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Recent Developments in the Japanese Financial System: 
Prudential Supervision by the Bank of Japan

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I. Introduction

Maintaining a stable currency value is the most important task that a central bank has to tackle as the sole issuer of the currency. At the same time, an important precondition for achieving stable economic growth is the maintenance and development of a safe and sound financial system. Therefore, those two policy goals are essential for the fulfillment of the roles as the guardian of the currency and, accordingly, are commonly shared among central banks in the world.

Quite recently in Japan, the financial system has been experiencing serious difficulties as a consequence of successive waves of asset inflation and deflation since the latter half of 1980s. The quality of bank loans has deteriorated significantly because of the fall in land and stock prices: the total amount of non-performing assets held by financial institutions has increased significantly. Therefore, the immediate task for the Japanese financial institutions should be to write-off the non-performing assets as soon as possible. But, in the long-run, the prudential supervision by regulatory agencies should be improved in various aspects such as the bankruptcy procedures, the accounting rules as well as the disclosure of information.

After this introductory section, Section II is to present a brief explanation about the prudential policy by the Bank of Japan (BOJ). Section III reviews the recent changes in the Japanese financial system. Section IV points out the recent problems of the Japanese banks. Section V and VI are explanations about the bankruptcy procedures and the Deposit Insurance System in Japan respectively. Section VII is to conclude this paper.

II. Prudential Supervision by the Bank of Japan

1. Importance of a Safe and Sound Financial System

The Bank of Japan (BOJ) is responsible for the maintenance of a safe and sound financial (or credit) system, in addition to the maintenance of the value of the currency, as stipulated in Article 1 of the Bank of Japan Law as follows:

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This paper was presented at the Seminar on Fiscal Policy in Macroeconomic Management, which had been organized by Vietnam Asia·Pacific Economic Center (VAPEC) and Institute of Global Financial Studies (IGFS), FAIR, JAPAN. The Seminar was held at Hanoi and Ho Chi Minh City on January 17-19, 1994. I would like to thank Messrs. Yuichiro Nagatomi, Vu Quang Tuyen, and Tran Van Tho for their valuable comments.
The BOJ has for its object the regulation of the currency, the control and facilitation of credit and finance, and the maintenance and fostering of the credit system, pursuant to the national policy, in order that the general economic activities of the nation might adequately be enhanced."

Ensuring a safe and sound financial system has recently gained importance as one of the policy objectives of central banks in the world, including the BOJ. The progress in data-processing and telecommunications technology and the development of financial globalization have dramatically altered the environment surrounding central bank policy.

First, the progress in data-processing and telecommunications has had a significant impact upon the financial system since financial institutions are one of the largest users of those technologies. In particular, such innovation in technology has contributed to the enormous increase in the volume of financial transactions requiring settlements by enabling a spontaneous transfer of data and information in large scale. It has also contributed to the financial deregulation in the sense that various financial products and services have been newly developed thanks to the technological innovations and that, accordingly, new financial markets have been established. In such circumstances, potential risks for both individual financial institutions and the financial system as a whole have significantly increased. This is because the larger volume of financial transactions tends to bring about larger potential risks, such as liquidity risks and credit risks, for individual financial institutions and also greater "systemic risks" for the financial system as a whole. For example, when a particular financial institution faces financial distress, i.e., liquidity or solvency problem, that may be transmitted to others through the contagion effect, and ultimately affect the financial system as a whole. Moreover, if a financial institution is unable to settle its position, other participating institutions may incur losses through a chain reaction in the payment system.

Second, the globalization of financial markets has made payment systems in Japan more closely interdependent with those in overseas countries. In a more specific way, Japanese banks have expanded internationally and an increasing number of foreign financial institutions have entered the Japanese financial markets. Accordingly, if a settlement failure arises in Japan, it may be transmitted to foreign countries and vice versa. In such circumstances, international cooperation with regard to prudential supervision has been necessitated, particularly among central banks. As such example of international cooperation, we can cite that, in 1975, the BIS Committee on Banking Regulations and Supervisory Practices released the Basle Concordat, which set forth general principles regarding the relative roles of home- and host-country supervisors. The revised Concordat and the minimum standards were released in 1983
and 1992 respectively. With respect to payment systems oversight, the central bank governors of the Group of Ten countries published a report by the BIS Committee on Interbank Netting Schemes in November 1990. In consideration of the report, the Governors endorsed the minimum standards for the design and operation of cross-border and multi-country netting and settlement schemes set out in the report and also agreed to adopt the principles for cooperative central bank oversight of netting systems.

2. The Activities of the BOJ in Order to Maintain a Safe and Sound Financial System

The activities the BOJ engages in so as to maintain a safe and sound financial system are three-fold: first, the BOJ facilitates settlements by issuing banknotes and transferring funds between current deposit accounts lodged in it by private financial institutions; second, the BOJ monitors the daily operations of financial institutions and conducts on-site examinations of those institutions; third, the BOJ acts as the “Lender of Last Resort.”

a. Provision of Payment Instruments and Payment Services

In Japan the BOJ is the sole issuer of banknotes, which are the legal tender for settling transactions as well as coins issued by the Government. The BOJ also provides financial institutions with current deposit accounts through which financial transactions among various financial institutions are settled with “finality.” In addition, in the area of securities settlement, the BOJ handles the registration and book entry system with respect to Government bonds, thus making it unnecessary to physically convey those bonds from place to place.

Faced with rapid developments in computer technology and data processing as well as financial deregulation and the progress of internationalization, the BOJ has been making its efforts to enhance the efficiency and reliability of Japan’s settlement system, so as to harmonize them with international standards and practices. In particular, the BOJ has launched an on-line settlement network called BOJ-NET, which provides an electronic-based facility for operations such as current account transfers, and registration and book-entry for Government bonds.

Thus the BOJ plays an important role in the smooth functioning of the clearing and settlement system in Japan. In this respect, it is also involved in the formation of rules and practices concerning the Bill and Check Clearing System, the Domestic Funds Transfer System, and the Foreign Exchange Yen Settlement System.
b. Monitoring and Supervision

It is important for the BOJ to be informed, as soon and as accurately as possible, of the business conditions of the country's financial institutions and the surrounding market environment. For this purpose, the Credit and Management Department of the BOJ monitor the daily operations of financial institutions and its Bank Supervision Department regularly conducts on-site examinations of them.

