The Bursting of the Bubble and Bank Shareholdings

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I Main thematic import

At the beginning of the 1990s the bubble economy burst in Japan. The ensuing sharp decline in land prices generated massive non-performing loans in banks' real estate-related loans, and many financial institutions fell into managerial crisis. Housing loan companies were particularly hard hit and, with their heavy borrowings from banks, the impact was feared to threaten the financial system as a whole. The government therefore decided to inject public funds to liquidate these housing loan companies. However, the injection of public funds into the non-bank entities triggered a sharp criticism from public and the financial crisis spread to major banks and security houses. Major factors behind the unfolding of events in this manner were government's clumsy macro-economic policies, the Ministry of Finance's mishandlings of bank failures in early stages of crisis, the outbreak of international currency crisis triggered by the Asian crisis. In the late 1990s several major banks including Hokkaido Takushoku Bank, Long Term Credit Bank of Japan, and Bond Credit Bank of Japan, as well as a couple of securities houses including Yamaichi and Sanyo collapsed. ~~In spite of the injection of public funds totaling more than ¥ 46 trillion, the~~The final resolution of the non-performing loan problem of major banks remained to be seen until 2005. In the meantime, the Japanese economy has grown at a minimal 1.1% rate on average during 1992-2002 with nominal GDP contracting at △1.2 % during 1998-2002.

(Note)

According to a recent survey, during the bubble years 1986-90, Japan's domestic gross assets increased by ~~to~~ a total of 1,599 trillion yen then decreased by ~~to~~ 1,389 trillion yen in the post-bubble years from 1991-2003. In this decrease in asset value, financial assets (mainly shares) accounted for 44 trillion yen, while real assets (mainly real estate) amounted to 1,345 trillion yen. Other categories include household 623 trillion yen, the corporate sector (excluding finance) 466 trillion yen, financial institutions 89 trillion yen, and general government 189 trillion yen. (Mitsubishi UFJ Research and

Consulting, 2006) ; Up to March 2000, 110 deposit-taking institutions were dissolved under the deposit insurance system. The Total amount spent in dealing with the non-performing loans problem from April 1992 to March 2000 was ¥ 86 trillion (17% of GDP), which included charge-off and provisioning by banks, transfers by the Deposit Insurance Corporation to cover losses of the failed institutions and capital injections to banks. The financial crisis of the 1990s in Japan was indeed unprecedented in terms of seriousness. (Nakaso,2001,2)

Against this backdrop, policy discussions over the financial crisis in Japan so far centered around the handling of non-performing loans and the injection of public funds. However, the bursting of bubble and the ensuing financial crisis accompanied another annoying issue. That was the grave influence of the deep drop in share~~stock~~ prices on the stability of Japanese financial system and the soundness of financial institutions.

In Japan, during the post-war period of economic reconstruction, large banks became major shareholders of corporate shares replacing individual shareholders. These bank shareholdings progressively increased through a series of stages such as the 1963-65 slump in securities markets, the liberalization of capital transactions from the 1970s, and the bubble economy of the 1980s. By way of international comparison, albeit there exist examples of German banks holding considerable client company shares, the sheer numbers held by Japanese banks, as well as the mutual shareholding format between banks and client companies, makes for a unique combination.

(Note)

Some experts divide the historical evolution of inter-corporate shareholdings between banks and industrial companies after World War II into three phases. The first phase covers the period from the post-war resumption of share~~stock~~ market activity to the slump in the securities market (1963-65). The second phase goes from this slump to the first oil shock (1973), while the third extends from the first oil shock to the bursting of the bubble.(Kawakita, 1993, 36; Ito, 2004, 86)

The shareholdings brought about huge latent gains for banks as a result of the sustained rise in share~~stock~~ prices until the bubble burst in the early 1990s. Many banks used the latent gain as a form of retained earnings, which enable banks to stabilize cash flow when their profits tumbled.

The latent gain was not only a matter of stable cash flow but was closely related to the fulfillment of BIS rules imposed on banks in the 1990s. Given the extremely small capital base, Japanese banks were allowed to count the 45% of latent gains into Tier 2 category of capital, and, taking advantage of this allowance, most banks could barely secure over 8% capital/asset ratios. However, with the sudden and deep fall in share prices after the bubble burst, the banks' latent gain decreased sharply and in 2002, when the Nikkei 225 index dropped below 8,000 yen, the latent gain fell into the negative on an *Zenkoku Ginko* (all domestically licensed banks) basis.

(Note)

Zenkoku Ginko is a statistical category of a group of deposit-taking institutions including city banks, regional banks, long term credit banks, and trust banks.

The disappearance of latent gain came as another big blow to banks that for several years had already exhausted their equity capital for the handling of massive non-performing loans. Moreover, in the 2001-02 period there existed practically no prospects for the quick recovery of share prices, rather fears of a further drop spread in the financial communities. However, it was clear that if banks, in order to avoid capital loss, embarked on selling off shares at once, this would engender a further precipitation in share prices.

