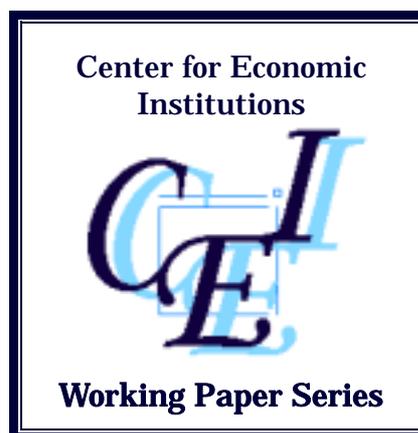


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*A Review of Japan's Bank Crisis from the  
Governance Perspective*

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# A Review of Japan's Bank Crisis from the Governance Perspective\*

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## Abstract

Why has Japan suffered from the NPL problem for such a long time? We will answer to this question from a governance perspective that emphasizes important influence of the governance structure on bank management. In our opinion, Japan failed to motivate banks to play the role of monitoring essential to the bank-centered financial system. We will stress that there existed a vacuum of governance in the bank management in the sense that bank managers were not effectively disciplined as to attain sufficient prudence in their management. The vacuum of governance accounts for the fragility of the banking sector and, more importantly, the prolongation of the NPL problem in Japan.

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“The view that actual behaviour is always to be understood as an efficient solution to a particular incentive problem seems a very high order of rationality, and says nothing about the process by which an efficient arrangement is actually achieved.” (Edwards and Fischer (1994: 28))

## 1. Introduction

Table 1 and 2 summarize the data of Japanese banks' non-performing loans (NPLs) in terms of 'risk management loans' since March 1998, when they began to disclose figures of comprehensively defined NPLs. The definition of risk management loans is comparable to that of NPLs adopted by the SEC in the United States. This table shows that during the last few years the amount of NPLs slightly increased amounting to more than ¥32 trillion, around 6.5 percent of GDP. The portion of NPLs not covered by the reserves for loan losses almost doubled from ¥13.8 trillion in March 1998 to ¥25.3 trillion in March 2001.<sup>1</sup>

This increase in NPLs does not necessarily mean Japanese banks' passivity

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<sup>1</sup> On May 24, 2002, all of the Japan's major banks (13 banks) reported the amount of non-performing loans (NPLs) existing at the end of March 2002. According to the reports, the total amount of those banks' NPLs increased to around ¥27.2 trillion on the consolidation bases, which accounted for 8.5% of loans and was 47% larger than that observed one year ago. To dispose of the NPLs, the major banks spent more than ¥8.0 trillion, which was more than twice of their current earnings from businesses. At the end of the last year, the government announced a scenario of eliminating NPLs by fiscal 2004. But the scenario seems unrealistic.

regarding disposal of NPLs. They seem to have been rather active in disposing of their NPLs. For example, during the last three years since April 1997, the Japanese banks recorded bad loan losses amounting to ¥27.7 trillion. Nevertheless, the amount of NPLs not covered by reserves increased during the same period. Obviously, the amount of NPLs has been increasing at a substantial speed in the Japanese banking sector during the last few years mainly due to the recent slowdown of the Japanese economy.<sup>2</sup>

The increasing number of bankrupted depository institutions (i.e., banks and cooperative financial institutions) in Table 3 also shows the current fragility of the Japanese banking sector. According to this table, more than 170 depository institutions have failed during the last decade since 1991. Most of the failures occurred since the mid-1990s. Until the end of March 2001, the Deposit Insurance Corporation (DIC) spent nearly ¥20 trillion to deal with those bank failures mainly with a view to protecting depositors. In addition, the government injected 'public funds' amounting to ¥10 trillion into a number of big banks to strengthen their capital bases since March 1998.

In spite of those capital injections, the Japanese banking sector has not succeeded in finding a way out of the swamp. The disclosed figures in Table 1

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<sup>2</sup> We should not neglect the NPLs in the sector of cooperative financial institutions, a major part of which is comprised of *sinjin* banks and credit cooperatives. The relative magnitude of the NPL problem seems more serious in this sector than in the banking sector. At March 2001, the NPLs amounted to ¥10.9 trillion (8.2% of the total loans) in this sector, and three fourths of the NPLS was not covered by reserves for loan losses.

give no hint of an immediate settlement of the NPL problem. To make matters worse, many people suspect the authenticity of the disclosed NPL figures, because bank managers could manipulate their assessment to underrate the amount of NPLs in some ways, and because they have strong incentives to do so. Thus, the current situation of the Japanese NPL problem may be much worse than what Table 1 suggests.<sup>3</sup>

The Japanese government started the so-called ‘pay-off’ of the deposit insurance at April 2002. This policy implies the abolition of the traditional blanket guaranty to protect all the depositors. Responding to this new regime, depositors have become very sensitive to soundness of banks. They started to shift their deposits from time deposits, which are insured only up to ¥10 million, to ordinary deposits, which are to be covered without any ceilings until the end of March 2003. They have also shifted their deposit from smaller banks to larger ones to which they suppose the ‘too big to fail’ doctrine will be applied. Thus, there remains large uncertainty whether or not banks will be able to survive the critical situation.

Why has Japan suffered from the NPL problem for such a long time? We

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<sup>3</sup> It is probable that the Financial Services Agency (FSA) allowed banks to underrate the amount of NPLs. This FSA’s policy made it possible for the banks to take the policy of gradually disposing their NPLs within the narrow limits of current profits. Obviously, this was a forbearance policy. It was accompanied with a delay of final resolution of the NPL problem. On the other hand, it is conceivable that this policy helped the banks avoid unnecessary liquidation of borrower firms in financial distress, which might worsen Japan’s economic depression.

will answer to this question from a governance perspective that emphasizes important influence of the governance structure on bank management. In our opinion, Japan failed to motivate banks to play the role of monitoring essential to the bank-centered financial system. We will stress that there existed a vacuum of governance in the bank management in the sense that bank managers were not effectively disciplined as to attain sufficient prudence in their management. The vacuum of governance accounts for the fragility of the banking sector and, more importantly, the prolongation of the NPL problem in Japan.

