United States General Accounting Office

GAO

Report to the Honorable
Charles E. Schumer
House of Representatives

December 1996

# BANK REGULATORY STRUCTURE

## Japan

GAO/GGD-97-5

GAO United States
General Accounting Office
Washington, D.C. 20548

**General Government Division**

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December 27, 1996

The Honorable Charles E. Schumer
House of Representatives

Dear Mr. Schumer:

Proposals by various parties to consolidate United States bank regulatory agencies have raised questions about how other countries structure and carry out their bank oversight responsibilities and central bank activities. You asked us to provide you with information about the structure and operations of regulatory and supervisory activities in several countries. This report presents information on Japan. It describes the Japanese bank regulatory structure and its key participants, how that structure functions, how banks are supervised in Japan, and how participants handle other financial system responsibilities.

We are sending copies of this report to Members of the House and Senate banking committees, other congressional committees and subcommittees, and other interested parties. We will also make copies available to others on request.

This report was prepared under the direction of Kane A. Wong, Assistant Director, Financial Institutions and Markets Issues. If you have any questions, please call me on (202) 512-8678. Other major contributors are listed in appendix II.

Sincerely yours,

James L. Bothwell, Director
Financial Institutions
and Markets Issues

# Executive Summary

## Purpose

Proposals by various parties to consolidate U.S. bank regulatory agencies have raised questions about how other countries structure and carry out their bank oversight responsibilities and central bank activities. Congressman Charles E. Schumer asked GAO to provide information about the structure and operations of such activities in several countries.[1] This report provides information on bank oversight in Japan.

GAO's objectives were to describe how (1) Japanese bank regulation and supervision is organized; (2) Japan's banking oversight structure functions, particularly with respect to bank licensing, regulation, and supervision; (3) Japanese banks are monitored by their supervisors; and (4) participants handle other financial system responsibilities. As with its reports on the structure of bank regulation and oversight in other countries, GAO did not attempt to assess the adequacy of bank supervision in Japan. Most of the information GAO gathered in this report, including translations and explanations of pertinent laws and recent changes to those laws, was obtained from Japanese officials and banking industry representatives.

It is important to note that GAO's work took place during a period in which the Japanese system for supervising banks was being revised with the intent of strengthening oversight. Such revisions continue and reflect an attempt to respond to problems that became evident when the economic boom of the 1980s was followed by a period of economic stagnation that brought significant declines in real estate and stock market prices. These falling prices helped generate a sizeable inventory of nonperforming loans across the Japanese financial services industry, estimated by the Ministry of Finance (MOF) to be 34.8 trillion yen ($326 billion)[2] as of March 1996. The nonperforming loan problem contributed to the failure of several financial institutions, including regional banks, credit cooperatives and seven housing loan companies. The estimated cost of resolving or disposing of failing institutions over the last 4 years was about 2 trillion yen ($19 billion) to 2.5 trillion yen ($24 billion), including over $7 billion in assistance provided by the Japanese Deposit Insurance Fund.

[1]For information on GAO's issued reports on the British, German, French, and Canadian regulatory systems, see Bank Regulatory Structure: The United Kingdom (GAO/GGD-95-38, Dec. 29, 1994); Bank Regulatory Structure: The Federal Republic of Germany (GAO/GGD-94-134BR, May 9, 1994; Bank Regulatory Structure: France (GAO/GGD-95-152, Aug. 31, 1995) and; Bank Regulatory Structure: Canada (GAO/GGD-95-223, Sept. 28, 1995). We also issued a capping report drawing lessons for the U.S. regulatory system from the foreign countries, Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure,(GAO/GGD-97-23, Nov. 20, 1996).

[2]Exchange rate of 106.6 yen per U.S. dollar, as of Apr. 25, 1996.

Several additional steps have recently been taken to help address these problems, including an appropriation of 680 billion yen ($6.4 billion) to aid in resolving an estimated 6.3 trillion yen ($59 billion) in nonrecoverable loans for the seven failed housing loan companies. A substantial increase in the deposit insurance premiums assessed on Japanese banks was also authorized to provide funds for resolving additional failures expected over the next 5 years and to help rebuild the deposit insurance fund. In addition, several laws, enacted in June 1996, were intended to improve the Japanese oversight of financial institutions. Other reforms were under consideration at the time GAO concluded its work.

It is also important to note that, while U.S. supervisors rely heavily on written orders or directives, in Japan, direction and guidance is more often provided through frequent—almost daily—contacts between bank officials and officials of MOF and the Bank of Japan (BOJ), the two bodies responsible for safety and soundness of the banking system. This report focuses more attention on describing the legal structure within which Japanese banking oversight has been conducted and less attention on the methods used to carry out that oversight.

## Background

The Japanese banking system is a highly segmented structure that includes various types of private institutions as well as several government institutions and Japan's central bank. This structure is a legacy of reforms originally instituted to promote economic recovery during the post-World War II period. Since the 1970s, some actions have been taken to eliminate certain distinctions among the different types of banks and broaden the markets they serve. Consequently, although important limitations and prohibitions still apply, banks now can engage in a variety of previously restricted financial activities. The 1,130 financial institutions operating in Japan as of March 31, 1995, held 1,148 trillion yen ($10.8 trillion) in combined assets.

More than half, or 53 percent, of these industry assets were held by Japan's "ordinary banks," which mainly focus on short-term financing. At the time of GAO's review, 11 of Japan's 140 domestically-owned ordinary banks were large city banks,[3] and 129 were regional banks. Based on total assets, as of December 1995, the six largest banks in the world were Japanese city banks. Also categorized as ordinary banks were 90 foreign-owned bank branches operating in Japan, of which 16 were owned

[3]As of Apr. 1, 1996, Mitsubishi Bank and the Bank of Tokyo merged, reducing the number of Japanese city banks to 10.

by U.S. concerns. The remaining 47 percent of industry assets were held by specialized financial institutions. Included in this group were 3 long-term credit banks, which are permitted to issue bank debentures with up to 5-year maturities; 7 trust banks;[4] 794 financial institutions serving small businesses; 48 agricultural, forestry, and fisheries cooperatives;[5] and 48 other institutions.[6]

Since 1928, two institutions have monitored the safety and soundness of the Japan's banking industry—MOF and BOJ, Japan's central bank. Although MOF's legal authority to supervise banks was first granted in 1872, BOJ began examining banks in 1928 on the basis of its contractual agreements with client banks, as recommended by the Financial System Research Council—an advisory council to the Minister of Finance. In 1942, the Bank of Japan Law gave BOJ the mission of maintaining and fostering a safe and sound financial system, thus giving BOJ what it believes is a stronger statutory basis to conduct on-site examinations of its client banks.[7]

In 1949, the Ministry of Finance Establishment Law gave MOF its current broad responsibility for the government's fiscal and related monetary functions, including budget formulation,[8] tax assessment and collection, as well as for the supervision and inspection of banks and securities firms. Also in 1949, amendments to the Bank of Japan Law gave BOJ responsibilities for formulating and implementing monetary policy.

With respect to banks, MOF's regulatory and supervisory responsibilities are set out in the Banking Law of 1981, which was prompted by economic and financial changes in Japan following the early 1970s oil crisis. Allowable activities for Japanese financial institutions were further expanded in 1992 with the passage of the Financial System Reform Law. The 1992 law, which eliminated many differences among financial institutions, allowed banks to engage in securities and trust activities through their subsidiaries. The law also provided MOF with the authority to

[4]In addition to these seven traditional trust banks, there were seven trust bank subsidiaries and nine foreign-owned trust banks as of Mar. 1995.

[5]These cooperative-based credit federations represented a total of 4,080 local agricultural and fishery cooperatives at the local, town, and village level of government.

[6]Other institutions included the Shoko Chukin Bank (a special corporation for providing financial assistance to unions of small- and medium-sized enterprises) and 47 labor banks.

[7]In Japan, the term supervisor is used only to describe government agencies, according to MOF. Since BOJ is not a government agency, it is not described as a supervisor in Japan, even though BOJ does perform some of the supervisory functions described below.

[8]The formulation, execution, and coordination of the national budget allows MOF to play a pivotal role within the national government. This role currently includes approving BOJ's budget.

establish standards to safeguard the soundness of banks and controls over transactions between banks and their subsidiaries.

The Deposit Insurance Corporation of Japan (DIC) was established as a special corporation in 1971 to protect depositors and maintain the stability of the financial system. The DIC serves these purposes by insuring individual depositors for up to 10 million yen ($93,800) and by providing financial assistance to facilitate the merger or acquisition of failing financial institutions. The DIC is supervised by MOF.

## Results in Brief

In Japan, two entities are responsible for ensuring the safety and soundness of the nation's banking system—MOF and BOJ. MOF, as a governmental agency, has the sole responsibility for licensing banking institutions and for developing and enforcing banking regulations. In addition to its power to order business suspensions and to rescind a bank's license, MOF can seek the imposition of fines, and, in some cases, imprisonment as enforcement measures. Although MOF officials said there have been no cases in which it has had to impose fines or seek imprisonment, it has used its power to order business suspensions.

MOF supervises through on-site and off-site monitoring to assess (1) compliance with laws and regulations and (2) soundness of financial institutions. MOF also uses its frequent—almost daily—contact with bank officials to gather information as well as to discuss supervisory concerns and to provide guidance. BOJ is not a governmental entity and has no regulatory authority. However, in order to fulfill its responsibility stipulated in the Bank of Japan Law, BOJ has contractual arrangements with 700 financial institutions, including all commercial banks, that allow it to examine these institutions and provide advice. BOJ conducts examinations to assess the safety and soundness of these financial institutions and, ultimately, the safety of the financial system. It also maintains oversight through frequent contacts with its client institutions. Over the period 1990 to 1994, MOF and BOJ have examined approximately 500 banks annually. MOF and BOJ do not regularly share information obtained during their separate on-site monitoring visits to the same banks, but they do work together on a case-by-case basis to resolve crisis situations.

In June 1996, several bills were enacted to help improve bank inspection and supervision in response to a series of failures of credit cooperatives, regional banks, and housing loan companies. The bills contained provisions designed to prevent the recurrence of problems with bad loans, to improve disposal of failing or failed financial institutions, and to provide additional funding for the Deposit Insurance Fund in anticipation of more potential failures over the next 5 years. In addition, other reforms affecting the banking system are under discussion.

Apart from their respective safety and soundness functions, MOF and BOJ have other financial system responsibilities. In connection with its responsibility to maintain the financial system's stability, BOJ is the lender of last resort. As the central bank, BOJ can provide funds to banks in trouble or to the system as a whole if there is no alternative financial provider of liquidity to prevent a systemic crisis, and such liquidity is needed. Under the Bank of Japan Law, BOJ sets monetary policy and the interest rate, known as the official discount rate, at which it loans or discounts bills for its client banks. In other areas, MOF and BOJ share responsibilities for such functions as failure resolution and representing Japan's interests in international forums.

**Figure 1: Responsibility for Bank Regulatory and Related Functions in Japan**

| Responsible entity | Developing laws | Developing regulations | Issuing regulations | Licensing banks | Bank information reporting and analysis | Bank inspections/ examinations | Developing enforcement actions | Enforcement authority | Failure resolution | Liquidity provider | Crisis management | Payments clearance system | International forum representative | Deposit insurance | Lender of last resort |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| MOF | ● | ● | ● | ● | ● | ● | ● | ● | ● | | ● | | ● | | |
| BOJ | | | | | ● | ● | | | ● | ● | ● | ● | ● | | ● |
| DIC[a] | | | | | | | | | | | | | | ● | |
| Private bankers associations | | | | | | | | | | | | ● | | | |

[a]Japan's deposit insurance system is administered by the Deposit Insurance Corporation.

Source: Japanese laws, bank regulation, and other materials obtained from Japanese sources.

## Principal Findings

### MOF and BOJ Authorities Differ Concerning the Safety and Soundness of Financial Institutions

Although both MOF and BOJ have responsibilities for the safety and soundness of the financial system, the basis for their respective authority is different. The Japanese parliamentary system and Japanese law gives MOF wide-ranging and diverse responsibilities to supervise and inspect financial institutions. In contrast, BOJ's oversight authority is obtained through its contractual agreements with client financial institutions. This contractual relationship allows BOJ to conduct examinations of and provide advice to its client financial institutions, which is necessary for it to fulfill its responsibilities for the soundness of the financial system stipulated in the 1942 BOJ law.

Although MOF and BOJ are responsible for the safety and soundness of the financial system and the guidance of banks, they function largely independently of each other. Moreover, only MOF has the legal authority to take enforcement actions against financial institutions, which could lead to fines, imprisonment, and licensing revocation resulting in closure of the institution. Although, according to MOF officials, there have been no cases in which MOF has had to impose fines or seek imprisonment, it has ordered suspension of business. For the most part, MOF has taken supervisory action through administrative notifications, such as issuing circulars, although the guidance provided through such notifications is not legally enforceable. Officials said that the use of administrative guidance has long served as a major instrument in Japan's approach to bank supervision. According to banking officials, banks are expected to act on MOF's guidance and do so. The number of cases in which MOF gave major banks what it calls "concrete" guidance, for the purpose of improving bank performance, totaled 127 in 1994. In addition to these cases, MOF also provides guidance through frequent contacts with banks.