When conducting on-site examinations, the BOJ staff has traditionally been paying close attention to the soundness of loan assets in order to evaluate the capital level and the efficiency of risk management. The BOJ staff evaluates the quality of individual loans of a financial institution, focusing on collectibility, then calculate the ratio of problem loans to total loans and ultimately assess whether the ratio would be excessive or not in comparison with the capital level of that financial institution. While evaluating the asset quality, the BOJ staff also investigate the credit analysis and risk management system of that financial institution in order to evaluate their lending policies and disciplines with respect to controlling credit risks. More recently, however, the BOJ staff has also come to pay close attention to various risks such as interest rate risks, foreign exchange risks, and systemic risks.

It should be noted that the supervision by the BOJ is different in purpose from the inspection by the Ministry of Finance (MOF). The BOJ exercises its authority as the Lender of Last Resort and gives expert advice after having closely surveyed the management situation of each financial institution. On the other hand, the MOF inspections are conducted in order to detect violations of the Banking Law and the Securities and Exchange Law. Despite such differences, the BOJ and the MOF share the common policy objectives of maintaining a safe and sound financial system.

c. Lender of Last Resort

The last, but the most important role of the BOJ in maintaining a safe and sound financial system is to exercise its "Lender of Last Resort" functions. When the possibility of a financial institution becoming insolvent was considered to pose an important threat to the credibility of the financial system as a whole, which might perhaps trigger a collapse in confidence, a central bank would be necessitated to take preventive measures by extending credit to such financial institutions. For example, the BOJ extended uncollateralized loans to the Yamaichi Securities House and others in distress in the securities depression of 1965.(2)

It should be added that the BOJ maintains close communication with the Deposit Insurance Corporation, whose office of the Chairman is to be assumed by the Senior Deputy Governor of the BOJ. More detailed explanation about
III. The Japanese Financial System

1. Characteristics of the Japanese Financial System

The Japanese financial system which had been rather well developed during the Meiji and Taisho periods and was reorganized after the Second World War has been characterized with a) functional separation of private financial institutions, b) interest rate regulation, and c) regulation over international transactions.

Functional Separation of Private Financial Institutions

The first characteristic has been the functional separation of private financial institutions. The greater role of the financial system within the national economy can be observed in some other countries than in Japan, but what has really been characteristic with the Japanese financial system is the fact that the rather strict allocation of individual functions among different categories of financial institutions has been observed. Such allocation of financial functions have been seen in the separation between long-term finance and short-term finance, the separation between deposit banks and trust banks, and the separation between banks and securities houses.

The separation of long-term finance and short-term finance has been based on the commercial banking philosophy similar to that of the United Kingdom and was first introduced to the Japanese financial system in 1882, the year the BOJ was established. Documents related to the BOJ Charter emphasized a very clear distinction between commercial funds related to transactions of commodities and agricultural or manufacturing funds related to promoting productions in those sectors. In 1952 Long-Term Credit Bank Law was enacted based on such philosophy and, accordingly, long-term credit banks which specialized in long-term finance and could float financial debentures were established. For those financial institutions that rely on the gathering of deposits as the primary source of funds, there are currently no legal provisions regarding the maturity of funds raised as well as funds utilized. However, the MOF exercises an administrative guidance with respect to maturity of deposits in order to avoid conflicts between such deposits and financial debentures issued by long-term credit banks.

The separation of banking business and trust business was made clear in the Trust Law and the Trust Business Law, both of which were enacted in 1922. The primary reason for such separation was not the conflict of interests, but was rather the separation of long-term finance from short-term finance. In 1948, however, trust companies were converted into banks and were permitted...
to conduct banking business as well as trust business at that time. But, in 1952, the MOF promoted the separation between banks and trust banks through enforcing mergers between trust departments of banks and trust banks, while the MOF permitted trust banks to offer "loan trust" to their customers.

The separation of banking business and securities business has had its roots in the concept of commercial banking. The idea was that banks may impair their stability by holding equity shares or long-term bonds because such assets tend to suffer from large price fluctuations. Also the conflict of interests has been a very important factor in supporting the separation between banks and securities houses. In the period before the Second World War, there were no legal provisions concerning the separation between banking and securities activities, but in fact there existed an informal practice of such separation. In the post-war period, the separation was legally established by Article 65 of the Securities and Exchange Law of 1948, which was based on the Glass-Steagall Act of the United States. The acceptance of this Law succeeded the informal practice of the separation in the pre-war period. Article 65 of the Securities and Exchange Law prohibits banks from engaging in securities business except in cases where there is an investment purpose or a trust contract. The Article also allows exceptions for banks' bond businesses of government bonds, local government bonds, and government-guaranteed bonds. In actual practice, however, banks engaged only in the underwriting of government bonds during the high growth period in the 1960s. The other bond businesses allowed by the Law were in fact prohibited by the administrative guidance of the MOF.

Interest Rate Regulation

The second characteristic of the Japanese financial system has been related to interest rate regulation. The first agreement on regulating deposit interest rate with enforcement provisions was set in 1918. The motivation for banks to establish such agreement was to avoid a banking crisis as a result of interest rate competition in gathering deposits. There existed a strong fear that such competition might have weakened the soundness of banks.

In December 1947, the Temporary Interest Rate Adjustment Law was promulgated and implemented. Under the Law the Minister of Finance determines whether or not interest regulation is necessary in the light of general economic conditions and then, if necessary, the Policy Board of the BOJ should seek the advice of the Interest Rate Adjustment Council. At present such process of determining the upper limits on deposit interest rates still holds, although significant portion of deposits of financial institutions has already been in the category of deposits with liberalized interest rates.
Foreign Exchange Control
The third characteristic of the Japanese financial system has been related to foreign exchange control. Rather strict control of foreign exchange during the high growth period in the 1960s meant that there was a segmentation between domestic and foreign financial markets. As time passed, however, such regulation concerning foreign exchange control was gradually eased in line with the international trend of liberalizing capital movement across borders.

2. Recent Changes in the Japanese Financial System
Recently the Japanese financial system has been experiencing various changes such as a) the deregulation of the separation of financial institutions, b) the liberalization of interest rates, and c) the deregulation of foreign exchange transactions.

