Japanese Banks in Transition:
Problems and Prospects

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Introduction: Three Valuable Insights from the United States

The Center on Japanese Economy and Business of Columbia Business School honors me by inviting me to share my thoughts and experiences on the banking industry in general, and more specifically on Japanese banks — their problems and prospects. My comments are based on my experiences as president and chief executive officer of Sanwa Bank California in Los Angeles from 1992 to 1994, and now at Sanwa Bank's American flagship, the New York Branch. The nature of banking is quite different in Los Angeles and New York. However, my experience as a bank executive in two of America's largest cities has left me with three valuable insights.

First, I have experienced state-of-the-art financial markets where competition in service and technological innovation are intense. Second, I have witnessed U.S. banks emerge from their devastating financial difficulties in the late 1980s and early 1990s to the strong recovery we see today. The third insight, precipitated by the Daiwa Bank incident, occurred while having to stand by as the world watched the management style of Japanese banks, the financial system in Japan, and indeed, Japan itself.

Today I will talk about the current situation of Japanese financial institutions, focusing on the recent bad debt issue. I will offer some comments from a banker's point of view about the impact of the recent Daiwa Bank incident. Then, in closing, I will share my opinions on the future of the Japanese economy.
Present Situation in the Japanese Financial Community: The Bad Debt Issue

Overall Picture of the Bad Debt Issue: Assessment of Amount of Bad Debt

Ever since the bad debt situation hit international headlines, U.S. bankers and members of the media have been asking me: “Are Japanese banks safe?” I think there are two points that should be clarified about the bad debt issue in Japan.

The first point concerns the total amount of bad debt, and there are two issues here. First, financial disclosure standards differ materially between the United States and Japan. What is considered adequate in Japan is not necessarily adequate by American standards, especially, for small- and medium-size financial institutions. Second, some categories of financial institutions, including credit co-ops and farmers’ co-ops, have reported their bad debt amount only to the Ministry of Finance. Therefore, the public has no direct information about their real exposure.

Because of these two issues, it is difficult to state for certain the magnitude of bad debt, and this has led to considerable speculation about the actual level of bad debt exposure. One American research organization has come up with the incredible figure of $1.4 trillion, while the Ministry of Finance suggests the actual figure is more like $380 billion.

The figure on page one provides some details of the bad debt issue. The source of this information is the Ministry of Finance, and these are the only official data we have. According to the Ministry of Finance, the total loss which may be absorbed by the banking system is approximately $180 billion. The total loss is estimated to be twice the profits of the current fiscal year. This shows that the Japanese banking system can mitigate against the loss if they allocate enough time to do it.

There is no question that, whatever the real figure is, it is a huge amount of money. As for
this huge exposure, keep in mind that the ratio of borrowing from financial institutions reaches 78 percent in Japan while being just 39 percent in the United States. The total amount of lending by Japanese financial institutions is $7 trillion, but just $3 trillion in the United States. If we compare the present ratio of bad debt to the total lending amount in Japan with the same ratio in the United States for 1991, which was the worst period for U.S. banks, there is no significant difference — both figures are at the 5 percent level.

Next look at the figures for city banks, the “shaded” region. Their ratio of bad loans to total loans is 4.9 percent which is lower than the ratio for other categories. Moreover, their business profits and latent reserves are huge. Thus you can see that the situation for city banks, including Sanwa Bank, is stronger than that of other types of financial institutions.

Another point concerns financial institutions that have experienced management failures. As the chart on page two shows, there are three broad categories of Japanese financial institutions — the central bank, that is the Bank of Japan, private financial institutions and government financial institutions. Private financial institutions include ordinary banks such as city banks and regional banks, and specialized financial institutions such as long-term credit banks, trust banks, credit associations and credit cooperatives. In addition, there are industry-based financial institutions such as agricultural and fishery cooperatives. All of these financial institutions handle deposits.

There are many types of financial institutions in Japan, and not all are on the verge of a crisis. The table on page three shows amounts of deposits and loans for Japanese depository institutions. You may have seen the names “Cosmo,” “Kizu” or “Hyogo Bank” in newspapers recently. Their bankruptcies hit Japanese headlines last year. But Cosmo and Kizu are credit cooperatives, and Hyogo Bank is a second-tier regional bank. Today all the bankruptcies are
restricted to the shaded parts of the table on page three, and their share of loans to total loans is only 20 percent. Therefore, these failures have a relatively small impact on the total Japanese financial system.