BOJ has no legal authority to take enforcement actions against financial institutions. However, it does provide advice to these institutions through frequent contacts. According to officials from several banks GAO visited, this advice is typically treated as binding by Japanese financial institutions.

### MOF Has Responsibility Over Licensing and Regulation

Under the 1981 Banking Law, MOF is responsible for regulating and supervising Japan's banking system. MOF licenses, regulates, and supervises banks that accept deposits or installment savings and lend money, discount bills, or conduct exchange transactions.

Under the 1981 Banking Law, MOF's role is to protect depositors and maintain an orderly credit system. According to the law, applicants must obtain a license from MOF before engaging in banking. MOF is responsible for determining whether applicants meet licensing criteria, such as whether they have adequate financial means to carry out banking business. MOF also has the authority to suspend business operations or revoke licenses for violations of any law, articles of incorporation, or MOF measures designed to protect the public interest. In addition, MOF may impose conditions on a banking license when it considers it in the public interest.

## MOF and BOJ Rely on On-Site and Off-Site Monitoring to Carry Out Safety and Soundness Responsibilities

MOF and BOJ obtain information needed to fulfill their safety and soundness responsibilities primarily through on-site and off-site monitoring. As part of their off-site monitoring, MOF and BOJ officials request various bank reports and conduct their own independent analyses. Japanese authorities also rely heavily on their day-to-day contacts with banks, which allow them to keep abreast of the financial condition and operations of the institutions they oversee. In addition, banks are required to submit reports to MOF twice a year on their business and financial condition. These reports are also submitted to BOJ. Banks submit more frequent periodic reports to BOJ covering such matters as deposits with BOJ, commercial paper, extensions of credit, and securities activities.

MOF has the authority to investigate banks at any time for the purpose of ensuring sound and appropriate bank management. MOF conducts two types of on-site inspections—comprehensive inspections and inspections focusing on specific aspects of a bank's operation, such as credit-risk or market-risk management. MOF's comprehensive inspections, which are unannounced, concentrate on banks' risk management, profitability, asset quality, and compliance with regulations.

For the purpose of meeting its responsibility for the overall safety and soundness of Japan's financial system, BOJ conducts on-site examinations that focus on the business operations of institutions, with special attention paid to assessing overall risk management. BOJ's examination authority is based on contractual agreements BOJ reaches with institutions at the time they open their accounts with the central bank. All major Japanese banks, including ordinary banks, long-term credit institutions, and most shinkin banks,[9] have current accounts with BOJ. BOJ typically provides banks with 2 months advance notice before an on-site examination. BOJ also requests bank reports before such examinations. BOJ's examinations review management, credit, market, foreign exchange, liquidity, operations, electronic data processing, and systemic risks.

To date, MOF and BOJ have not typically used independent external auditors to provide information on the banks they monitor. Although banks are subject to Commercial Code[10] provisions requiring them to obtain independent audits and do so, MOF and BOJ officials told GAO that they depend on their own on-site and off-site monitoring processes to obtain necessary information.

## Increases in Nonperforming Loans and Financial Institution Failures Caused Japan to Review Role of Banking Authorities

During 1995 and early 1996, Japanese banks and the banking system were confronted with several events that prompted the authorities to enhance the regulatory and supervisory system's ability to deal with industry problems. These events included mounting levels of nonperforming loans, an inadequately funded deposit insurance fund; financial institution failures, including seven housing loan companies; and improper trading by an employee of a city bank with offices in New York.

Economic changes, including Japan's stagnant economy and declining real estate prices, have led in the past several years to sharp increases in publicly reported nonperforming loans held by Japanese banks and other deposit-taking institutions, estimated by MOF to total at least 34.8 trillion yen ($326 billion) as of March 1996. Concerns have increased about the adequacy of the deposit insurance fund as losses from nonperforming loans have caused several financial institutions to fail. In the last 2 years, outlays of financial assistance provided to assist in the resolution of failing institutions have come close to depleting the deposit insurance fund, according to Japanese government officials.

The Japanese government recently designed a plan aimed at rebuilding public confidence and protecting depositors. In June 1996, the Diet passed several bills intended to provide new and more effective enforcement and resolution powers and to better protect depositors. Key features of the bills were (1) a system of prompt corrective action based on capital adequacy ratios, (2) a system under which supervisory authorities would

[9]Shinkin banks are cooperatives serving the financial needs of small companies and local residents.

[10]The Japanese Commercial Code, administered by the Ministry of Justice, was promulgated in 1890 to designate rules for conducting business.

be able to initiate proceedings for a financial institution's reorganization or bankruptcy, and (3) creation of a special premium for deposit insurance and governmental guarantees for borrowings by DIC for the disposal of failed credit cooperatives.

In September 1995, a Japanese city bank with offices in New York reported to the U.S. Federal Reserve that a securities trader in its New York office had initiated improper trades over an 11-year period that had gone undetected in inspections. Reported losses resulting from the unauthorized trading activities amounted to over $1 billion. The following month, U.S. banking authorities issued cease and desist orders against the bank requiring a virtual cessation of trading activities in the United States. In November 1995, MOF also took action intended to correct what were viewed as inadequate management of overseas practices at the city bank. MOF stated that it has committed itself to strengthening its supervision and inspection of overseas branches and offices of Japanese banks. BOJ also announced measures to improve and enhance examinations.

## MOF and BOJ Have Other Financial System Responsibilities

MOF and BOJ have other financial system responsibilities, some of which they share. BOJ has responsibility for setting monetary policy, thus influencing the nation's money supply and interest rates. It also acts as the lender of last resort—a function unique to the central bank. Additionally, BOJ has a key role in administering the payments clearance system in Japan.

BOJ and MOF share responsibilities for the deposit insurance system. MOF supervises DIC and plays an active role in approving key appointments and financial assistance decisions. If requested by DIC, BOJ staff handle administrative functions of DIC on an as-needed basis with the approval of MOF. The Minister of Finance appoints the Governor, and MOF approves the executive directors and committee member appointments to DIC. In addition, MOF must initially approve all applications for financial assistance to financial institutions.

MOF and BOJ both represent Japan in a number of international forums, including the Group of Seven,[11] the Group of Ten,[12] the Basle Committee,[13] and the International Monetary Fund. In addition, both participate in the Organization for Economic Cooperation and Development.

MOF and BOJ also work together in crisis management situations involving financial institutions. As the lender of last resort, BOJ can provide liquidity to troubled financial institutions or the financial system to prevent a systemic crisis. According to BOJ officials, in rare cases, BOJ has provided liquidity without eligible collateral.[14] They added that the following four conditions should be met before BOJ provides liquidity:

- There must be a strong likelihood that systemic risk will materialize;
- Central bank financial support must be indispensable to maintain the stability of the financial system;
- All parties responsible for the institution's problems must be penalized so as to avoid the emergence of moral hazard; and
- The financial soundness of the central bank must be maintained.

## Recommendations

This report contains no recommendations.

## Agency Comments

Senior officials from MOF, BOJ, DIC, the Federation of Bankers Associations of Japan, the Japanese Institute of Certified Public Accountants, and the three city banks GAO visited provided comments on a draft of this report. These comments were incorporated in the report where appropriate.

[11]The Group of Seven is a group of seven major industrial countries whose finance ministers and central bank governors meet occasionally. The seven countries include the United States, the United Kingdom, Germany, Japan, Canada, France, and Italy.

[12]The Group of Ten is a group of 11 major countries whose representatives meet to discuss issues of mutual concern. The participating countries include Germany, Belgium, Canada, the United States, France, the United Kingdom, Italy, Japan, the Netherlands, Sweden, and Switzerland.

[13]The primary purpose of the Basle Committee, which operates under the auspices of the Bank for International Settlements, is to address bank supervision-related issues. It is made up of the banking supervisors and central banks of the Group of Ten countries.

[14]The Bank of Japan Law allows the bank to make loans against collateral in the form of bills or notes, government bonds and obligations, and other negotiable securities, gold and silver bullion, or merchandise. These are considered "eligible" collateral.

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## Tables



## Figures



### Abbreviations

| | |
|---|---|
| BOJ | Bank of Japan |
| CPA | Certified Public Accountant |
| DIC | Deposit Insurance Corporation |
| FSRC | Financial System Research Council |
| JICPA | Japanese Institute of Certified Public Accountants |
| MOF | Ministry of Finance |
| SESC | Securities and Exchange Surveillance Committee |

# Introduction

Japan's highly segmented banking industry is made up of separate groups of institutions engaged in short-term or long-term finance; trust activities; foreign exchange, and trade financing; small business finance; and regional and agricultural finance. The segmentation of the banking industry reflects the extensive restructuring the Japanese economy underwent in the aftermath of World War II. At that time, as a key part of Japan's efforts to promote rapid industrial recovery, the government instituted legal reforms that created pronounced specialization in banking that persists to some degree to the present day. Although the Japanese banking industry remains segmented and specialized, deregulation and liberalization since the 1970s have eliminated many functional distinctions among the different types of banks and the separate, specialized markets they formerly served. Bank regulation and supervision are the responsibility of the central government, although some financial institutions are under the jurisdiction of local governments.

## Overview of Japanese Financial Institutions

The current Japanese banking system had its inception during the late 19th century with the emergence of a commercial banking system that was dominated by a small number of banks associated with major industrial conglomerates. After World War II, the Japanese government's efforts to rebuild the economy led to the dismantling of these prewar conglomerates and to restrictions on universal banking powers[1] that were formerly allowed to banks. As part of the nation's postwar economic and industrial recovery reforms, the Japanese government restricted banks from engaging in activities outside of banking, such as securities activities, and it limited their ownership of shares in other Japanese companies, particularly industrial companies. The result was a segmented banking structure, which even today retains some of its highly specialized character.

Japanese banks currently may accept deposits or installment savings, lend money, conduct exchange transactions, and certain ancillary activities. Allowable ancillary activities include purchasing, lending, and selling securities; underwriting government bonds; and the safekeeping of securities and precious metals. In addition, through associated companies, banks can provide venture capital, consulting services, leasing, housing finance, and loans. Industry deregulation initiated in the early 1980s that culminated with the 1992 Financial System Reform Law also now allows banks to compete in securities underwriting activities through

[1]Universal banking powers allow commercial banks to make loans, underwrite corporate debt, and take equity positions in corporate securities.

subsidiaries, albeit with certain restrictions on those activities. In addition, there is to be a clear separation of banking and securities activities. Banks, however, are currently prohibited from participating in insurance activities and from setting up holding companies.[2]

The structure of the Japanese banking system is made up of five types of specialized financial institutions: commercial banks, which are referred to as ordinary banks; long-term financial institutions; financial institutions for small business; financial institutions for agriculture, forestry, and fisheries; and public financial institutions, which include a postal savings system that is a major source of funds for the Japanese government. (See app. I.)

## Ordinary Banks

Ordinary banks in Japan include city banks, regional banks, and branches of foreign-owned banks. They offer a variety of products and services including deposit-taking, fund transfers, and short- to long-term loans, both domestically and abroad. Ordinary banks may also engage in certain government securities activities, including some securities underwriting, and the sale of corporate commercial paper (short-term unsecured funds) to institutional investors and financial institutions. Collectively, city banks are the largest private banks in Japan, whether measured by industry assets, loans, or deposits. They are also among the largest banks in the world. In December 1995, the six largest banks in the world, ranked by assets, were Japanese city banks.

## Long-Term Financial Institutions

Long-term financial institutions in Japan include long-term credit banks[3] and trust banks.[4] Historically, the Japanese government has established long-term financial institutions to provide long-term funds for agriculture and other industries. Until recently, they have been the only institutions permitted to raise long-term funds. Long-term credit banks may issue bank debentures with up to 5-year maturities, and trust banks may handle 5-year trust accounts. Since deregulation of the banking industry, however, ordinary banks are also making longer-term loans, and the historic differences between ordinary and long-term financial institutions have become less pronounced.

[2]Holding companies consist of a parent company and subsidiaries. In the United States, the dominant form of banking structure is the holding company.

[3]Japan has three long-term credit banks whose main business is long-term lending.

[4]Trust banks are long-term, specialized financial institutions that supply major corporations with funds that they mainly obtain from trusts.

## Financial Institutions for Small Business

The group of cooperative-based institutions known as financial institutions for small businesses serves the financial needs of their members, which include small- and medium-sized businesses and labor unions. Also included in this group are three central bodies serving the financial needs of their member cooperatives through such services as deposits and member loans, and a special corporation providing financial assistance for cooperative institutions.

## Financial Institutions for Agriculture, Forestry, and Fisheries

Institutions known as financial institutions for agriculture, forestry, and fisheries are made up of entities operating at three levels that serve local cooperatives. On the first level are cooperatives operating at the individual village, town, and city levels of government. These cooperatives in turn are members of a second level of prefectural-level credit federations serving clients within their prefectures.[5] At the third level is the Norinchukin Bank, which in several respects works as the central bank for agriculture, forestry, and fisheries.