Deregulation of the Separation of Financial Institutions
The first change is the deregulation of the separation of financial institutions, namely, the expansion of business area as well as trends towards revising regulations enforcing separation.

Regulations concerning the business areas of financial institutions have been liberalized in recent years. For example, banks have been allowed to handle many securities activities, starting with the over-the-counter sale of government bonds in April 1983. A wide range of banking institutions from city banks to credit cooperatives are now permitted to handle those bonds. Also, dealing in public bonds by banks was begun in 1984 and the scope of banking institutions which are permitted to deal in those bonds has been gradually broadened since then. Furthermore, in November 1988 banks were allowed to market their housing loan mortgage trusts.

Meanwhile, in 1984 securities companies developed, through tie-up with shinkin banks, a new financial instrument which linked medium-term government bond funds with bank deposits. With such financial innovation, the medium-term government bond funds became a de facto settlement account, even though settlements must be done through an ordinary bank deposit account.

Despite the fact that the business activities of the different financial institutions are becoming increasingly similar due to the expansion of business area of individual categories of financial institutions, there still remain fundamental regulations that divide institutional categories. However, the restructuring of the Japanese financial system has been seen recently. For example, the Financial System Committee of the Financial System Research Council, an advisory body to the Minister of Finance, published a report entitled "On a New Japanese Financial System" in June 1991. In this report the Committee concluded that mutual entries among individual financial categories in the form of
separated subsidiaries would be the appropriate approach towards a new financial system. Also the Securities Exchange Council, another advisory body to the Minister of Finance, discussed the revision of regulations concerning the separation of financial institutions. The Second Sub-committee for Fundamental Research of the Council published its report in June 1991 and concluded that the establishment of separated subsidiaries would be appropriate. Subsequently, Law Concerning the Reform of the Financial System was enacted in June 1992 and it became possible for ordinary banks, long-term credit banks, trust banks, and securities houses to set up wholly-owned subsidiaries in the designated financial categories, starting from April 1993. Although there are still important restrictions in terms of type of business which banks or securities houses can engage in (e.g. banks are not allowed to engage in stock-brokering) and relatively strict firewalls exist between parents and subsidiaries, the first securities subsidiaries formed by 2 long-term credit banks, the Norinchu-kin Bank, and 2 trust banks started operation in July 1993. Trust banks formed by 4 securities houses and the Bank of Tokyo started operation in October 1993. Big city banks have to wait a bit before embarking upon securities activities in order to mitigate the adverse impact of the simultaneous entry of many bank subsidiaries on small securities houses.

As for the segmentation of the banking system, the demarcations which separated various specialized banks have gradually and effectively been reduced and the trend will continue.

**Liberalization of Interest Rates**

The second change is the liberalization of interest rates. At first, the large issuance of long-term government bonds in the late 1970s triggered the liberalization of long-term interest rates as the auction method for many types of government bonds expanded in the early 1980s.

Deposit interest rates were steadily liberalized from 1979. At first, CDs were introduced in 1979. Large-denomination time deposits bearing market rates and money market certificates (MMCs) were introduced in 1985, small-denomination MMCs in 1989, and restrictions on minimum amount and maturity of such deposits were gradually relaxed thereafter. In June 1993, interest rates on time deposits became virtually free of any regulation. As a result of such deregulation, deposits at city banks bearing market-determined interest rates as a percentage of total deposits were all over 70% in 1990, compared with only 22% in 1985.

The remaining regulated deposit interest rates, i.e., liquid deposit interest rates, will be liberalized during 1994 except those on current deposits (checking accounts) whose rates will remain regulated to be at 0%.

Meanwhile, since November 1988 the BOJ made an effort in reforming the
interbank money markets, namely call and bill markets, so that the interbank rates would reflect the market conditions smoothly and the arbitrage transactions between interbank markets and various open markets would be enhanced. Thanks to the diversification of the open markets and reform of the interbank markets, inter-market arbitrage has been significantly increased since the 1980s. In order for money market operations to be effective, however, a well-developed money market where a central bank can conduct operations flexibly is essential and in case of Japan short-term government bills market needs to be developed.

**Liberalization of Foreign Exchange Regulations**

The third change is the liberalization of foreign exchange regulations. The Foreign Exchange and Foreign Trade Control Law was fully revised in 1980 and the basic principles concerning the international capital movement was changed from one of "prohibition" to one of "freely allowed," though regulated in case of emergency.

In May 1984, a report by the Joint Japan-U. S. Ad Hoc Group on Yen/Dollar Exchange Rate, Financial and Capital Market Issues suggested a number of deregulations with respect to both the raising and investing of funds by banks and other entities so as to promote the internationalization of the yen. Included among them were the removal of limits on the oversold spot foreign exchange positions of banks (i.e., yen conversion limits), the liberalization of Euroyen trading, and the elimination of the so-called "real demand rule" for forward exchange transactions. The rule stated that foreign exchange transactions between banks and their customers should be based on "real transactions" such as commodities trade.

All such measures contributed to expanding international financial transactions. The lifting of yen conversion limits resulted in expanding Euroyen interbank transactions and Eurodollar transactions with foreign exchange swaps, which in turn contributed most significantly to increased arbitrage between domestic interbank and open markets.

### IV. Recent Problems of the Japanese Banking Sector

1. **Changing Behaviour of Banks and Hikes in Asset Prices**

   In the second half of the 1980s, there were significant changes in the environment in which the Japanese banks operated as have already been stated in Section III of this paper. The most conspicuous response of the Japanese banks to the actual and potential loss of their franchise value as a result of financial liberalization was to expand lendings to less traditional areas, in particular to real estate and non-bank firms.
Between 1985 and 1992, bank loans to the real estate industry grew 13.7% annually, compared with 6.6% for total bank lending, and the share of such loans to total bank lending rose from 7.5% in 1985 to 12.1% in 1992. Lending to non-banks also grew rapidly, from 10.4% to 14.0% of total bank lending. Many of these non-banks were bank affiliates whose purpose was to lend to real estate firms and effect equity investments. Banks also expanded their equity portfolios, directly, or indirectly through special trust funds (tokkin funds etc). Similar behaviour was observed on the part of many agricultural cooperatives.

The increase in real estate prices in central Tokyo had already started in the early 1980s, but accelerated sharply around 1986–87. The rapid increase gradually spread to the suburbs of Tokyo and to other major cities. The increase in stock prices accelerated virtually hand in hand with the rise in land prices.