Large banks, including major commercial banks, can mitigate against their own bad debt with their own capital and profits. However, because of the inadequate explanations from Japan, the international community views all Japanese financial institutions as being in danger. The fact that Japan has not been forthcoming in disclosing or explaining the issues surrounding the bad debt situation has made it more difficult to understand. That is why the opportunity for me to speak today is so valuable — to give the Japanese — me — the chance to address these issues and hopefully to clarify them for you.

**Plan to Dispose of Jusen Bad Debt**

The largest concern facing the Japanese people now is the bad debt held by housing loan companies known as “jusen.” The three reasons that it is difficult to solve the jusen issue are: first, the huge amount that must be charged off; second, the large number of financial institutions involved; and third, the significant differences in the stakes involved among those financial institutions in terms of their individual strength and their respective relationships with jusen.

The chart on page four shows the plan which is currently being debated in the National Diet. This plan will liquidate seven companies and transfer assets to the Jusen Resolution Corporation, an organization to be established specifically to dispose of Jusen’s assets. At the asset transfer stage, the $64.1 billion in losses will be made up by: 1) $35 billion from founder banks; 2) $17 billion from lender banks; 3) $5.3 billion from agricultural financial institutions; and 4) $6.8 billion from public funds. The rest of the jusen loans which amount to $68 billion will be
taken over by the Jusen Resolution Corporation. The Jusen Resolution Corporation will recover as much of the debt as possible and any losses, so-called secondary losses, will be shared equally by the government and financial institutions.

Since even I find it complicated and difficult to understand, this plan is certain to be very difficult to understand outside Japan. One problem lies in the method used to determine the amount of the burden agricultural financial institutions should assume. In terms of the ratio of the liability for the seven jusen companies, agricultural financial institutions should assume about $12 billion of the burden. However, because of political pressure, this $12 billion was reduced to $5.3 billion, and as a result, $6.8 billion of public funds are needed to fill the gap. The percentage of the population engaged in agriculture is only 5 percent, but politicians calling themselves part of the agricultural group are extremely powerful and were able to persuade the government to reduce the actual burden by shifting more than half of it to the taxpayers.

Personally, I think this part of the proposal is wrong. Of course, the general public also thinks it is wrong. In a recent public opinion poll, 87 percent of those surveyed were opposed to the use of tax money to dispose of bad debt. Also, the same poll showed that 94 percent thought the explanation provided by the government was inadequate. I recall there was also a fair amount of public opposition in the United States at the time public funds were used to bail out the failed S&L’s (Savings and Loan Association). But, in the end, I think what convinced the public was adhering to the U.S. banking principles of “transparency” and “market mechanism.” Unfortunately, in the present debate in Japan, there is no adherence to such principles.

Response of Financial Institutions

Presently, the debate about the disposition of the jusen issue in the National Diet is still in
disarray. However, Japanese financial institutions will put loss liquidation in their field of vision and will take lump sum charge-offs.

Last week, three major banks — Sanwa Bank, the Industrial Bank of Japan, and the Long-Term Credit Bank of Japan — announced pre-tax losses for the fiscal year which ends this week. And yesterday, another three city banks — Sakura Bank, Daiwa Bank, and Asahi Bank — also announced red-ink. Japanese newspapers reported that 17 of Japan’s top 21 banks will report pre-tax losses this year. Such losses are the first ever since the end of World War II, and are the result of one-time write-offs of bad loans, including loans extended to jusen companies. This action represents a large step toward putting the jusen issue behind us.

Fortunately, the Japanese economy continues on a path of recovery and the stock market also continues to regain strength. Strong financial institutions will establish plans to dispose of bad debt within one or two years, and they can expect that their business performances will recover rapidly afterwards. I think the Japanese economic and financial condition today resembles that of the United States at its turning point in 1992.

The U.S.-Japan Banking Relationship

Balance of Power Between U.S. and Japanese Banks

Next, I will explore the U.S.-Japan relationship from a banker’s point of view. From the late 1980s to the early 1990s, a period when U.S. banks struggled with bad debt and were trying to raise their net-worth ratios, foreign banks, including Japanese banks, expanded rapidly in America. As a result, the presence of so many Japanese banks became a problem known as
The situation, however, has changed completely over the last several years. U.S. banks have dealt effectively with their bad debt, and many money center banks are boasting the highest profits in their histories. On the other hand, doing business in the United States has become extremely difficult for Japanese banks as a result of the bad debt issue, and the so-called "Japan premium" here in the United States. In particular, when this Japan premium increased to 0.5 percent last October, a number of smaller Japanese banks could no longer afford to do business in the United States. As a result, a few of them withdrew from the U.S. market.