## Public Financial Institutions

Japan has 11 wholly owned government financial institutions, of which 2 are banks and 9 are public corporations. These lending institutions, which are designed to supplement private-sector financing, are prohibited from competing with private banks. The institutions' funds come from loans from the government's Trust Fund Bureau, which in turn is largely financed by the government's Postal Savings System.

Although the Postal Savings System is not categorized as a bank, the magnitude of its financial resources gives it important financial significance in Japan. As of June 1995, the system held in excess of 200 trillion yen ($1.88 trillion) in deposits,[6] making it the largest financial institution in the world. The extensive system operates out of 24,000 Japanese post offices throughout the country.

As of early 1995, the 1,130 financial institutions conducting banking operations in Japan had approximately 1,148 trillion yen ($10.8 trillion) in industry assets, as shown in table 1.1. Ordinary banks alone accounted for over half, or 53 percent, of this total. Ten long-term financial institutions held the next largest share of banking assets, or 28 percent of the total. The most sizable share of banking assets controlled by cooperative-based

[5]Prefectures are Japan's political subdivisions. Each prefecture includes cities, townships, and villages.

[6]The U.S. dollar equivalent used in this report is based on the exchange rate of 106.61 yen per U.S. dollar published in the Apr. 25, 1996, Wall Street Journal.

institutions was held by financial institutions servicing primarily local communities, which had about 12 percent of total industry assets. As of February 1996, there were 90 foreign-owned bank branches in Japan, of which 16 were owned by U.S. firms, according to Japanese government officials. Appendix I provides greater detail on financial institutions in Japan.

**Table 1.1: Assets Held by Various Types of Japanese Financial Institutions (as of March 31, 1995)**

Yen in trillions
U.S. dollars in trillions

| Type of financial institution | Number | Percentage of industry deposits | Percentage of industry loans | Percentage of industry assets |
|---|---|---|---|---|
| **Ordinary banks** | | | | |
| City banks[a] | 11 | 1.1% | 38.2% | 28.5% |
| Regional banks | 129 | 25.8 | 26.2 | 23.0 |
| Foreign-owned bank branches | 90 | 0.4[b] | 1.1 | 2.0[a] |
| **Subtotal** | **230** | **57.3%** | **65.5%** | **53.5%** |
| **Long-term financial institutions** | | | | |
| Long-term credit banks | 3 | 7.5 | 7.4 | 6.4 |
| Traditional trust banks[c] | 7 | 12.1 | 8.7 | 21.9 |
| **Subtotal** | **10** | **19.6%** | **16.1%** | **28.3%** |
| **Other financial institutions** | | | | |
| Financial institutions for small business | 794 | 13.0 | 12.4 | 11.9 |
| Financial institutions for Agriculture, Forestry, and Fishery[d] | 48 | 8.8 | 3.6 | 3.8 |
| **Subtotal** | **842** | **21.8%** | **16.0%** | **15.7%** |
| Other Institutions[e] | 48 | 1.3 | 2.4 | 2.6 |
| **Total** | **1,130** | **100.0%** | **100.0%** | **100.0%[f]** |
| **Total yen (Total U.S. dollars)** | | **908.0 ($8.5)** | **701.6 ($6.6)** | **1,148.0 ($10.8)** |

(Table notes on next page)

[a]As of Apr. 1, 1996, the Mitsubishi Bank and the Bank of Tokyo merged, thereby reducing the number of city banks to 10.

[b]Data provided by Ministry of Finance on Feb. 22, 1996.

[c]There are 7 traditional trust banks in Japan and 16 others owned either by securities companies, financial institutions, or by foreign-owned banks.

[d]These institutions at the prefectural level provide deposit and lending services to about 4,000 local cooperatives.

[e]Includes the Shoko Chukin Bank (a special corporation for providing financial assistance to unions of small- and medium-sized enterprises) and 47 labor banks (banks promoting the welfare activities of organizations, such as labor unions, consumer cooperatives, and other labor bodies). Does not include special housing finance companies, known as jusen, nor does it include public financial institutions, such as the Postal Savings System.

[f]Amount does not add to 100 due to rounding.

Sources: Ministry of Finance, U.S. Department of the Treasury, and GAO analysis.

## History of Bank Regulation and Supervision in Japan

Historically, Japanese laws for bank regulation and supervision have been simple and limited in scope. The current Japanese bank regulatory and supervisory[7] structure is based on the 1981 Banking Law, which revised earlier banking laws. The 1981 Banking Law designated the Ministry of Finance (MOF) as solely responsible for authorizing and regulating the banking industry in Japan, and it maintained MOF's legal supervisory authority over banks. While the Bank of Japan (BOJ) lacks the regulatory authority of MOF, it carries out its safety and soundness responsibilities based on the authority granted by the 1942 Bank of Japan Law that BOJ maintain a safe and sound financial system.

Changes in the bank regulatory structure have resulted from essentially two stages of evolution in the Japanese banking industry, according to historical literature. The first stage spans the 1860s up to the early 1970s and includes the origin of the banking system as well as regulatory changes following World War II. The second stage, which dates from the mid-1970s to the present, was triggered by the first oil crisis in 1973.

[7]In our earlier reports on bank oversight in the Federal Republic of Germany, the United Kingdom, France, and Canada, we referred to supervision as (1) the conduct of examinations and off-site monitoring of financial institutions and (2) the taking of enforcement actions. According to MOF in Japan, the term supervisor is used only to describe government agencies. Since BOJ is not considered a government agency, it is not described as a supervisor in Japan, even though BOJ does perform some of the supervisory functions described above.

## Origin of the Banking System: 1860s to Early 1940s

The origins of the Japanese banking system can be traced to the Meiji restoration period in 1869, when money-transfer companies with many of the functions of modern banks were established in major cities. Soon after, Japan's first bank legislation (the National Bank Act) was enacted in 1872. This act created national banks, which were private banks issuing bank notes.

The central bank of Japan, BOJ, was founded in 1882, although it was later reorganized under the Bank of Japan Law of 1942. The original 1882 law gave BOJ the sole right to issue bank notes, taking away this responsibility from national banks, most of which disappeared soon after. The Banking Act of 1890 converted the remaining national banks and other private banks into ordinary banks.

In the same year, the Savings Bank Act of 1890 established savings banks, whose number then climbed steeply over the next decade to a peak of about 720 banks at the turn of the century. The 1915 amendment to the Savings Bank Act prohibited ordinary banks from engaging in similar savings activities until World War II, when the expansion of savings became a national policy goal. At that point, ordinary banks were allowed to conduct the same business activities as savings banks and, as a result, savings banks began to disappear.

## The 1927 Banking Law

In response to a nationwide financial panic in 1927, which heightened concerns about the stability of the Japanese banking industry, the government enacted the Banking Law of 1927. This law, which defined the structure and organization of Japan's banking system for the following 54 years, established a banking system focused on short-term lending.

## The 1942 Bank of Japan Law

Fundamental changes to BOJ's governance structure enacted in the 1942 Bank of Japan Law also made BOJ a means for conducting monetary policy. Prior to 1942, BOJ was a stock corporation that was directly accountable to its stockholders. However in light of wartime conditions, the 1942 law gave the government influence over the bank's operations. The government became the majority stockholder of the bank, while voting rights were denied to all stockholders.

The 1942 law, according to BOJ officials, provided BOJ a legal basis to foster and maintain a sound financial system. In particular, BOJ believes that the law provided a stronger statutory basis for conducting its safety and soundness examinations of client banks, which began in 1928. In addition to on-site examinations, BOJ relies on frequent contacts to ensure that financial institutions follow sound practices. BOJ carries out such examinations under the terms of contractual agreements made with all banks that have current accounts with BOJ. The roles and responsibilities of BOJ are currently under review by an ad hoc advisory committee to the Prime Minister with the aim of possibly making changes to recognize the changing economic and financial environment.

## Financial Specialization for Industrialization: Mid-1940s to Mid-1970s

Industrialization policies adopted in the mid-1940s to support the reconstruction of the postwar economy led Japan to develop a financial system characterized by a high degree of specialization. Pursuit of such broad goals as financial order and stable institutional earnings led the country to enact restrictions aimed at compartmentalizing banking activities. The national goal of protecting and strengthening Japanese securities companies, for example, led to the adoption of restrictions similar to those provided for in the Glass-Steagall Act, which separates the U.S. banking and securities industries.[8]

During the period from post-World War II to the 1970s, the "main bank system" (defined as a unique business relationship between banks and companies) played a key financial role in Japan's economic expansion. Under the main bank system, banks and companies were closely tied to each other through practices such as cross shareholdings and exchanging senior management personnel (usually from main banks to companies). As a result, companies enjoyed stable funding regardless of their health, while main banks maintained solid market share by supplying loans to companies. However, in subsequent years, factors such as an increase in the funding needs of companies due to economic expansion, the diversification of company funding sources due to financial liberalization, and the development of risk management based on portfolio diversification have diluted the relationship between banks and companies under the main bank system.

## Deregulation and Liberalization: Mid-1970s to Early 1980s

Japan was shaken from a period of stable economic growth by the first global oil crisis in 1973. The crisis, which initially disrupted the banking industry along with Japan's other economic sectors, eventually prompted the evolution of a more flexible, open, and international system. In turn,

[8]After the stock market crash of 1929, the U.S. Congress enacted the Banking Act of 1933, known as the Glass-Steagall Act, which forced the separation of the banking and securities businesses.

these changes have helped Japan emerge as a major global financial presence in the years since.

The shock to Japan's economic growth brought about by skyrocketing oil prices led, within a relatively brief period, to a doubling of Japan's public sector debt. To fund the public debt, the government issued an increasingly large volume of government bonds. In 1979, 6 years after the 1973 oil crisis, the government issued bonds worth a record total of 15.3 trillion yen ($70.5 billion).[9] However, as the deficit increased, financial institutions became less willing to help the government absorb the debt at above-market prices. Businesses also became less dependent on bank credit and services, such as bank loans. As a result of these developments, banks began to seek out new markets outside the traditional financial marketplace. To expand their market share and increase their competitiveness, banks and securities companies became advocates of financial liberalization, and banks began to diversify their loans and funding.

The resulting liberalization, which began in the late 1970s, has continued over the course of succeeding decades and has primarily affected three areas: interest rates, scope of business, and foreign exchange controls. The relaxation of restrictions on interest rates began in 1979, with the introduction of negotiable certificates-of-deposit, followed soon after by the emergence of money market certificates of deposit paying interest rates linked to money market accounts. By October 1994, interest rates had been liberalized on all time deposits except for checking accounts. Over the same period, the relaxation of lending regulations had enabled banks to increasingly set their short-term prime rates relative to the official discount rate.

The enactment of the 1980 Foreign Exchange Law eased the regulation of banks' foreign exchange activities, except during times of crisis. The 1986 opening of the Tokyo offshore market further liberalized Japanese banks' foreign exchange activities.

## The 1981 Banking Law

The primary law governing bank licensing, regulation, and supervision in Japan today is the 1981 Banking Law. The complete revision of the past law—the 1927 Banking Law—was prompted by the economic and financial changes that took place in Japan after the first oil crisis. The 1981 law was designed to maintain financial order and promote economic

[9]Exchange rate of 217 yen per U.S. dollar as of 1979.

development by ensuring sound and appropriate bank management, depositor protection, and facilitation of financial transactions. The law designated MOF as the governmental body responsible for authorizing and regulating banks.

The Banking Law of 1981, which totally revised Japanese banking law, provided banks with greater guidance in the conduct of banking business. The law reorganized the basic supervisory framework for Japanese banks without making major changes to MOF authority or responsibilities. In particular, the law provided more guidance on the conduct of banking business than was provided in the 1927 banking law, which up until that time had delineated the basic requirements for Japanese banks. Specific areas covered by the 1981 law include

- general requirements, such as banking licenses and capital requirements;
- permissible banking business;
- required reports;
- MOF supervision;
- MOF enforcement and penalty provisions;
- merger and transfer or acquisition of business;
- termination of business; and
- licenses for foreign bank branches.

## The 1992 Financial System Reform Law

The 1992 Financial System Reform Law was meant to be a comprehensive reform of Japan's financial and securities transaction systems corresponding to domestic and international developments. The law, which was enacted to expand the scope of permissible business activities, eliminated many differences among financial institutions, allowing them to compete in one another's sectors through subsidiaries, albeit with restrictions and firewalls. In particular, it allowed Japanese banks to conduct securities business through subsidiaries in which they have at least a 50-percent share. The law also provided MOF with the authority to establish standards to safeguard the soundness of banks and controls over transactions between banks and their subsidiaries.

## Proposed Changes to Bank Supervision: 1995 to Present

During 1995 and early 1996, Japanese banks and the banking system were confronted with several events that encouraged authorities to enhance the ability of the regulatory and supervisory process to deal with industry problems. These events included (1) a high number of nonperforming loans, (2) near depletion of the deposit insurance fund, and (3) large losses suffered by a major Japanese bank—the Daiwa Bank—due to improper trading by an employee.

