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Abstract

This paper discusses the current state of regulations and supervisions of Japanese banks, which have experienced and evolved through two crises – the post-bubble financial crisis which took place around 2000, and the global financial crisis which started in 2007. Firstly, the state of Japan's banking industry will be discussed in section 2. In section 3, an outline of Japan's banking regulations will be discussed. Then, in section 4, the financial system reforms that were implemented to address the post-bubble financial crisis will be explained. In section 5, an explanation detailing the new trend in financial regulations that respond to the global financial crisis will be provided. Finally, section 6 presents the conclusion.

Key words

Banking Regulation, Financial Crisis, Japanese Banks, Bank Supervision.

1. Introduction

In the 1980s, Japanese financial institutions increased their presence in Western financial markets. Japanese financial institutions had close business relationships with large Japanese corporations (interlocking *keiretsu* business relationships) and suffered few nonperforming loans because of the country's steady economic development, making

them the soundest financial institutions in the world. Table 1 shows the transition in the credit rating of major Japanese financial institutions and demonstrates that in 1988, many Japanese financial institutions were given a top credit rating.

However, in the 1990s, the financial condition of Japanese financial institutions deteriorated rapidly as a result of an increase in nonperforming loans brought on by an economic slump. For example, Figure 1 shows the changes in the balance of nonperforming bank loans that Japanese banks held. At its peak in 2001, this level exceeded ¥40 trillion. Figure 2 clearly indicates the severity of the problem, and Figures 2 and 3 show that, despite disposing of nonperforming loans exceeding ¥10 trillion every year in the late 1990s, the balance of nonperforming loans still increased.

In 1997, the financial condition of major banks grew severe, as evidenced by the failure of institutions such as Hokkaido Takushoku Bank, which had a significant standing within major commercial banks, and Yamaichi Securities, one of the four major security corporations. As described later, financial institutions that survived with government assistance barely escaped bankruptcy.

In the past, Japanese banks were subjugated under extremely strict regulations implemented by the Ministry of Finance. In the 1980s, however, financial globalization progressed, increasing the concern that if the regulations did not change, they may promote the hollowing out of the domestic markets. From 1996, the Japanese government advocated Japanese "Big Bang" financial reforms, and fundamentally restructured the regulations. These reforms could have been viewed as a "constructive" approach to financial regulations for a new economic environment.

On the other hand, the deterioration of the business conditions of financial institutions progressed at a speed and scale greater than what was anticipated. Because the laws that addressed such a situation were inadequate, financial regulators were forced to respond in an ad hoc manner, tackling each financial problem encountered by the major financial institutions as it occurred. After this trial-and-error approach of ten or more years, the restructuring of the regulations was almost completed by around 2005.

The financial regulation reforms, aimed at dealing with the financial crises in Japan that took place after the bubble economy collapsed (hereinafter referred to as the post-bubble financial crises to distinguish it from the global financial crises since 2007, which will be mentioned later), initially were passive in nature. However, these reforms enhanced the crisis-response capabilities of Japan's financial system.

During the global financial crises that plagued the entire world from 2007 onward, Japan's financial system did not encounter major problems, and the distrust in the soundness of financial institutions did not intensify among the general public. The Japanese economy was certainly confronted with severe economic afflictions resulting from a major decline in exports. However, unlike in the post-bubble financial crisis, the economic difficulties were not attributable to the financial system. In this sense, Japan's financial system had become equipped with crisis response capabilities.

However, since the financial markets are becoming globally unified, each country's financial regulations need to be mutually consistent. Specifically, the results of financial regulation reforms in countries like Europe and the U.S. indicates that Japan's financial regulators have to modify the domestic regulations. Eventually, they are considering the modification of capital adequacy regulation as the Basel III has been agreed as the new international rules.

This paper will discuss the current state of regulations and supervisions of Japanese banks, which experienced and evolved through two crises – the post-bubble financial crisis which took place around 2000, and the global financial crisis which started in 2007[1]. Firstly, the state of Japan's banking industry will be discussed in section 2. In section 3, an outline of Japan's banking regulations will be discussed. Then, in section 4, the financial system reforms that were implemented to address the post-bubble financial crisis will be explained. In section 5, an explanation detailing the new trend in financial regulations that respond to the global financial crisis will be provided. Finally, section 6 presents the conclusion.

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[1] More technical analyses are conducted in Ogura and Yamori (2010), Yamori and Harimaya(2009, 2010a, 201b), Yamori, Harimaya, and Asai (2006), Yamori and Okada (2007), Yamori, Tomimura, and Harimaya (2011). Also, many studies analyzes Japanese banking (e.g., Hall[1999, 2003, 2007], Honda [2002], Uchida and Udell[2010]).

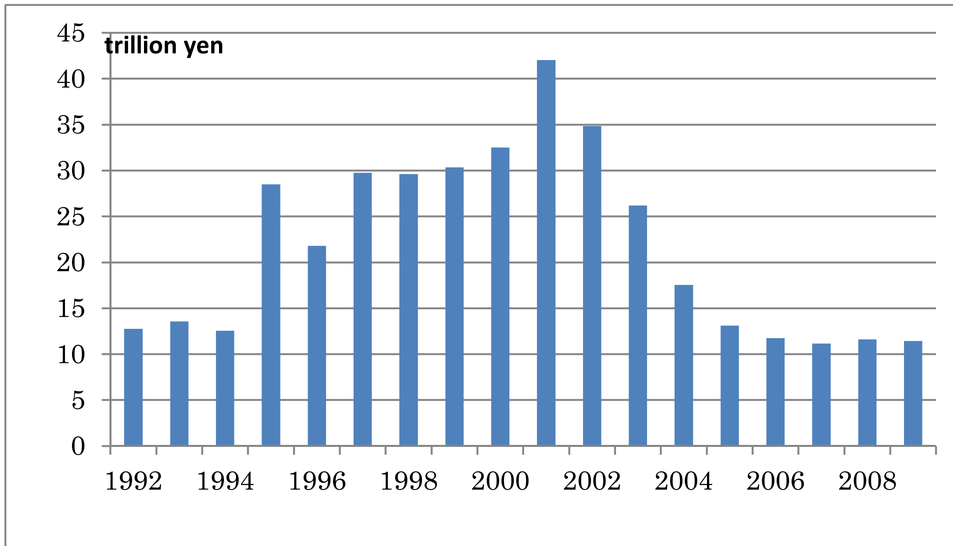
Table 1

Japanese Banks' Credit Ratings (Moody's Credit Rating)

	1988	1993	1998	2006 (as of end November)
Aaa	Dai-Ichi Kangyo, Sumitomo, Fuji, Mitsubishi, IBJ, Norinchukin			Shoko Chukin
Aa1	Sanwa, Mitsubishi Trust, Sumitomo Trust			
Aa2	Tokai, Tokyo, LTCB, Mitsui Trust			
Aa3	Yasuda Trust, Toyo Trust, Yokohama, Shizuoka	Mitsubishi, Sanwa, Tokyo, IBJ, Shoko Chukin, Shizuoka	Shizuoka, Shoko Chukin	
A1		Dai-Ichi Kangyo, Sumitomo, Fuji, Norinchukin	Sanwa, Tokyo Mitsubishi, Norinchukin	Norinchukin, Mitsubishi Tokyo UFJ, Sumitomo Mitsui, Shizuoka, Mizuho Corporate, Chuo Trust
A2		Sakura, Tokai, Asahi	Sumitomo, Nippon Trust	Higo, Sumitomo Trust
A3		Daiwa, LTCB, Yokohama	Dai-Ichi Kangyo, IBJ, Yokohama	Shinsei, Resona, Chuo Mitsui Trust, Mitsui Asset Trust, Yokohama
Baa1		Mitsubishi Trust, Sumitomo Trust, Toyo Trust	Sakura, Fuji, Toyo Trust, Sumitomo Trust, Asahi, Tokai	Aozora, Suruga, Hiroshima, San-In Godo
Baa2		Hokkaido Takushoku (Takugin), Nippon Credit, Mitsui Trust, Yasuda Trust, Chuo Trust, Nippon Trust	Mitsui Credit	Nishi-Nippon City, Ogaki Kyoritsu, Kiyo, Hokuriku, Hokkaido, North Pacific
Baa3			Nippon Credit, Hokkaido Takushoku, Chuo Trust, Yasuda Trust, Daiwa, LTCB	Ashikaga

