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Financial regulation in Japan: a sixth year review of the Financial Services Agency

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Abstract

The paper provides a critical review of the Financial Services Agency (FSA) of Japan since its establishment in June 1998 (as the Financial Supervisory Agency) to June 2004. During the six year period, the FSA faced the challenge of addressing severe insolvency problems in banking as well as life insurance industries. The paper argues that the initial separation of the supervisory role (in the Financial Supervisory Agency and the Financial Reconstruction Commission) and the policy planning role (in the Ministry of Finance) was useful in the sense it allowed the FSA to have a firm stance on the insolvency problem that was partially created by the failure of the past financial regulatory policy. Even after the creation of the FSA, the Bank of Japan remained as another bank supervisor. This seems have made the central bank reluctant in relaxing monetary policy out of the fear that such loose monetary policy would actually discourage re-organization of banking industry. This suggests a problem of having the central bank as a bank supervisor. For the life insurance companies, the FSA (both old and new) has not been successful in intervening (using prompt corrective action) before the failures. Finally, the paper also points out the important role of the leadership at the FSA that shapes the financial regulation, and suggests a problem of appointing a politician to this role.
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1. Creation of FSA in Japan

On June 22, 1998, the Financial Supervisory Agency (old FSA), a predecessor of the Financial Services Agency, was established by separating financial supervisory functions from the Ministry of Finance (MOF). This was a monumental step for the Japanese authorities in splitting the powerful ministry. Following the enactment of the Financial Reconstruction Act of 1998, which provided a framework for dealing with large insolvent banks, the Financial Reconstruction Commission (FRC) was established in December 1998. The FRC was placed under the Coordination Minister (later a part of the Cabinet Office) and the mandate of FRC was to give general directions to the old FSA. In July 2000, the old FSA was reorganized to form the Financial Services Agency (FSA). After a brief transition period, the FRC was dissolved and its function was absorbed by the FSA in January 2001.

The Japanese FSA is an integrated supervision agency, in charge of supervision of most financial institutions, such as banks, securities firms, insurance companies, and smaller financial institutions. The coverage is slightly larger than what the MOF used to cover, including some of smaller institutions (credit cooperatives which used to be supervised by respective prefectural governments).

The old FSA was praised for its swift move to nationalize the Long-Term Credit Bank of Japan (LTCB) and Nippon Credit Bank (NCB) in 1998, and to successfully stabilize the precarious positions of Japanese banks. After a round of capital injections to major banks of March 1999, the Japanese banks appeared to have regained its strength, or at least patched up weakness. Japan premium subsided in April 1999, and no banks failed from 1999 to 2001.

However, the weakness of Japanese banks emerged again in 2001. The crisis deepened as the stock prices sank further. The Japanese banks held a large portfolio of equities, and the decline in stock prices from mid-2001 to 2002 caused unrealized capital losses in their equity portfolio. When the capitals of Japanese banks were adjusted to reflect the unrealized losses, severe undercapitalization of most banks became obvious.

Yet, the head of FSA in mid-2002, Hakuo Yanagisawa, insisted that the Japanese banks were solvent and did not suffer from any serious capital shortage. In September 2002, Heizo Takenaka became the first head of FSA who is not a politician. He set up a new reform plan and started to pressure the banks to strengthen their capital positions and accelerate their efforts to resolve the non-performing loans. The new plan was not very much different from an old plan on paper, but the FSA under Takenaka has been more aggressive in its implementation.

This paper studies the performance of the new financial regulatory structure in Japan, which is at the end of the sixth year counting from the establishment of the old FSA (June 1998) as of this writing (June 2004). Next section reviews the motivations behind the establishment of the new regulatory structure and identifies interesting organizational changes that the structure has gone through. Section 3 looks at the performance of the new regulatory institutions and examines if the organizational changes identified in Section 2 had any visible influence on the performance. Section 4 concludes.

2. Economic rationales for changes

The creation of the new financial regulatory structure was predominantly motivated by the political factors. The goal of many politicians was not so much to improve the system of financial regulation but to reduce the power of the MOF bureaucrats. Why the politicians suddenly decided to strip much power from the MOF is an interesting question, but not what we focus here.[1] Instead we consider some economic rationales that have been pointed out during the policy debate, although these economic rationales alone would not have been sufficient to get the political support for the change.