The nonperforming loan problem originated in the economic boom of the late 1980s, when Japanese banks substantially increased their real-estate-related lending. After years of rapid appreciation, banks experienced rapid depreciation of asset prices. The value of nonperforming loans held by Japanese financial institutions as of March 1996, according to MOF, was 34.8 trillion yen ($326 billion), a condition considered unacceptable by the Japanese government. Nonperforming loans, which have caused several credit cooperatives and regional banks to fail, have also called into question the financial soundness of other financial institutions. As a result, Japanese officials recently undertook an analysis of the nonperforming loan problem, which has led to changes in the supervisory process.

The Japanese government's attention has also been directed toward devising supervisory responses to the problems of one particular type of institution, housing loan companies—called jusen—which have experienced heavy losses. Japan's eight jusen, which were established in the 1970s by Japanese banks and other financial institutions such as insurance companies and securities firms, have been especially hard hit in recent years with the steep decline of the Japanese real estate market. Although their original intended function was to supplement home mortgage lending, jusen became heavily involved in commercial real estate and housing development lending, which contributed to their losses when the Japanese real estate market declined sharply in early 1992.

As of March 1996, nonrecoverable problem loans of jusen were estimated at 6.3 trillion yen ($59 billion). In Japan, there was widespread concern that the failure of one or more jusen could spark public panic and lead to a chain reaction of withdrawals from other financial institutions, since many financial institutions had provided financing to jusen companies. To avert such a crisis, the Japanese government designed a plan aimed at rebuilding public confidence and protecting depositors, including establishing a jusen account in the Deposit Insurance Corporation (DIC) with a governmental contribution of 680 billion yen ($6.4 billion).

In the summer of 1995, Daiwa reported that a securities trader in its New York office had initiated improper trades over an 11-year period that had gone undetected. Reported losses totaled more than $1 billion. In October 1995, BOJ conducted a special on-site examination of Daiwa

Bank's—a major city bank—New York Branch to ascertain the facts at its New York Branch, as well as to evaluate Daiwa's overall risk management system. Also in October, banking regulators in the United States issued cease and desist orders against Daiwa requiring a virtual cessation of trading activities in the United States. In November 1995, MOF identified and took action intended to correct inappropriate management practices at Daiwa Bank. MOF also ordered Daiwa Bank to reduce its international operations, including the amount of loans outstanding, the amount of securities holdings, and market-related activities. MOF and BOJ also committed themselves to strengthening their oversight of overseas branches and offices of Japanese banks.

In the last 2 years alone, DIC has provided financial assistance totaling 643.3 billion yen ($6 billion) to assist in the resolution of troubled credit cooperatives and regional banks, which has come close to depleting the deposit insurance fund. At the time of our visit in September 1995, a DIC senior official told us that the insurance fund could be depleted if current resolution plans were implemented to handle the remaining failing financial institutions. In June 1996, the Diet—the Japanese Parliament—passed three financial bills to facilitate the resolution of failed or failing institutions and to increase deposit insurance premiums.

## Overview of Participants in Bank Licensing, Regulation, and Supervision

Bank licensing and regulation is the responsibility of MOF. However, both MOF and BOJ have responsibilities for ensuring the safety and soundness of the banking system. The two agencies' responsibilities do not typically extend to credit cooperatives, which are generally supervised at the local government level.

### MOF Responsibilities

MOF, the government's central agency with jurisdiction over the banking industry, is responsible for bank licensing, regulatory compliance, guidance, and supervision. Originally created in 1869, its legal authority to supervise banks was first granted in 1890, and again defined in the 1949 Ministry of Finance Establishment Law, which was enacted during a major government reorganization after World War II. The statute used by MOF to carry out its current responsibilities is the 1981 Banking Law.

Bank supervision is just one of MOF's broad responsibilities. Among other things, MOF is also responsible for overall administration of the government's fiscal and related monetary functions, including budget formulation and execution, and tax assessment and collection. The formulation, execution, and coordination of the national budget allows MOF to play a pivotal role within the national government. This currently includes approving BOJ's budget.

## Organization of MOF

MOF is headed by the Minister of Finance, a cabinet member appointed by the Prime Minister. The ministry is 1 of 12 ministries reporting to the Prime Minister. MOF's organizational structure consists of one secretariat and seven bureaus.[10] The Banking Bureau is the main bureau responsible for regulatory guidance and supervision of banks, but it shares these responsibilities with MOF's Secretariat and the International Finance Bureau. Generally speaking, domestic banking issues are under the auspices of the Banking Bureau, and international banking issues are under the International Finance Bureau.

The Banking Bureau consists of five divisions and one department. Three divisions—the Commercial Banks Division, the Special Banks Division, and the Small Banks Division—share responsibilities for providing supervision and regulatory guidance to banks. As of September 1995, according to MOF, the Banking Bureau had a staff of 130.

The Banking Bureau also works with MOF Securities Bureau in supervising bank securities activities. The Securities Bureau provides guidance and supervision to a broad range of participants in the securities market, including financial institutions engaged in securities business. As of September 1995, according to MOF, the Securities Bureau had a staff of 90.

The International Finance Bureau oversees the foreign activities of Japanese financial institutions. It also handles international finance-related affairs, including those involving the international currency system, the yen's internationalization, balance of payments, and foreign exchange control; and it coordinates activities with its foreign counterparts. As of September 1995, according to MOF, the International Finance Bureau had a staff of 114.

Prior to 1992, bank inspections were conducted separately by the individual bureaus. Since then, the MOF Secretariat's Financial Inspection Department has been responsible for conducting all inspections. As of September 1995, according to MOF, the Financial Inspection Department had a staff of 112, of which 80 to 90 were assigned to inspection teams. An additional 307 inspectors work in local branch offices, primarily inspecting

[10]The seven bureaus are: Budget, Tax, Customs and Tariff, Financial, Securities, Banking, and International Finance.

shinkin banks.[11] However, when needed, they conduct joint inspections of regional banks with inspectors of the Financial Inspection Department. In fiscal year[12] 1996, there is to be an increase of 20 inspectors in the Financial Inspection Department and an increase of 46 inspectors in local branch offices, according to MOF officials.

To strengthen oversight of the securities market, MOF established the Securities and Exchange Surveillance Commission (SESC) as a separate agency in July 1992. SESC is authorized to inspect securities companies, conduct surveillance of market transactions, investigate suspected criminal offenses, and propose policy changes to MOF. If illegal activities are discovered, SESC may recommend disciplinary actions to MOF.

SESC has the authority to obtain a court warrant, and it can bring charges against a suspect through the Public Prosecutor's Office if it believes a crime has been committed. SESC has a chairman and two commissioners that MOF appoints with consent of the Diet—the Japanese Parliament. They have equal power and serve 3-year terms. SESC has an Executive Bureau consisting of 2 divisions and 11 regional offices, with a staff of 206 employees as of February 1996.

## BOJ Responsibilities

BOJ first started examining banks in 1928, following financial crises caused by the recession after World War I and the Kanto Earthquake of 1923. All institutions having current accounts with BOJ are subject to its examinations in accordance with contractual agreements with BOJ. They include city banks, regional banks, trust banks, long-term credit banks, most shinkin banks, overseas branches and affiliates, branches of foreign-owned banks, and some securities companies.

BOJ has two principal missions: (1) stabilizing the value of money and (2) fostering a safe and sound credit and finance system. To keep the currency stable, BOJ:

- influences the money supply and money markets;
- implements monetary policy and controls credit by setting the official discount rate,[13] directly selling and buying securities and bills in the financial markets, and imposing the reserve deposit requirement; and

[11] Shinkin banks are cooperatives serving the financial needs of small companies and local residents.

[12] The Banking Law of 1981 required banks to adopt an annual business year which runs from April 1 to March 31.

[13] The interest rate charged by BOJ when extending loans to banks.

- intervenes—as the agent of the Finance Minister—in the foreign exchange market to stabilize the yen's value against foreign currencies.

To foster a safe and sound financial system, BOJ:

- facilitates payments and settlements by issuing bank notes and providing funds transfer services among bank accounts;
- monitors financial institutions and markets through regular contacts, on-site examinations, and the provision of advice; and
- acts as lender of last resort.

Legally, BOJ is a special corporation in a unique category. While BOJ's budget is currently approved by MOF, BOJ is considered to be neither a government entity, nor a private institution within the structure of the Japanese financial system. Although it coordinates some activities with MOF, BOJ functions as an independent organization separate from MOF, according to MOF officials. In March 1996, BOJ, whose assets totaled 57.7 trillion yen ($541 billion), had responsibilities for 700 financial institutions, as shown in table 1.2.

**Table 1.2: Financial Institutions Examined by the Bank of Japan (as of March 31, 1996)**

Japanese yen in billions
U.S. dollars in billions

| Type of financial institution | Number | Assets: Yen | Assets: U.S. dollars |
|---|---|---|---|
| **Banks** | | | |
| City banks, long-term credit banks, and trust banks | 43 | 477,975 | $4,484 |
| Regional banks | 129 | 267,775 | 2,512 |
| Shinkin banks | 358 | 106,679 | 1,000 |
| **Total banks** | **530** | **852,429** | **$7,997** |
| Other financial institutions[a] | 170 | N/A | N/A |
| **Total** | **700** | **1,704,858** | **$15,993** |

N/A: Data was not provided by BOJ.

[a]Includes branches of foreign-owned banks and foreign securities companies.

Source: BOJ.

## Organization of BOJ

BOJ is headed by its Governor. The Governor is appointed by the Cabinet for a term of 5-years and may be reappointed. Historically, BOJ governors have alternated between individuals with MOF or BOJ backgrounds.

The Governor is the link between the bank's executive board and BOJ's Policy Board. The Policy Board, which is BOJ's highest decisionmaking body, is the sole decisionmaking body for monetary policy, including decisions on the official discount rate. The Policy Board was established in 1949 by amendments to the 1942 Bank of Japan Law. The amendments were in response to a desire to modernize the Japanese monetary and economic system and to enhance BOJ's independence.

Board members include BOJ's Governor and representatives from MOF, the Economic Planning Agency, and four individuals with experience in and knowledge of banking, commerce, manufacturing, or agriculture. Government representatives from MOF and the Economic Planning Agency are nonvoting members. The four "knowledgeable and experienced" members, who are appointed by the cabinet with approval from the Diet, serve renewable 4-year terms without restrictions.

BOJ has 13 departments,[14] a Secretariat of the Policy Board, the Governor's office, and an Institute for Monetary and Economic Studies. In addition to its 33 branches and 12 local offices in Japan, BOJ has overseas offices in New York; Washington, D.C.; London; Paris; Frankfurt; and Hong Kong. Bank monitoring is handled by the Bank Supervision, Financial and Payment System, and Credit and Market Management departments, according to BOJ.

Within BOJ, the Bank Supervision Department[15] is primarily responsible for monitoring financial institutions. Headed by a director, it is divided into two divisions: the Bank Supervision Division and the Data Analysis Division. The former division manages on-site examinations of banks and securities companies through four examination groups. The latter division compiles and analyzes various statistics regarding financial institutions. As

[14]Individual BOJ departments are: policy planning, financial and payment system, credit and market management, bank supervision, international, operations, issue, budget and management, personnel, administration, information system services, research and statistics, and public relations.

[15]In Japanese, this department is known as "kosa." We were told that the English interpretation may be either examinations or supervision. BOJ interprets kosa in its broad sense and thus believes the English translation is supervision. However, MOF interprets kosa strictly, as only examinations, and believes the department should be known, in English, as the Examinations Department, because on-site monitoring on a statutory basis is called "kensa" (Inspection) and on-site monitoring not based on law is called "kosa."

of October 1995, according to BOJ, the Bank Supervision Department had an examination staff of between 100 and 120.

BOJ's Financial and Payment System Department's role is to maintain and foster a safe and sound credit system. It sets out the basic macro-prudential policies including working out the disposition of failed banks. BOJ's Credit and Market Management Department oversees the activities of domestic and overseas financial institutions. It also monitors money and capital markets, administers BOJ's money operations, and conducts off-site monitoring of financial institutions' activities in such broad areas as day-to-day cash positions and long-term management strategy.

### Prefectural or Local Governments

Each of the 47 prefectural governments authorizes and supervises credit cooperatives in its own prefecture. However, credit cooperatives must obtain MOF's authorization if their activities go beyond the prefecture's geographical boundaries. Although MOF and BOJ do not have responsibility for supervising credit cooperatives, such institutions are required to be insured by the deposit insurance system.

If a request is received from the prefectural governor, MOF may inspect a credit cooperative. The recent failure of several credit cooperatives has prompted the government to consider adopting measures to ensure close cooperation between national and local supervisory authorities. Measures under consideration are intended to provide local authorities with timely guidance, clarify conditions warranting MOF inspections, establish regular meetings, and provide for joint inspections by MOF staff and local authorities.

As of April 1995, according to MOF, Japan's prefectural governments had a supervisory and inspection staff of 338, of which 264 were inspectors. According to Japanese banking industry representatives, prefectural inspections are conducted by an insufficient number of inspectors, who must also carry out various other noninspection duties.