Figure 1

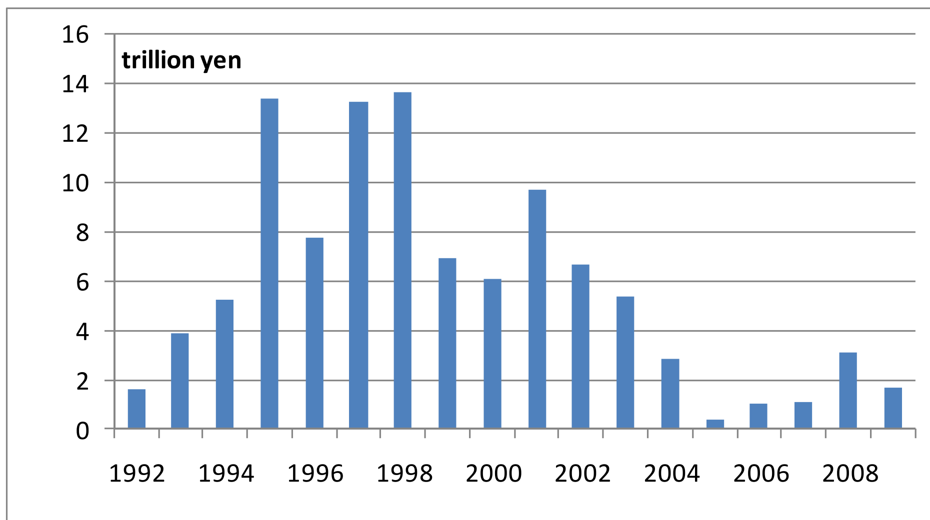
Changes in the Balance of Nonperforming Bank Loans



Note: The figure shows the risk management loans of banks at the end of each fiscal year (i.e., March 31). The statistics coverage has expanded in 1995 and 1997.

Figure 2

Changes in the Total Losses on Disposal of Nonperforming Bank Loans



2. Overview of the banking industry in Japan[2]

2-1. Types of banks

Figure 3 shows the basic structure of the banking industry in Japan.

Private banks can be divided into several categories based on such factors as business function or historical background. The distinction among city banks, regional banks, and member banks of the Second Association of Regional Banks (regional banks II) is not a legal one, but is a customary classification for the purposes of administration and statistics. City banks are large in size, with headquarters in major cities and branches in Tokyo, Osaka, other major cities, and their immediate suburbs. Regional banks are usually based in the principal city of a prefecture, conduct the majority of their operations within that prefecture, and have strong ties with local enterprises and local governments. Like traditional regional banks, regional banks II serve smaller companies and individuals within their home regions. Most of these banks converted from mutual savings banks into ordinary commercial banks in 1989.

In addition to these commercial banks, there are cooperative financial institutions, including credit associations (Shinkin banks) and Agricultural Cooperatives. These financial institutions are established to serve certain sectors. For example, credit associations are mainly engaging in providing loans to small- and medium-sized enterprises (SMEs), and Agricultural Cooperatives serve farmers.

Finally, Japan Post is a unique financial institution. The government ran the postal savings system until 2007, when Japan Post was established as a private stock company. However, the government still fully owns the stock of Japan Post, and most Japanese depositors regard Japan Post as a public-supported institution.

Figure 4 shows relative shares of these financial institutions regarding fund-raising and loans.

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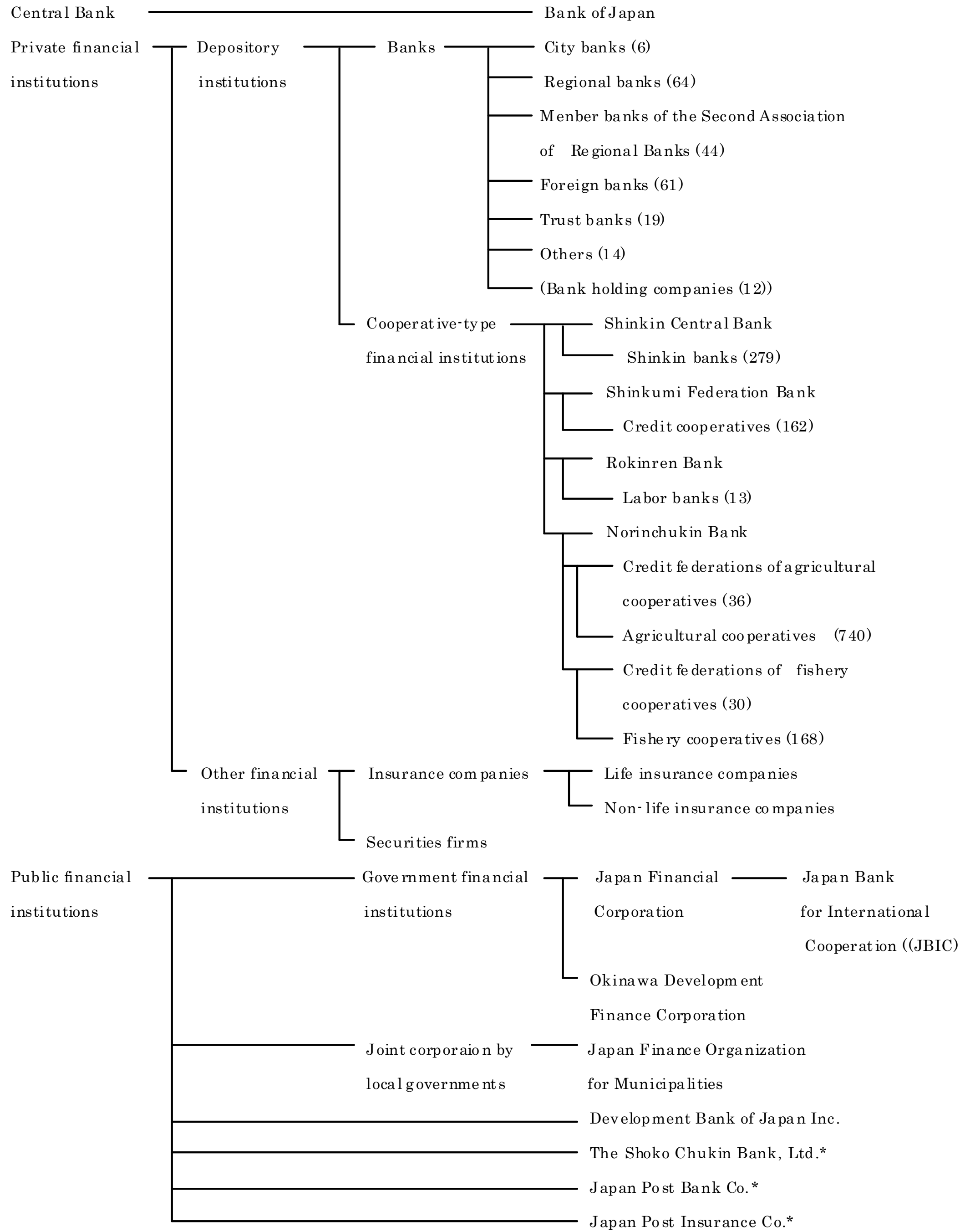
[2] See Yamori and Nishigaki (2008), which describes the large changes that have occurred in the financial system since the 1990s as well as the impacts of those changes on banks, and discusses the new challenges for Japanese banks.

Figure 3

Banking Industry Structure in Japan



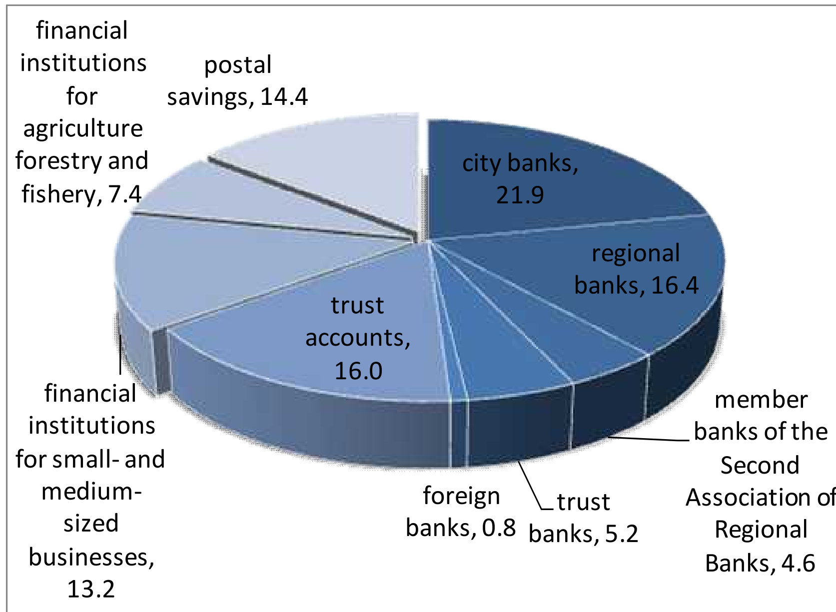
Note: Figures in parentheses represent the number of financial institutions in each category basically as of April 1, 2009.

