money to SMEs more aggressively. Third, the government decided to relax the current value accounting rules, partially following the U.S. and European countries. Overall, the FSA has abandoned its tough stance against banks and asked

\(^{15}\) An FSA bureaucrat points out this tendency (Omori 2007, 43–45).

\(^{16}\) A bill to revise the 2006 Financial Instruments and Exchange Act was passed in June 2008 and has been in effect since June 2009.
them to lend money aggressively to companies, especially SMEs. This has been
cased by pressure from politicians.

8. Conclusion

The financial system in postwar Japan was a bank-centered financial system that
was strictly regulated by the MOF in order to restrict competition among financial
institutions. However, after the late 1970s, financial deregulation encouraged the
development of capital markets, and large firms moved away from bank financing.
It also gave rise to a boom in speculative investment in stocks, bonds, and new
financial products among ordinary firms and raised stock prices. Land prices also
soared, in part because of financial internationalization.

Financial deregulation in Japan was “distorted deregulation.” Relaxation of the
regulations on corporate finance proceeded quite rapidly, but the regulations on
segmentation of financial services were not eased for a long time. Banks were
prevented from launching into the securities business, though large firms moved
away from bank financing. Banks then increased real estate loans rapidly. They
could gain massive profits through the traditional banking business of lending to
firms (real estate companies at that time). As banks increased real estate loans
rapidly, land prices soared sharply.

At the beginning of the 1990s, the economic bubble burst. Stock trading became
inactive because stock prices collapsed. Moreover, banks were burdened by
massive non-performing loans as land prices dropped drastically. The financial
system instability caused by the non-performing loans problem continued till early
2005. While financial innovation developed rapidly in the U.S. and Europe in this
period, Japanese financial institutions had to deal with the financial system
instability. Therefore, they have fallen behind the advances of the U.S. and
Europe’s financial institutions. Ironically, this has kept them from undergoing great

The financial system instability in Japan was prolonged for such a long time
because a tight relationship between the MOF and banks was maintained until the
1990s, as financial deregulation proceeded at a very slow pace. The MOF thought
that it would be harshly blamed for its failure in supervising the banking sector if
the seriousness of the non-performing loans problem was revealed. Therefore, the
MOF tried to hide it. Schemes for the disposal of failed banks and for the injection
of public funds into banks in order to avoid financial crisis were not established for
a long time.

It was not until 1997, when large financial institutions successively collapsed,
that the public and politicians perceived the seriousness of the non-performing loans problem. The MOF was blamed, and the financial divisions were separated from it. The FSA was founded, and it tried to transform the administrative style from discretionary administration, which takes precautions in advance, into rule administration, which reviews ex post facto. Financial regulations were eased rapidly because it was thought that insufficient liberalization, not excessive liberalization, had caused the financial crisis. Thus, the financial crisis led to further financial liberalization.

However, LDP politicians gave preference to generating an economic upturn and postponed the disposal of non-performing loans, even though they perceived the severity of the problem. They thought that the disposal of bad loans and the resolution of insolvent financial institutions would worsen the economy because SMEs, which were electoral constituencies for the LDP, depended entirely on bank financing. The bankruptcies of large companies that were burdened with excessive debts were also seen to possibly cause employment problems. However, the economic slump was prolonged because the non-performing loans problem was not resolved for a long time. Under then-Prime Minister Koizumi and then-Minister for Financial Services Takenaka, who insisted on advancing structural reforms despite a short-term economic downturn, the non-performing loans problem was finally resolved.

However, to make major banks accelerate the disposal of bad loans, the FSA inspected them in an arbitrary and heavy-handed manner. Therefore, the style of financial supervision did not resemble the Anglo-Saxon model completely. In fact, even after the crisis was overcome, financial liberalization did not advance sufficiently compared to the U.S. The FSA seems to be more eager to protect consumers than to activate the operations of financial institutions. Moreover, the regulations on segmentation between banking and securities businesses are still stricter than in the U.S. and European countries. Ironically, this has also kept Japanese financial institutions from undergoing great losses from the global financial crisis of 2007–2008.

However, the global financial crisis has changed the style of financial supervision by the FSA. The FSA has abandoned its tough stance against banks and has asked them to lend money to SMEs more aggressively.

In short, this article finds the following interaction between financial regulation and financial crisis. That is, distorted deregulation caused bubble economy. The bubble burst and financial crisis occurred. This crisis caused Japanese financial Big Bang and transformation of the administrative style. In order to resolve the
financial crisis, the FSA forced banks to dispose of non-performing loans in an arbitrary and heavy-handed manner. Therefore, after the crisis was overcome, the FSA took tough stance against financial institutions. However, the global financial crisis occurred and this has changed the style of financial supervision by the FSA.

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