First, throughout the 1990s, the MOF repeatedly failed to handle the insolvencies and other problems in the financial sector. *Jusen* problem (1992–1996), the “two credit cooperatives” problem (1994–1995), the Hyogo Bank failure as well as Kizu and Cosmo credit union failures (August 1995), and Daiwa Bank losses from a rogue trader and hiding losses in the New York (1995) all contributed to hurt the reputation of the MOF as a competent financial regulator.[2] It was argued that the problem lay in giving too much power to the MOF, both financial planning/legislative power and financial inspection/examination power. If the supervision framework is designed by the same people, tough actions against banks are unlikely to come, as it would suggest some faults in the initial design of policy.

Second, it was also argued that fiscal authority should not be in charge of the financial policy at the same time. As bank resolution has fiscal implications, the MOF had a tendency to forbear rather than to make the fiscal liability explicit by letting insolvent financial institutions fail. This was considered to be an important reason why the banking problem of the 1990s was allowed to grow to a monstrous size.

Third, the concentration of so much regulatory power at the MOF was believed to have led to serious corruption. Some MOF officials had been treated to wining, dining, and golfing by bankers for a long time. A series of gross scandals hit the Ministry in the mid-1990s. One of such scandals involved a MOF official taking a free trip to Hong Kong, paid for by an owner of a credit union that subsequently went bankrupt. The Ministry only imposed a slap-on-the-wrist sanction on this official. When investigated, many other corrupt behaviors of the MOF officials became exposed. The series of scandals was also important for turning public opinion against the MOF and making the break-up of the MOF even more politically attractive.

The MOF’s regulatory power was weakened in several ways. Separation of its financial supervisory role from the MOF was one of them. The Banking Bureau and the Securities Bureau, which were in charge of supervision of banks and securities houses respectively, were abolished and their jobs were transferred to the Financial Supervisory Agency (old FSA). The (old) FSA also absorbed majority of staff at local offices of the MOF whose

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[1] Some political scientists studied why the politicians in the ruling coalition (most importantly the Liberal Democratic Party; LDP) wanted to break up the MOF. For example, Mabuchi (1997) argues that the relation between LDP and the MOF got contentious when non-LDP government led by Prime Minister Hosokawa was in power between 1993 and 1995. LDP found the MOF was too cooperative with the non-LDP government, and they decided to punish the MOF after they regained the power in 1995.

[2] See Cargill, Hutchison, and Ito (1997; Chapter 6, 2000; Chapter 2) and Hoshi and Kashyap (2001; Chapter 8) for details of these episodes.

jobs were inspection of local financial institutions. Additional inspection staff was hired to boost the examination capability of the old FSA, although many observers still expressed the concern that the size of inspection staff was too small.

The so-called "planning" function of the financial policy temporarily remained within the MOF. The planning function includes drafting various rules and regulations for the financial industries. Until the Financial Services Agency (new FSA) was established (July 2000), the planning function stayed in the newly created Financial Planning Bureau of the MOF.

Another institutional change that aimed to reduce the power of the MOF was the passage of the New Bank of Japan Act in 1997 (effective April 1998). Under the new law, the Bank of Japan was given legal independence from the MOF for the first time in its history. Governor's tenure of 5 years would be guaranteed, and the monetary policy would be decided solely by the Monetary Policy Board where the government does not have any votes. Unlike many countries, where the central bank independence was legislated so that it can resist the government's pressure to inflate the economy, the Bank of Japan was already successful in containing the inflation for the most of 1980s and 1990s even without formal independence. Granting legal independence to the Bank of Japan was another way to reduce the power of the MOF, which confirms the highly political nature of the change in Japanese financial regulation around this time.

The government also introduced a new law to curb the scandals by public officials not only at the MOF but in general. The National Public Service Ethics Act of 1999 severely restricted public officials' socializing with interest groups. The rules against golden parachute (*amakudari*) were also tightened in 1998. The set of industries that an official cannot accept *amakudari* within 2 years after retirement was extended to cover all the industries under the Ministry's supervision (rather than the industries that were supervised by the Bureau that the official worked last).

It is worth noting that the change of the financial regulatory structure in Japan was not motivated by the vision to create a single authority of financial supervision. Indeed the MOF already covered the various areas of financial industry ranging from banking business, securities business, to insurance business. Unlike the case in the United Kingdom, creation of a super regulator with comprehensive coverage of all the financial services was not an objective. As we discussed above, the primary objective was political. The politicians tried to reduce the power of the MOF by separating financial supervision from its other functions (budgeting, tax collection, etc.).

As a byproduct of the reform, however, the old FSA ended up having a broader coverage in financial supervision than the MOF. For example, agricultural cooperatives, which used to be supervised only by the Ministry of Agriculture, Forestry and Fishery (MAFF), were put under co-supervision of the FSA and the MAFF. Credit unions, which used to be supervised by prefectural governments, were moved under the FSA's supervision after April 2000. Table 1 shows the change of the regulator for each type of financial supervisions that took place when the FSA was established in 1998.