(source : Japanese Bankers Association)

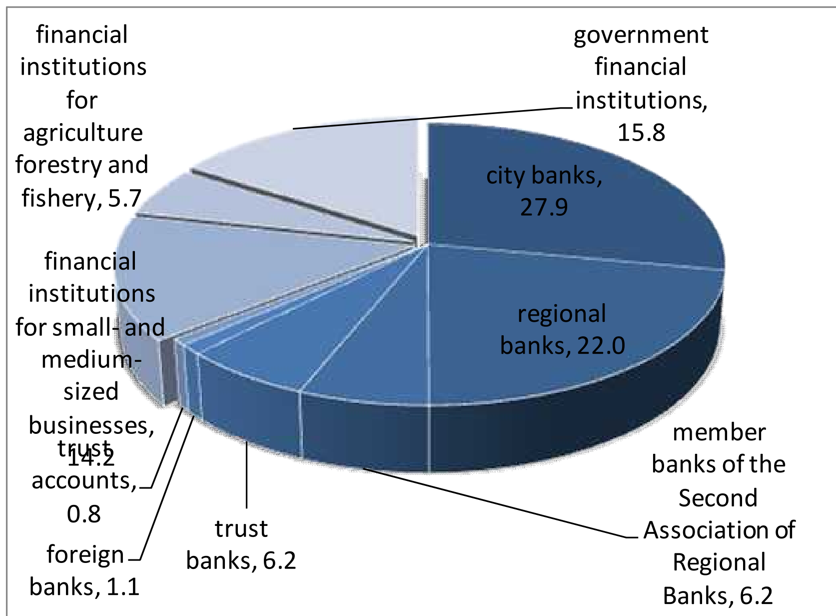
Figure 4

Market Share of Financial Institutions (%, as of the end of 2008)

(1) Fund raising (Total ¥1241 trillion)



(2) Loans (Total ¥701 trillion)



Notes:

(1) Funds include deposits, debentures and trusts.

(source: : Bank of Japan)

2-2. Merger and Integration of Japanese banks in the 2000s

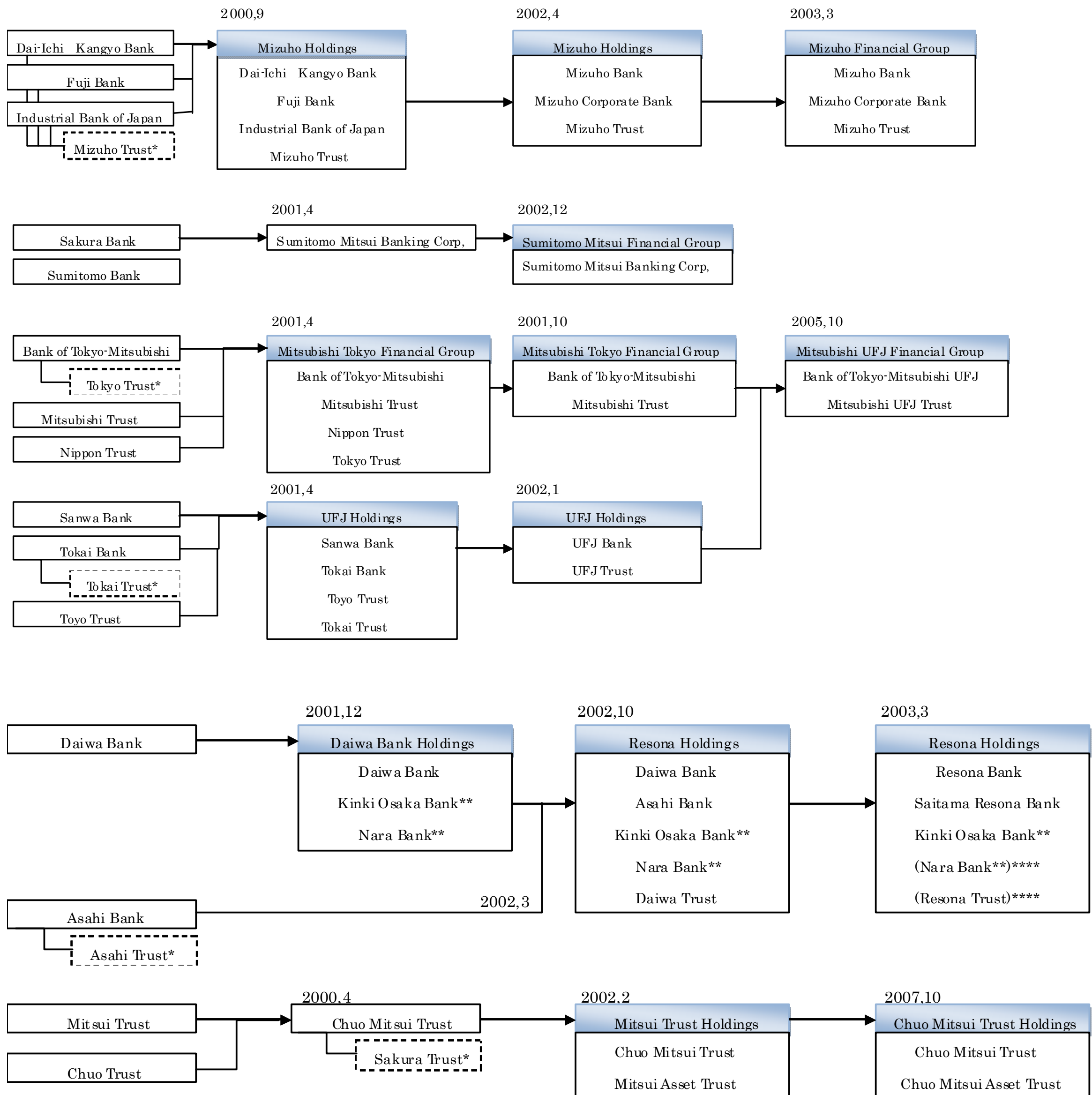
In the 2000s, a succession of mergers and integrations occurred over a short period of time to create "Mega Banking Groups" such as the Mizuho Financial Group, Mitsubishi UFJ Financial Group and Sumitomo Mitsui Financial Group. (See Figure 5 for details.)

These mergers and integrations were made possible by the modification of the legal and tax system, which enable banks to undergo large-scale organizational transformations, in addition to the drastic changes in the management environment requiring banks to deal with non-performing loan problems and cope with international competition. These industry-wide reorganizations were not limited to major banks but also spread to regional banks, resulting in the establishment of holding companies in some cases which cover regions broader than before.

Because of the mergers and acquisitions as well as failures, the number of banks continues to decrease in the 2000s (See Table 2). The average size of existing banks has inevitably increased.

Figure 5

Mergers and Integrations among City Banks, Long-term Credit Banks and Trust Banks



* trust bank subsidiary

** regional bank

*** The date of merger was January 1, 2006.

**** The banks were merged into Resona Bank.

(source : Japanese Bankers Association)

Table 2

Changes in Number of Banks

end of March	1990	1995	2000	2002	2003	2004	2005	2006	2007	2008	2009
City Banks	13	11	9	7	7	7	7	6	6	6	6
Regional Banks	64	64	64	64	64	64	64	64	64	64	64
Regional Banks Ⅱ	68	65	60	56	53	50	48	47	46	45	44
Trust Banks[1]	16	23	33	29	27	27	26	23	21	20	20
Long-term Credit Banks	3	3	3	3	2	2	1	1	0	0	0
Other banks[2]	–	–	–	5	5	6	9	9	10	13	14

1. including foreign-owned trust banks

2. including the Second Bridge Bank of Japan and the Resolution and Collection Corporation

(source : Japanese Bankers Association)

2-3. Entry of new-type banks

From 1999, non-financial institutions began to enter the banking business by establishing new types of banks such as banks specializing in settlements or Internet banks, which include Japan Net Bank (starting its operation in October 2000), IY Bank (presently, Seven Bank)(May 2001), Sony Bank (June 2001), eBank (July 2001), SBI Sumishin Net Bank (September 2007), AEON Bank (October 2007), and Jibun Bank (July 2008). In addition, banks focusing on lending to SMEs and start-up companies started their operation, including Nippon Shinko Bank (or, Incubator Bank of Japan)(April 2004), and ShinGinko Tokyo (April 2005)[3].