The organization of this chapter is as follows. The next section (Section 2) discusses the weakness of the managerial governance in the Japanese banking sector from the three perspectives; i.e. the disciplinary influence of the capital market, the pressures from market competition, and the disciplinary influence from the supervising authority. Section 3 discusses what we learn from responses of capital market to the bank crisis. Section 4 summarizes our discussion in this paper.

## 2. Defects of Governance in Bank Management

Efficiency of a bank-centered financial system, which is typically observed in Germany and Japan, depends on banks' monitoring of their client firms' management. Banks must play essential roles of evaluating credit-worthiness of borrowers and monitoring their management in order to prevent their moral hazard-like behavior under the asymmetric information. Then, how can we ensure

the prudent monitoring by banks? This is an issue ‘who monitors the monitor’ (Aoki (1994) and Prowse (1995)). If we fail to resolve this issue, the banking system is likely to be unstable, and impose heavy burden on taxpayers (Kane (1995)).

According to the standard theory of corporate governance, bank management could be disciplined by the following three means (Allen and Gale (2000)):

- (1) Capital market where either investors, particularly debt-holders including depositors, monitor performance of individual banks or the threat of hostile takeovers discipline managers for bad performance,
- (2) Competition in the banking industry that weeds out inefficiently managed, or
- (3) The supervision by regulatory authorities that prevents banks from taking excessive risk in the *ex ante* stages or forces managers of distressed banks to restructure their businesses in the *ex post* stages.

In the following, I will stress that these disciplinary means did not work in the case of Japan’s bank management.

## 2.1 Lack of capital market discipline

The standard theory of the corporate governance stresses importance of the disciplinary effect of the capital market on management (e.g. Monks and Minow 1995: Chapter 2). According to the theory, both the internal governance mechanisms based on the board of directors, and the external mechanisms of threats of hostile takeovers are effective in disciplining corporate managers.

However, as Allen and Gale (2000: 80) argue, the effectiveness of the capital market mechanisms has been widely questioned. Even in both the United States and United Kingdom, where the capital markets are supposed to have developed its disciplinary functions, incumbent managers seem to control decision making of the board of directors. A number of empirical researches on the effectiveness of hostile takeovers show that, contrary to the standard theory, the takeovers are not effective in enhancing the profitability of the targeted firms.

The Japanese capital market might have been particularly powerless in disciplining corporate managers because the managers of big companies have entrenched themselves by means of mutual shareholdings with other corporations. The banks are not exceptional for this case. Moreover big banks constituted the core part of the traditional mutual shareholding, which functioned to protect incumbent managers from the pressure of capital markets.<sup>4</sup> As for investors into

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<sup>4</sup> With respect to the capital market mechanism, we should note Japanese banks are more diffusely held than non-financial companies are. According to Kim and Rhee (1997), the top six shareholders of banks hold on the average 18.4 percent of the total shares outstanding. In contrast, Prowse (1992) finds that the top five shareholders for the Japanese mining and manufacturing companies hold 33.1 percent of the total shares outstanding.

It is also noteworthy that insurance companies have often occupied the status of largest shareholders of banks. The insurance companies were helpful to incumbent bank managers when they were required to strengthen their capital bases responding the introduction of BIS capital adequacy regulation at the end of the 1980s. Specifically, in order to increase their equity capital, Japanese banks issued a large amount of subordinate debt (or subordinate loans), which are counted as the tier II capital. Insurance companies actively bought most of the

banks' debt, they had no strong incentives to monitor and discipline bank management because of existence of a blanket guaranty in the Japanese financial system.

The mechanisms of the blanket guaranty: The financial safety net is widely recognized as indispensable to minimize the spillover effects of failures of banks and other financial institutions on the financial system as a whole (Diamond and Dybvig (1983) and Dewatripont and Tirole (1994)). However, the operation of the safety net changes the *ex post* distribution of social costs associated with bank failures. This risk-sharing implication of safety net decreases the monitoring incentives of depositors and other investors because they are either explicitly or

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debt to help bank management. The main objective for the insurance companies to buy banks' subordinated debt was obviously not to monitor bank management more strongly, but to keep business relationships with the banks. The insurance is most heavily protected in the Japanese financial industries. It is a plausible story that the government permitted banks to issue subordinate debts to increase their capital at the end of the 1980s immediately after the BIS capital adequacy regulation became effective, then implicitly order (or recommend?) insurance companies to support banks by buying most of the debts. If so, the insurance companies have been far from a reliable monitor of bank management. Fukao (2001: 29) points out that banks and life insurance companies relied on each other to raise broadly defined capital. While banks provided subordinated credit and surplus notes to life-insurance companies amounting ¥2.3 trillion at the end of March 2000, life-insurance companies provided ¥6.7 trillion of subordinated credit to banks and owned ¥7.7 trillion of banks stocks. "Given this effective double gearing between the two, it is difficult to expect strong governance pressure on banks from life-insurance companies."

implicitly protected from losses associated with bank failures (Black, Miller, and Posner (1978)). In order to keep the safety net viable, appropriate incentive mechanisms are required to reinforce monitoring of bank management. The wider is the scope of the financial safety net, the stronger moral hazard incentives are given to bank management, and thus, the more energetically the regulatory authorities must monitor banks to prevent excessive risk-taking in place of depositors and investors.<sup>5</sup>

The Japanese financial system was covered by a virtual blanket guaranty of the safety net implemented by the Ministry of Finance (MOF). It was usual for the MOF to either rescue or dispose of distressed financial institutions in tight collaboration with the Bank of Japan (BOJ) and private financial institutions, particularly the major banks belonging to the group of city banks and long-term credit banks.