## Objectives, Scope, and Methodology

At the request of Congressman Charles E. Schumer, we examined various aspects of the bank regulatory and supervisory structure of a number of countries. Specifically, our objectives were to describe how (1) Japanese bank regulation and supervision is organized; (2) Japan's banking oversight structure functions, particularly with respect to bank licensing, regulation, and supervision; (3) banks are monitored by their supervisors; and (4) participants handle other financial system responsibilities.[16] This report focuses more attention on describing the legal structure within which Japanese banking oversight has been conducted and less attention on the methods used to carry out that oversight.

To address these objectives, we interviewed senior officials from MOF and BOJ, both in Japan and in the United States. They provided us with documents and information, including annual reports, tables of statistics, translations and analysis of selected banking legislation, organizational summaries and charts, reports on the Japanese banking structure, lists of reports banks must submit, and other documents to illustrate the current regulatory and supervisory environment.

In addition to those interviews, we met with senior representatives of Japan's DIC; the Federation of Bankers Associations of Japan (Zenginkyo); the Japanese Institute of Certified Public Accountants (JICPA); senior executives at six Japanese banks representing a cross-section of Japan's specialized financial structure; senior executives from a public accounting firm; experts on the Japanese banking structure; and U.S. agencies with regulatory responsibilities over foreign banks: Department of the Treasury, the Federal Reserve, and the Office of the Comptroller of the Currency.

Finally, we relied on translations of the 1981 Banking Law, the law that relates most directly to bank regulation and supervision in Japan, and the 1942 Bank of Japan Law, which gave Japan's central bank its oversight authority. We also relied on translated summaries of three bills passed in June 1996 by the Diet, which significantly changed Japan's regulatory process and the disposition of failed and failing institutions.[17] This report does not include an evaluation of the efficiency or effectiveness of the Japanese bank regulatory structure.

[16]We completed similar studies on the bank regulatory and supervisory structures in the Federal Republic of Germany, the United Kingdom, France, and Canada. For information on these reports, see Bank Regulatory Structure: The United Kingdom (GAO/GGD-95-38, Dec. 29, 1994); Bank Regulatory Structure: The Federal Republic of Germany (GAO/GGD-94-134BR, May 9, 1994); Bank Regulatory Structure: France (GAO/GGD-95-152, Aug. 31, 1995); and Bank Regulatory Structure: Canada (GAO/GGD-95-223, Sept. 28, 1995). We also issued a capping report drawing lessons for the U.S. regulatory system from the foreign countries, Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure, (GAO/GGD-97-23).

[17]The three acts are (1) Act Ensuring Sound Management of Financial Institutions, (2) Act to Improve Reorganization and Bankruptcy Procedures for Financial Institutions, and (3) Amendment to the Deposit Insurance Act.

We conducted our review, which included one visit to Japan, from June 1995 through July 1996 in accordance with generally accepted government auditing standards.

We gave senior officials and executives of MOF, BOJ, DIC, JICPA, the Federation of Bankers Associations of Japan, and the three city banks we visited a draft of this report for their comments. They provided comments that were incorporated in the report where appropriate.

# Licensing, Regulation, and Supervision of Banks

MOF, as supervisor and regulator, licenses banks, regulates most aspects of Japan's banking operations, and monitors any developments in bank operations that may adversely affect the banking system, in accordance with the 1981 Banking Law. In its role as Japan's central bank, BOJ is to ensure the safety and soundness of the financial system through its oversight of financial institutions. Changes to oversight are being proposed due to the mounting levels of nonperforming loans. These changes are intended to make the supervisory system more transparent and increase the accountability of individual banks.

## MOF Licenses Banks

The 1981 Banking Law requires each bank to obtain a license from MOF. The law defines "banking" as a business that accepts deposits and makes loans or conducts exchange transactions. However, a license is also required of institutions that accept deposits or installment savings regardless of whether they lend money or discount bills at the same time.

In reaching licensing decisions, according to the 1981 law, MOF is to consider the applicant's:

- financial capability to conduct banking soundly, and efficiently, and the potential income and expenses of its planned business operations;
- competence and experience to conduct banking appropriately, fairly and efficiently; and its credibility; and
- reasons for entering the banking business and anticipated effects on the existing financial system (e.g., supply and demand of funds, the operations of existing banks and other financial institutions, and the local economy).

After applying the above criteria, MOF may impose conditions on a license to the extent it believes the public interest could be affected. Banks must obtain permission from MOF to establish a head office, branch, or subbranch and to relocate, change the status of, or close any such offices. However, Japanese banks are free of geographical restrictions on where their branches can be located.

Foreign-owned banks wishing to establish a branch or agency in Japan are required to obtain a license from MOF. Separate licenses are required for each branch. Concurrently, according to BOJ officials, BOJ determines whether to allow the bank to open an account with BOJ. For the fiscal year ending March 31, 1995, MOF reviewed four license applications for foreign-owned bank branches and approved all four. These banks also established accounts with BOJ.

In addition to complying with Japanese laws, branches of foreign-owned banks in Japan must conduct their banking business in accordance with the banking laws of their home country. They are to be supervised on a consolidated basis by the home country's authorities who have primary responsibility for the operation of the parent bank, according to MOF. Both BOJ and MOF examine or inspect branches of foreign-owned banks in Japan.

## Licensed Banks Must Meet Capitalization Requirements

A licensed bank is also required to be incorporated and properly capitalized. The 1981 Banking Law established a minimum capitalization level for banks established in Japan of at least 1 billion yen ($9.4 million). This threshold has since been raised to 2 billion yen ($18.8 million). According to MOF officials, banks are subject to two target capital ratio standards. Domestic banks with no overseas establishments are subject to a minimum 4-percent capital adequacy ratio. Banks maintaining overseas branches or subsidiaries are subject to an international minimum risk-based capital standard of 8 percent agreed to by the Basle Committee.[1] MOF does not apply these standards to Japanese branches of foreign-owned banks in Japan because they are to be supervised on a consolidated basis by their home countries.

# Regulatory Responsibility Belongs to MOF

MOF has broad responsibilities for formulating and carrying out policies relating to banks. Banking, securities, and other laws establish MOF as the primary, if not sole, authority with responsibility for financial regulation in Japan. Under these laws, the agency has responsibility for regulating most aspects of Japan's banking operations, including sources and uses of funds, terms on which banks can borrow and lend, activities in which they may engage, branching and merger activities, and investment decisions regarding other companies' stockholdings.

In Japan, legislative proposals are generally drafted by individual government ministries and are submitted through the cabinet to the Diet. Japanese laws typically give government ministries considerable latitude in their interpretation and implementation. Laws are supplemented by two types of governmental ordinances: cabinet and ministerial. Unlike laws,

[1]The Basle Committee, whose primary purpose under the auspices of the Bank for International Settlements is addressing bank supervision-related issues, is made up of the banking supervisors and central banks of the Group of Ten countries and Luxembourg: Germany, Belgium, Canada, the United States, France, the United Kingdom, Italy, Japan, the Netherlands, Sweden, and Switzerland. For further information on the Basle Committee, see International Banking: Strengthening the Framework for Supervising International Banks (GAO/GGD-94-68, Mar. 21, 1994). For additional information on risk-based capital adequacy standards, see International Banking: Implementation of Risk-Based Capital Adequacy Standards (GAO/NSIAD-91-80, Jan. 25, 1991).

ordinances do not need to be passed by the Diet, so they are used for adjustments required in response to social changes. For example, a bank's minimum capitalization requirement is set by cabinet ordinance and its business hours are set by ministerial ordinance. Bank activities are also subject to circulars and administrative notices issued by MOF. Circulars are used to explain laws and ordinances and to give guidance on their practical application. For example, MOF circulars established standards for judging institutional soundness, such as liquidity ratios. Similar circulars established uniform standards for bank accounting and reports.

MOF typically sets policy by consensus—a process that involves the input of many parties, such as other governmental agencies, industry groups, academic groups, and BOJ. In Japan, offices, ministries, and government agencies may establish councils, or government advisory bodies, for the purpose of studying and discussing important issues or to provide administrative reviews. These councils are often responsible for initial discussions of major regulatory issues which eventually result in ministerial ordinances or legislation. The Financial System Research Council (FSRC), a senior-level consultive body to the Minister of Finance, is one such advisory body. The current FSRC, which is mandated by law, was originally created in 1956 to study the monetary system and make recommendations to the Minister. It now has 17 members[2] who are chosen from a broad range of experiences and expertise, including the financial, industrial, and academic community to provide a broad-based forum on policy issues and to conduct studies of the Japanese financial system. The Banking Bureau serves as FSRC's Secretariat, and it provides FSRC with both information and resources, according to MOF officials.

Over the years, FSRC has served as a forum for discussing and analyzing proposed changes in Japan's banking legislation. Its findings provided a basis for the 1981 Banking Law. In 1992, changes it recommended for Japan's compartmentalized financial system similarly became the basis for the Financial System Reform Law. More recently, in a report issued to the Minister of Finance in December 1995, FSRC proposed ways to restore Japan's nearly depleted deposit insurance fund, promptly dispose of nonperforming loans, ensure sound management of financial institutions, and dispose of failing financial institutions.

[2]According to Japanese officials, by law FSRC may have up to 20 members.

## Banks Influence Changes in Policy Through Various Means

In addition to working with FSRC, banks also influence changes in policy through their bankers' associations. Japanese banks nationwide are organized into regional associations whose primary function is to operate a clearinghouse to clear checks and bills for participating institutions. For example, the Tokyo Bankers Association operates the Zengin data telecommunication system, which is a domestic funds transfer system operated on a national scale. The associations also play an important role in communicating the industry's views to governmental agencies.

Another group with a key role in communicating the banking industry's views to the government is the Federation of Bankers Associations of Japan, or Zenginkyo. The Zenginkyo is a consortium of regional bankers associations that acts as a representative for banks throughout Japan. Because the Zenginkyo represents a broad constituency, it attempts to reflect the views of its broad membership, not the particular interests of individual subgroups. This broad constituency has led such subgroups as city banks to turn to other types of affiliations to further their specific interests.

## BOJ as the Bankers' Bank

In its role as Japan's bankers' bank, BOJ maintains current accounts for its client institutions. Funds held in current accounts are used to clear accounts, make remittances among districts, and settle other transactions among financial institutions.

BOJ also discounts bills, a form of credit provision. In addition, it buys from or sells to current account holders various bills and bonds, including long-term government bonds, and government short-term bills.

## Ensuring Safety and Soundness of Banks

In ensuring the safety and soundness of the financial system, both MOF and BOJ monitor banks through on-site monitoring, reviewing financial reports, and frequent contacts. When corrective action is necessary, MOF and BOJ typically rely on guidance or advice, a form of moral suasion, as their main means of enforcement. MOF provides supervisory direction and guidance by issuing administrative guidelines and notifications, which function as important components of Japan's banking regulatory system.

### On-Site Monitoring

MOF designates its on-site monitoring of banks as inspections based on its statutory authority, while BOJ calls its on-site monitoring examinations and conducts them under its contractual agreements with client banks. Despite the different terminology, actual on-site monitoring activities are somewhat similar, although their monitoring objectives are different.

In conducting its supervisory responsibilities, MOF is required to

- ensure that each bank subject to MOF's supervision operates within limits set by both Japanese banking legislation and the bank's own internal policies, and
- monitor any developments in bank operations that may have an adverse effect on the integrity of the bank involved or the banking system as a whole.

BOJ also requires banks to undergo periodic on-site examinations and to submit necessary information upon request, which allow BOJ to obtain an understanding of the bank's operations to fulfill its responsibility to maintain and foster the safety and soundness of the financial system. BOJ carries out its bank oversight primarily through its Bank Supervision Department.

Both MOF and BOJ may inspect or examine banks at any time and with any frequency, although each typically examines the average bank once every 2 to 3 years. Officials from the agencies told us that they coordinate their on-site monitoring with each other so that banks are generally examined annually by either MOF or BOJ. For the fiscal year ending March 31, 1995, according to MOF, a total of 485 Japanese banks were inspected or examined by either MOF or BOJ, as shown in table 2.1.

**Table 2.1: Number of Banks Inspected or Examined by Both MOF and BOJ, (Fiscal Years 1992 to 1995)**

| Type of banks | Total number of banks[a] | 1992 | | 1993 | | 1994 | | 1995 | |
|---|---|---|---|---|---|---|---|---|---|
| | | MOF | BOJ | MOF | BOJ | MOF | BOJ | MOF | BOJ |
| City banks, trust banks, long-term credit banks | 21[b] | 4 | 9 | 4 | 4 | 9 | 5 | 9 | 7 |
| Regional banks | 129 | 41 | 51 | 45 | 47 | 46 | 47 | 54 4 | 1 |
| Shinkin banks | 421 | 190 | 150 | 198 | 155 | 213 | 157 | 212 | 162 |

[a]As of Mar. 31, 1995.

[b]As of Apr. 1, 1996, the Mitsubishi Bank and the Bank of Tokyo merged thereby reducing to 20 the number of city banks, long-term credit banks, and trust banks.

Source: MOF and BOJ.