The entry of non-financial entities into the banking business led to an amendment to the Banking Act concerning the regulation of bank shareholders from April 2002. Namely, shareholders of more than 5% of a bank's total shares must file with the

[3] Nippon Shinko Bank failed in 2010 due to huge bad loans.

Financial Services Agency (FSA), and those seeking to hold 20% or more need the FSA's permission to acquire the shares and are subject to FSA's inspection.

3. Current banking regulations in Japan

3-1. Brief historical development of banking regulation and supervision

Japan's financial administration has gone through major changes since 1990.We discuss the transition of Japan's financial administration here by categorizing these changes into three stages.

The first stage occurred approximately between 1997 and 2002, when the administration was pressured with addressing difficulties of financial system. In 1997, Hokkaido Takushoku Bank and Yamaichi Securities went bankrupt, followed by the collapse of the Long-Term Credit Bank of Japan (LTCB) and Nippon Credit Bank (NCB) in 1998. Despite the government having responded by making a ¥10 trillion capital injection and providing full protection on bank deposits, which was called the freeze on the "payoff system" in Japan, it was a period where concerns regarding the soundness of major commercial banks spread in an unprecedented manner.

It was a period in which the reorganization of information disclosure system, the tightening of asset evaluation which formed the basis of the information disclosure system, and a system of prompt corrective action were introduced in order to accurately capture the state of financial institutions. In this sense, it was the period where the financial administration began to depart from its traditional form. Furthermore, the financial legislations were being adjusted to process liquidation of insolvent financial institutions.

Until this period, Ministry of Finance had been responsible for financial supervision in Japan. However, with the growing financial turmoil in the wake of the collapse of bubble economy, there was much criticism regarding the fact that the Ministry of Finance held a dual function of financial administration and public financing. There was also an increasing criticism regarding the discretionary and obscure financial administration of the Ministry of Finance, which had led to the collapse of bubble

economy. Therefore, the financial supervising function was removed from the Ministry of Finance. First, the supervising function was transferred to the Financial Supervisory Agency. Later, the Financial Services Agency (FSA), which held the authority for overall financial administration, was founded in July 2000. At that time, the FSA Commissioner, in the discourse on "The commencement of the Financial Services Agency," promised to the Japanese citizens "greater clarification of rules, prompt and stricter implementations of those rules, as well as improvements on the transparency of the policy formulation process and administrative procedures." In other words, the implementation of a financial administration with high transparency level, based on clarified rules, was a priority issue.

A turning point from the first stage to the second stage was the Financial Revitalization Program, launched in October 2002 as a response to an emergency, under the Minister for Finance Services, Heizo Takenaka. While the financial administration was severely criticized for its strong intervention in the operations of individual banks, the Financial Revitalization Program strongly requested major banks to accelerate their disposal of nonperforming loans (with a balance reduction by half in three years).

The second stage, which began with the introduction of Financial Revitalization Program, was the period approximately between 2003 and 2007. In May 2003, the financial problems of Resona Bank Group surfaced, and based on the discussions held by the Council Order on Financial Crisis Response, approximately ¥2 trillion of public funds were injected.[4]

Later, with the moderate revival of the economy, completely lifting the freeze on the payoffs also became a possibility in 2005. Repayments of public funds began as well. It was a period where the stability of the financial system also began to restore. The switch from emergency mode to ordinary mode progressed.

Simultaneously, the financial administration's focus shifted gradually from the revival of a stable financial system, to user or consumer protection. Administrative measures against banks in this area began to appear frequently.

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[4] Detailed analysis conducted by Yamori and Kobayashi(2007). According to the results, the market recognized that this capital infusion was a "too-big-to-fail" type policy.

The third stage was the period from 2007 onward. The December 2007 "Financial Reform Program – Challenges toward a Financial Services Nation" defined the phase surrounding the current financial system to be departing from emergency responses dealing with nonperforming loan problem to a future-oriented phase, aimed at creating a desirable financial system for the future. If we were to borrow a slogan from the FSA, the time was entering a phase that saw "qualitative progress in financial regulation (better regulation)." However, in reality, the global financial crises directly triggered the bankruptcy of Lehman Brothers occurred and financial regulations to respond to the crisis had to be implemented again.

3-2. Current Prudence Policy in Japan

3-2-1. Traditional Preventive Measure

If banks do not fail, the banking industry as a whole will not collapse. In other words, one measure to prevent the entire banking industry from collapsing is to ensure that each individual bank does not collapse by protecting banks through limiting competition between banks and ensuring a minimum profit. The representative competition-limiting regulations implemented in post-war Japan were: the virtual prohibition of new entrants; deposit interest rate capping controls; branch regulations (permission was required from the Ministry of Finance for bank branch opening); business field controls (e.g., separation of banking business and securities business); short- and long-term business separation controls including specialization of trust services and financial bond issuance by long-term credit banks only, and domestic and foreign financial market segmentation regulation.

Given the fact that there were hardly any financial institution failures or financial confusions for a long time after the war, it's possible to surmise that regulations limiting competition were successful. However, these regulations became a hotbed for inefficiency, and the users of financial services experienced various inconvenience. Furthermore, with the advancements in financial informatization and globalization, competitions with foreign financial markets and financial institutions occurred outside the regulation framework, thus limiting the effectiveness of competition-limiting

regulations (in terms of protecting the profit of the existing financial institutions). In addition, because financial institutions behave in such a manner as to avoid regulations, inadequate regulations distort the actions of financial institutions, resulting in an increase in likelihood of expanding risks.

As the awareness of these types of adverse effects increased, many competition-limiting regulations were abolished. For example, in the past, deposit interest-rate ceilings were regulated in accordance with the Temporary Money Rate Adjustment Act. As a result, all deposit interest rates for all banks had been standardized, which led banks not to compete by raising interest rate for procuring deposits. However, with the liberalization of deposit interest rates, it then became possible for each bank to set its deposit interest rates freely[5].

3-2-2. Current Policy Measures[6]

We may classify the currently implemented prudence policies into five different types as follows: 1) Regulations relating to entry and exit, 2) Regulations concerning banks' business affairs (products), 3) Regulations in order to secure the soundness of banking operations, 4) Regulations to protect the users, 5) Supervision and verification. The details of these are explained below.

1) Regulations relating to entry and exit

In order for a bank to commence business, a license is necessary. However, the bank may lose its license in cases where a law was breached. Moreover, a bank cannot close without permission from authorities.

2) Regulations concerning banks' business affairs (products)

The scope of a bank's business affairs is limited by law (which is called Regulations

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[5] Now, banks are required to set the interest at 0% for current accounts only.

[6] Detailed information on Japanese bank regulation is provided in the FSA website at http://www.fsa.go.jp/en/policy/ofrsf/index.html

Prohibiting Other Business Fields). The objectives of the Regulations Prohibiting Other Business Fields are as follows: (i) to prevent reciprocal (adverse) interest trade, (ii) profit through specializing by concentrating on banking business, (iii) preventing the risks associated with the other business spreading to the banks. Similarly, to ensure that there is no eluding of Regulations Prohibiting Other Business Fields through the use of a subsidiary and holding company, there are also limitations on the business affairs of subsidiary companies that banks and bank-holding companies can have.

3) Regulations in order to secure the soundness of banking operations

In order to ensure the soundness of banking operations, standards related to specific financial indicators that must be fulfilled are set. This is called Balance-Sheet Regulations. Typical examples of existing balance-sheet regulations are regulations that limit large loans, and the capital adequacy requirements. (Basel Capital Accord). Regulations limiting large loans stipulate that the amount of a loan to the same individual must be below an established ratio of capital equity[7]. These regulations are necessary because when a loan is given in excess to a specific party, the soundness of the bank itself is threatened if the borrower fails to repay the loan. Because the capital adequacy requirements are especially treated as important they will be examined further in the next section.