The Daiwa Bank Incident

One event that brought critical focus to the problem of Japanese banks was the recent Daiwa Bank incident. This incident forced Daiwa to withdraw from doing business in the United States. Furthermore, it raised suspicions by the U.S. banking authorities about the soundness of all Japanese banks.

There is no doubt that the cause of this incident was slipshod internal management. Nevertheless, such fraudulent activity is something that can occur in any country's financial institutions. Some good examples are the 1994 incident at Kidder Peabody and the February 1995 incident at Barings Brothers.

Many Japanese feel that the sanctions against Daiwa were too severe. However, being here in the United States, I can understand the efforts of regulatory authorities and Congress to prevent instability in the U.S. financial system. I think the Daiwa incident reinforces the importance of strengthening financial disclosure requirements, improving the transparency of administrative decisions, and conducting close information exchanges between regulatory
authorities in each country.

Contribution of Japanese Banks to the U.S. Marketplace

As a result of the double punch from the bad debt issue and the Daiwa Bank incident, it is clear that Japanese banks are now in a very difficult business environment in the United States. However, Japanese banks should not withdraw from the United States simply for that reason because, as I explained previously, the United States is a lucrative market for Japanese banks, and Japanese banks are an important source of funds for the United States.

Let me explain the contribution of Japanese banks with some specific data. The share of C&I loans (commercial and industrial) in the United States from Japanese banks in 1995 reached 17 percent. A report released recently by the U.S. General Accounting Office stated that foreign banks provided a net $118 billion in funding in the United States in 1994 and praised the activities of foreign banks here. More than 50 percent of that funding came from Japanese banks. In addition, according to research by a U.S. consulting firm, 53 percent of America’s 1600 largest companies, including the Fortune 500 companies, are doing business with Japanese banks. Japanese banks in the United States are truly woven into the fabric of American banking, business and industry.

Japan Looking to the Future

Both the Japanese financial industry and the Japanese economy are in the greatest period of change since World War II, facing both internal problems and international competition. After the war, Japan concentrated on redeveloping its economy and achieved miraculously high growth rates. However, entering the 1990s, the Japanese economy lost its energy. Stock
prices and land prices fell dramatically, and the collapse of the bubble economy dealt blows that are still felt today in certain places. Over the last four years, real economic growth has been at just about 0% in Japan. On the other hand, the growth in the United States in the same period was between 2 and 3 percent, and the U.S. economy is now enjoying a long five-year period of expansion, the third longest since the end of World War II. In Japan, there are many who have lost confidence in the future of the Japanese economy and a feeling of stagnation has set in. This is in contrast with the U.S. economy which has regained the confidence of the public over the last several years.

A more realistic view of the Japanese economy will recognize the seeds of change that are indicators of continued growth in Japan. The seeds of change are flowering, and these flowers can be seen in the changes in individual and corporate philosophies which are creating a new vision of Japan’s place in the global scene.

On the individual level, take the success of the baseball player Hideo Nomo who pitches for the Los Angeles Dodgers. The decision to use his athletic skills internationally, which would have been unthinkable a generation ago, has undoubtedly stirred the feelings and ambitions of many young Japanese. Nomo’s expanded vision coupled with his success are effective stimulants for other young Japanese to take on the challenges of the global community. Look around you — these young Turks are beginning to reap the harvest of global opportunities, certainly in banking and manufacturing. They see Japan as a powerful player in the new global game, and they are eager to learn the rules of this new game.

The seeds of change can also be seen in the corporate world. A major illustration of the dramatic shift in corporate philosophy is the internationalization of the Japanese automotive industry. A generation ago, the concept of building Japanese cars in America would have been
unthinkable. However, thanks to a far-reaching vision paired with the uncompromising concepts of quality developed by Japanese auto makers, the Japanese car has become a benchmark for automotive performance worldwide. This kind of change will continue on an upward spiral into the next century. And again, all of this was simply inconceivable just a generation ago.

Of course, change doesn't happen over night — in fact, three periods of change can be identified in recent Japanese history. The original engine of change was the arrival of Commodore Perry and the start of the Meiji Restoration about 130 years ago. The Meiji Restoration marked Japan's transition from a feudal to a militaristic/capitalistic society. The second engine of change in Japan was the post World War II U.S. occupation. During this occupation, and indeed the post-occupation period, Japan shifted from being a militaristic society to focusing on developing its economy, particularly through manufacturing capability. Japan is now in a third period of change, marked by the collapse of the bubble economy in 1990. This collapse has become the catalyst for Japan to reposition itself as a major player in the global marketplace.