An important supervisory function was, however, left outside the FSA. It is the BOJ's role of supervising banks and maintaining the financial stability. Given the political motivation of the reorganization to reduce the power of the MOF, it is understandable that the politicians did not pay much attention to the BOJ's role in bank supervision. Later this would lead to a

Table 1
Supervising regulators for Japanese financial institutions

Financial institutions	Supervisor before 1998	Supervisor after 1998
City banks, long-term credit banks, trust banks, regional banks, tier II regional banks, Shinkin banks	MOF Banking Bureau	FSA
Life insurance companies, casualty life insurance companies	MOF Insurance Bureau	FSA
Securities companies	MOF Securities Bureau	FSA
Credit unions*	Prefectures	FSA (after April 2000)
Labor cooperatives	Ministry of Labor	FSA and Ministry of Labor and Welfare
Agricultural cooperatives	Ministry of Agriculture, Forestry and Fishery	FSA and Ministry of Agriculture, Forestry and Fishery

* Credit unions that operated in more than one prefectures were under the supervision of the MOF before the change and put under the supervision of FSA when it started in 1998.

serious coordination problem between the BOJ and the FSA, as we will discuss in the next section.

The organization of the FSA also differed from the MOF in that the supervisory functions of various types of financial institutions are put under the same department (Department of Supervision). In the MOF, the functions resided separately in three bureaus (Banking Bureau, Securities Bureau, and Insurance Bureau). In theory, this reorganization should have made it easier for the FSA to supervise the financial services industry in a consolidated and coordinated way. Whether such a coordinated supervision happened in practice is an empirical question.

Another point that is worth mentioning in the transition from the MOF to the FSA is the separation of planning function and supervision function. From the inception of Financial Supervisory Agency (old FSA) in June 1998 to its reorganization into Financial Services Agency in July 2000, the planning function was left behind with the MOF. Thus, the planning function and supervision function were clearly separated during the first 2 years of the new regulatory structure, but they were again housed under the same roof in the new FSA. As we argue more fully in the next section, such separation was actually beneficial. The old FSA (under FRC) was more aggressive in dealing with insolvent financial institutions than the new FSA has been. The transfer of planning function from the MOF to the FSA seems to have made the FSA more cautious against bank closures. The inspection and examination may become more tentative out of consideration of a possible embarrassment to the planning department (which sets the ex ante rules and regulation) that bank closures may cause.

3. Performance review of financial services agency

This section reviews the performance of the new financial regulatory structure in Japan in its first 6 years. We are especially interested in how the institutional changes described above influenced the incentives of the financial regulators and their performance. As Barth et al. (2003) argue, there is no clear statistical evidence for the relation between the bank supervisory structure and the performance across different countries. By focusing on the change in the banking supervisory framework in one country (Japan), we hope to examine the issue more closely.

Assessing the performance of a financial regulatory structure is not straightforward. Barth et al. (2003) examine the impact of financial supervisory structures on economic performance of banks by looking at bank profits. We do not look at the bank profits as a measure of the performance here, because we examine short time series from only one country, which makes it very difficult to control for the numerous factors other than the regulatory structure that influences the bank profitability.

Instead, we study how decisively the financial regulator dealt with non-performing loans problem. During the period that we examine, dealing with non-performing loans and near-insolvent banks was the clearest problem that the Japanese regulator faced. The problem existed when the Financial Supervisory Agency started in June 1998, when the Financial Reconstruction Commission was established in December 1998, when the Financial Supervisory Agency was restructured to create the Financial Services Agency in July 2000, when the FSA absorbed the FRC in January 2001, and the problem still haunts the Japanese financial system today (June 2004). Thus, by examining how decisively the financial regulator responded to the problem of insolvent banks in particular and non-performing loans more in general, we can review the performance of the Japanese financial regulator in the most important areas during this period.

Focusing solely on the bank supervision, however, would miss the possible effects of further consolidation of the financial regulation (even compared with the MOF) at the FSA. Thus, we also examine how the FSA handled the supervision of insurance companies, many of which have capital ties to major banks. Following the revision of Anti-Monopoly Act in 1997 and related legal changes that allowed financial holding companies in Japan, some of these financial groups have been reorganized as holding companies. By examining the FSA's supervision of the insurance industry, we can study one aspect of the new financial regulatory framework's approach to the potential issues involving financial conglomerates.

3.1. Banking supervision

First, we provide a narrative overview of the Japanese financial regulator's policy response to insolvent banks. Then, we examine quantitative measures that allow us to compare the performance over time.