4) Regulations to protect the users

In order for users to be able to assess the management contents of banks, the banks have a legal obligation to disclose their financial statements and other relevant information, even if they do not list their stocks on stock exchange.

5) Supervision and Verification

In order to be able to check whether the regulations are actually being adhered to,

[7] Basically, the maximum ratio is 25 percent of bank's capital.

supervision and verification are conducted by financial authorities (such as the FSA and the Bank of Japan). In addition, appropriate supervision and regulations are necessary to avoid moral hazard associated with the lender of last resort function, and the deposit insurance system.

3-3.Capital Adequacy Regulation as a Pillar of Bank Regulation

In 1988, it was agreed in the Bank for International Settlements (BIS) that capital adequacy requirements unified among the major countries would be implemented. Following that agreement, the capital adequacy requirements have been enforced in Japan as well. Recently, the capital adequacy ratios have been utilized as standards for a system of prompt corrective action, and been used for depositors to select a secure bank. For these reasons, the role of capital adequacy requirements are treated with great importance in the banks' operations and prudence policies.

3-3-1. Old BIS Regulation and New BIS Regulation

Because the current capital adequacy requirements began with the framework agreed internationally via the Bank for International Settlements (BIS) in 1988, they are known as the BIS regulations or Basel Regulation, referring to where BIS located. In the 1990s, BIS regulations began to form a pillar for bank regulations, introducing early corrective measures that would order business improvements and limitations on dividends if the capital adequacy ratios were below a predetermined level.

However, it became clear that there were various problems regarding these BIS regulations. For example, with regards to the capital adequacy requirements, only credit risk were being considered, and other risks such as market price risk and business risk, which the financial institutions bear were not considered. As a result, consider long term government securities. As their market price risk is high but the credit risk is zero, changing the portfolio from short-term government securities to long-term government securities does not affect capital adequacy ratio. Therefore, the

BIS regulations encouraged banks to hold more long-term bonds. In addition, the handling of credit risk was also simple, where all enterprises were considered similarly. This indicated that capital adequacy requirements provided an incentive to lend to high-risk enterprises.

With regards to this issue, the new regulations commenced from March 2007 (called the New BIS Regulations or Basel II). In the new BIS regulations, improvements have been made so that not only credit risk but also market price risk and business risk have been considered. In addition, improvements have been made for credit risk calculations so that they reflect the credit worthiness of the borrowers to a certain degree.

In sum, the old BIS regulations started with the objective of urging cautious management through bank incentives. However, these regulations were insufficient, and thus it became necessary to redesign the regulations.

3-3-2. Overview of Japanese Capital Adequacy Regulation (BASEL II)

The current Japanese capital adequacy requirements were classified into 2 types: one geared for banks that conduct international business, and the other for banks that focused only on domestic business. A summary of this is shown in Table 3. In addition, as shown in Table 4, if the capital adequacy ratio falls below a predetermined level, then an early corrective measure is initiated by the authorities, in accordance with the degree of the shortfall in capital.

Furthermore, as mentioned later, given the occurrence of the global financial crisis, efforts are currently being made to adjust the domestic regulations to Basel III, which has been agreed upon internationally in 2010.

Table 3

Overview of Basel II

Entities	Basel I	Basel II
Japanese Governments (including local governments)	0%	**0% (claims in JPY)**
Japanese PSEs (Public Sector Entities)	10%	**10% (20% for some entities) (claims in JPY)**
Banks and Securities Firms	20%	**20%～150% (dependent on the credit ratings of the sovereigns of incorporation)**
Corporates (excluding SMEs)	100％	**20%～150% (dependent on their credit ratings)※ or 100%(for all corporate claims)**
SMEs, Individuals	100％	**75%**
Residential Mortgage Loans	50%	**35%**
Past due loans	100％	**150% ※※ (could be lowered according to the level of provisions)**
Equities	100%	**100%**

※ Only solicited ratings will be allowed.

※※ Past due loans are the loans to those whose payments are past due for more than three months.

(Source： FSA, The Outline of Draft Rules for the New Capital Adequacy Framework, March 31 2005. (available at http://www.fsa.go.jp/news/newsj/16/ginkou/f-20050331-8/14e.pdf).

See also FSA Newsletters, May 2006,

Table 4

Overview of Early Corrective Measures

Capital Adequacy Ratio		Measures
Banks that Conduct International business	Banks that Focused only Domestic business	
Less than 8%	Less than 4%	Preparation of management improvement programs And implementation orders
Less than 4%	Less than 2%	Prohibiting or limiting dividends and bonus to directors
Less than 2%	Less than 1%	Order to enhance capital adequacy, shrink major business affairs, conduct merger or abolish bank businesses
Less than 0%	Less than 0%	Order to suspend a part of or all businesses

See notes for Table 3.

3-4. FSA's New Supervisory Stance: Better Regulation

Since the summer of 2007, the FSA has begun implementing further qualitative improvements in the financial regulations. In other words they are continuing their efforts for "better regulation." With regards to better regulation, the following four points have been considered:

1) An optimum arrangement of rule base supervision and principle base supervision.
2) Prompt early recognition of priority issues and effective responses.
3) Emphasizing the value of financial institutions' self-reliant efforts and incentives.
4) Improving the transparency and predictability of administrative responses.

1) Rule base and principle base

First, we consider "the optimum arrangement of rule base control and principle base control." Criticisms regarding the financial administration during the previous Ministry of Finance era focus primarily on the issue that there were no clear rules, and it was an arbitrary and discretionary administration. On the basis of that reflection, the financial control function was removed from the Ministry of Finance, and Financial Supervision Agency was established, with its basic principle being to conduct a transparent and fair

financial administration, based on clear rules.

From that original objective, the FSA's supervisory technique is a rule-based one, involving establishing detailed rules, which were applied to individual cases. For the financial institution, this was advantages as it ensures predictability and the administration arbitrariness was removed. However, establishing detailed rules bears two bipolar harmful effects. Firstly, by determining the rules to a detailed level, innovative developments in the financial institutions that are being supervised are constrained. By thinking everything will be fine by following the rules, there are concerns that financial institutions will then slide into brain-numbed operations.

On the other hand, it cannot prevent the vicious behavior of seeking loopholes in the regulations. There is the trend for regulations to be minutely detailed in order to try to fill loopholes. However, even after doing this, as the rule-making follows on after the occurrence of problems, it is not possible to say that the protection of the depositors and investors is sufficient.

As for the principle base supervision, several main fundamental rules are indicated, the advantages gained through this framework is that it promotes the financial institutions adhering to these regulations to have an autonomous approach, and a degree of freedom in management of the financial institution is ensured, and originality and ingenuity are encouraged. In addition, based on the principles, the FSA can also deal appropriately with the kind of behavior seeking loopholes.

While "principle-based" may sound good, it may grant too much discretionary power to an administrative authority because how some ambiguous principle are interpreted is not sure. It is similar to the opaque discretionary administration from which it was trying to break away. In addition, in order for the supervision of the principle base to work effectively, the principle is shared by the supervisory authorities and the private financial institutions. A cultural maturity where "even if it does not violate the law, we won't engage in undesirable activity," becomes a prerequisite.

Considering its original intended form, however, combining the two supervisory techniques of the rule base and the principle base in a mutually complementary manner is desirable. It is now the case that an optimum combination of both is being sought.

2) Prompt early recognition of priority issues and effective responses

The second pillar of better regulation is the "effective responses towards priority issues," which can be referred to as risk-focused, or a forward-looking approach. This means being able to recognize the risks inherent in the financial system as quickly as possible, and transferring administrative resources effectively, in order to give a response to such priority issues. In order to do that, an understanding of the economy and market trends, and an accurate awareness of the strategies and activities of financial institutions are important, and further strengthening of the communication between the FSA and financial institutions as well as market participants is essential.

3) Emphasizing the value of financial institutions' self-reliant efforts and incentives.

There have been proposals for effective and selectable administrative responses, from various perspectives. It is possible to paraphrase this by saying that the aim is to achieve a desirable financial system through the power of the "private," rather than being led by the "government."

The trend towards importance being placed on incentives and respecting self-reliant effort, has to some degree already been interwoven into the framework of recent financial regulations, such as the Financial Inspection Rating System, Basel II, and other frameworks. Among these, in the Financial Inspection Rating System, there are ten rating items, including "operational management system; fundamental components," "legal compliance system," "management system including customer protection," "integrated risk control system," "capital management system," "credit risk management system," "property assessment management system," "market risk management system," "liquidity risk management system," and "operational risk management system." The FSA conducts an evaluation on each item, rating them A, B, C, or D. The results of the evaluation would reflect the intensity of future inspections (inspection frequency, scope, depth). This system is beneficial for banks because if the results are positive, then the degree of freedom in business operation increases.