Probably the most important rescue program implemented by the MOF before 1990 was the merger between Sumitomo Bank and Heiwa-Sogo Bank in October 1986. Heiwa-Sogo got into difficulty during the first half of the 1980s. In

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<sup>5</sup> Total abolition of the financial safety net would strengthen the incentives of depositors and investors to monitor and discipline bank management. However, most of depositors are small-sized wealth-holders enjoying no economy of scale in collecting and analyzing information about bank management. There also exists a "free-riders" problem to hinder efficient information production. Thus, it would be unrealistic to totally depend on the market discipline to keep stability of the banking system. As Dewatripont and Tirole (1994) argue, we need to have a sort of the financial safety net in order to protect small-sized investors in the banking sector.

1985, the MOF made a bailout plan in order to prevent the outright bankruptcy of Heiwa-Sogo from destabilizing the Japanese banking industry as a whole. In 1986, the MOF succeeded in persuading Sumitomo to absorb Heiwa-Sogo. Despite *de facto* bankruptcy, the closure of Heiwa-Sogo did not cause damage to depositors and holders of other debt issued by this bank. Sumitomo bore the cost of dealing with the distressed bank. On the other hand, Sumitomo was able to expand its branch network at once by absorbing Heiwa-Sogo's branches. This was beneficial for Sumitomo who wanted to extend the branch network in the metropolitan area.

As this case suggests, the MOF's program protected not only depositors, but also other investors into bank debts from the risk of bank failures. In some cases, the bailout program virtually lessened even the burden of banks shareholders.<sup>6</sup> When Japan's bank crisis got worse and a number of banks and depository institutions such as credit cooperatives went bankrupt in the mid-1990s, the

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<sup>6</sup> Banks' shareholders may have been protected in compensation for their silence on bank management. In reality, the shareholders have been rather similar to debt-holders in the governance structure of bank management. This is evidenced by the fact that a dividend on bank shares has been extremely stable regardless of bank performance. For example, the profits of city banks were either very small or negative during the five years from 1993 to 1997 mainly due to large loan loss provisions. Nevertheless, the city banks continued to pay almost constant amount of dividends to their shareholders. The total amount of profits for the city banks was less than minus ¥1.8 trillion for the five years. On the other hand, the total amount of dividend paid out by the city banks was a little larger than ¥1.0 trillion for the same five years. If they had not paid the dividend at all, the total amount of capital would have been larger by 10% for those banks than the actual amount in March 1998.

MOF's traditional rescue program was found too costly. Then, the MOF belatedly started to burden some debt-holders and shareholders with bankruptcy costs of failed banks.<sup>7</sup> However, it was too late. The disciplinary function of the capital market would have been constructive in preventing banks from engaging in excessive risk-taking during the 1980s. The blanket guaranty blocked the capital market's function of preventing a serious NPL problem in Japan. The Japanese government should have narrowed the scope of the financial safety net before the NPL problem got serious. Actually, after the bank crisis got worse, the government decided to abandon the blanket guaranty by starting the so-called pay-off of deposit insurance. This is a mistaken policy sequence.

The function of the DIC: The Deposit Insurance Corporation (DIC) has been equipped with a means of paying off the insured deposits of failed banks from the time of its establishment in 1971. However, the government announced in December 1995, a quarter century after the start of deposit insurance, that they were not yet prepared to exercise it. In December 1997, the government declared that all investments into deposits and other bank debts such as bank debentures would be protected from bank failures.<sup>8</sup> The purpose of this policy was to calm

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<sup>7</sup> When Kosumo, one of the largest credit cooperatives, went bankrupt in July 1995, some financial institutions lending to the credit cooperative were forced to bear some of its bankruptcy costs. When Hyogo Bank and Taiheiyo Bank were reorganized into new banks after their bankruptcy in 1995 and in 1996 respectively, the shareholders' equity of the old banks was reduced.

<sup>8</sup> The frameworks of the Bankruptcy Law and the Corporate Rehabilitation Law

people's growing concern over the danger of bank failures during the financial crisis following the bankruptcy of Hokkaido-Takushoku Bank and the failures of a few major securities companies, including Yamaichi at the end of 1997.

Of course, this declaration is likely to produce further moral hazard on the side of bank management by weakening incentives of depositors and investor to monitor bank management.<sup>9</sup> However, even before the declaration the existence of a long-standing blanket guaranty had produced among depositors and other investors a perception that they would never be required to share the burden if their banks should go bankrupt. Because of this widespread perception, a government policy of paying off insured deposits without rescuing other bank debts would have resulted in an unexpected shock to the financial system, and thereby made Japan's bank crisis more serious. Thus, at the end of 1997, the Japanese government had no choice but to ensure that the traditional blanket guaranty was valid.

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required time-consuming procedures when debt holders' stakes were reduced. Thus, it was practically impossible to operate the pay off within a few days under the legal framework. The amendment of Deposit Insurance Law of 2000 eased the legal framework to make the pay-off of a failed bank's deposits possible.

<sup>9</sup> On May 22 1999, the Financial Revitalization Commission announced that Kofuku Bank, a regional banks located in Osaka, would be under the control of an official receivers appointed by the Commission. At that time, the chairman of the Commission accused the bank of borrowing the huge amount of money from inter-bank money markets with substantial premiums immediately after the Commission ordered the bank to take prompt corrective actions to strengthen its capital. This is a typical moral hazard like behavior, and it is just the tip of an iceberg of the moral hazard prevailing under the wide-scope safety net.

Since the beginning of the 1990s, when the ‘bubble’ burst, it has become increasingly difficult for the MOF to maintain the tradition method to bail out bank failures. This is reflected in the fact that the government has often utilized the facility of deposit insurance to cope with the financial distress of individual banks, although, as we have explained, the paying off of insured deposits has never been exercised. The increasing importance of the DIC in the government’s bailout scheme marked a significant change in the operation of the Japanese safety net.