When the Financial Supervisory Agency started, the Japanese banking was still in the crisis that was triggered by the failures of Hokkaido Takushoku Bank (one of the top 20 banks at the time) and Yamaichi Securities (one of the big four securities houses) in November 1997. The injection of public funds in March 1998 did not help, and the stock prices of major banks continued to fall. The first major task for the Financial Supervisory Agency was the "special inspection" of 19 major banks. The inspection of the Long-Term Credit Bank revealed that the bank's capital at the end of September 1998 was below the unrealized capital loss of the investment securities, making the bank virtually insolvent. Following the result, which was delivered to the bank on October 19, the bank applied for nationalization under the Financial Revitalization Act on October 23, 1998, the day the law was enacted.

The LTCB had more than 10% in Basle Capital Adequacy Ratio as of March 1998, according to self-assessment. However, just 6 months later, it was found insolvent. This episode showed how lax the supervision regime was before March 1998, and that capital injection of March 1998 was carried out without examining asset and liability conditions of banks. Separating the supervision function from the MOF to create the (old) FSA seems to have been successful in this sense, although much of pressure to nationalize the LTCB came from the market where share prices had been sharply lowered.

The inspection of the Nippon Credit Bank showed that the condition was even worse than the LTCB: as of the end of March 1998, when public subscription of new shares was orchestrated by the MOF in addition to public capital injection, NCB was already de facto insolvent. On December 13, 1998, the Financial Reconstruction Commission forced the nationalization of NCB, even though the NCB protested the decision. In dealing with the NCB, the new regulators at the FRC and the FSA clearly pointed out the problem of the rescue operation led by the MOF. Admitting failure of the past policy would have been very difficult without the institutional change to separating the financial supervision function from the MOF. Since the stock price movement of NCB had not predicted the demise of the bank, the FSA action was regarded as the clear assertion of FSA independence and decisiveness.

In 1999, the FRC moved to deal with insolvent regional banks. During the year, they closed five regional banks (Kokumin Bank on April 11, Kofuku Bank on May 21, Tokyo Sowa Bank on June 11, Namihaya Bank on August 7, and Niigata Chuo Bank on October 2) and put them under the receivership of the Deposit Insurance Corporation. The wave of closures of major banks, however, stopped here, although the problem of the Japanese banking sector was not considered to be over.

The change in policy coincided with the change of the leadership at FRC. The first chair of the FRC, Hakuo Yanagisawa, was widely credited as an effective leader, acting to strengthen the banking system. His leadership was considered to be uninfluenced by political considerations. Yanagisawa, however, was replaced in October 1999. In the final 14 months of existence, the FRC had four chairs, with only one, Sadakazu Tanigaki, perceived to be politically neutral. The others have been seen as less serious about cleaning up the banking sector.[3] During this period, FRC did not close any major banks.

As we discussed in the previous section, the FSA/FRC was not the only financial supervisor in Japan. The BOJ examined the banks periodically and continued to do so even after the MOF's supervisory function was moved to the FSA. The Bank of Japan Act of 1997, which granted legal independence to the BOJ, mentioned the financial stability as one of the goals of the BOJ. Faced with the banking crisis that was intensified soon after the BOJ gained independence, the BOJ's monetary policy seems to have been influenced significantly by the development in the banking sector. In February 1999, the BOJ started to encourage the overnight inter-bank loan rate to zero (later termed the zero interest rate policy) to expand the monetary policy as much as possible, but soon started to point out the trade-off between expansionary monetary policy and resolution of the non-performing

[3] There had been leaks of their speeches and conversations that suggested the reluctant stance toward tough examinations.

loan problem. This view is clearly expressed in a speech given by Eiko Shinotsuka on July 12, 2000, then a policy board member of the BOJ:

Monetary easing has the side effect of alleviating the pain in the process of structural adjustment, but at the same time it makes economic entities delay adopting radical solutions to structural problems. If the zero interest rate policy continues while the economy is recovering, it may be natural for firms to fall into comfortable belief that they should postpone painful structural adjustment based on a short-sighted and false assumption that economic recovery can be supported solely by monetary policy ("Japan's Economy and the Role of the Bank of Japan", available as www.boj.or.jp/en/press/00/ko0007b.htm).