Several non-monetary factors are cited as background to the rise in land prices, among others: a) the increased importance of Tokyo as a major world financial and trade center, and b) the favourable tax treatment of investments in land—the effective inheritance tax on real estate was much lower than on other assets; the capital gains tax could be avoided if income from the sale of real estate was reinvested in other real estate.

It is also true that the economic environment and macro economic policy contributed significantly to the increase in asset prices. Monetary ease continued: the official discount rate of the BOJ, which had already been lowered four times in a short period, was lowered again to a historically low level of 2.5% in February 1987 and remained there until mid-1989. The economy, which had been in recession due mainly to the deflationary impact of the substantial appreciation of the yen, exhibited signs of recovery around the end of 1986 and then showed brisk growth in 1987 and 1988. However, monetary policy was not changed as prices of goods and services remained stable due to the appreciation of the yen, in stark contrast to the sharp rise in land and stock prices.

Since the latter half of the 1970s the BOJ has paid its attention to the broadly defined money stock and, in particular, has published the quarterly forecasts of M2 + CDs. The BOJ, however, has not adopted the monetary targeting policy, but has followed a more pragmatic approach in the sense that it has not set any target zones of the monetary aggregates and instead has treated the money stock as one of the important economic indicators (e.g., various interest rates, foreign exchange rates, industrial production, investment/consumption expenditures and so on) in reaching a so-called "comprehensive judgement" about the state of the economy.

Under this pragmatic approach, the BOJ has nonetheless succeeded in gradually lowering the growth rates of the money stock (M2 + CDs) between the
late 1970s and the early 1980s. At the same time, the growth rates of nominal GNP and of GNP deflator have followed a declining trend almost in parallel with those of M2+CDs. Since the mid-1980s, however, the growth rates of M2+CDs have been accelerated to double-digits, while inflation measured by CPI and WPI has been kept at relatively low level. In contrast, as has already been mentioned, prices of stock shares and real estates have continued to soar to the historically highest levels until the end of 1980s.

2. Decline in Asset Prices and Policy Reaction

By early 1989 it became evident that inflationary pressures were mounting, and monetary policy was tightened in May 1989. The MOF, for its part, asked the banks in 1990 to contain the growth of their real estate-related lending to less than that of total lending. Asset prices continued to rise for a while thereafter, but stopped rising or started to decline around the end of 1989. The Nikkei Stock Average Index peaked in December 1989 at 38,917 and fell rapidly to record a low of 14,309 in August 1992. The movement of land prices varied considerably from region to region, but clearly changed to a downturn in 1990.

In the meantime, the growth rates of M2+CDs have indicated a sharp decline to the historically lowest level of \(-0.5\%\) and \(-0.2\%\) over the previous year in the fourth quarter of 1992 and the first quarter of 1993 respectively.

The quality of bank loans deteriorated significantly as a consequence of the fall in land and stock prices: total non-performing assets held by city banks, the bulk of which consisted of loans to real estate and non-bank firms, stood at ¥12.8 trillion at the end March 1993, or 3.2% of total outstanding loans, and thus recorded a 60% increase in only one year.

Banks and financial institutions encountering difficulties have received support from others in the sector, either by merger or substantial financial assistance. An example of the former was the merger of the Toho Sogo Bank, a small regional bank which became insolvent, with the Iyo Bank, a larger and sound bank in the same region; and a typical example of the latter was the assistance provided by banks to Nippon Housing Loan, a non-bank specializing in mortgages and which held a vast amount of non-performing assets, the failure of which would have caused serious problems for agricultural cooperatives. Another joint effort of the banking sector to overcome current difficulties was the establishment of the Cooperative Credit Purchasing Corporation (CCPC), an institution designed to facilitate the liquidation of the real estate assets of banks.

V. Bankruptcy Proceedings in Japan

In this section we would like to explain the proceedings available under the
Japanese law designed for or having the effect of relieving or otherwise dealing with those banking institutions which are on the verge of bankruptcy. We intend to cover not only the statutory bankruptcy, but also other available proceedings and procedures which are designed for or have the effect of relieving financially disabled banks as much as possible. Such proceedings include mergers or acquisitions by profitable banks of those other banks which are in financial distress, various proceedings or action which may be taken by a regulatory agency for or against banks in financial distress, such as temporary suspension of their banking business and affairs or permanent termination of their banking business licenses.

1. Applicable Statutes

When a bank is in serious financial distress and is unable to continue its business in the same way as before, then it will, like any other corporation, naturally be subject to statutory bankruptcy proceedings under the bankruptcy law, which includes the Bankruptcy Act (Hasan Ho, hereinafter referred to as “BA”), the Stock Company Reorganization and Rehabilitation Act (Kaisya Kosei Ho, hereinafter referred to as “SCRRA”), the Arrangement Act (Wagi Ho, hereinafter referred to as “AA”) and the related provisions governing corporate reorganization and special liquidation proceedings of stock corporations included in the Commercial Code (Sho Ho, hereinafter referred to as “Code”). All of those statutory bankruptcy proceedings, if applied to a bank, have the effect of liquidating or reorganizing the bank through a unified and blanket legal procedures designed to adjust in an equitable manner the rights and interests of all parties who have valid claims against the bank, under the supervision of the court.

All banks are required under Article 4.1 of the Banking Act to obtain and maintain a valid banking business license in order to engage or remain in the banking business. Their dissolution and liquidation procedures are inevitably affected by the Banking Act, since the Minister of Finance has the power and authority to permanently terminate their banking business licenses under certain circumstances therein specified. In addition, banks business and affairs may be affected by the Deposit Insurance Act (Yokin Hoken Ho, hereinafter referred to as “DIA”), which provides certain insurance coverage for the protection of depositors.