Today I have given you a look at Japanese problems and prospects — not a very rosy picture. But if I have a chance to see you again in the year 2000, perhaps I can report the significant progress Japan has made.
Japanese Banks in Transition; Problems and Prospects

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Handouts

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The Current Situation of Japanese Financial Institutions (as of September, 1995)

<table>
<thead>
<tr>
<th>Financial Institutions</th>
<th>Number of Institutions (March '95)</th>
<th>Total Loans</th>
<th>Bad Loans</th>
<th>Bankrupt &amp; Past Due</th>
<th>Restructured</th>
<th>Loans to Jusen</th>
<th>Loan Loss Provisions</th>
<th>Loans to be disposed of</th>
<th>Business Profit FY'95</th>
<th>Latent Reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td>City Banks ($ billion**)</td>
<td>11</td>
<td>274,613</td>
<td>13,557</td>
<td>8,102 (81)</td>
<td>5,455 (54)</td>
<td>1,434 (14)</td>
<td>3,273 (32)</td>
<td>2,938 (29)</td>
<td>1,810 (18)</td>
<td>8,096 (80)</td>
</tr>
<tr>
<td>Long-term Credit Banks</td>
<td>3</td>
<td>54,529</td>
<td>3,971</td>
<td>2,116</td>
<td>1,855</td>
<td>1,502</td>
<td>842</td>
<td>602</td>
<td>327</td>
<td>2,504</td>
</tr>
<tr>
<td>Trust Banks</td>
<td>7</td>
<td>61,480</td>
<td>6,302</td>
<td>2,797</td>
<td>3,505</td>
<td>2,068</td>
<td>767</td>
<td>1,446</td>
<td>274</td>
<td>2,234</td>
</tr>
<tr>
<td>TOTAL (21 Major Banks)</td>
<td>21</td>
<td>390,622</td>
<td>23,830</td>
<td>13,015</td>
<td>10,815</td>
<td>5,004</td>
<td>4,882</td>
<td>4,986</td>
<td>2,411</td>
<td>12,834</td>
</tr>
<tr>
<td>Regional Banks</td>
<td>64</td>
<td>133,545</td>
<td>4,976</td>
<td>3,348</td>
<td>1,628</td>
<td>851</td>
<td>845</td>
<td>1,481</td>
<td>n.a.</td>
<td>701</td>
</tr>
<tr>
<td>Regional Banks II</td>
<td>65</td>
<td>51,038</td>
<td>2,823</td>
<td>2,202</td>
<td>621</td>
<td>257</td>
<td>439</td>
<td>1,054</td>
<td>n.a.</td>
<td>260</td>
</tr>
<tr>
<td>Others ****</td>
<td>890</td>
<td>129,108</td>
<td>6,459</td>
<td>6,124</td>
<td>335</td>
<td>0</td>
<td>793</td>
<td>3,068</td>
<td>n.a.</td>
<td>746</td>
</tr>
<tr>
<td>TOTAL (Other Japanese Financial Institutions)</td>
<td>1,019</td>
<td>313,691</td>
<td>14,258</td>
<td>11,674</td>
<td>2,584</td>
<td>1,108</td>
<td>2,077</td>
<td>5,603</td>
<td>n.a.</td>
<td>1,707</td>
</tr>
<tr>
<td>TOTAL ($ billion**)</td>
<td>1,040</td>
<td>704,313</td>
<td>38,088</td>
<td>24,689 (246)</td>
<td>13,399 (133)</td>
<td>6,112 (61)</td>
<td>6,959 (69)</td>
<td>10,589 (105)</td>
<td>7,700 (77)</td>
<td>4,118 (41)</td>
</tr>
</tbody>
</table>

(Source: Ministry of Finance)

- "Business Profit (Gyomu Jun-eki)" = "Gross Operating Profit" -- "General & Administrative Expenses"
- The exchange rate to convert is 100 yen/$.
- **Italic figures are estimated.

- Shinkin Banks, Credit Cooperatives, Labor Credit Association, The Shoko Chukin Bank,
  Financial Institutions for Agriculture, Forestry and Fishery
- Loans to Jusen which are not classified as Restructured Loans amount to 4,918 billion yen.
Categories of Financial Institutions in Japan (as of March, 1995)

- **Central Bank**
  - The Bank of Japan

- **Ordinary (commercial) banks**
  - City banks (10*)
  - Regional banks (64)
  - Regional banks II (65)
  - Foreign banks (90)

- **Specialized financial institutions**
  - Financial institution for foreign exchange
  - Financial institutions for long-term credit
  - Financial institutions for small and medium sized businesses
  - Financial institutions for agriculture, forestry and fishery