As financial business gets more complicated, it is important to accurately recognize the

limits of what the authorities can do. Therefore, we believe that the most important consideration regarding future financial supervisory administration would be whether private financial institutions that are regulated and supervised are given adequate freedom to comply with the law.

4) Improving the transparency and predictability of administrative responses.

In the fourth pillar "improving the transparency and predictability of administrative responses," FSA's inspection manuals that stipulate the focus during inspection supervision, supervision guidelines, inspection principles for each administrative year, and supervision principles are disclosed. The issue involves aiming for the improvements of transparency and predictability, such as by disclosing standards for administrative measures, making improvements in the no-action letter system, and publishing Q&As on rule interpretation.

4. Banking Regulation Reform under the Post-Bubble Financial Crisis

4-1. Financial Crisis in the 1990s and early 2000s

During the financial crisis in Japan in the late 1990s, many banks and cooperative financial institutions went bankrupt. Regarding bank failures, 17 banks collapsed, beginning with the failure of Hyogo Bank in August 1995 and ending with the failure of Ashikaga Bank in November 2003, as shown in Table 5. The table shows the amount of funds provided by the Deposit Insurance Corporation of Japan (DICJ) to the collapsed banks. Liquidation costs for the failures of LTCB and NCB were enormous, accounting for more than ¥3 trillion. In total, ¥17.9 trillion was provided to financial institutions (including credit associations and credit cooperatives) that went insolvent, by the end of March 2003. Although the deposit insurance premium must cover such costs, approximately ¥10 trillion government funds (i.e., tax revenues) were used to cover these costs given the shortage in premium funds. In fact, the Japanese public bore the substantial cost of maintaining the reliability of the financial system.

The collapse of the bubble caused by the economic boom from the late 1980s to the

early 1990s triggered instability in Japan's financial system. The system was stabilized by fully guaranteeing bank deposits and capital injections from the public fund, as discussed below.

Table 5

Collapsed Banks and Disposition Costs (¥100 million)

Date	Collapsed institution	Fund by DICJ	Date	Collapsed institution	Fund by DICJ
8/30/95	Hyogo Bank	4,730	4/12/99	Kokumin Bank	1,837
4/1/96	Taiheiyo Bank	1,170	5/24/99	Kofuku Bank	4,941
11/21/96	Hanwa Bank	806	6/14/99	Tokyo Sowa Bank	7,626
10/14/97	Kyoto Kyoei Bank	438	8/9/99	Namihaya Bank	6,526
11/17/97	Hokkaido Takushoku Bank	17,732	10/4/99	Niigata Chuo Bank	3,817
11/25/97	Tokuyo City Bank	1,238	12/28/01	Ishikawa Bank	1,809
5/15/98	Midori Bank	7,711	3/8/02	Chubu Bank	944
10/23/98	LTCB	32,350	11/29/03	Ashikaga Bank	--
12/14/98	Nippon Credit Bank	31,414			

(Source: Data compiled from DICJ at http://www.dic.go.jp/katsudou/katsudou2.html)

4-2. Stricter Disclosure Regulations

After the economic bubble burst, the Ministry of Finance (MOF) delayed the process of addressing the problem. Thus, the MOF was criticized for causing an unnecessarily prolonged financial crisis (Hoggarth et al. (2002), Sakuragawa (2006), etc.)[8].

If the problem was cyclical, it would have been solved after the economy had improved, and clearly the MOF should not mechanically handle insolvency cases resulting from a temporal deficit. On the other hand, if the problem was structural, procrastination further strains the situation. Unfortunately, the MOF in the 1990s magnified the issue because they misinterpreted the problem of Japanese banks as cyclical and not

[8] According to Hoggarth et al. (2002), the average duration of a financial crisis in number of years since 1980 (worldwide) has been 3.6 years; however, it has remained for nearly 15 years in Japan.

structural, and delayed pursuing a solution.

As is often noted, financial institutions with excessive liabilities undertake risky investments because if these investments prove to be successful, they can offset their losses. However, if unsuccessful, they will collapse. Certainly, the high possibility of failure worsens the degree of excessive liabilities. The longer they delay the closure decision, the greater the amount of funds needed to protect deposits.

Strong doubt exists as to why the MOF was unable to handle insolvency cases before experiencing greater losses. A major factor was insufficient information disclosure. First, the bad loans that each bank was required to disclose solely consisted of the debts of failed firms. Even after the range of disclosure expanded to include the debts of possible failed firms, the self-assessment of bad loans was so simplistic that other doubtful loans were assessed as normal.

In addition, a "device" to delay the problem was enforced by both the public and the private sectors. For example, when stock prices dropped and the latent profits of equity capital decreased, the government counted the valuation profit of land that the banks possessed as equity capital.

However, such a "device" created public distrust over concealing the problem. Because financial market participants tended to be bearish on uncertainty, the public conjectured that the banks were concealing more than they really were[9]. As a result, this "device" that was designed not to destabilize the market in fact accelerated the unrest. For example, the interest rate premium (Japanese premium) required when Japanese banks borrow funds from European and American banks, rose suddenly.

This was the time to switch between a traditional supervisory technique that "does not see" or "obscures" the problem and a new technique that makes the problem easy to face and grasp[10]. During this process, the authorities admitted that the use of market forces by information disclosure was the only choice for them to make.

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[9] For example, *Nihon Keizai Shinbun* (October 12, 2002)stated that a British economic research firm published an analysis report stating that Japanese financial institutions must amortize "at least ¥120 trillion" of bad loans, while FSA reported ¥52 trillion (in March 2002).

[10] Discipline in banking is discussed in Berger (1991) and Spiegel and Yamori (2007).

Spiegel and Yamori (2006) examined the situation in detail. In March 1996 and 1997, credit associations had the freedom to choose to disclose bad loans. Consequently, certain credit associations did not disclose bad loans, some only disclosed bad loans of unstable firms, and others disclosed debts including reductions or exemptions of interest, as banks do. In March 1998, when compulsory information disclosure was enforced, almost all credit associations thoroughly disclosed bad loans. Thus, the concealed amount was also revealed. The study's empirical results confirmed that unsound credit associations were passive to disclose; this implies that problematic information tends to be concealed.

Furthermore, Kondo (2010) also showed that financial institutions with problematic information tended to be passive regarding disclosure, especially if they were rated by foreign rating agencies.

Theoretically, the possibility exists that banks are willing to disclose under the pressure of competition in the banking market, because depositors do not choose institutions that are passive on disclosure. However, the effect of competition is reduced when financial institutions have deposit insurance as their defense. Spiegel and Yamori (2006) and Kondo (2010) indicated that policy makers must set a benchmark for information disclosure that enables financial institutions to disclose information compared with other institutions.

4-3. Safety Net in the Japanese Banking Market and Deposit Insurance

A deposit insurance system plays a central role as a safety net in the modern banking industry. The system takes on the deposit liability and guarantees payment when banks (including credit associations and credit cooperatives, but excluding branches of foreign banks in Japan) go bankrupt. In principle, a principal amount of up to ¥10 million (excluding foreign currency deposits and certificates of deposits) and its interest are guaranteed.

All deposits were protected for their entire amount by March 2002 because the deposit insurance cap was frozen. In April 2002, savings deposits such as term deposits were excluded from full protection because of a partial lifting of the freeze on the cap. In

April 2005, excluding settlement deposits (checking accounts and new transaction accounts without interest), all deposits introduced the cap. The savings of Agricultural Cooperatives (JA) and Fishery Cooperatives have an Agricultural and Fishery Cooperatives Savings Insurance system, similar to that of deposit insurance.

There are two ways to guarantee deposits. One is the direct payment method, where the DICJ pays a premium and purchases the deposits of failed financial institutions. The other is the financial assistance method, in which the DICJ provides financial assistance to financial institutions that merge with failed financial institutions. The direct payment method is inconvenient for users because the failed financial institution ceases to exist. For example, depositors that use account transfers for public utility payments must withdraw their accounts. Thus, the direct payment method has never been used in Japan. In reality, the FSA publicly prefers to solve insolvency cases using the financial assistance method because the functions of the failed financial institutions can be taken over.