From April 1992, when the DIC supplied funds to bail a small regional bank out, to March 2001, the DIC intervened into 93 cases of disposing troubled banks and provided the banks participating in the bailout schemes with subsidies of more than ¥14.7 trillion. In addition, the DIC spent more than ¥5.1 trillion to purchase bad loans from failed banks. The deposit insurance system will be more and more intensively utilized in the Japanese financial safety net.

## 2.2 Disciplinary influence of market competition

We may expect that full-scale market competition will exert strong disciplinary influence on corporate management by weeding the inefficiently managed firms out. It should be noted that there exist some theoretical models, which refutes the disciplinary effect of product market competition (Nickell, Nicolitsas, and Dryden (1997)). However, the following argument given by Allen and Gale (2000: 109-110) seems very convincing:

‘In dynamic market with constantly changing prices, products, and markets,

[managers] identify new opportunities and coordinate the managerial team as it seeks to exploit these opportunities. In such cases, it may not be possible to say with any degree of confidence *ex ante*, which management will succeed and which will fail. It is precisely in this case that competition in the product market can be important. In the absence of valuable information on the part of shareholders and effective means of controlling management decisions, competition among companies both reveals which managers are the best and at the same time disciplines them.’

Thus, regardless of its specific ownership structure or any other financial governance structure, the corporate management would be disciplined by market competition.<sup>10</sup>

The Japanese manufacturing firms may have achieved excellent performance not because they have been effectively disciplined via the bank-centered financial system, but because they have long faced with fierce competition in the global market. Although this view remains a conjecture that must be empirically tested in the future, it is fairly well grounded (Hanazaki and Horiuchi (2001)). In contrast, the Japanese financial services industries including the banking sector have been protected from full-scale competition by the counter-competition regulation. Thus, the market competition has not worked to discipline management in the banking and other financial services industries in Japan. This accounts for the current fragility of the Japanese financial system.

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<sup>10</sup> Nevertheless, as Allen and Gale (2000: 110) suggests, there exists only a limited number of the empirical study on the effectiveness of market competition

Role of counter-competition regulations: The counter-competition restricting regulations, such as interest rate controls and restriction on new entry into banking and other financial business through the system of compartmentalization, conferred a handsome amount of rents on existing banks and other financial institutions. Although it has never been explicitly announced, the primary purpose of the MOF's administrative guidance was to suppress full-scale competition in each of the compartmentalized financial businesses, thereby protecting the less competitive small-scale banks, *shinkin* banks and credit cooperatives. The MOF's policy stance was often called the 'convoy administration.'<sup>11</sup>

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on efficient corporate management.

<sup>11</sup> The MOF's administration of branch offices was a significant area of regulation. During the high growth period, when almost all deposit interest rates were under regulation, branch offices were an important means of non-price competition for banks and essentially the vehicle by which they competed for deposit funds. Under the MOF's administration, banks were not free to either expand or change the location of their branch networks. In permitting new branches, the MOF reportedly gave preferential treatment to small banks. The number of branches of small-scale banks increased more rapidly than did that of city banks, both during and after the high growth period (Horiuchi (1984)). The MOF partially abandoned branch administration by allowing regional banks and *shinkin* banks to freely increase the number of branch offices in May 1993. At that time, the MOF announced that the branch regulation for city banks would be gradually liberalized while taking into account the influence on small and medium sized financial institutions. In May 1995, the MOF totally liberalized the regulation regarding the number of branch offices for all banks.

Some scholars argue that the counter-competition regulation contributed to sustenance of the Japanese traditional financial regime in two ways (Aoki (1994) and Hellmann, Murdock and Stiglitz (1997)). First, it produced the rent in the financial service industry that gave banks and other financial institutions incentives to refrain from excessive risk-taking in order to continue enjoying handsome rents. Furthermore, thanks to protection offered by the counter-competition regulations, even inefficiently managed banks rarely went to the brink of managerial difficulty that is particularly likely to induce moral hazard behavior.<sup>12</sup>

Second, the regulators were able to utilize the rents accumulated in the banking sector as a means of dealing with banks in financial distress. Specifically, the regulators relied on private banks' collaboration in implementing the safety net, and major banks faithfully bore a disproportionate share of the costs involved. This mechanism would not have worked had the major banks not enjoyed the rents stemming from the counter-competition regulations. The MOF also utilized the regulations to induce banks to accept its initiatives in the process of dealing with

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<sup>12</sup> Aoki (1994) argues, by assuming asymmetric information about banks' monitoring activities, that the rent was necessary to motivate private banks to faithfully and efficiently monitor their borrowers. He suggests that the long-term relationship between major banks and borrower firms, called the "main bank relationship," in Japan was crucially dependent on the competition-restricting regulations. However, the restricting full-scale competition was not always necessary to motivate banks to supply a "high quality" level of monitoring. The *laissez-faire* market would be able to motivate banks to conduct good monitoring. See Klein and Leffler (1981).

bank failures. The MOF could do favors for those banks that toed the line and to penalize those who failed to heed their guidance by manipulating the regulatory means. The specific administrative guidance based on the counter-competition regulation was an instrument for the MOF to determine the distribution of rents among banks.<sup>13</sup>

The counter-competition regulation was thus an ingredient of the Japanese traditional safety net. However, the regulation seems to be self-defeating in the following sense. As has been pointed out, the rent could be an important incentive for prudent bank management. Nevertheless, but for a credible penalty for inefficient management, the incentive would be powerless in ensuring banks' prudent management. The MOF did not prepare any credible penalty for inefficient management. Rather, through the 'convoy administration,' the MOF virtually protected inefficiently managed banks and financial institutions. The

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<sup>13</sup> Even during the 1990s, the MOF manipulated its administrative guidance in order to induce private banks to collaborate with its rescue program. In 1994, for example, Mitsubishi Bank obtained preferential treatment from the MOF in exchange for rescuing Nippon Trust Bank, which had been seriously damaged by the accumulation of a huge amount of bad loans since the early 1990s. Mitsubishi Bank was 'rewarded' by being allowed to pursue a full complement of trust banking business through Nippon Trust, which is now its subsidiary. Other banks are prohibited by the MOF from engaging in full-line trust banking business through their trust bank subsidiaries. The same story is true of the case in which Daiwa Bank financially supported Cosmo Securities Company, which was seriously damaged by the depression in the securities market after the "bubble" burst at the beginning of the 1990s. Cosmo has been a subsidiary of Daiwa Bank. However, Cosmo retained its stock brokerage business that has not yet been

MOF's administration based on the counter-competition regulation worked to keep the old-fashioned financial system intact in the face of rapidly developing technologies related to financial services. According to the terminology used by North (1990), the counter-competition regulation deprived the Japanese financial system of 'adaptive efficiency.'