A view similar to this one is considered to have been behind the decision of the BOJ to terminate the zero interest rate policy prematurely in August 2000.[4]

Thus, the reluctance of the BOJ in experimenting with extraordinary expansionary monetary policy seems to be partially explained by its preoccupation with the banking problem, as they felt it is the most important impediment to Japan's economic recovery and it is their responsibility. As a result, the deflation continued and it in turn made the FSA reluctant to pursue aggressive approaches toward the reduction of non-performing loans. If the bank supervision had been removed from the BOJ and transferred to the FSA, the BOJ and the FSA might have been able to establish the division of labor in which the BOJ expands the monetary policy and the FSA deals with the non-performing loan problem in a decisive manner. In this sense, we can conjecture that the failure to concentrate all the bank supervision to the FSA created costly policy miscoordination between the BOJ and the FSA. This may be another cost of having the central bank as a bank supervisor.[5]

When the new Financial Services Agency took over the functions of the FRC in January 2001, Yanagisawa was brought back as the head of FSA. He called for "final resolution of non-performing loans" and announced that he would resume his task of reorganizing the banking sector. Following the initial moves by Yanagisawa, the BOJ lowered the target interest rate again and restored the zero interest rate policy in March 2001. In September 2001, the FSA published their timeline to deal with the non-performing loans problem as a part of the "reform schedule" by the Koizumi Cabinet. The plan declared that the amount of non-performing loans would be halved in 3 years.

A couple of insolvent banks were closed (Ishikawa Bank on December 28, 2001 and Chubu Bank on March 8, 2002). The FSA also conducted "special inspections" of major banks in March 2002, especially focusing on the quality of loans to largest borrowers. Although the special inspections revealed some under-reporting of and under-reservation against the non-performing loans, the FSA judged all major banks overall healthy.

To complete the "final resolution" of the non-performing loans problem, some started to argue for another round of public fund injection to major banks. Yanagisawa, however, rejected the idea on the ground that the major banks are all healthy and well capitalized.

[4] See Arai and Hoshi (2004) for more detailed chronology of the Japanese monetary policy during this period.

[5] A usual argument against the central bank supervising banks points to the possibility that the central bank pursue too accommodative monetary policy to avoid banking problems. See Barth et al. (2003) for more discussion. Here, the central bank preoccupied with cleaning up the banking sector may have set the monetary policy too tight.

In August, the government, which suspected some major banks were undercapitalized and was more sympathetic to the idea of capital injection, replaced Yanagisawa with Heizo Takenaka, who was also the Minister of State for Economic and Fiscal Policy.

Takenaka moved quickly as soon as he was appointed as a minister in charge of the FSA. In the first week of October 2002, he talked tough, formed a project team with members who were regarded as having radical ideas of closing down large borrowers in financial trouble as well as the banks with a large amount of non-performing loans, and called for not allowing deferred tax credit toward the Basle capital adequacy ratio. He also suggested that no big bank is too big to fail. When he created a project team to form the concrete plan, however, the stock prices fell rapidly, and the LDP politicians balked at the Takenaka plan. In the end, the plan ("Program for Financial Revival") was put together at the end of October, but the content was significantly watered down.[6]

Indeed, on paper, Takenaka's Program for Financial Revival and its implementation schedule did not look much different from Yanagisawa's Reform Schedule. Although Takenaka was reported to have wanted to limit the inclusion of deferred tax assets in the official bank capital, the final report just mentioned that the auditors should be prudent in allowing the use of deferred tax assets. The program also called for the establishment of rigorous and consistent assessment standards on bank assets, but this was what Yanagisawa tried to achieve in "special inspections". Finally, the program specified the end of fiscal 2004 (March 2005) as the target date to reduce the amount of non-performing loans to a half, which was exactly the same as the Yanagisawa's plan (halve the non-performing loans in 3 years).

Although the plan looked similar to an old plan and it was not as tough as Takenaka was reported to have wanted, it showed some potentially important differences. First, the new program explicitly stated that public funds will be injected to banks if necessary, following the Deposit Insurance Act, which allows the government to use public funds to deal with banking problems that have systemic implications. Second, the program specified several ways to intensify the monitoring of the financial institutions that received public funds. For a financial institution that receives funds based on the Deposit Insurance Act, the FSA dispatches a management monitoring team. For a financial institution that has received public funds (based on the Financial Revitalization Act or the Deposit Insurance Act) but has not making reasonable progress toward recovery, the FSA now orders a business improvement administrative order. Finally, the program stresses the importance of reviving distressed corporations in order to solve the non-performing loan problem. The program called for strengthening of the corporate revival function of the RCC and creation of new organization to handle corporate revival (which led to the establishment of the Industrial Revitalization Corporation of Japan (IRCJ) in April 2003).

Following the FSA's renewed resolution on rigorous standards to assess bank asset quality, especially the quality of deferred tax assets, many auditors started to be cautious against use of tax deferred assets to inflate the bank capital. Without liberal use of tax deferred assets, some banks found themselves severely undercapitalized, which triggered FSA interventions.