## MOF and BOJ Rely on Guidance and Advice

Actions that MOF and BOJ take against banks subject to their jurisdiction are typically through guidance or advice. MOF relies on administrative guidance to influence actions taken by banks it supervises. BOJ lacks such authority because it is not a regulatory authority. Instead, BOJ provides advice, which according to government and bank officials banks generally follow.

### MOF's Legal Enforcement Authority

Under the 1981 Banking Law, MOF can suspend a bank's business activities or revoke its license if the bank violates a law, its article of incorporation, MOF's enforcement actions, or if its activities undermine the public interest. The Banking Law also provides penalties for law violations, including fines and imprisonment. For example, individuals can be liable for imprisonment or fines of up to 3 million yen ($28,140) if they conduct banking activities without obtaining a license from MOF. Individuals are also liable for fines of up to 500,000 yen ($4,690) if they do not meet reporting requirements, or if they refuse, obstruct, or circumvent an examination. However according to MOF officials, there have been no cases in which MOF has used fines or imprisonment.

According to bank officials, MOF has the authority to correct the operations of a troubled financial institution. MOF can also remove bank managers from their positions and order the restructuring of a bank's management or suspension of its business if violations of laws and regulations are found. Although MOF has such legal enforcement authority, until recently it has not been used. Instead, banking industry representatives said, MOF prefers to rely on administrative guidance as its primary means of enforcement. MOF also provides supervisory direction and guidance through the frequent contacts it has with banks.

### MOF's Administrative Guidance

MOF's administrative guidance basically involves the agency interpreting existing laws and regulations and providing these interpretations to banks. This guidance can take the form of oral guidance or written circulars or notices. MOF sees this flexibility as one advantage of administrative guidance. MOF officials also described such forms of guidance as preferable to initiating legal proceedings in the Japanese court system, which can be a lengthy process.

Although administrative guidance is not legally enforceable, government officials and bankers said that banks are expected to act on it and they typically do. According to MOF, banks are allowed to interpret administrative guidelines within reason. When conflicts arise, differences are resolved through discussions with bank officials and MOF. Circulars or notices may also be used to clarify or explain terms and concepts.

The Japanese government recently adopted new legislation to ensure that governmental administrative actions are more transparent. In October 1994, the Administrative Procedures Law was passed to establish standards for fairness and openness in the administrative process. The law, among other things, requires a clear explanation of administrative decisions, and it requires that guidelines for regulated institutions, which include banks, be standardized. It also confirms that compliance with administrative guidance is strictly voluntary. Under new provisions of this law, MOF is to issue administrative guidance in writing, if required by the affected party. According to MOF, the number of cases in which it gave, what it termed concrete guidance on business-improvement measures to major banks totaled 178 in 1992, 129 in 1993, and 127 in 1994.

### BOJ's Safety and Soundness Advice

In order to fulfill its mission of maintaining price stability and fostering a safe and sound financial system, BOJ said it extends safety and soundness advice to solve the prudential problems of each examined bank, if necessary. In this regard, BOJ's advice is different from law-based action taken by governmental agencies, such as MOF. BOJ's authority comes from its contractual agreements with client banks. Advice to banks may cover such areas as operational safety and soundness and risk concentration.

## Increases in Nonperforming Loans and Financial Institution Failures Caused Japan to Review Role of Banking Authorities

The high number of nonperforming loans and the near depletion of the deposit insurance fund in 1995 led Japanese officials to conclude that changes were needed in the supervisory process. A committee of FSRC, in September 1995, after almost 3 months of deliberation, proposed a number of supervisory changes.

Interim and final reports by FSRC[3] observed that supervisory authorities should have responded to the loan problem by constructing a financial system in which market mechanisms and the principle of self-responsibility of both banks and depositors would come fully into play. Specifically, the reports proposed strengthening supervisory oversight and suggested that supervisory authorities:

[3] Interim Report by the Financial System Stabilization Committee of the FSRC, Sept. 27, 1995 and The Summary of the Final Report of the Financial System Stabilization Committee of the FSRC, Dec. 22, 1995.

- take action in a timely manner,
- inspect financial institutions more frequently,
- increase the number and quality of inspection and monitoring staff,
- introduce tools to promote the prompt correction of financial institutions' mismanagement,
- promote more disclosure of nonperforming loans, and
- implement a prompt disposal procedure for failing or failed financial institutions.

In addition, in late December 1995, MOF announced plans intended to reform Japan's bank supervisory system.[4] MOF was to (1) issue new guidance for banks regarding internal controls and risk management, (2) increase its staff of bank inspectors from 420 to 490, (3) make use of external audits and encourage external audits in overseas branches, and (4) promote a closer exchange of information with other supervisory authorities abroad. Under the new supervisory system, banks will be encouraged to

- improve their own internal control and risk management systems in accordance with new MOF guidelines,
- make greater use of certified public accountants (CPA) to conduct external audits,
- provide timely notification of wrongdoing, and
- ensure their business operations comply with requirements through check and balance functions.

Collectively, these measures are intended to make the supervisory system more transparent and increase the accountability of individual banks.

Some supervisory reform measures are already under way, including the passage of three reform bills in June 1996. In addition to increasing the frequency and scope of inspections of overseas branches and subsidiaries in Asia, MOF has issued an inspection checklist on overseas offices. BOJ has initiated special examinations of the New York branches of some major Japanese banks. In addition, BOJ is expanding the scope of its examinations of overseas branches to (1) enhance examinations, (2) upgrade examination skills, and (3) increase cooperation with other central banks.

[4] Measures to Improve Banking Inspection and Supervision by the Ministry of Finance, Dec. 26, 1995.

# Safety and Soundness Information Is Obtained Through On-Site and Off-Site Monitoring

MOF and BOJ obtain information needed to fulfill their safety and soundness responsibilities primarily through on-site and off-site monitoring. MOF and BOJ also rely on required and ad hoc reports from banks, frequent meetings with banks, and their own research and analysis. The two agencies cooperate with each other, as necessary, in order to achieve their distinct missions. Neither agency has typically used audit information developed by external, statutory,[1] or internal auditors.

## On-Site Monitoring Conducted Independently

Although the scope of MOF's and BOJ's on-site bank monitoring, which MOF calls inspections and BOJ calls examinations, is similar, the two agencies' actual on-site monitoring is carried out largely independently of one another. Recently, due to financial liberalization, both MOF and BOJ have placed greater emphasis on their on-site monitoring of risk management. Although there is no legal requirement governing the frequency of bank examinations, MOF and BOJ coordinate their monitoring efforts to ensure that most banks are monitored annually. This coordination allows MOF and BOJ to alternate their on-site monitoring of the approximately 700 banks[2] subject to their inspections or examinations.

## MOF Inspections

MOF conducts an on-site inspection of the banks it supervises about once every 2 to 3 years. The average duration of inspections and the size of inspection teams varies due to several factors, including the size of the bank and its operational record. Inspections of city banks take about 6 weeks and involve about 10 inspectors. For regional banks, inspections last 4 to 5 weeks and typically require five inspectors. Inspections of shinkin banks, which are conducted by one of MOF's regional bureaus, take about 2 weeks and involve four to five inspectors. Inspection teams are led by a chief inspector, and team members are responsible for different components of the inspection.

MOF conducts two types of on-site inspections—comprehensive inspections and inspections focusing on specific aspects of a bank's operation, such as credit-risk or market-risk management. Comprehensive inspections, which are the most common type of inspection, are

[1]The Japanese Commercial Code was promulgated in 1890 to designate rules for conducting business. It requires banks with paid-in-capital of at least 500 million yen ($4.7 million) or total liabilities of 20 billion yen ($18 million) or more to have their financial statements audited by independent auditors and to appoint at least two auditors, known as statutory auditors.

[2]This number includes 93 foreign-owned bank branches. MOF also inspects other financial institutions, such as insurance companies, in addition to banks. In all, MOF has inspection authority for more than 3,000 financial institutions.

unannounced. Nonetheless, banking officials said the timing of past visits tends to indicate when they are likely to receive their next inspection. Comprehensive inspections assess all major elements of a bank's activities, including regulatory compliance, assets and liabilities, profits and losses, general business operations, and such physical items as cash on hand.

As part of the inspection process, MOF inspectors check a bank's overall risk management policies and procedures. They also check the bank's compliance with regulations related to financial soundness, such as those dealing with its minimum capital ratio requirements and large loan exposures to a single party. MOF inspectors also review the bank's compliance with other regulations, for instance, those specific to the risk management of a particular business activity or product.

Prior to conducting a comprehensive inspection, MOF inspectors review bank documents to help focus their on-site efforts. Following this review, they initiate the inspection, beginning with physical items, at one branch or simultaneously at several branches. Comprehensive inspections, which usually involve verification of records, typically involve inspectors inspecting cash, securities, notes, legal documents, deposits, and loans. At any time during the inspection, MOF inspectors can request additional information.

Inspectors classify assets according to their likelihood of repayment. Such classifications, combined with an analysis of the bank's capital, indicate how deposited money is used and the extent of credit risk present, according to MOF. Assets are classified into four categories:
(1) unmarked—when the loan is considered sound,
(2) substandard—when the loan carries above average risk,
(3) doubtful—when full payment is considered doubtful and some loss is expected, and
(4) loss—when the loan is considered unrecoverable.

During on-site inspections, inspectors select loans to ensure a coverage ratio of at least 50 percent of a bank's entire loan portfolio, according to MOF. Standards call for the selection of loans with large exposures over a certain amount, loans overdue beyond a certain period, and loans to companies having financial problems at the time of inspection. MOF inspectors also conduct financial analyses and interview bank management and key personnel to better understand bank policies and other matters.

Since 1987, MOF has used a rating system similar to the U.S. CAMEL rating system, which bases ratings on five factors: capital, assets, management, earnings, and liquidity. In June 1996, MOF issued guidelines for banks' risk management of market-related risks, which are based on guidelines established by the Basle Committee.

## BOJ Examinations

BOJ examiners conduct on-site examinations of banks subject to the agency's examinations about every 2 to 3 years, although the frequency of examinations can vary depending on bank size, business conditions, and MOF's inspection schedule. BOJ examiners provide approximately 2 months advance notice of an on-site examination and typically request documents and other information in advance of their visit. Requested information commonly includes, for example, loan and deposit balances for each branch, data on client bankruptcies, and internal investment policies. BOJ examiners request additional information from banks with international operations on such matters as the condition of foreign real estate loans and earnings from their international banking activities.

Since BOJ obtains bank information in advance of visits, its on-site examinations generally require less time than do MOF inspections, according to bank officials. Examinations of city banks typically take 3 to 4 weeks for one or two senior examiners, which BOJ calls chief supervisors, and ten examiners. In comparison, regional bank examinations take 2 to 3 weeks for one or two chief supervisors and four or five examiners. For shinkin banks, comparable examinations take 1 to 2 weeks for a chief supervisor and three examiners.

As part of the examination process, BOJ examiners place their main emphasis on checking a bank's overall risk management, including policies and procedures. Examiners use a check list for risk management developed in 1987 and later completely revised in 1996 to reflect the changing financial environment. They also check the bank's compliance with MOF regulations related to financial soundness, such as those dealing with its minimum capital ratio requirements and large loan exposures to a single party. As for other regulations, such as those on business area or product, BOJ reviews them from a risk management viewpoint rather than from a compliance perspective.

BOJ's examination process has two key components: (1) a preexamination analysis and (2) fieldwork. The initial preexamination analysis is used to identify a bank's primary activities and to focus on potential problem areas. As part of this analysis, examiners look at bank operations from a risk management perspective, including lending, funding, internal controls, and international activities. During the fieldwork component, which consists of the actual on-site examination, examiners meet with the bank's senior executives to review policies and discuss problems. They assess asset quality by (1) evaluating individual loans, (2) holding discussions with loan officers, and (3) reviewing the credit files of borrowers and other related documents. BOJ officials told us that examiners typically evaluate about one-half of a bank's total loans.

BOJ selects bank loans for review by categorizing them into one of three categories: (1) insider loans, (2) marked loans, and (3) large loans.[3] During the examination, loans are classified as to their quality using procedures similar to those used for MOF's classification.

As part of their fieldwork at a typical bank's head office and selected branches, BOJ examiners review the bank's daily operations for reliability. They review cash on hand, accounting books, and other financial documents. In addition, they assess the bank's management of risk related to credit, interest rates, and foreign exchange. At the completion of this process, BOJ chief supervisors give an overall evaluation to the bank management regarding the bank's condition, as well as provide recommendations to improve risk management.

In addition to regular full-scope examinations, BOJ periodically conducts special examinations of particular aspects of bank operations. A recent example is the special examination of Daiwa Bank, which primarily involved investigating the case and ascertaining risk-management deficiencies in the bank's New York branch trading operations. Another recent BOJ special examination focused on the use of operational controls and the management of market risk by the New York branches of leading Japanese banks.

BOJ also conducts on-site examinations of securities firms that have current accounts with it. During these examinations, examiners check such indicators of overall financial conditions as the firm's risk-management policies and procedures, asset quality, and earnings. Such examinations, which take 2 or 3 weeks, are usually conducted every 2 to 3 years by 1 or 2 chief examiners and 4 to 6 examiners. Securities

[3]BOJ categorizes direct loans to directors and loans guaranteed by directors as insider loans. Loans with problem purposes and terms and loans to borrowers in bankruptcy are categorized as marked loans. Consolidated loans higher than designated amounts are categorized as large loans.

subsidiaries of banks are often examined at the same time the parent bank is examined.