In addition to the statutory bankruptcy proceedings, there are, in a much broader sense, other proceedings which are also designed for or have the effect of relieving financially unhealthy banks. Included among them is the merger of a bank which is in a financially unhealthy condition into another bank which is financially healthy and profitable. Such a merger is subject to the special procedural rules set forth in the Banking Act, and the Act Governing Mergers
between and Conversion of Banking Institutions (*Kinyukikan No Gappei Oyo-
bi Tenkan Ni Kansuru Ho*), hereinafter referred to as the “M&C Act”), whose
primary purpose is to regulate mergers between or among two or more banking
institutions of different kinds. DIA may become operative, among other situa-
tions, in or near bankruptcy, because, for the purpose of facilitating the liq-
uidation or rehabilitation of a bank in financial distress, DIA authorizes and
empowers the Minister of Finance to act as an intermediary to promote and ex-
pedite the merger of the bank into another bank or the acquisition by any
other bank or banks of all or substantially all its assets and/or capital stock
shares on one hand, and gives such other bank or banks a chance to avail them-
selves of “Financial Assistance” provided by the Deposit Insurance Corpora-
tion thereunder on the other hand.

### 2. Bankruptcy Proceedings Categorized

In general, the bankruptcy proceedings, which are designed for or have the
effect of liquidating or rehabilitating a financially unhealthy bank, such as a
bank with an extremely poor equity ratio, can be classified into the following
three categories:

1. liquidation type proceedings—to wind-up a financially unhealthy
   bank and distribute its assets to its creditors and shareholders. Special
   liquidation proceedings under the Code and bankruptcy proceedings
   under BA come under this category;
2. rehabilitation type proceedings—to reorganize and rehabilitate a
   financially unhealthy bank;
3. merger & acquisition type proceedings—to let a bank or banks in a
   sound financial condition to acquire and assume the assets and liabili-
ties of a financially unhealthy bank.

*Liquidation Type Proceedings*

(a) Special Liquidation Proceedings under the Code and Permanent Ter-
mination of Banking Business License under the Banking Act

Special liquidation proceedings under the Code are proceedings designed
specifically for corporations of which ordinary liquidation proceedings have al-
ready commenced, with cooperation among their creditors and trustees, who
are usually appointed among their respective chief executive officers. (Articles
431 through 456). The proceedings can be triggered only when such corpora-
tions are found to be in any “condition or circumstances which may substan-
tially interfere with the prosecution of [their normal] liquidation proceedings”
or there is “a suspicion of [their] insolvency.” (Article 431. 1). Once these
proceedings are triggered, it has the effect of eliminating the bankruptcy
proceedings under BA. Before liquidation proceedings (whether normal or spe-
cial) can be effectively triggered with respect to any corporation, it must have passed a resolution of its dissolution or an order of its dissolution issued by an appropriate regulatory agency. In case of a bank, however, it is also required to satisfy certain other requirements under the Banking Act, before it can trigger the proceedings. The Banking Act, in Article 26, authorizes the Minister of Finance to totally or partly suspend the banking business and affairs of any bank, if and to the extent he or she deems it “necessary [to do so] in the light of the bank’s [existing] operational and/or financial conditions.” Article 28 thereof further authorizes him or her to permanently terminate at any time the banking business license of any bank whose banking business and affairs are for the time being suspended totally or partly by the Minister of Finance pursuant to Article 26, if he or she finds it necessary [to do so] in the light of the progress of the [bank’s] winding up proceedings. “The business and affairs of banks whose banking business licenses are so terminated must be wound up [in due course] and to go into liquidation proceedings or, if they are insolvent, then special liquidation proceedings under the Code. (Article 40 and 44).

(b) Bankruptcy Proceedings

Bankruptcy proceedings are of proceedings in which a debtor, who is unable to meet his or her debts when due or is deemed so because of the fact that he or she suspends payment in general or who is insolvent, can be adjudicated a bankrupt by a court, and the net proceeds realized from selling or otherwise liquidating his or her estate by a trustee can be distributed to his or her creditors on a pro rata and equitable basis. (Articles 126 and 127 of BA). There exists no special rules with respect to how, when or who may file a petition in bankrupt by a court. But when a bank is adjudicated a bankrupt by a court, the court is required to notify the regulatory agency in charge of the bankrupt (i.e., the Minister of Finance) of such adjudication, and by virtue of Article 404 of the Code the bank will ipso facto be required to go into winding up proceedings and its banking license will be nullified pursuant to Article 41.3 of the Banking Act.

Rehabilitation Type Proceedings

The reorganization proceedings under SCRRRA can be triggered by a court for the reorganization and rehabilitation of a stock corporation (Kabushiki Kaisya, or K. K. for short) which is “unable to meet its debts as and when they become due without causing any substantial inconvenience in the continuance of its operations” or which is “likely to commit any act of bankruptcy,” upon a petition filed by the corporation itself or any of its creditors or shareholders. (Article 30.1). When reorganization proceedings thereunder are triggered with respect to any corporation, then a proposed reorganization and rehabilitation
plan will be prepared pursuant to which, among other things, the rights and interest of all parties concerned would be adjusted and modified, its outstanding debts adjusted and paid, its business and affairs administrated and its capital structure changed and, subject to the court's approval, such plan will be implemented by a trustee appointed by the court, while it remains a going concern. As is the case of bankruptcy proceedings mentioned earlier, there exists no special rules with respect to how, when or who may file a petition for the reorganization and rehabilitation of banks. But when a petition for the reorganization and rehabilitation is filed by or against a bank with a court or when the court grants the petition, the court is required under Article 35 or 48 of SCRRA to notify the regulatory agency in charge of the bankrupt, namely the Minister of Finance, of such fact. Article 194 of SCRRA guarantees the Minister of Finance opportunities to express his opinion or make comments on any and all draft plans for the reorganization and rehabilitation of banks filed with the court. It should be noted that since the reorganization proceedings do not necessarily cause the winding up proceedings, the fact that a petition for reorganization and rehabilitation has been filed and is pending alone does not operate as a valid cause for the permanent termination of its banking business license.

Merger and Acquisition Type Proceedings

As mentioned earlier, a merger between two or more banks is generally subject to the relevant provisions of the Code including, but not limited to, Article 408.1 which requires the parties to a merger to prepare and execute an appropriate written merger agreement; Article 408.3 and 343 which require the merger agreement to be approved by a special resolution of their respective shareholders adopted by a two-thirds majority of the voting rights represented at a shareholders meetings at which shareholders holding more than 50% of the outstanding voting shares are present; Article 408-III which gives dissenting shareholders an appraisal remedy or a put option to sell their shares to the company of which they are shareholders at fair market value; Article 100 and 416 which guarantee creditors opportunities to file objections against the proposed merger to protect their own interests; and Article 414 requires that upon consummation of the merger, appropriate filings be promptly made at all local legal affairs bureaus having jurisdiction over the parties to the merger. (3)

The statutory requirements under the provision of the Code, however, are somewhat intensified or mitigated by the Banking Act, to the extent they are applicable to merger of banks. For example, Article 30 of the Banking Act makes all mergers between any two or more banks further subject to the approval of the Minister of Finance, while banks who are parties to a merger are exempted from the obligation to give notice of the merger individually to their creditors
including their client depositors. In Japan, in addition to ordinary banks, there are several other types of banking institutions. Each type has its own law which regulates entities belonging to that type and their business. The M&A Act makes it possible for any two or more banking institutions of different types to merge, which would not be otherwise possible.