[6] The plan is available on the FSA website (www.fsa.go.jp/news/newse/e20021030.pdf). The schedule for implementing the plan was published in November 2002 (www.fsa.go.jp/news/newse/e20021129-1a.pdf).

Table 2
Bank closures: 1998–2002

Bank	Date
Long-Term Credit Bank of Japan	23 October 1998
Nippon Credit Bank	13 December 1998
Kokumin Bank	11 April 1999
Kofuku Bank	21 May 1999
Tokyo Sowa Bank	11 June 1999
Namihaya Bank	7 August 1999
Niigata Chuo Bank	2 October 1999
Ishikawa Bank	28 December 2001
Chubu Bank	8 March 2002
Ashikaga Bank	29 November 2003

Sources: Financial Supervisory Agency Annual Report (1999, 2000 issues); (Financial Services Agency Annual Report (2001, 2002, 2003 issues); Financial Services Agency website (www.fsa.go.jp).

The first such incident happened with Resona Bank, the major bank in the fifth largest financial group (Resona Group). As the auditor of Resona approved only small amount of deferred tax assets, its capital ratio dropped to 2.07%, well below the regulatory required minimum of 4%. In May 2003, the government approved the injection of public funds following the Deposit Insurance Act. Since the amount of funds injected (about ¥1.9 trillion) was so large that the government ended up holding more than 50% of voting shares of Resona, de facto nationalizing Resona.

A close examination of quality of deferred tax assets by the FSA in its inspection led to a failure of Ashikaga Bank, a large regional bank, in November 2003. In this case, Ashikaga Bank was judged insolvent and explicitly nationalized following the Deposit Insurance Act.

Overall, Takenaka seems to have succeeded in turning around the FSA to be more serious about bank supervision than ever. The banks have been increasing their efforts to resolve the non-performing loans. At March 2003, the first accounting year end after Takenaka took over as the head of the FSA, the amount of risk management loans (a measure of non-performing loans) declined by 17% from a year ago. The decline partially reflects the macroeconomic recovery of the Japanese economy that began in 2003, but the renewed pressure from the FSA cannot be ignored. At this pace, the goal of reducing the non-performing loans by half by March 2006 seems feasible.

Let us now turn to more quantitative evaluation of the FSA's performance. Table 2 lists the bank closures from 1998 to 2002. The closures were concentrated during the first year of the FRC. After that, the FRC and the FSA became reluctant to close the banks although the problem in the banking sector continued. Even under Yanagisawa, who has the reputation of being serious about cleaning up the banking sector, the FSA managed to close down only two banks. The table does not include the Resona case as a closure because the bank was allowed to continue although it was *de facto* (but not explicitly) nationalized. More importantly, the current shareholders of Resona were not wiped out.

The concentration of bank closures during the period when the FRC was active is consistent with the idea that the separation of financial policy planning and financial supervision had an unintended (but favorable) outcome of making the FRC tough. Under this regime, the FRC was able to concentrate on cleaning up the banking sector ex post without worry-

Table 3
Prompt corrective actions for banks: 1998–2002

	July 1998–June 1999	July 1999–June 2000	July 2000–June 2001	July 2001–June 2002	July 2002–June 2003
Banks	5	1	1	2	2
Shinkin banks	1	10	3	4	1
Credit unions	11	20	17	8	2
Agricultural cooperatives	1	1	0	1	0

Sources: Financial Supervisory Agency Annual Report (1999, 2000 issues). Financial Services Agency Annual Report (2001, 2002, 2003 issues).

ing about being criticized for the failure of ex ante banking regulation. After the FRC was abolished and the FSA gained both policy planning function and supervision function, their ex post intervention may have become tentative once again.

Table 3 examines another aspect of ex post interventions by the Japanese financial regulator. The table shows the number of prompt corrective actions taken for each type of financial institutions in each year. Again we find there were more corrective actions when the Financial Supervisory Agency and the FRC were in charge than when the FSA was in charge. The incidences of prompt corrective actions declined after the (new) FSA was established.