Judging the delay in handling non-performing loans to be the main reason for the prolongation of financial crisis and economic stagnation, the government pressed banks for the prompt disposal of these loans at that time. However, given the already sharp drop in share prices, few financial institutions could afford to deal with non-performing loans by realizing latent gains. As a result, the government's policy met with a dead end.

Against this backdrop, the government imposed restrictions on bank shareholdings on the one hand, while establishing a public organization named "Organization for the Acquisition of Bank-held Shares" to purchase shares from banks in order to absorb the prospective selling pressure. Furthermore, as a supplementary measure, the government requested the Bank of Japan to buy up shares from banks.

These were explicitly interventionist policies at odds with the idea of the sweeping liberalization of the Japanese capital market ~~markets~~ (Japanese version of the financial Big Bang which aimed at institutionalizing "Free, Fair, Global" markets in Tokyo). A series of government's countermeasures including a couple of share price-keeping operations had prolonged distorting effects on the capital market~~markets~~ and the eruption of scandals in financial communities in the meantime deeply undermined the credibility of the Japanese financial system.

This paper seeks to focus on the problems associated with the fall in share prices under bank ownership and the ways this was handled. These problems were less documented so far compared with problems of the massive bad loans and the injection of the public fund. The paper also addresses the countermeasures implemented by banks and the government to combat the problems. We will first look in Section II at the history and the recent situation of bank shareholdings and in Section III will consider the main factors behind the phenomenon. In Section IV we will examine how the post-bubble drop in share prices affected bank management and Section V will deal with government's counter-measures and price-keeping operations. Section VI provides a conclusion.

II Bank shareholding: history and present situation

The Anti-Monopoly Law (Articles 10 and 11) enacted just after the end of World War II imposed strict limits on corporate shareholding. With the exception of parent-subsidiary companies approved by the Fair Trade Commission, industrial companies were prohibited from acquiring or holding shares in domestic businesses. Furthermore, financial institutions including banks were prohibited from acquiring shares in rival financial institutions, and were not allowed to acquire or hold in excess of 5% of outstanding shares in any industrial companies.

Between 1949 and 1953, the Anti-Monopoly Law underwent successive revisions. It became possible for industrial companies and financial institutions to acquire shares in other businesses (provided that this would not "substantially restrain competition"), and the upper limit for shareholdings by financial institutions in domestic corporations was raised to 10% of outstanding shares.

Facilitated by the revision of Anti-Monopoly Law in tandem with the remarkably swift advancement of the formation of business groups, there occurred acceleration in inter-corporate shareholdings which centered around major banks. According to a report by the Fair Trade Commission(1954), which investigated the shareholding of financial institution in 1953, the shareholding ratios of financial institutions (ratio of bank-held shares to total outstanding shares) rose suddenly from the level of 9% in 1949 to over 23% in the first term of 1952. The report went on to add:

"Particularly notable is the fact that the amount of bank shareholdings is extraordinarily large; furthermore, it is made up of an extremely diverse spectrum of industry types," and "to those familiar with shareholding statements in general industrial companies, it is at least remarkable" (Fair Trade Commission, July 1954,14).

The report above mentioned pointed out that bank shareholding in Japan had already commenced before the first period of high economic growth (1955-60). It all started when banks purchased shares relinquished by individual investors in the course of economic recession accompanying the 1948 Dodge Line (tight-money policy based on nine principles for economic stability). The ratio of shares held by financial institutions and business corporations rose from a total of 15.5% in 1949 to 23.7% in 1950 (Ito, 2004, 87).

(Note)

Individual investors originally acquired these shares when parent companies of large business combines (*Zaibatsu*) were split up as part of the post-war economic democratization process. The large amount of shares under the ownership of Zaibatsu parent companies were sold out to public, giving rise to dispersed shareholding structures in post-war Japan.

There was further concentration of bank-held shares associated with the formation of business groups during the period of high economic growth. At that time, banks acquired shares at low prices assigned at par value by client companies. Moreover, client companies also attached great importance to maintain a favorable trade relation with banks and stepped up efforts for the stable holding of bank shares. As a result, inter-corporate connections developed between banks and companies via cross-shareholdings. One important feature of this inter-corporate connection was the high ratio of "mutually held shares" between banks and their client companies.

The bank-centered cross-shareholding first culminated around 1960, when the corporate shareholding ratios detained by financial institutions and companies reached 40%. Then around the mid-1960s, the corporate shareholding ratios rose again and in 1966 exceeded those of individual shareholdings. In 1971, the shareholding ratios of financial institutions also overtook individual ratios. The main factor behind this rise in corporate shareholding ratios was the release of large numbers of shares that had been held by the organizations for share purchase (Japan Joint Securities Co. Ltd., and Japan Securities Holdings Union) which were incorporated to deal with the 1965 slump in securities markets. Corporate investors, including banks and insurance companies, were dominant takers.