DIA includes intricate provisions regulating the merger of a financially unhealthy banking institutions into another financially healthy and profitable institutions. Article 59 of DIA states that any banking institution which is financially healthy and profitable and which is going to merge, as the surviving entity, with any financially unhealthy banking institutions or acquires all or any part of the assets and/or capital stock shares of such financially unhealthy banking institutions may, in order to facilitate such merger or acquisition, request the Deposit Insurance Corporation to extend “Financial Assistance.” The term “Financial Assistance” means, by definition, the donation of cash funds, extension of loans, purchase of assets and assumption and guarantee of debts.

Technically speaking, if the Deposit Insurance Corporation pays insurance proceeds to depositors of a financially disabled bank pursuant to DIA, such decision or payment is solely for the purpose of protecting the depositors with a view to maintaining the credibility of the nation’s financial system as a whole, and it is totally independent from the liquidation or rehabilitation of such disabled bank. When the “First Class Insurance Risk Situation,” which term is defined to mean suspension of payment to depositors, occurs with respect to any bank, or when “Second Class Insurance Risk Situation,” which term is defined to mean and include the termination of the banking business license, adjudication of bankruptcy or passing of a resolution of dissolution, occurs with respect to any bank, DIA entitles each and every depositor to file an insurance claim with the Deposit Insurance Corporation and obtain insurance proceeds out of the Corporation's funds to the amount of ¥10 million per depositor.

3. Relationship among Various Bankruptcy Proceedings

In Japan bankruptcy proceedings applicable to banks are subject to not only the general rules and principles set forth in the Civil Code and the Commercial Code, but also to those set forth in three other groups of law: namely, a) the Banking Act (in relation to the temporary suspension of the banking business and affairs or the termination of a banking business license): b) the bankruptcy law, which includes the provisions of the Code relating to special liquidation proceedings, BA and SCRRA; and c) DIA (in relation to “Financial Assistance” to expedite mergers and acquisitions and payment of insurance proceeds). Unfortunately, from the practical point of view, they are very complicated in that a) one cause or event which may act as a trigger for any
proceedings against a bank under one of the three groups of law does not necessarily so act for any proceedings against the bank under any other group of law, which fact often creates a situation where the time to initiate proceedings under one group of law has elapsed, but it has not under any of the other groups of law, i.e., the problem of timing difference; b) the parties who are entitled to file a petition for or initiate proceedings against a bank or to make decisions thereunder are different as from one group of law to another, i.e., the problem of the lack of uniformity in parties; c) there may be cases where two or more proceedings under two or more different groups of laws are pending against one and the same bank, either with or without cooperation or coordination between them, i.e., the problem of the cumulative nature of proceedings; and d) how and to what extent bankruptcy proceedings, if initiated against any bank, will affect the bank's banking business license is not altogether clear, i.e., the problem of uncertainty.

VI. The Deposit Insurance System in Japan

In this Section we will briefly explain the Deposit Insurance System in Japan. As has already been mentioned above, the Deposit Insurance System can play an important role in promoting the merger and acquisitions of financially unhealthy banks by financially healthy and profitable banks. In fact, the Deposit Insurance Corporation implemented, for the first time in its history, the "Financial Assistance" in April 1992.

1. Framework of the Deposit Insurance System

The Deposit Insurance System in Japan was created under the DIA which was promulgated and enforced in April 1971. DIA stipulates that the aim of the System is to protect depositors with a view to maintaining the stability of the financial system, by either making insurance payments to depositors in the event of the suspension of deposit repayments, or extending "Financial Assistance" to facilitate mergers or acquisitions of failing financial institutions. Financial institutions which are legally obligated to participate in the Deposit Insurance System include all the following types of financial institutions with headquarters in Japan: a) Banks (city banks, regional banks, member banks of the Second Association of Regional Banks, trust banks, long-term credit banks), b) Shinkin banks, c) Credit cooperatives, d) Labor banks. Government-related financial institutions and Japanese branches of foreign banks are not covered by this System.

It should be noted that the insurance relationship arises automatically among the Deposit Insurance Corporation, financial institutions, and their depositors when financial institutions accept insured deposits. The following
deposits and other liabilities of member institutions are insured under the System: a) Deposits, b) Installment savings, c) Money-in-trust whose principal has been guaranteed, specifically jointly managed designated money trusts, and loan trusts.

The Deposit Insurance Corporation (DIC) was created in July 1971 under the provisions of the DIA for the purpose of operating the Deposit Insurance System. The Corporation was capitalized at ¥455 million, of which the Government and the BOJ subscribed to ¥150 million respectively. The remaining ¥155 million was provided by private financial institutions.

The DIC's decision-making body is the Management Committee which consists of the Governor (concurrently, the Deputy Governor of the BOJ), the Executive Director, and the other six members. Those members are appointed by the Governor with the approval of the Minister of Finance from among persons with expertise in financial fields. At present, the Chairman of the Federation of Bankers Association of Japan and other representatives of the financial communities are serving on this Committee.

The major functions of DIC include the collection of insurance premiums, payment of insurance claims, execution of "Financial Assistance" and the management of funds.

Member institutions must pay premiums to the Deposit Insurance Corporation within 3 months of the beginning of each business year. The premium amount to be paid is calculated by multiplying the premium rate (currently 0.012%) and the total balance of insured deposits held by a financial institution at the end of the preceding business year.

All surpluses of the Corporation derived from insurance premiums and other revenues are accumulated in the Deposit Insurance Fund to be used, when and if necessary. At the end of March 1993, the outstanding balance in the Deposit Insurance Fund stood at ¥770 billion. The Corporation is legally authorized to borrow funds within a designated limit (currently, ¥500 billion) from the BOJ.

