

# JAPANESE MAIN BANK SYSTEM

## A Theoretical Analysis of Costs, Benefits and Current Crises

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### **Abstract \***

This paper presents an introductory overview and a basic theoretical analysis of costs, benefits and current crises in Japanese main bank system. The main bank system was designed for stabilizing the financial system in an environment of high macroeconomic volatility and information asymmetries. The most important benefits the system can generate are the reduction of agency costs through investment in monitoring, avoidance of problems of information imperfection and their asymmetric distribution and reduction of restructuring and reorganization costs in times of financial distress. The soft budget constraint and hold-up problems are the two serious flaws with the system that can lead to the misallocation of financial resources. The emergence of the new economic, political and technological forces led to undertake financial deregulations in the late 1970s that substantially changed operating environment and the structure of Japanese financial system. The deregulation of the financial system dramatically altered the structure of corporate financing and substantially reduced the role of main bank in corporate governance and monitoring. The role of main bank system in corporate governance and monitoring is becoming weak but not collapsed. The system can yet be made more effective even in the free, fair and global financial environment.

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\*I would like to extend my sincere gratitude to Professor Akira Takamasu for his valuable guidance and suggestions in preparing this paper. I am also indebted to the prominent scholar Professor Masahiko Aoki of Stanford University whose pioneering works on 'Japanese main bank system' motivated the choice of my ongoing research work on the role of Japanese main bank system and its transferability to developing economies.

## **1. Introduction**

The development of institutional values and practices largely depends on the economic, socio-cultural and historical changes along other national particularities. The changes that took place after the World War II in attempts to create a New Japan brought some remarkable measures giving new lives to socio-economic conditions of Japan from her wartime devastation. This period marked a significant turning point in the socio-economic history of Japan. The postwar economic policies were designed primarily to regain prewar status and later aiming at growth and stability. The designated system had a good macroeconomic impact making Japan the world's second largest economy in the 1970s.

It has been a common belief that well-functioning financial system to channel capital to the productive investment and allocate financial resources is crucial for economic success. According to the relative role of financial intermediaries and the market, the financial system is broadly divided into bank-based and market-based system. The former is also referred to as Japan-German system and the later Anglo-American model. Because of a combination of strong government favoritism of bank financing and tight regulation of securities markets, the postwar Japanese financial system is bank dominated with strong holds of main banks. The post war financial system in Japan was subject to heavy state regulations, which retained the institutional inheritance of wartime and early post war era. It was aimed at aiding the reconstruction and channeling funds into the directed sectors and later the promotion of high growth. The regulatory authority, the Ministry of Finance, went for a bank loan-based finance for industrial corporations. The corporate bond issue was restricted. Thus, the Japanese financial system developed as a typical bank-based model with heavy dependence of bank loan corporate financing. The policy makers often interpret the rationale for bank finance over corporate bond issue as the savers in the early post-war period wanted safe, liquid and short-term financial assets. The savers' risk aversion behavior, the regulatory framework supportive to the bank lending over corporate bond issue and low supply of information aggregation led Japanese financial system a dominant bank-based system. Industry financing was dependent on banks. In the 1970s, Japan faced major economic shocks due to worldwide events. As a result, the industrial structure had to be changed. A detailed discussion on historical events and conditions supporting to the development of stable financial system is beyond the scope of this paper. The primary aim of this paper is to assess the theoretical framework of Japanese main bank system relative to its cost, benefits and major causes and consequences of current crises.

### **1.1. What is main bank system?**

The Japanese financial system is highly dominated by the main bank system. It is the system of intensive relationship between the banks and firms in terms of reciprocal shareholding, monitoring, and providing informational, managerial and other banking services.

The main bank is the largest single lender to its corporate client and its largest shareholder among banks. It is the bank that strictly monitors the management performance of its client firm and provides ample informational and managerial services to the firms. If the client firm faces financial crisis and if that makes economic sense, the main bank has special responsibility to rescue and restructure the firm. This system developed in Japan in the early period of uncertainty and difficulty following the World War II and grew rapidly in the high growth era.

The main bank system rather than being simply a long term relationship between a bank and its client firm has been defined (by Aoki, Patrick and Shred, 1994) as a nexus of relationship comprising a multitude of financial, informational and managerial ties between the firms and their partner banks, a unique reciprocal relationship among major banks and between the regulatory authorities such as Central Bank and Ministry of Finance. What distinguish the main banks from ordinary banks are the information advantages linked to its role as shareholder including monitoring, payment settlements and rescue functions during financial turmoil. The most important and distinct feature that the Japanese main bank system qualifies than the ordinary banking is that it is typically the firm's bank of payment settlement, primary lender, shareholder, delegated monitor and lender to the last resort in the times of financial distress.