Delayed deregulation in the financial markets: Although Japan started the financial deregulation at the beginning of the 1980s, the deregulation policy was colored with 'gradualism.' The government took the policy of gradually liberalizing financial system in order to prevent 'unduly destabilizing' impacts of financial deregulation. In reality, this gradualism was synonymous with the policy of protecting vested interests existing in the financial services industries. The gradualism thus suppressed disciplinary effects that the financial deregulation was expected to exert on management in the financial services industries including banking.<sup>14</sup> The so-called 'Big Bang' financial reform plan proposed by the Hashimoto cabinet in November 1996 was the government's commitment to

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permitted to the securities subsidiaries of other banks.

<sup>14</sup> The financial deregulation was promoted by the pressures from abroad, particularly from the U.S., rather than on the government initiative. For example, the ad-hoc Yen/Dollar agreement between U.S. and Japan, which was realized by the strong requirement by the Reagan administration in 1984, compelled the Japanese government to specify a timetable of liberalizing financial markets. Frankel (1984) explains the process of the Yen/Dollar agreement. Takeda and Turner (1992) discuss the relationship between the internationalization of Japanese financial markets and domestic financial deregulation in great detail.

abandon the policy gradualism. This sort of ‘shock-therapy’ was needed to make up for lost time.

We could not totally deny the impact of financial deregulation on domestic financial markets during the 1980s. In particular, major companies reduced their dependence on bank borrowing by issuing a large amount of corporate bonds in international markets. This internationalization of corporate finance induced the deregulation of domestic corporate bond markets since the mid-1980s (Takeda and Turner (1992)). However, the Japanese banks and other financial institutions were able to base their domestic business on the huge amount of wealth accumulated by households amounting to ¥1,200 trillion as of the mid-1990s. Thus, it would be an exaggeration to say that the internationalization of corporate finance exerted substantial influence on their way of business. Heavily protected in the domestic market, many Japanese banks surprised their foreign rivals by aggressive expansion of business in international markets during the 1980s. Since it sacrificed profitability, the aggressiveness undermined soundness of bank management.<sup>15</sup>

### 2.3 The role of regulators: Another agency problem

Under the current legal framework, the great authority and responsibility of monitoring bank management is delegated to the government. The Banking Law authorizes the government to intervene into bank management for the purpose of

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<sup>15</sup> After the burst of the ‘bubble’ at the beginning of the 1990s, most Japanese banks withdrew from the international businesses.

attaining managerial prudence through the regulators, specifically the MOF, and the Financial Services Agency (FSA) that took over the role of supervising from the MOF in 2000.

Ideally the regulators would maintain the safety net so as to impose the lowest social costs. They do not automatically pursue this social obligation, however, because they tend to give priority to their own preference over the policy objectives assigned by taxpayers. If the regulators fail to conscientiously pursue their designated policy goals, banks could aggressively extend their risk-taking activities, transfer this risk to taxpayers, and thereby undermine the viability of the safety net itself. Kane (1995) analyses how this aspect of the principal-agent problem between the regulator, banks, and taxpayers destabilizes the financial system covered by the safety net.<sup>16</sup>

Banks' shareholders benefit when a safety net facilitates more aggressive risk-taking by the bank. To limit this type of risk-taking by banks at the expense of taxpayers, regulators are responsible for monitoring banks, using means such as requiring banks keep their capital/asset ratios at sufficiently high levels, and penalizing banks for imprudent and inefficient management. If they freely get access to the information relevant for assessing regulators' activities, taxpayers could force the regulators to accomplish this responsibility. However, the

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<sup>16</sup> Kane (1995) warns us against carelessly assuming that regulators are fully trustworthy or automatically pursue the social role assigned to them. As he argues, "the faith-full agent presumption focused economists' attention on evaluating pricing and regulatory structures rather than on analyzing the web of incentives facing the officials responsible for designing and enforcing these structures."

asymmetric information hinders taxpayers from precisely evaluating regulators' behavior. It is difficult for taxpayers to determine whether the regulators ostensibly regulate in pursuit of objectives quite different from those assigned by taxpayers.<sup>17</sup>

There are a few piece of evidence that the regulators were not effectively disciplined in Japan. For example, in 1954 the MOF introduced the capital adequacy regulation, which required banks to increase broadly defined capital to more than 10% of total deposits. However, the MOF allowed banks to have capital

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<sup>17</sup> At this point one must address Kane's (1995: 441) suggestion that "manager-stockholder conflict poses a counterincentive to pressures for deposit-institution risk-taking." That is, if managers dominate bank decision-making, the safety net would not necessarily motivate banks to expand risk-taking because these activities "exposes the manager's human capital to career damage that is hard to diversify." This argument is relevant here because conventional wisdom holds that Japanese corporations, including banks, are organized and monitored in ways that bear little resemblance to the commonly assumed shareholder-oriented agency model of corporate management (e.g., Prowse (1992:1122) and Milhaupt (1996)). In addition, the practice of long-term employment in Japan makes human capital more specific so that career damage becomes all the more serious an issue. Even if managers dominate decision-making, however, regulators can mitigate the threat greater bank risk poses to human resources for bank managers if they adopt a policy of forbearance towards those banks with which they colludes. To the extent this regulatory approach limits career damage, it also reduce the effectiveness of the counter-incentive mechanism identified by Kane (1995). More specifically, if bank managers can collude with regulators through *amakudari* to reduce the likelihood of a human capital crisis for managers, the practice of *amakudari* is likely to be associated with more aggressive risk-taking on the side of bank

substantially lower than the required levels. Consequently, the bank on the average decreased capital/deposits ratio from 6% around 1970 to the level lower than 4% at the mid 1980s (Horiuchi (1999)).