## Results Are Provided Orally and in Writing by MOF and BOJ

When MOF and BOJ complete their inspection or examination, they meet with senior bank officials to discuss their findings and recommendations for improvement. Both agencies regard these individual discussions with bank management at the completion of their work as an essential method for communicating inspection or examination concerns.

Typically, MOF's chief inspector meets with the bank's management to discuss findings at the conclusion of an inspection. This meeting is an opportunity both for the chief inspector to express his opinions informally and for the bank's management to provide comments. Following this, an official inspection report is prepared and reviewed by senior MOF officials. MOF then issues an official conclusion in the form of a letter or an administrative order, which is given to the bank along with a copy of the inspection report. The conclusion, when appropriate, identifies areas needing improvement and provides guidance for the bank. MOF sometimes requests an improvement plan and periodic reports if the situation warrants such follow-up actions.

At BOJ, periodic, interim, and closing meetings are attended by both examiners and senior bank management. According to BOJ officials, interim meetings are held to minimize later misunderstandings. At the closing meeting, BOJ examiners discuss examination results to highlight identified problems and to provide recommendations and supervisory guidance. A written report is subsequently shared with the bank's senior management.

## Off-Site Monitoring by MOF and BOJ

MOF and BOJ independently conduct their own off-site monitoring, which typically involves analyses of information about banks under their jurisdictions. Information is obtained through periodic reports submitted by banks and frequent contacts with bank personnel and management.

### Minimum Reporting Requirements

Reports submitted by Japanese banks play a key part in MOF's and BOJ's bank monitoring. Under the 1981 Banking Law, each bank in Japan is required to submit an interim banking report and an annual banking report to MOF describing its business activities and financial position. Interim and annual reports are also submitted to BOJ. Both MOF and BOJ may also require additional information as needed.

Annual reports provide the most extensive information. They are to include certain detailed schedules on securities, loans, fixed assets, commitments and underlying capital, total amount of domestic and foreign drafts remitted and received, and total amount of foreign currency bought and sold. Interim reports, which are submitted on a semiannual basis, provide less extensive information on a bank's activities and financial position.

In addition, banks must report certain information to MOF on a more frequent basis that ranges from daily to quarterly. Information on a bank's trading activities, for example, is typically provided to MOF monthly and quarterly, according to MOF officials. BOJ also requires each institution to file periodic financial reports. For the most part, MOF and BOJ do not require banks to file reports electronically. However, BOJ does gather computer-generated data from banks on a monthly basis. Currently, none of the information gathered from routine reports or daily monitoring is accumulated in an early warning system to identify banks that may be in trouble. However, MOF officials said MOF is developing a computerized system that is to accumulate information from banks, which would serve as an early warning system.

### Meetings Provide Critical Information

MOF and BOJ officials told us they rely a great deal on frequent contacts with bank personnel and management during which useful information is exchanged. During informal meetings, which are held as needed, MOF and BOJ officials are able to provide guidance or advice while staying abreast of developments at individual banks. Meeting topics can include, but are not limited to, bank liquidity, overall business activities, new product development, and corrective actions.

## MOF and BOJ Share Monitoring Information When Necessary

Although MOF and BOJ at times share information informally on a case-by-case basis, there is no legal or formal requirement for MOF or BOJ to share supervisory information with each other. In fact, MOF's staff is bound by law to maintain confidentiality with respect to information gained in the course of their duties or by virtue of their position in the government. On the other hand, BOJ's staff are not bound by law to maintain confidentiality with respect to information gained in the course of their duties. While MOF's staff are restricted from sharing information regularly with BOJ's staff, MOF may disclose information in those cases in which circumstances warrant such actions.

As a result, on-site monitoring results ordinarily are not shared, unless problems arise requiring joint action by MOF and BOJ. BOJ officials explained that its examination results are considered proprietary, and that MOF respects this proviso.

For serious problems requiring supervisory coordination, MOF typically assumes responsibility for coordination and exchanges of information, according to MOF and BOJ officials. In addition, MOF and BOJ officials told us they also communicate through daily telephone calls and informal meetings.

## Limited Use of Independent Auditors

Independent bank audits by CPAs have not historically played a major role in the supervision of Japanese banks, according to MOF and BOJ officials. MOF and BOJ have not typically used internal audits by statutory auditors. However, use of independent external audits by MOF appears likely to increase with the introduction of new legislation to improve oversight of the banking system.

### Banks Are Audited Under Corporate Law but MOF and BOJ Do Not Rely on These Independent Audits

Japanese banks with capital stock totaling at least 500 million yen ($4.7 million), or with total liabilities of 20 billion yen ($188 million) or more, are required by Japan's Commercial Code to undergo annual audits by an independent certified public accountant. Such audits must be undertaken prior to the bank's annual shareholders' meeting, which is typically held within 3 months of the end of the company's financial year.

Prior to World War II, independent or external audits were not required. However, corporations offering securities to the public became subject to mandatory annual audits by CPAs with passage of the Securities and Exchange Law in 1948. The new requirement grew out of the postwar demand for business reforms and corporate disclosures and in response to the introduction of foreign capital for postwar economic development. Subsequent amendments to the Commercial Code in 1974 and 1981 extended the auditing requirement to other types of corporations.

Independent auditors are required to certify in their reports that

- the balance sheet and profit and loss statement fairly present the bank's financial position and the results of its operations;
- proposed uses of retained earnings and accounting matters in the business report are presented in conformance with applicable laws and articles of incorporation; and
- accounting supplementary schedules present correct data and are in accordance with provisions of the Commercial Code.

In addition to significantly enhancing the CPA's role in the Japanese corporate system, the revised Commercial Code also required every bank to appoint statutory auditors. Statutory auditors are responsible for (1) auditing the bank's accounting records and (2) monitoring the activities of its directors. Japanese Institute of Certified Public Accountants (JICPA) officials told us that statutory auditors rely on the results of the audits performed by CPAs on a bank's accounting records. These audits and monitoring activities must be completed prior to the annual general meeting of the shareholders.

Under the revised code, statutory auditors are considered "members" of the bank, but they cannot be employees or directors of the bank or its subsidiaries. According to accounting officials, statutory auditors, who receive salaries from the banks they audit, are often retired bank employees or former bank managers. The revised code does not require statutory auditors to have specific qualifications, and few are CPAs. Several independent auditors said the independence of statutory auditors is often compromised by their prior relationship with the bank being audited and their lack of auditing expertise.

MOF and BOJ officials told us they do not rely on reports prepared by independent or statutory auditors. They said they depend instead on their own contacts with banks and their own monitoring activities. Our discussions with the Japanese Institute of Certified Public Accountants confirmed that CPAs have little contact with MOF or BOJ.

As mentioned in chapter 2, legislative measures have been enacted that are designed to strengthen the supervisory oversight of banks. One provision requires increased use of external audits to ensure sound management of certain segments of the banking industry.

# BOJ and MOF Have Other Financial System Responsibilities; DIC Administers Deposit Protection

BOJ and MOF have other financial system responsibilities in addition to their regulatory and/or safety and soundness responsibilities. BOJ is responsible for maintaining liquidity, serving as the lender of last resort, and providing funds transfer service. Both BOJ and MOF share responsibility for managing financial crises and for participating in international forums. A special corporation—the Deposit Insurance Corporation—administers the insurance system that protects deposits in Japanese banks.

## Liquidity Provider

BOJ's statutory responsibilities for monetary policy are based on the 1942 Bank of Japan Law. As the nation's central bank, BOJ influences the nation's money supply and interest rates to maintain adequate market liquidity, to help provide a basis for sustained economic growth. It also sets commercial bank reserve requirements and participates directly in financial markets by buying and selling securities and bills at market prices to influence the money supply and money markets and to ensure the smooth functioning of the financial system.

## Lender of Last Resort

As lender of last resort, BOJ can provide liquidity when an institution has severe difficulties in obtaining sufficient funds from the market, and such liquidity is needed. However, BOJ is expected to exercise discretion in deciding whether to extend loans to failing financial institutions. In an October 1994 statement, the Governor of BOJ stated that the central bank should only serve as lender of last resort for those cases in which an institution's liquidity shortage could threaten the stability of the entire financial system. According to BOJ officials, in certain rare cases and with special approval, BOJ has provided liquidity without eligible collateral.[1]

According to BOJ officials, BOJ's function as lender of last resort basically involves its providing liquidity to troubled financial institutions or to the financial system, to prevent a systemic crisis. They explained that the following four conditions should be met before it can carry out this function:

- There is a strong likelihood that systemic risk will materialize;
- Central bank financial support must be indispensable for the successful disposal of a failed financial institution;

[1]The Bank of Japan Law allows the BOJ to make loans against collateral in the form of bills or notes, government bonds and obligations, and other negotiable securities, gold and silver bullion, or merchandise. These are considered "eligible" collateral.

- All parties responsible for the institution's problems must be penalized so as to avoid the emergence of moral hazard; and
- The financial soundness of the central bank must be maintained.

## Payments Clearance

BOJ also plays a key role in clearing payments. The main payment system in Japan is the bill and check clearing and domestic funds transfer system, which is operated by private institutions. Local bankers associations operate the check clearinghouses and the Zengin data telecommunication system, which form the core of the domestic funds transfer system. BOJ cooperates with these institutions and plays a key role in the payments and settlements process by issuing bank notes and transferring funds among account holders. Banks can draw checks on BOJ or issue transfer instructions to it.

In late 1988, BOJ launched a network for on-line settlements of payments called the Bank of Japan financial network system. The network, which links BOJ with hundreds of private financial institutions, provides an electronic infrastructure for operations, including funds transfer and government securities transfers. As of March 1996, BOJ data show 420 institutions had used the network for funds transfer, 266 had used it for yen settlements of foreign exchange transactions, and 432 had used it to transfer Japanese government securities.

## Participation in International Organizations

BOJ and MOF participate in the activities of numerous international organizations, including those of the Group of Seven,[2] whose meetings they regularly attend. In addition, both attend Group of Ten[3] meetings, such as the group's governor's meetings, which primarily focus on macroeconomic and monetary policy issues. BOJ also participates in such international organizations as the Bank for International Settlements and the International Monetary Fund. As a shareholder member, BOJ sits on all Bank for International Settlements institutional committees, according to a BOJ official. As Japan's central bank, BOJ also cooperates and coordinates closely with other central banks on such issues as intervention in foreign exchange markets with the aim of achieving currency stability.

[2]The Group of Seven is a group of major industrial countries whose finance ministers and central bank governors meet occasionally. The seven countries are the United States, the United Kingdom, Germany, Japan, Canada, France, and Italy.

[3]The Group of Ten is a group of major industrial countries whose representatives meet to discuss issues of mutual concern. Participating countries include Germany, Belgium, Canada, the United States, France, the United Kingdom, Italy, Japan, the Netherlands, Sweden, and Switzerland.

MOF and BOJ also participate in activities of the Basle Committee on Banking Supervision, as well as those of the International Monetary Fund and the Organization for Economic Cooperation and Development. In addition, MOF's securities supervisors attend meetings of the International Organization of Securities Commissions.

## Crisis Management and Resolution of Troubled Institutions

MOF and BOJ work closely together to assist troubled institutions to establish policies and provide a plan for resolving crises. They told us that once the two agree on an overall resolution plan, BOJ typically manages cash transactions and provides liquidity when necessary.

According to the Bank of Japan Law, BOJ may, with approval from MOF, conduct such activities other than its normal business as are necessary for the maintenance and fostering of the credit system. According to MOF officials, this should also include BOJ making loans to troubled institutions without eligible collateral. Close cooperation and coordination between the two agencies has resulted in MOF supporting all of BOJ's past decisions, according to MOF officials.

Although prefectural governments supervise credit cooperatives, MOF and BOJ can step in to resolve crises affecting troubled credit cooperatives. According to a MOF official, MOF and BOJ recently formulated a resolution plan to prevent a financial crisis involving the Cosmo and Kizu credit cooperatives. BOJ also provided needed liquidity to the two institutions.

## Deposit Insurance Is Administered by DIC

The Deposit Insurance Corporation of Japan (DIC) was established as a special corporation in 1971 to protect depositors and maintain the stability of the financial system. DIC serves these purposes by insuring individual depositors for up to 10 million yen ($93,800) and by providing financial assistance to facilitate the merger or acquisition of failing financial institutions. DIC is supervised by MOF.

Institutions required to be insured include banks (city banks, regional banks, trust banks, long-term credit banks, foreign exchange banks), shinkin banks, credit cooperatives, and labor banks. Agricultural cooperatives, fishery cooperatives, and fishery production cooperatives, due to their special characteristics, are not required to be insured by DIC. Depositors at these institutions are instead protected under a separate system administered by the Savings Insurance Corporation,[4] established in September 1973.