Until the 1980s banks acquired newly issued shares at par value from client companies, and the continued rise in share prices generated significant latent gains in banks' portfolio. These latent gains – which did not show up on the banks' balance sheets – acted as a kind of internal reserve that served to stabilize the banks' cash flow. However, in the latter half of the 1960s, the high growth of the Japanese economy began to wane and demands for bank-lending from industrial companies was on a declining trend (the disintermediation in corporate finance). In such a climate, many banks actively sought to increase their shareholdings as lucrative investment.

As a result, the number of industrial companies in which financial institutions were high-ranking shareholders has rapidly increased. This phenomenon induced concern in supervisory bodies (the Ministry of Finance and the Fair Trade Commission) that major banks would gain an excessively dominant business power. This led to a revision of the Anti-Monopoly Law in 1977 whereby the upper limit for shareholdings by financial institutions (except for life insurance) in domestic corporations was lowered from 10% back to 5%. Nevertheless, in order to alleviate the effect of this change in regime on the share~~stock~~ market, a period of ten years' grace was accorded to those financial institutions whose shareholdings had already exceeded 10%.

Despite these measures to limit shareholding in financial institutions, according to investigations by the Fair Trade Commission, as of December 1986 – one year before the above-mentioned period of ten years' grace was due to expire – of the 145 domestic banks surveyed, only three regional banks and three mutual savings banks did not exceed the 5% shareholding limit, and the number of companies in which banks held shares amounted to a total of 1,457.

In the bubble years from 1985 to 1990, banks pursued share~~stock~~ investment with renewed vigor. During this period, city banks' equity investment ratios (shareholding ratio to gross assets on a book value basis) rose on average from 3.2% to 5.7%, and other financial institutions including long term credit banks and regional banks showed similar increases in equity investment ratios. In the first year after the collapse of the bubble economy (at the beginning of 1990), the shareholdings amounted to a total of 35 trillion yen on the basis of all domestically-licensed banks, accounting for 4.7% of total assets.

III Main factors behind bank shareholdings

Why did Japanese banks seek so actively to own large amounts of corporate shares? And how did shareholding by banks affect their management?

According to Okumura (1975), one of the first researchers on the inter-corporate shareholdings centered on bank, the main motivation that promoted major banks' share~~stock~~ ownership in the 1950s was not so much the return on portfolio investments, as the concentration and expansion of business groups. By becoming stable shareholder of their client companies, banks could enhance the connection of their business group and ensure the various transactional relations with client companies, thereby also stabilizing their earnings base.

A study by a private investigatory institution (Norin-Chukin Soken, 1993) examining the motivation behind bank shareholding also pointed out that banks attached larger importance to the increased earnings base through the amplification of financial transactions with client companies rather than to return on portfolio investment including dividend yields. As a matter of fact, from the 1960s on, the dividend yield of bank shareholding floated under bank's funding cost. However, the study went on to conclude that, together with various side benefits generated from stable and multiple financial transaction with client companies, the total revenue amply covered the cost of shareholding.

According to the same study, in the 1980s the main motivation behind bank shareholdings clearly shifted from the reinforcing transactional relations as described above back to the return of portfolio investments, particularly the expected increase in share prices.

Actually the expected cash flow from dividend yield via shareholding itself worsened in the period with prevailing of share issuance at market prices and the ensuing rise in offer prices. The cash flow from dividend yield minus funding cost of all city banks is estimated as entailing a deficit to the scale of one trillion yen in 1991. This loss amounted to 70% of city banks' net business profit.

Despite this deterioration in cash flow from dividend yield, throughout the 1980s banks boosted their shareholding with the main intent of reaping large latent gains as a result of the rise in share~~stock~~ prices. According to this study, the latent gain of all city banks from March 1981 to March 1989 totaled 33 trillion yen, 27 trillion yen of which was generated during the three-year period between March 1986 and March 1989. For this same three-year period, major city and long-term credit banks together sold off part of their shareholdings, realizing a profit of over 7 trillion yen, which amounted to almost 80% of the ordinary profit of these banks.

The huge latent gains in the shareholdings of major banks not only contributed to the stabilization of their cash flow, but also had another important implication for the banks' management. Because the latent gains, in addition, served for banks as quasi-equity capital that could make up for the shortage of equity capital required by the "BIS rules".

The BIS rules of July 1988 required internationally active banks to maintain more than 8% capital/asset ratios. However, at that time, most major Japanese banks had severe difficulty in fulfilling the requirement. A local rule was therefore applied to Japanese banks whereby 45% of latent gain in off-balance assets might be counted into the supplementary item (Tier 2) of capital up to the amount of Tier 1 (proper equity capital). Despite the fact that the enforcement of BIS rules coincided timely with the collapse of the bubble economy, this measure enabled major banks to secure capital/asset ratios of 9%-10% even after 1993. As a consequence, as opposed to original forecasts of unavoidable credit crunch following the introduction of BIS rules, many banks could afford to maintain the outstanding lending (Matsuura, 2000, p.57).