The prevailing practice in the Japanese banking industry of accepting ex-senior officials from the regulatory authorities on to banks' managerial boards may be a form of collusion in which banks provide regulators with job opportunities after retirement, and in turn, regulators indulge banks in expanding their business by increasing their leverage ratios. Since a higher leverage ratio implies a greater possibility of financial distress for the banks and larger transfers of risk from banks to the safety net, the collusion manifest in *amakudari* will ultimately undermine the viability of the safety net. Horiuchi and Shimizu (2001) empirically test this hypothesis based on data of more than 120 regional banks. Their result cannot refute the hypothesis.

The possibility of disciplining the regulator: The principal-agent problem with regard to regulatory processes also indicates the danger of forbearance policies. The regulator responsible for disciplining banks for sound management will desire to conceal existence of distressed banks and to postpone definite disposition of virtually failed banks. This forbearance policy will induce those banks to undertake excessive risk-taking, and will increase the social costs of bailing out them to protect depositors and other investors.

National legislators could prevent collusion between regulators and banks

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management than otherwise be the case.

from undermining the effectiveness of the safety net if they could either precisely monitor the regulator or introduce the system incentives compatible with the policy objectives assigned to the regulatory agency. In reality, however, neither legislators nor taxpayers have access to all of the relevant information about regulators and their behavior.<sup>18</sup>

Thus, the Japanese people were not given incentives to monitor bank regulators until at least the beginning of the 1990s. And, although deposit insurance was introduced in 1971, it remained nominal until 1992. The MOF dealt with the management problems of individual banks by forcing relatively sound banks (in most cases, large city banks) to merge with those at the brink of bankruptcy. On the surface this policy did not create any obvious burden for taxpayers. In addition, the legal framework supporting deposit insurance did not include any explicit rules or procedures for injecting taxpayers' money into the bail out scheme of unsound banks. The regulatory practice obscured the extent to which taxpayers were required to share the social costs of the safety net. Because they were unaware of the actual costs of poorly managed banks, Japanese taxpayers were largely not attentive towards monitoring bank regulators.

After the bursting of the 'bubble' at the beginning of the 1990s, the growing amount of non-performing loans in the banking sector and the clumsiness of the MOF in dealing with distressed banks revealed the demerits of the existing safety

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<sup>18</sup> Moreover, if those with access to relatively greater information are limited in number, they too can be seduced into the collusion relationship. In other words, we cannot neglect the similar principal-agent problem between legislator and

net. As we have explained at the beginning of this paper, the weakness of the safety net forced the Japanese government to prepare public funds to deal with the bank crisis. These developments made the Japanese people recognize the importance of monitoring the regulators' implementation of the safety net.

#### 2.4 Delayed disposition of NPLs

We have stressed that there existed a vacuum in the governance of Japanese banks' management in the sense that nobody was effectively motivated to monitor and discipline bank managers. It is easy for us to understand that a vacuum of governance tends to induce incumbent bank managers to take aggressive policy under the protective safety net. I think that the non-performing loan problem since the early 1990s was a consequence of the aggressive expansionism policy adopted by bank managers during the late 1980s. But the vacuum of governance was also responsible for the delayed process of disposing NPLs on the side of bank managers.

Bank managers have not strong incentives to assess dubious loans as non-performing and to quickly write them off partly because the loans may be recoverable when business picks up, and mostly because the quick write-off will decrease their capital bases revealing their mistakes in risk management. Of course, the wait and see policy regarding dubious loans is accompanied with risk, because the borrowers' business conditions would get worse, making collection of

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taxpayers.

the debt less likely and because the collateral backing up the debt would lose their value. Thus, the wait and see policy would be too risky for banks' shareholders and particularly for banks' debt-holders. However, they are powerless to make bank managers hasten to dispose of dubious loans due to the vacuum of governance.<sup>19</sup>

The regulators neither have strong incentives to realize quick disposition of NPLs. The appearance of increasing amount of banks' NPLs would be responsible not only for bank managers but also for the regulators to which a supervising role is delegated. The regulators would prefer the banks' wait and see policy regarding NPLs to the quick disposition policy. The opaqueness of quality assessment of specific loans enhances these incentives to postpone disposing NPLs on the side of both bank managers and the regulators.<sup>20</sup>

## 2.5 Governance problem of cooperative financial institutions

In spite of heavy protection given by the MOF to cooperative financial institutions, the NPL problem has been more serious for those institutions than for

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<sup>19</sup> With the NPL problem getting worse, the bank managers had stronger incentives to delay in disposing NPLs. This was because decreases in current profits narrowed the room for banks either to write off bad loans or to increase reserves for bad loans. Obviously bank managers had incentives to intentionally underrate the amount of NPLs in order to avoid booking negative profits.

<sup>20</sup> The opaqueness of specific loans implies that the quick disposal of dubious loans might be destructive in the sense that banks are forced to sever a credit relationship with a promising but temporally distressed borrower firm. There may exist a trade-off between quickly disposing banks' NPLs and to keep constructive

other banks. The governance problem substantially accounts for the fragility of cooperative financial institutions. First of all, both *shinkin* banks and credit cooperatives are not incorporated and their management is rather loose. Because of their legal status, managers of those institutions are immune from direct disciplinary influence from the capital market. Part-timers occupy a majority of the board of directors in those institutions. As of March 1989, the ratios of part-timers in the total number of directors were 42.4% for *shinkin* banks and 73.1% for credit cooperatives respectively. Quite often a small number of directors can monopolize the decision-making of the boards. Moreover, the supervision of credit cooperatives by the financial authority used to be ineffective because the government delegated supervisory activities to the local governments who did not have sufficient expertise to fulfill the delegated role.<sup>21</sup> It is noteworthy that the cooperative financial institutions were allowed to extend their business territories under this weak governance structure in the late 1980s.