- **Private financial institutions**
  - Specialized foreign exchange bank** (1) ..... BOT
  - Long-term credit banks (3) ..... IBJ, LTCB, NCB
  - Trust banks (23)
  - Zenshinren Bank (1)
  - Shinkin banks (credit associations) (421)
  - National Federation of Credit Cooperatives (1)
  - Credit cooperatives (374)
  - Shoko Chukin Bank (1)
  - Labor banks (48)
  - Norinchukin Bank (1)
  - Credit federations of agricultural cooperatives (47)
    - Agricultural cooperatives (2,625)
    - Credit federations of fishery cooperatives (35)
    - Fishery cooperatives (1,455)

- **Other financial institutions**
  - Insurance companies
  - Securities companies (282)
  - Life Insurance companies (31)
  - Non-life Insurance companies (56)

- **Government financial institutions**
  - Banks and Finance corporations (11) ..... JDB, EXIM etc.
  - Postal savings (1)
  - Others

* Figures in parentheses represent the number of financial institutions in each category.
** The specialized foreign exchange bank is occasionally classified as a city bank.
### Amount of Deposits and Loans of Japanese Financial Institutions (as of March, 1995)

<table>
<thead>
<tr>
<th>Category</th>
<th>Number of Institutions</th>
<th>Deposits (trillion)</th>
<th>Share(%)</th>
<th>Loans (trillion)</th>
<th>Share(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>City Banks</td>
<td>11</td>
<td>282</td>
<td>31.2</td>
<td>268</td>
<td>38.7</td>
</tr>
<tr>
<td>Long-term Credit Banks</td>
<td>3</td>
<td>68</td>
<td>7.5</td>
<td>52</td>
<td>7.5</td>
</tr>
<tr>
<td>Trust Banks</td>
<td>7</td>
<td>110</td>
<td>12.2</td>
<td>61</td>
<td>8.8</td>
</tr>
<tr>
<td><strong>TOTAL (21 Major Banks)</strong></td>
<td><strong>21</strong></td>
<td><strong>459</strong></td>
<td><strong>50.8</strong></td>
<td><strong>381</strong></td>
<td><strong>55.0</strong></td>
</tr>
<tr>
<td>Regional Banks</td>
<td>64</td>
<td>172</td>
<td>19.0</td>
<td>131</td>
<td>18.9</td>
</tr>
<tr>
<td>Regional Banks II</td>
<td>65</td>
<td>62</td>
<td>6.9</td>
<td>53</td>
<td>7.6</td>
</tr>
<tr>
<td>Shinkin Banks</td>
<td>421</td>
<td>94</td>
<td>10.4</td>
<td>68</td>
<td>9.8</td>
</tr>
<tr>
<td>Credit Cooperatives</td>
<td>373</td>
<td>24</td>
<td>2.7</td>
<td>19</td>
<td>2.7</td>
</tr>
<tr>
<td>Financial Institutions for Agriculture, Forestry and Fishery</td>
<td>48</td>
<td>80</td>
<td>8.9</td>
<td>25</td>
<td>3.6</td>
</tr>
<tr>
<td>Others (The Shoko Chukin Bank, Labor Credit Association)</td>
<td>48</td>
<td>12</td>
<td>1.3</td>
<td>17</td>
<td>2.5</td>
</tr>
<tr>
<td><strong>TOTAL (Other Japanese Financial Institutions)</strong></td>
<td><strong>1,019</strong></td>
<td><strong>444</strong></td>
<td><strong>49.2</strong></td>
<td><strong>312</strong></td>
<td><strong>45.0</strong></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>1,040</strong></td>
<td><strong>903</strong></td>
<td><strong>100.0</strong></td>
<td><strong>693</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

*Page 3*
JUSEN LIQUIDATION PLAN

($ billion)

*The exchange rate to convert is 100yen/$

The founder banks 35 ➔ (debt discharge)
The lender banks 17 ➔ (debt discharge)
Agricultural financial institutions (donation)

7 housing loan companies (JUSEN)

- Current actual value:
  - About 68

Jusen Resolution Corporation

- Recovery
  - 3 secondary losses

1st Phase

- Government: 0.8 ➔
  - About $130 in assets (book value)

2nd Phase

- Deposit Insurance Corp.
  - General Account
  - Special Fund (about $10)

- Financial Institutions

- The funds to buy assets will be offered by
  - The founder banks: about 22
  - The lender banks: about 22
  - Agricultural financial institutions: about 22

- The government will cover half of this losses.
- The remaining half will be covered by the operating profits of the Special Fund set up in the Deposit Insurance Corp.