In an analytical study, Aoki and Patrick (1994) explain the main bank system as an informal set of regular practices, institutional arrangement, and behavior that constitute a system of corporate finance and governance. The main bank does not only provide loans, but also holds equity, monitors the client firms and intervenes in times of financial distress. Hoshi and Kashyap (2001) assert that the main bank, by definition, has close ties to its customers through lending, shareholding and board representation and other personnel placement. The uniqueness of Japanese financial system is the close firm-bank ties in terms of financial, managerial, informational and cross-shareholding relationship in which the financial intermediaries provide capital that invest in obtaining customer-specific information and evaluate the firms' performance through multiple interactions over time. This system was the creation of wartime designation of the financial policies in line with other economic policies. In particular, the main bank system played an important role of monitoring of firms to a great extent, and the system is understood as a specific system of corporate financing and governance with a special relation between banks and businesses, and regulatory authorities.

## **1.2 Institutional Features**

The Japanese financial system incorporates special relation-based institutions with stable and 'cross-shareholdings' (*Kabushiki mochiai*) among financial and non-financial firms that makes Japanese corporate finance structure quite different from the rest of the world. Most of the Japanese firms are attached, as a system, either by interlocking shareholdings or by common main bank relationship or by certain degree of business transactions known as enterprise groupings (*Keiretsu*). Members of such enterprise groupings have the affiliated city

bank in the same group as their main bank. The following table exhibits the pattern of cross-shareholdings that remain almost stable until the mid-1990s and declines slightly thereafter.

Table 1	Bank firm cross-shareholding (percent)											
	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Firm holds firm shares	4.10	4.40	4.70	4.80	4.90	4.70	4.70	4.80	4.90	5.00	4.70	4.30
Firm holds bank shares	6.70	6.00	5.50	5.90	5.70	6.00	5.80	5.70	5.40	4.20	3.50	3.20
Bank holds firm shares	6.20	6.70	6.80	7.20	7.30	7.20	7.00	7.10	7.00	7.70	7.50	6.50
Bank holds bank shares	0.40	0.40	0.30	0.40	0.40	0.40	0.40	0.40	0.30	0.20	0.10	0.00
Other entities	4.00	3.60	3.01	3.10	2.90	2.90	2.90	2.90	2.80	2.50	2.30	2.00
Total	21.40	21.10	20.31	21.40	21.20	21.20	20.80	20.90	20.40	19.60	18.10	16.00

Source: NRI Research Institute (1999), based on samples of 2,426 firms, recited from Scher (2001).

As shown in the table above, the prevalence of interlocking shareholding is one of the most striking features of large Japanese firms. The system of interlocking and stable shareholdings and the powerful keiretsu groups, backed by supporting main bank relationships, served Japan well in the process of developing her economy rapidly. Notwithstanding their problem of mounting non-performing loans, bank deposits exceed stock market capitalization by approximately 50% in Japan. Whereas in the US the relationship is reversed with market capitalization approximately three times the level of bank deposits (The Economist, 2001). The practices of interlocking shareholdings, in terms of corporate governance, appear to be aimed at minimizing the potential free-rider and managerial moral hazard problems. Aoki (1994) asserts that stable shareholdings give the main bank confidence that it can enforce implicit contracts in the times of financial frictions and it will get an appropriate share of quasi-rents. This type of model is referred to as 'state contingent governance' whereby the main bank acts as the ultimate monitor with an implicit contract to step in and direct the affairs of the company in the case of financial distress.

Statistics reveal that firms in an excellent and favorable financial position, with greater bargaining power, have more than one main bank. They may have little or no sustained long-term bank borrowing; however the main bank is expected to perform a major monitoring role for bondholders and stockholders. The relationships with such firms are loosely intertwined but still the banks exercise the corporate governance and monitoring due to the cross-shareholding relations. More specifically, a true main bank system is clearly observable in the relationship between banks and the firms with normal financial positions, which largely depend on bank borrowings for corporate financing. In such situation, the main bank plays a leading role in the provision of loan contracts, and corporate governance and monitoring. This was the case observed in Japan as 63 percent of listed manufacturing firms were in the category of normal financial position at the end of 1990 (Aoki, Patrick and Sheard, 1994). A more significant role of the main bank in the corporate governance structure is obvious for the firms with critical

financial position. The role of main banks for the firms in this category is much more significant in providing them with the rescue operation in addition to normal lending and corporate governance functions. Thus, the main bank system involves a unique contingent corporate governance system in which the main bank significantly influences the management of its client firms depending on their financial health.

The bank's representation of directors or auditors of the board of the firm also maintain the relationship between the bank and its client firm. The bank can also send, if any agreement, its employees as the permanent managers of the client firms. This can be evidenced from the fact that about 25 percent of the 40,045 directors of listed Japanese firms were from outside the firm in 1992. Out of these, 21.7 percent were from main banks (Aoki, Patrick and Sheard, 1994). A sample of 100 companies surveyed by Miyajima (1998) finds that the number of companies to which bank representatives were dispatched increased from 23 in 1958, to 36 in 1963, and to 53 in 1969.