DIC makes insurance payments in the following two types of situations: a) First Class Insurance Risk — Claims arising from the suspension of the repayment of deposits in financial institutions, and b) Second Class Insurance Risk — Claims arising from the cancellation of a financial institutions' operating license, the declaration of bankruptcy, or the resolution to dissolve the financial institution. In case of First Class Insurance Risk, DIC must convene its Management Committee and decide whether or not to make insurance payments within one month of the suspension of payments. In case of Second Class Insurance Risk, DIC is required to make insurance payments. Insurance payments payable to individual depositors are equivalent to the total balance of insured deposits held by that depositor in the financial institution in ques-
tion, not exceeding the sum of ¥10 million per individual depositor.

When a "failing financial institution" suspends the repayment of deposits or is in the verge of doing so, and another "relieving financial institution" decides to merge with the failing financial institution, take over its business or acquire its stock, DIC can extend "Financial Assistance" to the relieving financial institution to facilitate the merger or other actions mentioned above. Financial Assistance may take such forms as money grants, loans, deposits, purchase of assets, guarantee of liabilities, and acceptance of liabilities by DIC.

2. Recent Cases of Financial Assistance by DIC

On October 16, 1991, the Iyo Bank, which has its principal office in the City of Matuyama, received approval from the Minister of Finance of its application for Financial Assistance to facilitate its merger with the failing Toho Sogo Bank, which had its principal office also in the City of Matuyama. On the following day, the Iyo Bank applied to the DIC for Financial Assistance. DIC's Management Committee met on October 28 and decided to extend Financial Assistance to the Iyo Bank. The Financial Assistance was implemented on April 1, 1992. To be more accurate, DIC has extended to Iyo Bank a floating interest loan in the aggregate amount of ¥8 billion for a period of 5 years at the rate equal to the coupon rate of the 10-year Government bonds minus 5%. By this loan, Iyo Bank can save interest expenses by as much as ¥2 billion by the end of the 5-year period.

On May 21, 1992, the Sanwa Bank, which is one of the city banks and has its principal office in Osaka, received approval from the Minister of Finance of its application for "Financial Assistance" to facilitate its merger with the failing Toyo Shinkin Bank, which had its principal office also in Osaka. DIC's Management Committee met on June 1 and decided to extend "Financial Assistance" (grant of ¥20 billion) to the Sanwa Bank. The grant was provided on October 1, 1992. In fact, most of the branches of Toyo Shinkin Bank have been sold to 22 Shinkin banks in the region of Osaka.

VII. Conclusion

We have briefly reviewed recent development in the Japanese financial system as well as the prudential supervision by the BOJ. As we have shown, the Japanese banking sector is now facing not only the immediate problem of writing-off large amount of non-performing loans, but also the more fundamental problem of restructuring the environment which surrounds the financial system as a whole. The improvement of the bankruptcy procedures is one of the area where such restructuring should be necessitated. We also find it
necessary to improve the accounting rules as well as the disclosure of information so that we can gain a more accurate understanding of the management conditions of the Japanese banks.

[Reference]


Appendix: Japanese Financial Institutions

The Japanese financial institutions are categorized as shown in Chart 1, based on type of business and customer.

The classification is done in three stages. The first stage is whether a financial institution is private or public. The postal saving system is categorized as a public financial institution. It collects deposits from the public through its extensive network of approximately 24,000 local post offices nationwide. This system is operated by the Ministry of Posts and Telecommunications. Postal savings account for as much as 30% of total deposits made by individuals nationwide.

As the second stage of the classification, private financial institutions are divided into intermediaries and the other financial institutions. The latter include securities houses, which play a key role in securities markets for equities and bonds through their broking, dealing, selling, and underwriting functions. In addition, they also deal in certificates of deposits (CDs), and bankers’ acceptances (BAs) and offer medium-term government bond funds. There are more than 200 securities houses in Japan, but the “Big Four”, i.e., Nomura, Daiwa, Nikkou, and Yamaichi, dominate capital markets as they account for about 70% of total underwriting volume and nearly half of all trading on the Tokyo Stock Exchange.

Finally, the private financial intermediaries are divided into depositary institutions and non-depositary institutions.
1. Depositary Institutions

There are four types of depositary institutions: ordinary banks, long-term financial institutions, financial institutions for small business, and financial institutions for agriculture, forestry, and fishery.

(1) Ordinary Banks

Ordinary banks consist of four types. City banks, only 11 in number, comprise the largest share among ordinary banks. They account for about 25% of the total deposits of all financial institutions. City banks are located in large cities and have extensive nationwide branch network. They supply most of short-term corporate finance requirements in Japan and also have international business network. They maintain close ties with large corporations as their “Main Banks.” They not only provide a large amount of loans to those firms, but also invest heavily in their equity shares. Many of those banks are even included in informal industrial group called “Zaibatsu.”

Regional banks have their headquarters in smaller cities and most of their business is within narrower area such as prefectures. They engage in the same activities as city banks, but on a smaller scale. However, regional banks depend more on deposits by individuals, and their lending customers are mainly individuals and small- to medium-sized businesses.

Member banks of the Second Association of Regional Banks (or, second-tier regional banks) were formerly categorized under financial institutions for small business as sogo banks, which were transformed into ordinary banks in February 1989. Sogo banks, based on the Sogo Bank Law of 1951, had their roots in a common traditional financing institution called “Mujin Companies” and were designated as financial institutions for small businesses. However, in parallel with the progress of financial liberalization and internationalization, the business activities of sogo banks became similar to those of the other ordinary banks. Thus, with the aim of promoting fair competition, sogo banks were permitted to change their status into that of ordinary banks based on the Banking Law. In 1991 the Toho Sogo Bank, which was the last remaining sogo bank, became an ordinary bank as a result of merging with the Iyo Bank.