(Note)

This Japan-specific application of BIS rules came about at the strong request of the Japanese financial authorities during the course of negotiations about the BIS rules among OECD member countries. Fearing that the strict enforcement of BIS rules would have a strong contractive effect on major banks with low capital/asset ratios, Japanese financial authorities and banking communities called for the application of a local rule to alleviate the effect.

However, this expedient application of BIS rules facilitated the reluctance in restructuring equity finance in major Japanese banks, resulting – coupled with the collapse of the bubble economy – in the erosion in bank soundness. This was because the local rule made banks depend more heavily on high share~~stock~~ prices to secure the required capital/asset ratios, with result of fluctuations in share~~stock~~ prices causing unordinary repercussions on banks' behavior.

As described above, the primary incentive for banks to continue long-term shareholding resides in the building-up of strong ties that would serve to maintain stable trade relations with client companies. The shareholdings, in turn, generated the considerable latent gains with the ensuing rise in share~~stock~~ prices. However, the motivation for shareholdings came to play not only on the side of banks but also on the side of industrial companies.

During the period of high economic growth many industrial companies welcomed banks as stable and reliable shareholders with intension of precluding possible TOB. From the 1980s many companies, taking advantage of the sharp rise in share~~stock~~ prices and abundant market liquidity at this time, implemented a vigorous policy of equity finance. In so doing, they expected that their main banks continued to own shares~~stock~~ as stable shareholder avoiding a drop in stable holding ratios (the ratio of holdings by stable shareholders to outstanding shares).

According to a survey conducted by a private investigatory organization in 1990, the ratio of companies that considered over 50% of their outstanding shares to be held by stable shareholders rose from 83% in 1985 to 90% in 1990. Furthermore, among these companies, the ratio of those that regarded banks as desirable stable shareholders was as high as 90%, with very few companies seeking to reduce their stable holdings ratios in the future. (Kawakita, 1995, p.84)

In 1985, Japanese supervisory bodies took steps to liberalize the placement of foreign currency-denominated convertible bonds and new issuance of shares at market prices for banks. These steps made it possible for convertible bonds to be issued domestically, thereby enhancing the potential for banks' equity finance.

This liberalization of bank equity financing was instituted abreast with BIS negotiations in Basel. Major banks implemented an extremely vigorous policy of equity finance in preparation for the future enforcement of capital requirement. During the three-year period from 1987-89, the very heyday of Japan's bubble economy, the total equity finance employed by banks accounted for around 20% of that of all listed companies. (Kawakita, op. cit., p.109) In order to manage the massive equity finance in a climate of accelerating financial deregulation, banks expected their client companies to hold even more shares as stable shareholders.

This background accounts for the fact that the mutual shareholdings was maintained as a necessary framework for both banks and companies even during the bubble years.

(Note)

Kawakita (see above) points out the following correlations between equity finance and share prices. "If share~~stock~~ prices were high, the amount of equity finance increased at the same time or slightly (around two months) later. Furthermore, when equity finance became active, corporate shareholders' net buying of shares also increased at the same time or slightly (around two months) later. And the rise in the net amount of shares bought up by corporate shareholders also entailed a simultaneous increase in share prices." (p.139)

IV The fall in share prices and banking crisis

After reaching a peak at the end of 1989, share prices went into a sudden downspin at the beginning of the following year, 1990: the share~~stock~~ market bubble had burst. From its highest level of 2,884 (Nikkei 225 average: 38,915 yen) recorded on 18 December 1989, the Tokyo Stock~~Stock~~ Exchange Stock~~Stock~~ Price Index (TOPIX) slumped to 1,102 (Nikkei 225: 14,309 yen) in August 1992. Although TOPIX was subsequently backed by the government's share price keeping operations (PKO), it continued to fall from 1995, reaching its lowest level of 770 (Nikkei 225: 7,607 yen) in March 2003.

This drastic fall in share prices had a far-reaching twofold effect on the management of major banks that held huge quantity of corporate share in their portfolios.

Firstly, as mentioned earlier, up until the babble burst banks had used the sizable latent gains in shareholdings as a kind of internal reserve to stabilize profit and cash flow. However, the drop in share prices of such magnitude brought about a quick evaporation of latent gains, with many banks experiencing latent losses. Although it is not easy to provide an accurate appraisal, according to a survey by a private investigatory organization (Teikoku Databank) by the mid-business term of September 2001, all fifteen major banks had incurred latent losses, amounting to a total of almost 1.8 trillion yen. It is estimated that these banks suffered a loss of 4.3 trillion yen in the market value of their securities portfolio.

This decrease in latent gain, coupled with large amounts of non-performing loans after the collapse of the bubble economy, engendered serious financial problems for banks. The losses posted by eight city banks in processing non-performing loans amounted to 7.2 trillion yen for the March 1998 period and 6.7 trillion yen for the March 1999 period. It became impossible for banks to offset these huge losses by realizing off-balance gains as they had done before.