A general relationship between the banks and their client firms in dealing with the regular transactions and other banking business is not surprising one. But much distinctive, intensive, closer, special and well-established but informal contractual relationship between banks and firms in Japanese main bank system makes Japanese model notably distinct from the rests. This seems to be directly aimed at mitigating the problems of information asymmetries and high uncertainties brought about by wartime devastation of socio-economic conditions in Japan. Patrick (1994) asserts that the relationships, arrangements and commitments in Japanese main bank system are based, not on legal contracts, but on a history of understandings and expectations, the accumulation and investment in trust and reputational effects.

A large loan share of the client firms, non-lending business with fees and commission, undertakings of payment settlement and some opportunities to extend its business to clients' business partners along with the larger sale of saving deposits to the employee of the client firms are the major sources that the system generates some rents for the main bank. Moreover, the stable monetary and fiscal policies in line with the moderate rate of inflation, positive real interest rate on deposits and lending and tight regulation of direct corporate financing undertaken by the government during 1955-1975, the high growth period, were the important prerequisites for good performance of the main bank system. The following table shows that both return on asset and equity were moderate during the high growth period and subject to declining trend since the early 1970s. The ratio of loans to assets during the period remains almost stable during the high growth era. This suggests that the government regulated financial system helped banks to reap the high rents. Limited competition between banks, strict regulation for corporate bond issuance and increasing financial health of client companies were important catalysts for extracting higher rents to the main banks. In other words, the financial regulation promoted the role of main banks in both corporate finance and governance

Fiscal year end	Number of banks	Loans/Assets	ROA	ROE
1955	86	73.65	0.77	66.61
1956	86	73.94	0.70	46.13
1957	87	72.52	0.68	51.93
1958	86	73.99	0.64	51.88
1959	87	73.31	0.68	40.60
1960	87	73.83	0.70	44.79
1961	87	73.53	0.73	47.76
1962	88	73.74	0.70	55.66
1963	88	74.33	0.60	43.27
1964	87	73.11	0.47	30.72
1965	87	72.36	0.46	33.72
1966	86	73.58	0.48	34.43
1967	86	71.32	0.66	39.27
1968	86	74.47	0.63	44.43
1969	86	75.08	0.66	49.59
1970	86	76.83	0.68	50.66
1971	85	76.67	0.60	50.59
1972	87	75.69	0.53	47.06
1973	87	75.41	0.53	45.80
1974	86	75.64	0.43	40.45
1975	86	74.41	0.35	33.94

Source: Annual Report by Ministry of Finance Banking Bureau, various issues, recited from Hoshi and Kashyap (2001)

The main bank controls management by possessing the residual right of control for efficiency purpose whereas stockholders control management by possessing the ownership right. For this purpose, the monitoring by main bank can be divided into three stages: ex ante monitoring, interim monitoring and ex post monitoring (Aoki, 1994). The ex ante monitoring refers to the investor's assessment of the credit-worthiness of a firm itself, investment projects proposed by the firm and their screening. The company cannot borrow money from the main bank, if it cannot pass the screening process of the main bank. The monitoring in this stage has the effect of solving the problems associated with adverse selection. The interim monitoring refers to monitoring on an ongoing management behavior and the use of funds in particular after the funds are committed. The monitoring at this stage solves the problems associated with moral hazard by management. Ex post monitoring refers to the verification of performance outcomes of the firm, judgment on the long run viability of the firm in case of financial distress,

and the use of that information for possible corrective or punitive action. If investors make a credible commitment to punish poor management performance, management would have an incentive to avoid ex ante and interim behavior that might result in poor performance.

## **2. Benefits**

The relation-based financial system explicitly prevalent in Japan and Germany has often been described as a growth-oriented financial system capable of serving the needs of developing and transition economies better than market based Anglo-US system in which the securities market play a pivotal role in corporate financing. In contrast to the large firms in the US and UK that tend to rely on the bond financing, many Japanese firms typically received much of their finance in the form of bank loans from their main banks until the deregulation of financial system in the early 1980s and more rapidly in the 1990s.

The most important aspects that, at least theoretically, improve the effectiveness of main bank system are the reduction of agency cost through investment in monitoring, avoidance of the problems of information imperfection and asymmetric distribution, and reduction of restructuring and reorganization costs in times of financial distress.

The investment in market-based system is sensitive to the stock market price whereas the long-term investment is encouraged in the relation-based financial system. The close firm-bank tie is also helpful in reducing the macroeconomic volatility by stabilizing investment activities. The system is also considered better for stage financing. Even if the big firms go for direct financing thereby reducing the role of financier in direct monitoring and corporate governance, the relation-based financing still deserves the quality of supporting the small firms that can't get sufficient market facing with liquidity constraint. This system can more possibly support the government to intervene into the economy managing the economic problems in times of financial distress. The financial market is never a complete, always suffering from inherent problems of hidden information and moral hazard. In order to solve these problems, the relational financial system is relatively more efficient than the market-based system as the later seriously lacks information access.