Besides protecting depositors, the procedure to address systemic risk is also important in the deposit guarantee system. Because the safety of deposits was always guaranteed for depositors through the introduction of the deposit guarantee system, it was unnecessary for them to create a bank run on the basis of uncertain information. Therefore, banks also did not have to worry about depositors running on a bank and could thus provide long-term loans.

Although the deposit guarantee system effectively secures the stability of the financial system, it has certain limitations. First, it distorts the incentives of both depositors and bank managers. Depositors could make deposits to banks that offer a high deposit interest rate because the deposit is guaranteed even if management deteriorates. Indeed, a principal amount of up to ¥10 million is guaranteed even if a bank fails. On the other hand, bank managers like to engage in risky business because the premiums are comparatively cheap as long as it is uniform (as it is today). Variable premium rates, where the deposit premium rises depending on banks' financial conditions, have been introduced in the U.S. to prevent adverse effects; however, they have not yet been introduced in Japan.

Second, while depositors do not monitor banks earnestly because they are protected by the deposit guarantee system, regulators have to fulfill all supervision and monitoring responsibilities. To minimize adverse effects, an upper bound of deposit insurance protection (¥10 million) is set. Because large depositors may lose part of their deposits, bank management matters to them. Thus, depositors are expected to discipline bank management.

Third, given the massive relief fund for depositors, the possibility exists that deposit premiums run short and taxpayer burdens increase. In fact, as many banks had failed successively since the burst of the economic bubble, it was impossible to cover only by the deposit premium to fully protect the deposit and therefore approximately ¥10 trillion government funds were provided.

4-4. The Lender of Last Resort

The lender of last resort, the Central Bank, lends money to commercial banks when they are short of liquidity (because funds from private lenders are unavailable as a result of a run on banks, for example,) and to secure depositors' trust on financial institutions and ultimately, the financial system. Indeed, the Bank of Japan provided loans to individual financial institutions (emergency financing) during the financial turmoil after the burst of the economic bubble.

The emergency lending by the Bank of Japan was considered effective for preventing a chain of collapses of financial institutions. When exercising the function of the lender of last resort, the Bank of Japan must judge whether banks are in a temporary liquidity shortage situation or are insolvent. If the Bank of Japan misjudges, there is a danger of overlooking the problem because the Bank of Japan then becomes a lender to banks with debts exceeding assets. Therefore, the Bank of Japan set four principles of emergency financing to clarify the rules for invocation (Table 6).

Table 6

Four Principles of Emergency Financing by the Bank of Japan

Four Principles
Principle 1. There is a possibility of systemic risk.
Principle 2. It is imperative for the Bank of Japan to finance.
Principle 3. Appropriate response such as clarification of the responsibility of all concerned must be taken to prevent moral hazard.
Principle 4. Maintaining the financial strength of the Bank of Japan itself must be considered.

4-5. Public Fund Injections

4-5-1. Positive and Negative Effects

To prevent the crisis, the Japanese government injected funds into banks to reinforce their equity capital. When equity capital is insufficient as a result of an increase in bad loan disposals, banks generally secure their capital from ordinary shareholders. However, in an emergency situation such as a possible financial crisis, few shareholders will support banks in increasing their capital. Thus, the possibility exists that the government injects public funds to maintain stability in the financial system.

The effects of injecting public funds are summarized as follows.

1) Possibility of avoiding bank failure

When banks fail, there are adverse effects not only on depositors but also on firms that cannot find other banks for new borrowings. Regardless of their ability to pay under normal circumstances, the failure of banks facing insufficient liquidity has a harmful effect on the soundness of other banks. Therefore, injecting capital to prevent banks from failing and to stabilize the financial system is a significant social benefit.

2) Effectiveness of the "credit crunch" countermeasure

Banks become able to take risks if their equity capital increases by receiving public funds. If bank lending increases, the problem of credit crunch is expected to be resolved.

3) Promotion of the disposal of nonperforming loans

During an economic stagnation, a financial system does not remain stable for long because banks are unwilling to handle bad loans. The financial recovery of banks through an injection of capital is expected to promote the disposal of nonperforming loans.

4) Pump-priming effect of the reorganization of financial institutions

Because there are several banks in Japan, the merger and integration of banks are promoted through the injection of capital. For example, the Act on Special Measures for Promotion of Organizational Restructuring of Financial Institutions enacted in December 2002 actually allowed financial institutions that would do a merger to receive public funds injections.

However, capital injections have harmful effects. The following issues have been frequently pointed out.

1) Moral hazard by banks

If the government always helps banks when they face difficulties, banks may not make an effort to be safe and may overvalue risky management. Thus, the moral hazard of banks may occur and such risk may increase adversely by injecting capital.

2) Damage to the soundness of the entire financial system

If the cost of the capital injected is imposed on other financial institutions, these healthy institutions may find themselves in trouble. Therefore, it is not necessary that the soundness of the entire financial system will improve from a capital injection.

3) Uncertainty over increases of bank loans

Even if equity capital increases, banks do not automatically increase their lending. Because it is possible to only increase investments in government bonds, the effects that

the government anticipates may not necessarily be achieved through capital injection.

4) Concern over extending the existence of problematic banks

The disposal of nonperforming loans should not depend on the financial strength of banks. If a bank lacks the ability to dispose of nonperforming loans, public funding will fail to solve its problem and will only extend its life. It is necessary to strengthen the disposal functions (e.g., by establishing a Resolution and Collection Corporation and an Industrial Revitalization Corporation).

5) Decrease in incentives for private financial institutions

Improving sustainable profitability for banks that received public funds may be difficult if the government's commitment is so strong. In Japan, when the government planned to inject public funds in response to the financial crisis during the late 1990s, private banks hesitated to apply for such a capital injection because they feared increasing government involvement.

4-5-2. Brief Description of Capital Injections

The first injection of public funds into banks in Japan to increase capital occurred in March 1998 and was based on the Financial Functions Stabilization Act . Total public funds of ¥1.8 trillion were injected into 21 banks, including large city banks, to respond to the financial crisis that was aggravated by the failure of banks such as Hokkaido Takushoku Bank in November 1997. However, because the injection was small, the weak management of banks such as LTCB that received the injection remained unresolved.

In summer 1998, the world financial crisis that originated in Japan was feared due to the increase in Japanese premium while international finance crises were expanding. Thus, the public insisted that a large-scale capital injection was necessary. A total capital of ¥25 trillion was prepared based on the bank recapitalization bill approved in October 1998. Beginning with a total injection of ¥7.5 trillion for 15 banks in March 1999, by March 2002, a total of ¥8.6 trillion was injected based on the Law concerning

Emergency Measures for Early Strengthening of Financial Functions.

After the bank recapitalization bill lapsed, the Financial Crisis Response ordained in the Deposit Insurance Law was the only possible scheme for further injection of public funds into banks. An amount of ¥2 trillion public funds was injected into Resona Bank in May 2003 based on this scheme. Because the scheme was supposed to be exercised only in a state of emergency during a financial crisis, it results in responses only after a problem has occurred.

Therefore, the Financial Function Strengthening Act was approved in 2004, which enabled the government to inject capital prophylactically into financial institutions that have not had a problem but that lack capital. Although the Act was originally effective only until March 2008, a revision in response to the Lehman shock extended its effectiveness to March 2012.

5. Development of Japanese Banking Regulation after the Lehman Shock

Financial markets throughout the world became dysfunctional after the Lehman shock. The Japanese financial market was also exposed to a difficult situation, although not as difficult as in Europe and the U.S. A critical problem was the deterioration in financing for SMEs, not to stabilize the financial system[11]. In this section, we discuss the regulatory measures taken by the government to ensure smooth supply of funds to SMEs during the period.[12]

5-1. Revised Act on Special Measures for Strengthening Financial Functions

As discussed in section 3-3, because banks in Japan are bound by capital adequacy rule, they require additional equity capital to increase lending. Therefore, after the Lehman shock, the concern was that a credit crunch or credit withdrawal would be triggered regarding SMEs given this capital adequacy rule. Moreover, if many banks

[11] The FSA reported that total amount of subprime-loan-related products that Japanese depository institutions held as of September 30, 2008, was 797 billion yen, while the Tier 1 capital of these institutions amounted to 50.1 trillion yen.

[12] A detailed discussion on the system was also found in Yamori and Kondo (2011).

had weak capital adequacy ratios, the financial system would become unstable.