Secondly, until this point of time, banks had managed to secure the required capital/asset ratios by counting latent gains into Tier 2. However, it became increasingly difficult to fulfill the BIS rules in this way when the sharp drop in share prices led to the evaporation of latent gains.

Although major banks had announced that they could afford to maintain the post-bubble capital/asset ratios at the level of 10%-11%, the figures were considerably inflated taking advantage of various accounting manipulations. Firstly, banks included in equity capital deferred tax assets that amounted to 30%-50% of net worth (Tier 1). However, deferred tax assets were in themselves contingent assets, and their realization was dependent on unsecured future profits. Secondly, the loan loss provisions might be arguably insufficient at this time. This is because the authorized classification scheme of bad loans was too vague to conduct an accurate evaluation of credit risk. Thirdly, the injection of public funds from March 1999 (exceeding six trillion yen for banks in March 1999) served to pad the reduction in equity capital. According to an evaluation, based on the capital/asset ratios and share~~stock~~ prices in March 2002, all major banks had practically fallen into insolvency with negative net value amounting to around six trillion yen, equivalent to the amount of public funds injected (Fukao, 2003, p.38).

In such circumstances, in order to provide relief to ailing banks, from March 1998 the financial authorities took steps to allow the application of *Genka*-method (the original cost method) to bank shareholdings, whose booking was conventionally required to be based on *Teika*-method (the lower-of-cost-or-market accounting method).

Many banks therefore changed to the *Genka*-method from the *Teika*-method to avoid posting of capital losses. It is estimated that this change saved for all banks a total of around two trillion yen of revaluation loss. (Okuda, 2000,49)

For banks, shareholding that no longer generated latent gains implicated a new burden in the light of BIS rules. This was because, as in the case of lending, banks were required to maintain equity capital equivalent to 8% of the book value of shareholdings.

In the period from 1999 to 2000 there was a temporary rise in share prices and banks once again sold off more shares for realizing latent gain. According to banking commentators, the profit accrued from selling off shares by eight major city banks for the second half fiscal year of 2000 amounted to 3.8 trillion yen, which at the same time amply made up for the cost of bad loan disposals. However, these massive sales of shares for realizing latent gain lead to the rise of book value of their shareholdings, with result of increased equity capital requirement.

(Note)

In most cases, the selling off of shares were not outright alienation but accompanied with repurchase arrangements. Putting it differently, immediately after selling off at market value with realized gains, banks repurchased the shares at market value minus commissions for the counterpart buyers. In consequence, the book value of shareholdings increased.

In addition to the direct effects described above, previous studies have pointed out that the sharp fall in share prices after the bubble burst also influenced bank management in indirect manners.

One study documented the following relation between share prices and bank lending: when share prices fall and latent gains decrease, banks seek to curtail lending. The change in bank behavior is strongly apparent in short-term operating fund lending compared with long-term loan. Furthermore, in terms of corporate scale, the effect is more strongly apparent with small and medium-sized enterprises compared with that of big businesses. Even discounting the sluggish demand for bank credit from borrower companies due to the slack economy, the interrelation can still be clearly observed. The study concluded that the interrelation between share prices and bank financing may not be considered as an outcome of business fluctuations, but as a phenomenon having a pro-cyclical effect of its own. (Ashihara, 2001)

From 2000 downward Japanese share prices entered another phase of depreciation and the TOPIX finally recorded an all-time low of 770 in March 2003. The biggest factor behind this sharp drop in share prices was the intensified sale by banks. There were a couple of reasons for this rapid increase in sales from 2000. Firstly, banks were concerned that, if the further fall in share~~stock~~ prices was not confined, increased latent losses would perilously undermine their capital base. Secondly, the market-value-based accounting was finally introduced from the September 2001; if latent loss occurred, 60% of this was required to be deducted from equity capital. Thirdly, based on a Financial System Council's report (June 2001), the government moved to institute a policy whereby bank shareholding would be restricted to the Tier 1 range of equity capital.

At the same time, the banking crisis was getting extremely acute. Despite efforts by banks to accelerate the processing of non-performing loans, due to the deepening economic recession and increasing business failure, the outstanding amount of non-performing loans continued to rise. On the all banks basis the total amount of non-performing loans in 1996 decreased from 28.5 trillion yen to 21.7 trillion yen due to temporary economic recovery combined with huge write off of losses of over 13 trillion yen in the previous year. However, from 1997 recurrent economic recession brought about another upswing in the amount of non-performing loans, exceeding 30 trillion yen in 1999 and reaching 42 trillion yen in 2001. These staggering non-performing loans were not only a result of asset deflation caused by the collapse of the bubble economy, but were newly generated by the downslide in economic fundamentals and ensuing increase in business failures.

The pressure remained on banks to sell off shares as share prices were seemingly still on a downward trend and had still not hit their bottom. There extended fears in both authorities and financial communities that the eventual collapse of share~~stock~~ market, coupled with the intensified bank failures would trigger a full-scale breakdown in the Japanese financial system.