The intensive monitoring function performed by main bank can better address the agency problem and encourage long-term business relationship between the firms and banks. This leads to the long-term and stable investment. Also the rescue operation of the bank in times of financial distress avoids the social cost of myopic liquidation of temporarily depressed but potentially productive firms. Such operation brings less hardship to firms in recession by easing the financial constraint and stabilizes the economy better. In other words, main bank rescue operation significantly lowers the social and economic cost of instability in times of economic

turmoil. The close relationship between the bank and its client firm allows several special contractual features, including flexibility and discretion, the extensive use of contracts and the inclusion of collateral requirements (Boot, 2000). Such contractual features may facilitate implicit long-term contracts and resolve agency and information problems. In contrast to the transaction lending viewed as arms-length finance focusing on the particular transaction rather than being aimed at an information-intensive relationship with customer, Japanese main bank system provides an informal but well established set of contractual long-term relationship between the lenders and borrowers. Such relations are essentially important for well functioning of the financial system.

The possible transformation of the Japanese model in developing economies where the economic development is in the early or middle stage can also be advocated on the ground that the firms in those countries need to raise enough funds from bank borrowing in order to establish sufficient credibility before accessing the capital markets. Once the firms become financially sound and well established, they can switch to capital market funding. Put differently, there is a sequential complementarity between bank and capital market financing. These are the cases observed in Japan when the Japanese firms grew largely and also the government deregulated financial market sufficiently providing rooms for capital market financing. This might be one of the various reasons for fading strength of main bank system. However, this argument needs further confirmation.

The main bank is delegated the monitoring of the client firms which helps to avoid duplication of monitoring by the other lenders. Moreover, the system can reduce the real costs of restructuring the firms in times of financial crisis than going for costly liquidation process. The main bank by definition has very close ties to its clients in terms of lending, shareholding, board representation and other personal placement. Such ties are helpful in easing the access to information about the investment decisions of the firms. The close ties between firms and banks also reduce the monitoring costs. With lower cost of monitoring, borrowers can be charged lower interest rates for a given level of monitoring. The moral hazard problem is a serious matter that severely erodes the company's prospects if left unchecked. There are controversies whether Japanese main bank system can avoid or add the moral hazard problem by dispatching its personnel to the company's board. Sheard (1994) examines the empirical determinants of bank director dispatch. He finds that bank directors are less likely in financially strong or highly profitable firms. This result suggests that the bank directors are sent to the firms that are assumed to be more prone to moral hazard problem and hence in need of more intense monitoring. However, there may arise another problem if the dispatched directors develop personal ties with the company board in their favor rather truly representing themselves as monitors through banks. The study of compensation arrangement for CEOs in different



Japanese firms by Kato (1997) shows that the managerial compensation scheme is less important in group affiliated firms than independent firms. This is because the study shows that the firms that are affiliated in group (*keiretsu*) pay their CEO considerably less than comparable independent firms. This result suggests that the bank involvement in monitoring can help reducing the management cost.

The main bank system can moderate the conflict of interests between debt and equity holders. The equity holders may favor the excessively risky investment project whereas the debt holders are interested into safe project. Thus, main bank being both the lender and a large equity holder can, at least in principle, moderate the conflict of these interests.

There are various empirical evidences suggesting that the main bank play important role in reducing the cost of financial distress. Hoshi, Kashyap and Scharfstein (1990) find that the keiretsu financing reduces the cost of financial distress. The main banks are likely to give more concessions on interest or principal for the potentially viable firms and restructure them before going to lengthy liquidation process.

A number of literatures suggest that the close ties between firms and banks in Japan have become important factor in the international competitiveness of modern Japanese firms, which could serve as a model for developing and transition economies. They claim that bank-firm ties can solve the problems of managerial behavior and information asymmetries between the borrowers and the lenders. The contingent monitoring of their client firms helps banks to overcome problem of information asymmetries and receive ample information about the firm's creditworthiness, uses of the borrowed funds and the future prospects of the ongoing projects in making decision for further financing. The proponents of Japanese main bank system as a suitable model for mitigating asymmetric information problem assert that the firms with strong ties to banks may be able to weather financial distress better than firms without such ties, giving such firms a more stable, informed, and committed source of financing (Hall and Weinstein, 2000). Hoshi et al. (1990) finds the similar result that the firms with bank ties are able to maintain investment after the onset of financial distress better than the firms without such ties.

Despite these various benefits the Japanese main bank system enjoys, why the system is not able to fully absorb them? Are the costs overwhelming these benefits? What are the causes and consequences of weakening main bank system in the 1990s? A complete solution to these questions is beyond the scope of this paper. However, the following sections attempt to provide brief explanations.

### **3. Costs**

The effects of banking relationship on access to capital and on borrowing cost have been

subject to extensive theoretical and empirical studies. In spite of the various benefits of the main bank system, it is not free from some serious drawbacks. In fact, the Japanese main bank system was built on a foundation of regulation that suppressed alternative ways of corporate financing. The regulation protected the banking sector from outside competition that helped banks to enjoy a comfortable profit margin. The situation that arose after the deregulation of financial sector heavily altered the system from bank to capital market financing thereby reducing the role of banks for corporate finance and ultimately, for corporate governance and monitoring.