### 3. A Vacuum of Governance and Market Responses

Could we derive any lessons from the complicated relation between the development of the NPL problem and responses of the capital market in Japan? In my view, at least until the summer of 1995, investors in the capital market

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bank-firm credit relationships.

<sup>21</sup> The Japanese government decided to take back the role of supervising credit cooperatives from the local governments at April 2000 in order to strengthen

believed in the government's capability of implementing the traditional wide-scope safety net, the vulnerability of the banking sector did not provoke the capital market. Although investors had recognized deterioration of bank performance due to rapid increases in non-performing loans, they trusted that the traditional blanket guaranty would protect them from losses associated with bank failures in the end.<sup>22</sup> Thus, they did not think it necessary to differentiate good banks from bad ones.

However, as the non-performing loan problem dragged on in the banking sector, the traditional safety net apparently reached a dead end, incurring investor's distrust of the government's capability to bail out distressed banks. The Japanese major banks, which used to play an important role in the government's traditional bailout, are now suffering from a huge amount of NPLs. Thus, the traditional bailout scheme is no longer functioning smoothly. Then, the market started disciplining bank management.

For example, the positive Japan premium was not observed until the end of

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monitoring of the financial institutions.

<sup>22</sup> Moody's, a US rating company, started downgrading of some Japanese banks as early as June 1986 well before the 'bubble' burst. The total number of downgrades of Japanese banks by Moody's from June 1986 to June 1998 was 73. Some of Japanese investors started to concern soundness of a few banks that were reported to be seriously damaged by increasing NPLs in the first half of the 1990s. The three long-term credit banks used to issue their bank debentures at precisely equal interest rates until the beginning of the 1990s. That is, the investors did not differentiate those banks in terms of their managerial soundness. However, the financial turmoil in Japan surfacing in 1995 forced them to differentiate the three

September 1995. The Japan premium at the end of September was only 1.042 basis point (in terms of 3 month US dollar). However, the premium jumped to 20.313 basis point at the beginning of October.<sup>23</sup> This abrupt jump was caused by the announcement on September 29 that the U.S. authority discovered Daiwa Bank's wrongdoing in New York. The MOF's handling of the Daiwa case was rather awkward. This fact also contributed to the market turbulence. Associated with a number of bank failures in the summer of 1995, this scandal triggered skepticism in the financial markets of the government's capability to stabilize the banking system by means of the traditional safety net as they used to do. The abrupt jump in the Japan premium reflected the wide spread skepticism among investors.

Once investors disbelieved the government capability of implementing the blanket guaranty, they were naturally motivated to severely monitor and discipline bank management. In short, the capital market started to fill the vacuum of governance in bank management. In order to 'calm down' the capital market, the government should have quickly strengthened monitoring and disciplining bank management. Unfortunately, the Japanese government did not recognize this

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banks' debentures.

<sup>23</sup> The Japan premium shows that Japanese banks pay a higher interest rate in the international inter-bank money markets. It reflects investors' evaluation of Japanese banks relative to their foreign rivals. The higher Japan premium suggests investors are more seriously concerned with capacity of Japanese banks to repay their debt. Thus, as well as banks' share prices, the Japan premium is one of the most conspicuous signals through which the capital market disseminates its evaluation of Japanese banks' managerial weakness (Peek and Rosengren (2001)).

development in the capital market and failed to introduce effective measures to force banks to quickly re-capitalize.

In the framework of banks' management governance, the capital market is expected to prevent deterioration of banks' management well before a bank crisis occurs. In reality, the disciplining mechanism of capital market started when most of banks were troubled with a large amount of non-performing loans. Thus, it is not strange at all that the capital market treated banks quite harshly. From the bank managers' viewpoint, the capital market functioned rather destructively. Some people may criticize the capital market for its brutal way in which it deals with distressed banks. However, we should note that the government has long neglected to fill the vacuum in the governance of bank management, and that the capital market started to fill the vacuum just at the worst timing. In order to avoid the destructive force of the capital market, the government should have committed itself to fill the vacuum in place of the capital market.

Any policy measures to cope with the current bank crisis would fail without a positive response from the capital market. The government and the capital market are struggling with each other to fill the governance vacuum in the bank management. If the government wins, the market will be calmed down. However, if the government loses this struggle, the market will become cruel for the time being. This episode shows how the market could be an effective instrument not only for disciplining bank management, but also for disciplining the regulators in the financial system. Thus, we could use the capital market to mitigate the principal-agent problem with respect to the regulation only if we feed the relevant information to it.

#### 4. Concluding Remarks

This paper made an overview of the recent bank crisis in Japan from the management governance perspective. It would be an exaggeration to say that this perspective could account for all the aspects of Japan's bank crisis. For example, the government's mismanagement regarding the monetary policy that resulted in an excessive financial expansion in the late 1980s, and the long-lasting slow-down of industrial sectors since the early 1990s were responsible for the fragility of the banking sector. However, we should not neglect some issues related to the governance of bank management to understand the developments of the NPL problems. We stressed that there existed a vacuum in the Japanese bank managerial governance. Neither the capital market nor the government was unable to prevent the banks' expansionist policy that caused a huge amount of NPLs, and to induce prompt reorganization of the banks' management after their fragility was revealed. Thus, the most important lesson we learn from Japan's experience is that the governance structure is quite important for constructing and maintaining a stable financial system.