V Bank rescue measures and share~~stock~~ price keeping operations

The Japanese government did not stand by idly during the persistent downslide of share~~stock~~ prices after the collapse of the bubble economy. From the summer of 1992, when the Nikkei 225 index fell to around 14,000 yen, the government, provoked by a sense of impending crisis, bought up repeatedly shares using funds of postal savings and postal life insurance, measures known as Price Keeping Operation (PKO). Whenever the Nikkei average index neared the purported threshold point of 14,000 yen (at which banks' latent gains were supposed to disappear), PKO was carried out.

However, PKO in turn affected the investment judgment of domestic and foreign investors and entailed artificial distortions in the share prices. Taking advantage of this market anomaly institutional investors could tap sizable profit through speculative transactions.

(Note)

The PKO and other price-keeping measures conducted by the government were basically in line with business communities' desire to reactivate the capital markets. They argued that then-share prices were too low and price-keeping measures should be justified as policies to recover the fair level of share prices. There exists another line of argumentation. "it will be very difficult to make the case that the government should intervene in the national interest because the prices on that market are too low……..Even when the Nikkei 225 Average declined to the 8,000 level, the stock market was still functioning properly. Perhaps those who demanded action to revitalize the market really only wanted to see share prices higher and were not interested in boosting turnover or increasing efficiency for their own sake." (Osaki, 2005,13)

Anyhow, the government could not solely afford to buy up sufficient amount of shares using quasi-public funds in the postal savings and postal life insurance. This was because these funds were not government's equity capital but contingent outside capital which the government should pay off to policyholders in the future. Unless the downslide of share prices was brought under control, the continued recourse to PKO carried the undue risk undermining the public confidence in the system of postal savings and postal life insurance.

In 2001, when a sudden drop in share prices made the Nikkei index fall below 10,000 yen, it became virtually impossible for the government to continue PKO. PKO was clearly powerless to absorb the large selling pressure accelerated by fear for impending systemic crisis.

In April 2001, the government announced new emergency economic measures, which proclaimed the pressing need to eliminate market risk from banks' balance sheets, the initiative of new legislation to limit bank shareholdings, and the introduction of a public share purchase scheme in order to alleviate the selling pressure.

In September of the same year, the Nikkei 225 index plunged to the critical level of 9,500 yen. Against this backdrop with all major banks suffering unabsorbable latent losses, a bill including the Emergency Economic Measures was submitted to the Diet and was enacted in November.

With the establishment of the Banks' Shareholdings Purchase Corporation, and in accord with newly enacted law which came into effect from September 2004, the ceiling of total shareholdings by banks was set at the level equivalent to equity capital (Tier 1). The Corporation executed the government's policy of buying up shares (domestically-listed issues or OTC issues) from member banks up to two trillion yen through the four-year period until the end of September 2006.

The Corporation started buying up shares from February 2002. However, it was clear from the outset that this scheme did not provide a real solution to the problem. Firstly, the scheduled purchasing limit of two trillion yen was too small compared with bank shareholdings which amounted to over 44 trillion yen on a book value basis. Secondly, in order to sell shares to the Corporation, banks had to pay in contribution equivalent to 8% of the sale price. This provision turned to be a heavy burden to banks at this time and provoked banks into refrain from selling off. In fact, the purchases by the Corporation did not progress smoothly and as of April 2003 amounted to around 220 billion yen, far below the expected level.

Given the fact that the Corporation did not provide a real solution to the problem, the government called for the Bank of Japan to implement a unprecedented measure of direct purchase of shares from private banks. The Bank of Japan, without any major objection, accepted the government's request and in September 2002 embarked on purchasing shares from major banks up to two trillion yen.

(Note)

The Bank of Japan's spontaneous acceptance of this unprecedented request from the government was compelled by a couple of factors. First of all, the Bank took into account the then political context in which a prolonged financial crisis may be problematic in coordinating diplomatic relations with the USA. In September 2002, at a summit meeting between Japan and the United States, Prime Minister Koizumi had promised US President Bush a swift solution of the problem of non-performing loans. Moreover, the Bank of Japan, with responsibility for safeguarding the stability of financial markets, also took the impending systemic risk more seriously than the government. (Nakaso, 2001)

At first, there was no sudden increase in the sale of shares by banks, but the sale became livelier before long. According to the estimations of a private investigatory body (Dai-ichi Mutual Life Insurance Co., 2003), from November 2002 when the Bank of Japan commenced the operation to the end of March 2003 its purchases amounted to around 1.2 trillion yen (on the basis of current prices). This is estimated to be equivalent to 60% of the total number of shares sold off by major banks (1.9 trillion yen at current prices, 4.8 trillion yen at book value).

On the other hand, in September of the previous year, the government had set forth a new program for financial revival. The government compelled banks to accelerate the write-off of non-performing loans. The banks which could not achieve the disposal of non-performing loans on schedule would be placed under the prompt corrective measures including the enforced dismissal of the management.