Due to the overall success of Japanese economy during 1950s to early 1970s, there are few empirical evidences showing the real costs of main bank system with compared to its benefits. Both the theory and practice show that the soft budget constraint and the hold-up problems are the two serious flaws with the system that can lead to the misallocation of financial resources. The extent of the problem would depend on how well the monitoring function of the main bank and the supervision function of the government can be performed. However, the studies have shown that the Japanese main bank system is not notably suffered from soft budget constraint problem. Moreover, it has been argued that the strong banks may extract high rents from firms. This is evidenced from the fact that the growth rate of firms in keiretsu group was lower and the financial cost was higher due to rent extraction (Weinstein and Yafeh, 1998). The success of main bank system is based on the balanced bank-firm relationship along with bank debt and cross shareholding. The change of bank-firm relationship might bring about a change to the system. As the firms depend less and less on the main bank, with a change of corporate financing structure, the monitoring function could go into malfunction. Since the early 1980s, the Japanese big firms started to have enough internal funds and diversify their external financing as the financial deregulation opened their funding access through capital market financing.

The state protection system may discourage innovation, as there are no rewards to the innovators. The evidences show that bank assets increased by 11.5% per annum in real term from 1955 to 1975, exceeding even the real GDP growth rate of 8.3 % for the period, but the profit did not keep pace (Hoshi and Kashyap, 2001). They argue that the high return on equity was a result of high leverage rather than high profitability.

The main bank rescue operation, in principle, can prevent the temporarily distressed, but potentially viable firm from myopic liquidation. However, non-viable firms may be rescued just for keeping its reputation of being good and responsive main bank. Thus, main bank rescue operation, if guided only by reputational matter or demonstration effects, may lead to inefficient rescues. The main bank is also one of the largest equity holders of the client firm. During the high growth period, bank could hold 10% of firm's equity. This was reduced to 5% after the 1977

reform of the Anti-Monopoly Act. The banks have significant influence on the firm's management. This influence may put too much weight on creditor preferences than on shareholder's interests thereby leading firms to have more debt than is optimal.

Another possibility is that the main bank as a lender does not want the firms to undertake risky projects. This forgoes the chances of big windfall gains to the shareholders and also contradicts the hypothesis 'higher the risk, the higher will be the return'. However, this risk aversion is consistent with the generally low levels of bankruptcy for large firms in Japan.

Sharpe (1990) and Rajan (1992) point out that if the monitoring bank obtains information monopoly, the bank is able to extract rents from the borrower, which in turn leads to the distorted investment decisions of the borrower. A number of literatures (Aoki, Patrick and Sheard, 1994; Kaplan and Minton, 1994; Kang and Shivdasani, 1995; and Morck and Nakamura, 1999 and others) suggest that the stable long-term relationship between Japanese banks and firms reduces the information asymmetries and forms an important monitoring function by the main bank. However, some recent empirical studies have shown that hold-up costs are also significant for the Japanese companies with main bank ties. These studies show that Japanese companies with a main bank relation tend to exhibit low profitability and growth (Weinstein and Yafeh, 1998; Pinkowitz and Williamson, 2001). Petersen and Rajan (1994) find that close ties with creditors have small effect on the cost of credit, but that availability of credit financing is greater for firms with ties to creditors.

The relationship between the banks and firms, core of the main bank system, being a personal matter of the respective institutions may be attributed to the discrimination in favor or large industrial enterprises thereby ignoring small and medium sized firms. This problem may distort in allocating the financial resources in small but strategically important industries. Put differently, the main bank system may concentrate financial resources in favor of large borrowers through which they can abstract sufficient rents.

#### **4. Weakening Main Bank System and Banking Crises**

Setting the objectives of any financial system depends, among other things, on how the system is organized and what constitute the core of national institutional and developmental conditions. The post war Japanese financial system was stable with no entry and virtually no failures or exits except some few negligible cases. The essence of the regulatory regime was to guarantee that banks would not fail under the 'convoy system' policy designation. The system is said to be highly supportive to the phenomenal and impressive growth of the economy since 1955 to early 1970s.

In the 1970s the new economic, political and technological forces emerged and changed the

operating environment of Japanese financial system. These new forces along with intense international pressure forced regulatory authorities to begin a process of financial deregulation in the late 1970s. The shift towards more competitive and market based system of banking and capital markets created greater pressures to cut costs, increase efficiency, and develop new financial products to sustain in the new environment. This new environment has created new kinds of risks, with new opportunities and dangers to taking risks, including interest rate risks for assets and liabilities, exchange rate risk and credit risks since companies are also in a more competitive environment.