The principal functions of DIC include the collection of insurance premiums, payment of insurance claims and advance payments, execution of financial assistance, purchase of assets from failing or failed financial institutions, and management of funds. DIC is headed by a management committee consisting of up to eight members and the corporation's governor and three executive directors. By law, the governor is appointed by the Finance Minister. The governor appoints the executive directors and committee members, after obtaining approval from MOF.

DIC's administration is handled by its secretariat and the Special Operations Department. The latter was established by the June 1996 amendment to DIC law. In September 1995, DIC secretariat had a staff of 15 employees, but recent legislation substantially increased its staff. As needed, some administrative functions can be delegated to BOJ or to private financial institutions with MOF's approval. In emergencies, for example, these institutions may be asked to provide staff and other assistance for the processing of claims.

DIC insures member institutions[5] through premiums levied on their insured deposits. The premium rate, which is determined by the management committee, requires MOF approval. Before April 1996, member premiums were set at 0.012 percent of insured deposits. In order to build up the deposit insurance fund in preparation for potential future insolvencies, the premium was raised four-fold to 0.048 percent. Furthermore, based on revision in the Deposit Insurance Act, a special premium of 0.036 percent, which is to be paid into the Special Account[6] of DIC, will be assessed for 5 years. Member institutions are required to make half of the annual insurance payments within 3 months and the rest within 9 months of the beginning of the business year.

In 1995, the insurance premiums and other revenues that accumulated in the deposit insurance fund represented a small proportion of insured

[4]Government-related financial institutions and Japanese branches of foreign banks are not covered by either DIC or the Savings Insurance Corporation.

[5]As of Mar. 31, 1995, according to DIC, 1,009 financial institutions, including 167 banks, were insured by DIC.

[6]As a temporary measure for the next 5 years, a Special Account was established within DIC. With this account, the corporation is authorized to accord financial assistance up to the full amount of loss incurred by a failed institution; the amount of financial assistance has thus far been limited to the equivalent of pay-off cost.

deposits in Japanese banks. As of March 31, 1995, according to DIC, the fund totaled 876 billion yen ($8.23 billion). The value of insured deposits on that date totaled 555.7 trillion yen ($5.2 trillion), which represented 78.2 percent of total deposits in Japanese financial institutions. At March 1995 funding levels, the deposit insurance fund reserves constituted less than 0.16 percent of insured deposits.

Financial assistance to a failing institution, which must be approved by MOF, may be provided through grants, loans, deposits, purchase of assets, guarantee of liabilities, or acceptance of liabilities. As of March 1996, the total cost of disposal during the past 4 years amounted to between 2 trillion yen ($19 billion) to $2.5 trillion yen ($24 billion). The deposit insurance fund totaled about 387 billion yen ($3.63 billion) as of March 31, 1996. However, the premium increases required by the June 1996 legislation are expected to raise approximately 2.3 trillion yen ($22 billion) over the next 5 years, according to Japanese officials.

# Principal Japanese Financial Institutions

The highly segmented Japanese banking structure consists of private sector institutions, government institutions, and a central bank. Banks specialize in different areas, such as short-term finance, long-term finance, finance for small- to medium-sized companies, trust activities, and foreign exchange. The nation's financial sector also includes other types of depository and nondepository institutions, such as insurance companies, as shown in table I.1.

**Figure I.1: Principal Japanese Financial Institutions,** (as of April 1996)

| Type | Group | Category | Subcategory | Number |
|---|---|---|---|---|
| **Central bank** | The Bank of Japan | | | 1 |
| **Private financial institutions** | Ordinary banks | City banks | | 10 |
| | | Regional banks | | 129 |
| | | Foreign-owned banks | | 93 |
| | Long-term financial institutions | Long-term credit banks | | 3 |
| | | Traditional trust banks | | 8 |
| | Financial institutions for small- and medium-sized businesses | Zenshinren Bank | | 1 |
| | | | Shinkin banks | 416 |
| | | National Federation of Credit Cooperatives | | 1 |
| | | | Credit cooperatives | 369 |
| | | Shoko Chukin Bank | | 1 |
| | | Rokinren Bank | | 1 |
| | | | Labor banks | 48 |
| | Financial institutions for agriculture, forestry, and fishery | Norinchukin Bank | | 1 |
| | | | Credit federations of agricultural cooperatives[a] | 47 |
| | | | Credit federations of fishery cooperatives[b] | 35 |
| | Other private financial institutions | Insurance companies | Life insurance companies | 29 |
| | | | Nonlife insurance companies | 58 |
| | | Securities companies | | 283 |
| **Public financial institutions** | | Banks and public finance corporations | | 11 |
| | | Postal savings | | 1 |

[a]These cooperatives at the prefectural level provide deposit and lending services to about 2,500 local agricultural cooperatives.

[b]These cooperatives at the prefectural level provide deposit and lending services to about 1,500 local fishery cooperatives.

Source: MOF and Zenginkyo.

## Ordinary Banks

Ordinary banks, which are established in accordance with the 1981 Banking Law, are licensed by MOF. There are three types of ordinary domestic banks—city banks, regional banks, and regional banks II. Branches of foreign-owned banks are also classified as ordinary banks. Ordinary banks focus on short-term finance with an emphasis on deposits, lending, and funds transfer. They also handle medium- and long-term financial transactions with corporations and individual, as well as domestic and international finance.

In addition to conducting primary banking business, ordinary banks may engage in certain securities activities with restrictions, such as commercial paper underwriting, foreign exchange and trade financing, and international securities activities. Additional activities ordinary banks may engage in through their affiliates include leasing, consumer finance, and investment advisory services. While banks are permitted to maintain equity investments in affiliates, they are prohibited from jointly managing such businesses.

## City Banks

Japan's 10 city banks[1] maintain their main offices in major cities, and their branches are located throughout the country. Although these banks emphasize wholesale business, their branches have also made them competitive at the retail level. They are active in the securities business and international operations. All city banks are licensed as foreign exchange banks and may conduct transactions in foreign exchange markets.

One-half of Japanese city banks' deposits are from large corporate accounts. Loans to large corporations, which make up one-third of city bank assets, usually are short-term loans. The remaining loans are to small- and medium-sized enterprises and individuals.

[1]The 10 city banks are Asahi Bank, Bank of Tokyo, Dai-Ichi Kangyo Bank, Daiwa Bank, Fuji Bank, Hokkaido Takushoku Bank, Mitsubishi Bank, Sakura Bank, Sanwa Bank, Sumitomo Bank, Tokai Bank. and the merged Mitsubishi Bank and the Bank of Tokyo.

## Regional Banks

Regional banks in Japan are categorized as regional banks and regional banks II. As of March 1995, there were 64 regional banks and 65 regional banks II. Both types of banks conduct most of their operations within their own prefectures.

Regional banks are located in the main cities of prefectures, where they maintain strong local ties to the community. They lend primarily to small- and medium-sized businesses, and more than half of their deposits come from individual account holders. Regional banks II also serve smaller companies and individual account holders in their regions, but they generally have a smaller asset base than that of regional banks.

### Foreign-Owned Bank Branches

There were 93 foreign-owned bank branches operating in Japan as of March 31, 1996, of which 16 were owned by U.S. concerns. These branches, which account for about 2 percent of industry assets, emphasize off-balance-sheet trading, particularly in the derivatives market. Foreign-owned bank branches conducting banking business in Japan legally qualify as banks subject to Japan's Banking Law. They may establish bank subsidiaries, bank branches, and representative offices in Japan. Representative offices, which cannot conduct regular banking business, primarily serve as liaisons with their home offices. Foreign-owned bank branches and subsidiaries are licensed by MOF, and they function like those of city and regional banks.

## Long-Term Financial Institutions

Historically, the Japanese government established long-term financial institutions to provide long-term funding for agriculture and other industries. Until recently, they were the only financial institutions permitted to raise long-term funds. However, under banking industry deregulation, ordinary banks have captured a share of the long-term lending market, and the historic differences between ordinary and long-term financial institutions have become less pronounced.

### Long-Term Credit Banks

Long-term credit banks were established by the 1952 Long-Term Credit Bank Law to facilitate rapid industrial recovery in Japan. Japan's three long-term credit banks share exclusive rights to issue bank debentures with up to 5-year maturities. Since October 1993, however, ordinary banks have been able to issue medium-term time deposits with up to 4-year maturities. Long-term credit banks concentrate on providing long-term loans to industrial clients for plant and equipment, and long-term working capital.

### Trust Banks

Trust banks, which are long-term specialized banks licensed to conduct both banking and trust activities, are granted additional operational latitude under the 1943 Concurrent Trust Business Law. They receive a majority of their funds from trusts, and they supply funds to major corporations. Trust banks receive and manage funds on behalf of their clients. Their funding sources include pooled individual and corporate deposits in money trusts, pension trusts, loan trusts, and securities investment trusts.

## Financial Institutions for Small Business

Financial institutions for small business are basically cooperatives that serve the financial needs of small- and medium-sized businesses, labor unions, consumer cooperatives, and other labor bodies. Also included in this group are three central bodies that take deposits, provide loans, and meet other financial needs of their cooperative members. One such institution, the Zenshinren Bank, serves shinkin banks. The Shinkin Federation Bank similarly serves credit cooperatives, and a third institution, the Rokinren Bank, serves labor banks.

### Shinkin Banks

Shinkin banks are nonprofit cooperatives with strong local community ties that operate in accordance with the 1951 Shinkin Bank Law and its 1981 revision. Their target customers are small- and medium-sized enterprises and the general public. They accept deposits and installment savings from members and nonmembers, advance loans to members, discount bills for members, transfer funds, and conduct foreign exchange operations. They may also conduct some ancillary operations, such as the placement of securities and trust services involving land and charities. Each shinkin bank is a member of the Zenshinren Bank, the national federation of shinkin banks. The Zenshinren Bank, which exists primarily to serve as a central bank for shinkin banks, engages in deposit-taking, lending, and funds transfer for its members, but it conducts ancillary business including securities-related activities and also acts as an agent for public financial institutions.

### Credit Cooperatives

Credit cooperatives provide their small- and medium-sized member enterprises and their employees with such services as deposit accounts, installment savings, and loans. Such cooperatives, which are subject to ceilings on the credit they provide to any single member, may also lend to local government bodies. Their authorization is granted by the local governor if their activities remain within prefectural boundaries. If their activities extend beyond these boundaries, they must obtain MOF permission to operate. Supervisory responsibility for credit cooperatives resides at the local government level rather than directly with MOF or BOJ. The central bank for credit cooperatives is the Shinkin Federation Bank, whose primary business is deposit accounts for members, national and local government bodies, and nonprofit organizations. In addition, the federation lends to its members and nonmembers.

## Financial Institutions for Agriculture, Forestry, and Fisheries

Serving local agriculture, forestry, and fisheries enterprises are private, cooperative-based, financial institutions that operate on three levels. At the lowest level are cooperatives operating at the village, town, and city levels of government. At the middle level, these cooperatives in turn are members of 47 prefectural-level associations called credit federations that serve clients within their own prefectures. At the top level is the Norinchukin Bank, which serves in several respects as the central bank for agriculture, forestry, and fisheries enterprises. Supervisory responsibility for the lowest level institutions is handled by local governments, while the Norinchukin and the prefectural level associations are supervised by the Ministry of Agriculture, Forestry, and Fishery and the Ministry of Finance.

## Public Financial Institutions

Loans by public institutions are primarily designed to supplement private-sector financing. Public institutions, which are prohibited from competing with private banks, borrow funds for permitted loans from the government's Trust Fund Bureau. Public corporations serve the financial needs of specific sectors of the Japanese economy. For example, public corporations may finance special sectors of the Japanese economy, such as housing, agriculture, fisheries, small business, and environmental sanitation.

Japan's two government banks are the Japan Development Bank and the Export-Import Bank of Japan. The purpose of the Japan Development Bank is to supplement and encourage the credit operations of private financial institutions. The Export-Import Bank of Japan serves to supplement and encourage financing of exports, imports, and overseas investments provided by other financial institutions.

## Postal Savings System

Another government financial institution is the Japanese postal savings system. Although the system is not a bank, the magnitude of its financial resources gives it important financial significance in Japan. As of May 1995, the system held more than 200 trillion yen ($1.88 trillion),[2] making it the world's largest financial institution. The postal savings system was originally created to promote small-volume personal savings to the general public. It offers such services as ordinary deposits, time deposits, installment deposits, and deposit-based loans. The system, which operates out of 24,000 Japanese post offices throughout the country, accepts deposits from individuals of up to 10 million yen ($93,800).

Over the years, the postal savings system has gradually expanded its services beyond demand deposits. For example, the system now offers automatic payment of bills for public utilities and similar services. The system's expanded services have led to heightened competition with private financial institutions. As a result, some Japanese banking industry officials increasingly believe that the postal savings system has outgrown its original purpose, and that a thorough review of its operations is needed.

The system's deposits are a major source of funds for the government's fiscal investment and loan activities, which are administered by the Trust Fund Bureau through the Fiscal Investment and Loan Program. This program is a trust fund for special accounts, government-affiliated financial institutions, public corporations, local governments, and special companies.

[2]Exchange rate of 106.61 yen per U.S. dollar, as of Apr. 25, 1996.

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