To construct apparently modern and sophisticated financial institutions does not necessarily lead to attainment of financial stability. To extend the government capability of intervening into management of banks and financial institutions does not necessarily improve their management and contribute to stabilizing the financial system. The managers of banks and other financial institutions should be monitored and disciplined for efficient management. Even the government must

be motivated to do good jobs as an agent to monitor bank management. The recent bank crisis in Japan suggests that it is not so easy to build up such an incentive compatible system.

We have, however, an optimistic view that Japan is just in process of constructing a more stable financial system from the governance viewpoint. There are good grounds for this optimism. First, the Japanese capital market has been quickly developing its capacity of evaluating individual banks' management. The recent resolution of mutual shareholding between banks and their client firms will enhance the capital market capability in this regard. The so-called pay-off policy that the government started at April 2002 will strengthen the capital market monitoring, because the policy implies a more limited scope of the financial safety net than the traditional one prevailing in Japan until the end of the 1990s.

Second, the government's intervention into banks' management is becoming more and more transparent after the adoption of the prompt corrective action rule in April 1998. According to this rule, the government must intervene to bank management following explicitly specified criteria based on banks' capital adequacy ratios. Thus, this rule will help us to monitor the government administration regarding financial stability more precisely than before, and will contribute to prevention of the government's notorious forbearance policy. In addition, the Financial Services Agency is reportedly endeavoring to construct a sort of arm's length relationships with the banks it supervises. Both the transparent administration and the arm's length relationships between the regulator and regulated banks will substantially mitigate the agency problem we mentioned in the context of the financial regulation.

Finally, we hope that the Japanese financial system will be more widely exposed to full-scale competition in the near future. The ‘Big Bang’ financial reform has already made the Japanese financial system more competitive. Better or worse, the bank crisis since the early 1990s has been destroying the coalition of vested interest groups in the Japanese financial system that had resisted developments of full-scale competition in the financial system. The competition in the Japanese financial system will inevitably heighten, and it will exert disciplinary effect on banks and other financial institutions.

**Table 1: Non-performing loan disclosures (All banks: ₹ trillion)**

	<b>March 1998</b>	<b>March 1999</b>	<b>March 2000</b>	<b>March 2001</b>
(a)Total of risk management loans =(1)+(2)+(3)+(4)	29.76 (5.38)	29.63 (5.85)	30.37 (6.12)	32.52 (6.58)
(1)Loans to bankrupted borrowers	6.84 (1.24)	4.42 (0.87)	3.10 (0.62)	3.33 (0.67)
(2)Past due loans	10.77 (1.95)	15.50 (3.06)	18.36 (3.70)	17.79 (3.60)
(3)Past due more than 3 months	3.25 (0.59)	1.63 (0.32)	0.92 (0.19)	0.67 (0.14)
(4) Restructured loans	8.90 (1.61)	8.06 (1.59)	7.99 (1.61)	10.72 (2.17)
(b)Specific reserve for loan losses	15.93 (2.88)	11.23 (2.22)	8.46 (1.69)	7.24 (1.47)
(a)-(b)	13.83 (2.50)	18.40 (3.63)	22.00 (4.43)	25.27 (5.11)
Total loans	553.13 (100.0)	506.60 (100.0)	496.17 (100.0)	494.19 (100.0)
Bad loan losses accumulated since F.Y. 1992	45.14	58.77	65.71	71.82

Table2: Non-performing Loans by Type of Banks (¥ million)

	March 1998	March 1999	March 2000	March. 2001
<b>City Banks</b>				
(a) Total loans	2,656,560	2,494,670	2,414,690	2,389,450
(b) NPLs	128,190	128,840	120,480	128,950
(b/a: %)	(4.83)	(5.16)	(4.99)	(5.40)
(c) Reserve	86,380	61,750	51,060	48,520
(c/a: %)	(67.38)	(47.93)	(42.38)	(37.63)
<b>Long-Term Credit Banks &amp; Trust</b>				
(a) Total loans	1,002,100	707,180	750,770	746,430
(b) NPLs	91,590	73,660	77,240	63,860
(b/a: %)	(9.14)	(10.42)	(10.29)	(8.56)
(c) Reserve	49,630	30,830	25,730	20,870
(c/a: %)	(54.19)	(41.85)	(33.31)	(32.68)
<b>Regional Banks</b>				
(a) Total loans	1,872,590	1,864,170	1,796,270	1,806,010
(b) NPLs	77,800	93,770	105,940	132,340
(b/a: %)	(4.15)	(5.03)	(5.90)	(7.33)
(c) Reserve	42,140	55,390	45,520	46,160
(c/a: %)	(54.16)	(59.07)	(42.97)	(34.88)
<b>All Banks</b>				
(a) Total loans	5,531,250	5,066,020	4,961,730	4,941,890
(b) NPLs	297,580	296,270	303,660	325,150
(b/a: %)	(5.38)	(5.85)	(6.12)	(6.58)
(c) Reserve	178,150	147,970	122,300	115,550
(c/a: %)	(59.87)	(49.94)	(40.28)	(35.54)

(Source) Federation of Bankers Associations of Japan,  
*Analysis of Financial Statements of All Banks.*

**Table 3: The number of bankrupted depository institutions<sup>a)</sup>**

	<b>Banks<sup>b)</sup></b>	<b><i>Shinkin</i> banks</b>	<b>Credit cooperatives</b>	<b>Total</b>
1990	0	0	0	0
1991	1	0	0	1
1992	0	1	0	1
1993	0	1	1	2
1994	1	0	4	5
1995	1	0	5	6
1996	2	3	3	8
1997	5	0	7	12
1998	3	1	31	35
1999	5	6	15	26
2000	1	5	27	33
2001	1	9	37	47
Total	20	26	130	176

Notes: (a) This table contains not only the cases of bank failures dealt with the government, but also those privately disposed. For example, in October 1994, Mitsubishi Bank rescued Nippon Trust Bank at the brink of bankruptcy on its own initiative. The government did not provide any financial support in this case. But this table contains it. (b) This column includes city banks, regional I and II banks, trust banks and long-term credit banks. (c) Until November 2001.

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