The bank dominated financial system during the high growth era in Japan underwent a significant change that took place with the initiation of financial system deregulation in the late 1970s, notably in the early 1980s. The financial deregulation adopted several measures to develop bond markets. Because of government deficit for social security system and economic expansion, it increased its bond issuance, which reduced profitability of the banks that had been forced to absorb the government bonds with low yield. Moreover, there were strong demands of financial deregulation from capitalists, politicians and international investors. What factors motivated them to choose a free and competitive financial system? The answer, however, is not straightforward. The deregulation in bond issuance, foreign exchange transactions, interest rate controls, stock market regulation and new product introduction benefited the corporate borrowers by providing them various new options and hurt the banking sector as the borrowers became less dependent on bank loans. The large companies reduced not only their dependence on bank loans but also the number of board members dispatched from their main banks. This changed relationship declined the relative bargaining power of banks in corporate monitoring and the rescue operation of troubled firms did not go effectively.

Looking at the ownership structure of the Japanese corporate sector, it is still true that corporate ownership is highly concentrated on banks and business companies. However, some noteworthy changes can be observed in the Japanese corporate ownership structure in the 1990s. This fact suggests that the Japanese corporate governance system entered a new stage. Naughton and Hovey (2002) argue that the current economic problems in Japan can in part be attributed to the failure of the Japanese system of corporate governance to adapt to the changed world economic order of the late twentieth century.

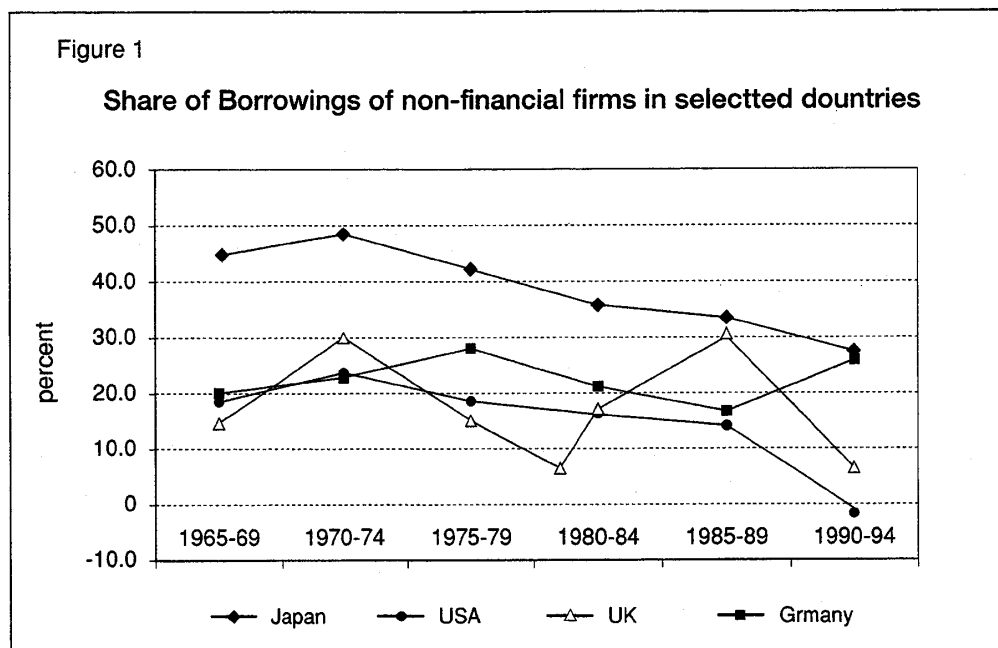
The strong corporate sector wanted more freedom of investment decision and financing thereby switching towards direct market financing rather than being dependent on bank loans. International pressures led Japan to follow the Thatcher and Regan's neo-liberal financial policies. Consequently, the Japanese financial system went for liberalization. The deregulation of financial system significantly changed the pattern of corporate financing with increasing

excess to direct market financing. The table 3 compares the structure of corporate finance in some selected countries. It shows that over 40 percent of the total fund raised by non-financial firms in Japan was bank borrowings during the 1960s and 1970s. The share of bank borrowing in Germany where the banking sector plays substantial rule is much less than that of Japan. The internal sources of fund raising in Japan reached to 70 percent in early 1970s from around 50 percent of its 1960s' level.

		Year	Japan	USA	UK	Germany
Internal Funds		1965-69	49.7	68.2	74.5	69.3
		1970-74	42.8	55.2	34.5	61.1
		1975-79	49.5	67.2	79.5	64.8
		1980-84	59.0	73.3	80.4	75.2
		1985-89	51.7	82.9	63.6	78.7
		1990-94	70.2	80.8	58.0	57.9
External Funds	Borrowings	1965-69	43.8	18.2	14.0	20.1
		1970-74	48.8	24.7	31.0	23.4
		1975-79	42.5	19.0	15.3	27.8
		1980-84	35.1	16.6	17.3	21.3
		1985-89	33.2	13.9	31.0	16.2
		1990-94	26.3	-1.3	5.5	27.0
	Securities	1965-69	5.2	13.6	11.5	4.1
		1970-74	5.6	19.2	4.5	3.5
		1975-79	7.7	13.8	5.2	1.4
		1980-84	6.1	10.1	2.4	3.6
		1985-89	10.8	1.6	7.4	5.1
		1990-94	7.5	9.8	25.5	8.6

Source: Annual Report by Ministry of Finance Banking Bureau, various issues, recited from Hoshi and Kashyap (2001)

The banks lost their big borrowers as they went for bond issuance for corporate financing. In this, the banks had no choice except to find out another source of profit and reorganize their lending pattern. With the decrease of big companies' borrowings, the banks increased the lending to the small firms. It resulted in higher debt ratio for them and also their share in total borrowing of banks went up from 60% in 1973 to 80% in 1997 (Lee, 2001). In addition, the bank lending to the real estate companies, especially to small housing loan companies (*Jusen*) increased in order to reap the profits from increasing land prices during the so-called 'asset price bubble' in late 1980s. The following table depicts the increasing share of bank lending to real estate sector that nearly doubled during the peak of the bubble economy from its 1980's level.