In this way, with the government's urgent economic measures and two public schemes for purchasing shares, major banks in Japan could barely overcome the critical situation by the first quarter of 2003. Estimations by Dai-ichi Mutual Life Insurance Co. found that major banks' latent losses declined to 1.2 trillion yen and share prices at the break-even point (at which latent gains and losses cancel each other out) fell on the Nikkei index to 8,850 yen. Furthermore, according to a recent estimation, even if Nikkei 225 average should drop to the level of 4,860 yen, they would still be able to maintain 8% of BIS capital ratios.

In 2005, after a prolonged and painful business restructuring, big businesses recovered their profitability and their share~~stock~~ prices came back on the track of recovery somewhat earlier than anticipated. Another remarkable factor behind this share~~stock~~ price recovery was the inflow of funds from institutional investors including domestic investment trusts or overseas investment funds. Moreover, it is noteworthy that from the latter half of 2005, funds from individual investors – who had hitherto been wary of the share~~stock~~ market – began to flow in.

From the latter half of the 1990s, the government and financial industries have made desperate efforts to invite individual investors' funds into the share~~stock~~ markets. They expected that the shift of a portion of enormous individual financial assets from bank deposit and postal savings to the capital market~~markets~~ will afford to absorb the unwinding of cross-shareholdings of banks and businesses. However, it took more than ten years for this shift to happen.(Osaki, 2005)

In the latter half of the 1990s, when several big equity investment trusts put on sale by major securities houses went under par due to the decline in share~~stock~~ prices, many individual investors incurred painful loss. Furthermore, a series of scandals erupted in financial communities including the cozy relationship between MoF's bank examiners and bank managements, illegal loss compensations for corporate clients by major security houses and trust banks, unjustifiable profits provided by banks and securities houses to *Sokaiya* (corporate racketeers), and the intra-company transfer of concealed losses (*Tobashi*, by Yamaichi), to single out just a few of them.

Given these scandals, the credibility of financial authorities was bitterly undermined and individual investors were scared away from markets. The financial authorities tried to enforce a package of measures to revitalize the securities markets, including the revision of the Investment Trust Law and the Securities and Exchange Law, the lift of securities transaction tax, and enactment of the Special Purpose Company (SPC) Law.

From 2005 downward the turnover in the Tokyo Stock~~Stock~~ Exchange has remarkably increased and TOPIX is moving on a lively up-trend. Particularly notable is the conspicuous increase in turnover of individual investors' deal as well as the brisk purchase by a variety of investment trusts. The active running of recent capital market~~markets~~ is regarded as the evidence of changing behavior of individual investors.

Ⅵ Conclusion

In December 2004, the Financial Services Agency, a newly institutionalized supervisory organization separated from then-the Ministry of Finance, announced a new policy package (*the Program for Financial Reform*).

This Program clearly highlighted the authority's recognition~~judgment~~ that the worst part of the problem was over and the financial crisis since the collapse of the bubble economy was already a thing of the past. In other words, as a consequence of a series of institutional reforms together with several emergent measures, the disposal of bad loans was accelerated and prolonged slump in capital market~~markets~~ was finally overcome.

In accord with the recognition on the government's side, many commentators now argue that the coming back of increased individual investors and foreign institutional investors was the compelling evidence of the enhanced bullish sentiment in the market. In fact, in major banks that had in the meantime achieved far-reaching business restructuring along with active mergers and acquisitions, business net profit showed a conspicuous improvement and these banks intensified the initiatives to pay back ahead of schedule the public funds injected by the government.

(Note)

However, with the recovery of bank profitability and share~~stock~~ prices, a series of new problems began to surface, of which the Livedoor Case in January 2006 was the most controversial. In the Livedoor Case, prosecutors revealed untoward share~~stock~~ price manipulations and related wrongful financial conducts by an influential IT company that had achieved amazing rapid growth in the past decade. The case made it clear that although the Japanese capital market~~markets~~ had accomplished a wide range of reforms over the past ten years, many problems remained to be attended in terms of transparency and stability. Particularly disappointing was the fact that relevant entities such as the Tokyo Stock Exchange or the Securities and Exchange Commission failed~~were unable~~ to deter Livedoor from conducting untoward and unlawful share price manipulations, causing considerable capital loss to ~~in~~ innocent shareholders. Furthermore, the course of events was not covered by media until the Tokyo Metropolitan Prosecutors' Office began imperative investigations. In addition, the suspension of large volume of orders for Livedoor shares in tandem with the –market disruption triggered by the wrong sell-offer by Mizuho Securities further spoiled~~spoiled~~ the reputation of the Tokyo Market.

Turning to the main theme of this paper – the problem of bank shareholdings – since the 1990s, the cross-shareholding seems to have loosened considerably with banks continuing to sell off shares~~stock~~, combined with corporate sale of bank shares. However, compared with European and American banks, Japanese banks still hold exceptionally large amounts of shares to this day and the problem of bank shareholdings itself has not disappeared.