One may argue that the apparent slow down of the ex post interventions can be explained by the success of the initial interventions and improvement of the financial conditions of the Japanese banks that followed. If this was the case, we would have observed continued efforts of the banks to deal with the non-performing loans even without bank closures. Fig. 1 shows

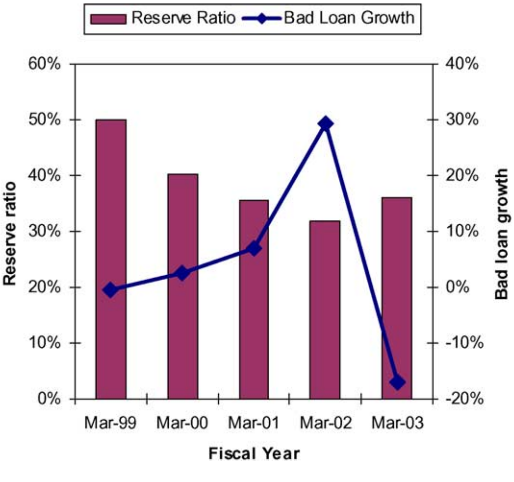

Fig. 1. Loan loss reserve ratio and growth of non-performing loans for Japanese banks: fiscal 1998–2002. *Note:* Loan loss reserve ratio is calculated as the amount of loan loss reserves at the end of the fiscal year divided by the amount of risk management loans at the end of the fiscal year. *Source:* Financial Services Agency (2003). “The status of non-performing loans as of end-March 2003” (Table 4) (available at the FSA website: www.fsa.go.jp/news/newse/e20030801-1.html).

this was not the case. The non-performing loans actually increased more rapidly in fiscal 2000 and 2001, and the loan loss reserve ratio continued to decline. The slow down of bank closures and incidences of prompt corrective actions in this period cannot be explained by the improved financial situations. Only after late 2002, when Takenaka replaced Yanagisawa, the amount of non-performing loans started to decline.

When Mr. Yanagisawa was brought back as a head of FSA in 2001, there was a high hope that he would resume a pro-active policy toward weak institutions. Many thought that banks would be asked to deal with non-performing loans problem quickly and, if undercapitalized, another round of capital injection maybe carried out. However, Mr. Yanagisawa maintained from 2001 to September 2002 that banks were healthy enough that no capital injection would be needed. Until he was replaced at the end of September 2002, Mr. Yanagisawa did not force banks to act to reduce non-performing loans.

In the reshuffle of cabinet at the end of September 2002, Mr. Takenaka replaced Mr. Yanagisawa, and started a new policy to force banks to recognize more non-performing loans and deal with them. Mr. Takenaka seems to have been successful in dealing with the non-performing loans following the reform program of 2002.

3.2. Regulation of insurance companies

Dealing with insolvencies of banks was probably the most urgent task for the new financial regulatory institution, but it was not their only task. The FSA faced problems in insurance companies, securities companies and other financial institutions as well. Indeed the FSA had to deal with some insurance companies that became insolvent during this period. This subsection studies how the FSA handled the insolvencies and other problems of insurance companies. We will pay special attention to the question whether the consolidation of the financial regulation, which was further advanced under the new framework, helped the FSA come up with a comprehensive approach to financial conglomerates.

The first major regulatory change for the insurance companies after the establishment of FSA was the introduction of the prompt corrective action. The legal change took place in January 1999 and became effective as of April 1, 1999. When an insurance company's solvency margin falls below 200%, the FSA was now required to intervene and force the insurance company to submit a plan to improve the situation.

Unlike the bank deposits, which were 100% guaranteed with interest payment during this period, the insurance policies were not guaranteed. The policy holders of failed life insurance companies were to take reduction in their coverage (especially saving portion of the policies). Systemic risk, which is a serious problem for a bank failure, is not an issue for a failure of an insurance company. Thus, the rationale for prompt corrective action is less clear. The Japanese government, however, established the Insurance Policy Holders Protection Organization, which financially assists an insurance company that acquires a failed insurer or underwrite the policies of the failed insurer if nobody comes to the rescue, in December 1998 to help the policy holders of failed insurance companies. The prompt corrective action was introduced to limit the loss of the Insurance Policy Holders Protection Organization, which was funded by both the government and the insurance industry.

To date, a prompt corrective action was ordered to an insurance company only once. In February 2000, the (old) FSA's examination found that Taisho Life was de facto insolvent

Table 4
Failures of insurance companies

Closed insurance company	Date
Nissan Life Insurance	25 April 1997
Toho Life Mutual Co.	5 June 1999
Dai-ichi Fire & Marine Insurance	1 May 2000
Dai-hyaku Life Insurance	1 January 2000
Taisho Life Insurance	29 August 2000
Chiyoda Life Insurance	9 October 2000
Kyoei Life Insurance	20 October 2000
Tokyo Life Insurance	23 March 2001
Taisei Fire & Marine Insurance	22 November 2001

Sources: Nihon Keizai Shimbun. Financial Supervisory Agency Annual Report (1999, 2000 issues). Financial Services Agency Annual Report (2001, 2002, 2003 issues).

and required recapitalization through new share issues. The lack of prompt corrective actions during this period does not imply the Japanese insurance companies were financially healthy. On the contrary, many life insurance companies were suffering from the gap between the actual return on their assets and the high minimum returns (*yotei riritsu*) that they guaranteed in the late 1980s. As Table 4 shows, six life insurance companies and two casualty insurance companies failed after the prompt corrective action was introduced. With the exception of Taisho Life case, the FSA was not able to intervene before those companies failed.