The banks suffered from the excessively declining profits after the bursting of the bubble in the early 1990s. The burst of the real estate and stock market left huge amount of non-performing loans in the banking sector as their asset values declined sharply. Estimates of bad loans by private agencies are substantially greater than the amounts disclosed by the banks and the ministry of finance. Due to the combination of definitional, measurement and disclosure reasons, the actual amount of bad loans has been ambiguous.

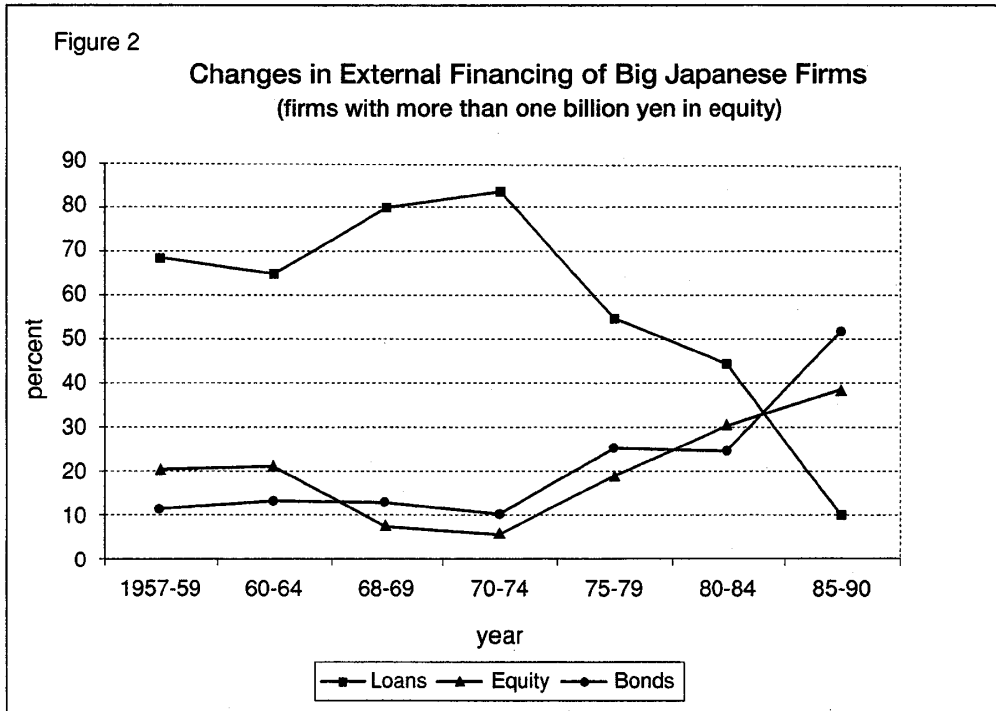
Table 4 Lending to real estate and non-bank companies, in trillion of yen  
(Numbers in parenthesis denote the percentage of total lending)

Year	1984	1985	1986	1987	1988	1989
Total lending (all banks)	299.3	249.6	273.3	297.6	322.3	356.8
To real estates	17.4 (7.5)	22.2 (8.9)	30.2 (11.1)	33.5 (11.3)	37.3 (11.7)	43.3 (12.1)
To non-bank companies	23.2 (10.2)	29.6 (11.9)	36.9 (13.5)	45.1 (15.2)	50.9 (15.8)	59.6 (16.7)

Source- Cargill, Hutchison and Ito, 1997

The notable point in this context is that the serious non-performing loan problem in Japan is not in the manufacturing sector composed of big companies that already reduced the bank borrowings as shown in the figure below. This suggests that the mounting non-performing loan problem in Japanese banking sector in the 1990s is not due to the soft budgeting problem of

main bank system as argued by many analysts but because of weakening position of stable relationship between banks and companies that forced banks to increase their lending to the real estate related sectors that supported the bubble. Moreover, the easy equity financing through stocks and bonds also led over-investment by the manufacturing sector, which further fueled bubble economy in the late 1980s.