As discussed in section 4-5-2, the Financial Function Strengthening Act, which enabled the government to inject public funds for prevention purposes based on applications from financial institutions, was implemented to strengthen the financial condition of regional financial institutions in Japan. The Act was temporarily in effect from the end of August 2004 to the end of March 2008. Given the seriousness of the global financial crisis related to the failure of Lehman Brothers, a new Financial Function Strengthening Act (hereafter, the revised Act) was implemented in December 2008. The revised Act remains in effect until March 2012.

Because the old Act placed significant responsibility on the directors at banks that received public funds, only two banks applied for such assistance, Kiyo Holdings, Inc. (Kiyo Bank) and Howa Bank. Unlike the old Act, the revised Act does not review executive responsibilities related to a bank's poor performance when the bank applies for a capital injection.

Table 7 lists the banks that received an injection of public funds under the revised Act. The table indicates that the number of banks that applied for an injection was much higher than under the old Act. On the other hand, because management and shareholder responsibilities were not significant under the revised Act, there was a concern that the problem of moral hazard may occur[13].

[13] Based on the Act, Examination Board has been established to review the application and monitor the performance of banks. Currently, Yamori, an author of this paper, serves as a member of this Examination Board.

Table 7

Banks that Received Capital Injection under the Revised Financial Functions Strengthening Act

Name of financial institutions	Date of capital injection	Amount(¥100 million)
Hokuyo Bank	March 2009	1000
Fukuho Bank	March 2009	60
Minami Nihon Bank	March 2009	150
Michinoku Bank	September 2009	200
Kirayaka Bank	September 2009	200
Daisan Bank	September 2009	300
The Shinkumi Federation Bank (Yamanashi Prefecture Shinkumi)	September 2009	450
Towa Bank	December 2009	350
Kouchi Bank	December 2009	150
Fidea Holdings (Hokuto Bank)	March 2010	100
Miyazaki Taiyo Bank	March 2010	130

Note: Capital injection into the Shinkumi Federation Bank was made through purchasing trust beneficiary right. Other injections were made by purchasing preferred shares.

(Source: DICJ Homepage)

5-2. New Administrative Measures to Facilitate the Financing of Firms

"New measures for financial facilitation" were announced in March 2009 to facilitate firms' borrowings because business conditions of not only SMEs but also middle-size and large firms deteriorated remarkably during the recession after the Lehman shock. There are three main measures.

First, special off-site interviews were conducted at the end of FY2008 to investigate whether banks were eager to supply funds to firms. Based on the results of the

interviews, the operations of major banks as well as regional financial institutions that were swamped with complaints were examined from April to June 2009[14].

Second, the FSA changed the risk weight for emergency guaranteed loans[15]. As emergency guaranteed loans was fully guaranteed by the public credit guarantee corporations and banks hold no credit risk about them, the FSA decreased their risk weight from 10% to an exceptional 0%[16].

Third, capital injections based on the revised Act were promoted during open hearings to financial institutions by requesting them to consider a more positive use of the Act.

5-3. Act to Facilitate Financing for SMEs

"Act on temporary measures to facilitate finance for SMEs" (hereafter, the Act to Facilitate SMEs Finance) was implemented in December 2009 to assist SMEs that had difficulty with management and finance, which resulted from the recession after the Lehman shock. The Act imposes obligations on financial institutions to make efforts to respond to requests as best as possible when SMEs and mortgage borrowers apply for softening borrowing conditions such as extensions of repayment deadlines.

The Act could possibly cause an increase in nonperforming loans; therefore, banks might hesitate to respond to borrowers' requests. Thus, some measures were taken to promote the implementation of the Act. If a financial institution accepts the softening loan conditions, it does not have to classify them as nonperforming loans in most cases under the Act. Moreover, although banks must make an effort to respond to borrower requests, a legal penalty is not specified if they fail to do so. However, banks must

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[14] Yearbook "One Year of the Financial Services Agency (Fiscal Year 2008)" indicates that there were no regional financial institutions that were swamped with complaints.
[15] In the credit guarantee system by then, when loans were defaulted on, financial institutions bore 20% of the defaulted loans and the Credit Guarantee Corporation bore 80% (a shared responsibility system). The emergency guarantee system that calls for the Credit Guarantee Corporation to assume 100% of the debt repayment was implemented in October 2008.
[16] In Japan, the public credit guarantee corporations generally guarantee 80 percent of loans losses. Exceptional emergency guarantee scheme was introduced in October 2008. Risk weights for loans covered by normal public guarantee scheme remained 10 percent.

organize their implementation system, report their implementation results to the authorities and disclose them. A penalty is imposed for false disclosures or reports.

Table 8 summarizes the implementation of the Act from the beginning to the end of September 2010. The implementation ratio is at a relatively higher level because of the measures discussed above. However, from the point of view of the financial stability, we are concerned that banks hold many unreported nonperforming loans because substantial loans with extended repayment periods may be classified as normal loans[17].

[17] The Act allows banks to classify these potentially risky loans as normal, but several banks voluntarily classify them as bad.

Table 8

Implementation Rate of the Act to Facilitate SME Finance (in cases in which debtors are SMEs)

	1 (%)	2 (%)
Major banks (11)	96.7	85.2
Regional banks (106)	97.1	87.7
Other banks (28)	95.8	86.3
Credit associations (273)	97.7	88.8
Credit cooperatives (160)	97.7	89.9
Labor credit associations (14)	100.0	100.0
Credit federation of agricultural cooperatives and Credit federation of fisheries cooperatives (67)	98.9	92.0
Agricultural cooperatives and fisheries cooperatives (887)	97.3	87.0
Total (1546)	97.3	87.9

Note 1: Column 1 displays the implementation ratio that equals the implementation number divided by both the implementation number and the rejection number.

Note 2: Column 2 displays the implementation ratio that equals the implementation number divided by the total application number. The discrepancy between Column 1 and 2 is due to the numbers of applications under reviews.

Note 3: Saitama Resona Bank is included in the regional banks.

(Source: the FSA)

6. Concluding Remarks

This study explains the current bank regulations in Japan. Although Japan had the steadiest banking system in the world in the 1980s, the system weakened significantly after the collapse of the economic bubble in the early 1990s. Indeed, bankruptcies of financial institutions occurred one after another since 1995. By the early 1990s, the

administration had successfully arranged mergers of problematic banks with other healthy banks. However, it had been impossible to prevent these financial bankruptcies since the mid 1990s because the problems inherent in the financial system exceeded the administration's capacity.

First, legal measures to deal with insolvent banks were created. For instance, the Deposit Insurance Law originally did not protect deposits exceeding ¥10 million. However, the full guarantee of bank deposits was believed to be necessary to prevent a run on banks by depositors, and thus the law was revised. Moreover, if no bank took over the assets of failed banks, borrowers of failed banks would experience financial trouble. Indeed, in the late 1990s, the financial authority could not find a bank willing to take on failed banks. Thus, a special bank was established within the DICJ and a legal system was created to take over the debts of failed banks.

Second, the measures to prevent bank failure must be provided in advance to the administration. One method is capital injection of public funds, which was established in 1998. Another important method is to strengthen information disclosure to ease the level of distrust of financial institutions. This stricter disclosure regulation was implemented in the late 1990s.

Bank supervision regulations have changed in response to the financial crisis in Japan. Because Japanese financial institutions did not hold a large amount of securitized assets related to subprime loans, direct losses were not large during the global financial crisis of 2008. Namely, regarding maintaining the stability of the financial system, the regulations functioned well.

However, the global financial crisis influenced the future of financial regulations in Japan. Because the U.S. and the European countries have established new rules related to the international money market, Japan should also review and reform its bank regulations. For instance, capital adequacy regulations are expected to be revised corresponding to the international mutual agreement of Basel III, which requests an increase in core capital.

Finally, the regulations and the supervision of banks described in this study were implemented to increase stability. However, it must be noted that it is necessary to

activate the economy from the financial side, where economic activity has been sluggish in recent years[18]. We leave this matter for future research.

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[18] On December 24, 2010, The FSA released "The Action Plan for the New Growth Strategy," which consists of following three pillars: (1) Supply of funds to the companies commensurate with borrowers' size and stage of development; (2) Financial sector serving as a bridge between Asian and Japanese economies; (3) Provision of asset management capabilities to utilize Japanese national assets safely and effectively.

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