According to a survey by a private investigatory body (Daiichi Seimei Institute, 2004), compared with the mid-1990s the break-even point of bank-held shares has fallen dramatically, and few commentators predict a possible drop in share prices which should disrupt banks' fulfillment of BIS capital requirements in the near future. Nevertheless the market risk on banks' balance sheet should not be considered negligible. Given a large change in share~~stock~~ prices, the event can reveal a considerable vulnerability in banks' cash flow as well as capital base.~~.~~

(Note)

Based on a detailed examination on banks' shareholdings, Ito(2004) concludes: On a *Zenkoku Ginkou* (all 134 banks, 2002 FY) basis, the total outstanding shareholdings in all banks amount to ¥ 23.2 trillion, accounting for 3.1% of their total assets (¥ 746 trillion) and nearly equivalent to equity capital (¥ 24.8 trillion). Calculated on the probability of 5~~1~~% and 1~~5~~% level, based on the price volatilities in the past five years, the VARs of this shareholdings are ~~is~~ ¥ 5.2 trillion, ¥ 7.3 trillion respectively. The fact that the shareholdings that account for only 3.1% of assets carry market risk of 20～30% of equity demonstrate that the shareholding is still excessive. (We should notice that shareholding/assets ratios in large banks are in average higher than that in all banks.)

In this context, it may be advisable for financial authorities to explore appropriate policies to dismantle the inter-corporate shareholdings between banks and client companies from a long term perspective. As mentioned~~discussed~~ above, the Financial System Council has proposed limiting bank shareholdings to the range of bank equity capital. However, from an international viewpoint, this standard remains extremely high. It seems more appropriate to set the ceiling somewhere under 50% of equity capital and to implement measures to transfer the ownership of shares from banks to securities arms under bank holding companies.

The main prerequisite condition of these measures was the continuous increase in individual investors as long-term buyers. In order to fulfill the precondition, a sizable portion of the individual financial assets should be mobilized into the capital market~~markets~~ in line with the government's initiatives toward the *market-based indirect financing*.

(Note)

The market-based indirect financing denotes the architecture of financial system in which deposit-taking financial institutions play a substantial roll together with other intermediary channels including investment trusts as well as SPCs and a variety of syndicated lending schemes facilitated by advanced securitization. The essence of this architecture is the complementary combination of bank-oriented intermediation and financial securitizations with dispersion of financial risk among wide range of markets and players.

To achieve this, it will be indispensable to further enhance the transparency and functionality of the capital market~~markets~~ together with reinforcing the supervisory system and building up the processing capacity of the Tokyo Stock~~Stock~~ Exchange. Of particular importance is the prompt enactment of the Financial Services Act in order to safeguard innocent individual investors from unjustifiable disadvantages due to the market inefficiency or anomaly, not to mention of wrongful conducts of Livedoor style.

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Table 4 Segmental Breakdown of Shareholding (% of total outstanding, on ma

	governm-ent	financial institution	long term, city, regional bank	trust bank	investme-nt fund	pension fund	life insurance	casualty insurance	other financila institution	se ho
1991	0.3	42.8	15.6	9.7	3.4	1.0	12.2	3.9	1.4	
1992	0.3	42.9	15.6	9.9	3.2	1.2	12.4	3.8	1.2	
1993	0.3	42.3	15.4	10.0	2.9	1.4	12.1	3.7	1.1	
1994	0.3	42.8	15.4	10.6	2.6	1.6	12.0	3.7	1.1	
1995	0.3	41.1	15.1	10.3	2.2	1.8	11.1	3.6	1.0	
1996	0.2	41.9	15.1	11.2	2.0	2.4	11.1	3.6	0.9	
1997	0.2	42.1	14.8	12.4	1.6	3.8	10.6	3.5	0.9	
1998	0.2	41.0	13.7	13.5	1.4	4.7	9.9	3.2	0.8	
1999	0.1	36.5	11.3	13.6	2.2	5.0	8.1	2.6	0.9	
2000	0.2	39.1	10.1	17.4	2.8	5.5	8.2	2.7	0.7	
2001	0.2	39.4	8.7	19.9	3.3	6.0	7.5	2.7	0.7	
2002	0.2	39.1	7.7	21.4	4.0	5.8	6.7	2.6	0.7	
2003	0.2	34.5	5.9	19.6	3.7	4.5	5.7	2.4	0.9	
highest	0.9(86)	44.1(88)	20.9(85)	21.4(02)	4.0(02)	6.0(01)	12.8(86)	4.8(79)	2.6(87)	2.3
lowest	0.1(99)	31.6(70)	5.9(03)	7.3(86)	1.4(98)	0.4(82)	5.7(03)	2.4(03)	0.7(01)	0.6

Source: Tokyo Stock Exchange, Fact Book, 2005.