The declining dependence of bank loan financing of big corporations weakened the bargaining power of main banks in corporate governance and monitoring. The bank firm relationship remained stable only through their cross-shareholdings rather than banks' role in intensive monitoring function while undertaking a new investment project by the companies. This changed relationship brought the problem of moral hazard in the corporate governance of firms. However, the stable relationship between the banks and firms has not been broken up due to the cross-shareholding relationship. A big Japanese company, Toyota, for example, has not borrowed from any banks for 20 years but still three main banks own its share by around 5% each and Toyota owns the banks' share. Thus, we can't say the main bank system has been really broken up, although the decline of the bank-based financial system in Japan was very clear for big firms since the late 1980s (Miyajima, 1998). Patrick (1998) argues four major causes of banking crises in Japan: the failure of prudential regulatory system after deregulation, the creation and then bursting of the stock and real estate bubbles, globalization and the high rate of financial innovation.

It should also be noted that the core of the banking sector problem in Japan arose not only with the ill performance of the banking sector itself but due to some external and internal structural factors that aggravated the macroeconomic stability and the whole financial system. However, the performance of the banking sector itself cannot be denied for accumulation of mounting non-performing loans accounting to nearly 20 percent current GDP. Though the banking sector problem in Japan became explicit with the bursting of the so-called 'bubble' in the early 1990s, it developed as a full-blown crisis in the late 1997.

During the high growth era, the demand of funds for financing investment outstripped the supply of savings. As a result of impressive and phenomenal growth of economy and trade, the accumulation of financial wealth by both individuals and corporations reduced the pressure on the supply side. But this phenomenon could not last long. The several exogenous shocks in the early 1970s changed the situation. Consequently, the changes in the financial structure and policies became inevitable. The changes proceeded gradually from partial deregulation of financial system in the late 1970s to the full-fledged deregulation scheme, the Big Bang, in the late 1990s. The deregulation brought significant changes in the banking sector that was subject to heavy state regulation and protection from both domestic and foreign competition. The deregulation of the financial system dramatically altered the structure of corporate financing thereby shifting toward capital market from then existing heavy reliance on bank financing. The bank finance dramatically reduces from 83 percent in early 1970s to 10 percent in late 1980s.

The deregulation in interest rate, liberalization in bond and equity market and free entry to banking industry will not end, though severely affected, the main bank system as the relationship between banks and their client firms exists through reciprocal shareholding and providing other services including payment settlements, expertise in bond services etc. and the financial deregulation does not necessarily change the essence of corporate governance model. It has been argued that shift that has occurred in the source of financing of large firms will not end the main bank system since the provision of loans appears only as one of the many aspects of this relationship. Many economists strongly support that the participation of banks in the governance of corporate groupings is by far the most prominent aspects of main bank relationship rather than simple provision of loans.

## **5. Conclusion**

The wartime designation of economic policy favored state regulated financial system with limited entry and competition in the Japanese banking industry for channeling funds into strategically important sectors of the economy. The policy makers often interpret the rationale for bank finance over corporate bond issue as the savers in the early post-war period wanted safe, liquid and short-term financial assets. The savers' risk aversion behavior, the regulatory framework supportive to the bank lending over corporate bond issue and low supply of



information aggregation led Japanese financial system a dominant bank-based system. The main bank system developed in Japan as a system with special relationship between large banks and their client companies from provision of loans, informational and managerial services to rescue operations in times of financial distress. The system played an important role in corporate governance and monitoring of the client firms and hence, it is better understood as a specific system of corporate financing and governance with special relationship between banks, business communities and regulatory authorities. However, some recent literatures challenge the economic significance of Japanese main bank system.

Along with other implicit advantages, the main bank system can generate following three major benefits; the reduction of agency costs through investment in monitoring, avoidance of problems of information imperfection and their asymmetric distribution, and reduction of restructuring and reorganization costs in times of financial distress. Notwithstanding the various benefits, the system may lead to the serious hold-up and soft budgeting problems. The extent of these problems depends on how well the monitoring function of the main bank and the supervision function of the government are performed.

The changes that took place in the early 1970s dramatically altered the structure of the Japanese financial system. The introduction of financial liberalization reduced the corporate financing role of main banks since their big corporate borrowers went for direct market financing. This event subsequently reduced the role main bank corporate governance and monitoring. However, the stable cross-shareholding relationship between the banks and firms and dispatch of corporate directors from their main banks still exist. This suggests that financial deregulation does not necessarily displace the role of main bank in corporate governance and monitoring.

If an atmosphere of financial panic develops, the bank failure may not be limited to banks that have mismanaged their assets. This adversely affects the whole system. The emergence and bursting of the asset price bubble turned into the severe banking sector problem since the banks lost their big corporate clients and increased their lending to the bubble related sectors. The bursting of the bubble in the early 1990s substantially reduced the value of banks' assets and left huge amount of non-performing loans in the banking sector. The financial deregulation encouraged big companies to go for direct market financing. The banks had no other options than increase their lending to real estate related companies such as *Jusen* to reap the higher profits from so-called asset price bubble. Thus, the mounting non-performing loan problem, rather than declining strength of main bank corporate governance and monitoring function, has become the most serious problem in Japanese banking sector. Overall, the main bank system itself is not the cause of these problems rather the changing environment weakened the role and functioning of main bank system.

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