Fukao (2003) argues that the major reason for the failure of supervision is found in the extreme lenient calculation of the solvency margins. For example, the net asset (numerator of the solvency margin) can include deferred tax asset and future expected profit, which are not allowed under the US regulation. The weights given to market risks (which influence the denominator of the solvency margin) are much lower than the weights specified in the US regulation. Moreover, the threshold for the intervention (200%) is lower than that in the US (250%).

The only case of prompt corrective action, ordered to Taisho Life Insurance, was not successful. It was not able to prevent Taisho Life from failing. Worse, it may have rather increased the cost to policy holders. Tokyo-based Claremont Capital Holding bought about ¥10.5 billion of new shares of Taisho Life and helped the recapitalization. In return, Yoshihiko Kokura, president of Claremont, became a managing director of Taisho Life. Kokura received about ¥26 billion from Taisho Life by selling "financial products" of Claremont until he was arrested for financial fraud in August 2000. After all, the recapitalization attempt at Taisho Life ended up costing additional ¥8.5 billion (estimated amount being swindled) to policy holders.[7]

Many insurance companies now belong to financial holding companies, which also include banks, securities houses, and other financial institutions. One potential problem of a financial conglomerate is cross-shareholdings or double-gearings among the member financial institutions, which increase the amount of capital for each institution without

[7] According to "Appalling Reality of a Man Who Led Taisho Life into Bankruptcy" Nikkei Business (11 September 2000), the FSA knew the shady past of Kokura from the earlier cases he was involved, but did not give warning to Taisho Life.

increasing the amount of capital of the group as a whole. The FSA admitted the double-gearing was a serious problem in Japan and introduced the rules to limit that.[8]

Majority of life insurance companies in Japan are mutual, so they do not have formal cross-shareholdings with other financial institutions. Fukao (2003) finds, however, a substantial extent of de facto double-gearing between life insurance companies and Japanese banks. As of the end of March 2001, seven major life insurance companies collectively held ¥5.4 trillion of bank stocks and ¥5.1 trillion of bank subordinated debts. In return, the banks held ¥1 trillion of surplus notes (capital for a mutual company, roughly speaking) and ¥1.2 trillion of subordinated debts of the life insurance companies (Fukao, 2003). Although the FSA seems to be in an ideal position to point out the problem of such de facto double-gearing arrangement, the FSA has not done so.

4. Conclusion

The new framework for the financial regulation in Japan was established in June 1998 by separating the supervision and examination function from the MOF. The separation of the financial supervision from the MOF as the fiscal authority made it possible for the old FSA to close insolvent banks without worrying so much about making fiscal liability of banking problem explicit. Moreover, the old FSA did not have planning function of financial regulation. The separation of planning function and supervision function made the old FSA less hesitant in closing down insolvent financial institutions, because they did not have to worry about a possible embarrassment to those who designed the ex ante rules and regulation. Under the new FSA, which started in July 2000, both planning and supervision functions are housed in the same organization. This seems to have made the FSA more cautious about closing insolvent banks.

Another problem of the design of the financial regulatory structure can be found in that the central bank was allowed to remain an important bank supervisor. This seems to have caused the BOJ to be reluctant in relaxing monetary policy so that re-organization in the banking industry is not discouraged. The deflation continued and that made the FSA reluctant in dealing with the non-performing loan issue in a decisive manner.

The FSA (both old and new) never seems to have tried aggressively to limit the failure of insurance companies. Prompt corrective action was ordered only on one occasion. Even in this case, the intervention was not successful in reducing the cost of the failure. Double-gearing between mutual life insurers and banks is a serious problem, but the FSA has not actively tried to limit the practice. In this sense, the FSA has not used its potential to be a comprehensive regulator of financial conglomerates.

Another point of consideration is whether it makes economic sense to have a politician as the head of the FSA. When a failure of a bank is expected to cause bankruptcy of large companies in a particular region, politicians from that region would put political pressure on the FSA to adopt forbearance policy. Whether the head of the FSA can resist such a pressure depends on strength of the person. Whether this is an economically optimal

[8] See, for example, Financial Supervisory Agency (2000). Kin'yū Kantoku-chō no Ichinen, Chapter 14.

institutional arrangement should be examined in the future. The FSA under Takenaka, who was not a politician when he became the minister, was far more successful in dealing with the non-performing loan problem.

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