Foreign Banks are defined as branches or agencies established in Japan by banks of foreign countries. According to the provisions of the Banking Law, a license should be obtained from the MOF for each branch when a foreign bank wishes to establish branches and engage in banking activities in Japan. Thus, foreign banks have the same legal position as ordinary banks. A characteristic of foreign banks is that their main sources of funds are Euro-money borrowings from their head offices or market funds such as uncollateralized call
Chart 1 The Japanese Financial Institutions at the end of March, 1992

Central bank

The Bank of Japan

Commercial banks
- City banks (10)
- Specialized foreign exchange bank (1)
- Regional banks
- Regional banks II
- Foreign banks

Long-term financial institutions
- Long-term credit banks
- Trust banks
- Zenshin Bank
- Shin Bank

Financial institutions for small business
- National Federal of Credit Co-operatives
- Credit co-operatives
- National Federal of Labour Credit Association
- Labour credit associations
- Shinkokin Bank

Financial institutions for agriculture, forestry, and fishery
- Credit federations of agricultural co-operatives
- Agricultural co-operatives
- Credit federations of fishery co-operatives
- Fishery co-operatives

Securities investment trust management companies
- Life insurance companies
- Non-life insurance companies
- Various kyu-e (mutual aid) co-operatives
- (National Mutual Insurance Federation of Agricultural Co-operatives, etc.)

Private housing finance companies
- Consumer credit institutions
- Venture capital firms
- Securities finance companies

Securities companies
- Money market dealers

Banks
- Postal Savings Special Account (post office)
- Trust Fund Bureau, Special Account for Post-Office life Insurance and Postal Annuity, Industrial Investment Special Account (funding for FILP)
- Japan Development Bank
- Export/Import Bank of Japan
- Overseas Economic Co-operation Fund
- People’s Finance Corporation
- Small Business Finance Corporation
- Small Business Credit Insurance Corporation
- Environmental Sanitation Business Finance Corporation
- Agriculture, Forestry, and Fishery Finance Corporation
- Housing Loan Corporation
- Finance Corporation of Local Public Enterprises
- Hokkaido and Tohoku Development Corporation
- Okinawa Development Finance Corporation
- Government-related funding bodies, etc.

Public corporations

Depository institutions

Private financial institutions

Non-depository institutions

Other financial institutions

Public financial institutions

*Sum of home offices, branches, and sub-branches. Excludes foreign offices, cash machines outside offices.
*Excludes call loans and bills bought.
*Excludes commodity bonds.
*Excludes foreign trust banks.
*Sum of banking accounts of trust banks and trust accounts of all banks (money trusts, pension trusts, employees’ property-formation benefit trusts, loan trusts).
*Sum of banking accounts of trust banks and trust accounts of all banks.
*Total net assets.
*Excludes foreign life insurance companies.

Sources: BOJ, Economic Statistics Monthly, etc.
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<th>Capital (or capitalization)</th>
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\(^\text{a}\)Operating assets.
\(^\text{b}\)Excludes foreign non-life insurance companies.
\(^\text{c}\)Sum of National Mutual Insurance Federation of agricultural co-operatives plus 47 prefectural mutual insurance federations of agricultural co-operatives.
\(^\text{d}\)Figure for 1989, estimated by the Japan Consumer Credit Industry Association.
\(^\text{e}\)Figure for small business investment companies.
\(^\text{f}\)Excluding branches of foreign securities companies in Japan and settori members who match the sell and buy orders placed by the regular members.
\(^\text{g}\)Margin trading loans.
\(^\text{h}\)Excludes foreign currency intermediaries.
\(^\text{i}\)Sum of call-money borrowing and bills sold.
\(^\text{j}\)Sum of call-money lending and bills bought.
\(^\text{k}\)Sum of borrowings and securities (excluding external bonds).
money since their abilities to collect deposits are limited because of their small branch networks.

(2) Long-term Financial Institutions

There are two kinds of long-term financial institutions, the first being *long-term credit banks*. Three long-term credit banks are established under the Long-Term Credit Bank Law and provide mainly long-term financing to manufacturing industries. Their primary sources of funds are financial debentures. In addition, they are permitted to accept deposits except from individuals.

The second type of long-term financial institutions is *trust banks*. Unlike long-term credit banks, trust banks are permitted to conduct both ordinary banking and trust businesses and those two businesses are conducted under separate accounts. There are two kinds of trust banks, i.e., 7 Japanese trust banks and foreign trust banks. In October 1985, foreign banks were allowed to engage in trust activities in Japan through separate institutions. Those trust activities allowed include money trusts, securities investment trusts and so on.

(3) Financial Institutions for Small Businesses

As for financial institutions for small businesses, *shinkin banks* are mutual associations of small non-financial businesses. They provide ordinary banking services as well as installment services, mainly to their members. The *Zenshinren Bank* acts as a central organization for *shinkin* banks.

*Credit cooperatives* are cooperative financial institutions based on the mutual support among owners and employees of small businesses. They are allowed to accept deposits and installment savings from certain kinds of depositors and can also lend or discount bills, in principle, only to members. The *National Federation of Credit Cooperatives* acts as a central organization for those cooperatives.

(4) Financial Institutions for Agriculture, Forestry, and Fishery

Financial institutions for agriculture, forestry and fishery are organized at the national, prefectural, and municipal levels. At the municipal level, there are *agricultural cooperatives* (*Nokyo*), *fishery cooperatives* (*Gyokyo*), and *forestry cooperatives* (*Shinrin Kumiai*). They are mutual associations of farmers, fishermen, and foresters that provide marketing, purchasing, and management guidance for their respective products as well as financial services. At the prefectural level, there are *Shinnoren*, *Shingyoren*, and *Shinrin Kumiai Rengoukai*.

The *Norincyukin* Bank acts as a central organization for primary industries, namely agriculture, forestry, and fishery. It is the largest institutional in-
vestor in Japan and holds the largest portfolio of Japanese government bonds.

2. Non-depositary Institutions

Insurance companies are non-depositary institutions. The insurance market in Japan is the second largest in the world and has been growing at a rapid pace.

The Japanese insurance industry is legally divided into life insurance and non-life insurance. The latter is often called fire and marine insurance industry.

Insurance companies have traditionally used premiums to provide loans to large industrial borrowers. However, securities investments have recently been increasing and replacing traditional lending activities. Consequently insurance companies have become the largest shareholders in Japan.

NOTES

(1) The BOJ had the drastic organizational restructuring in May 1990. Its main objective was to change the organizational structure so that the BOJ would be able to cope with the rapidly changing environment characterized by financial deregulation, globalization of financial markets and so on. Among those organizational changes, Financial and Payment System Department was newly set up in order to assume major responsibility for the prudential supervision of financial institutions and for the construction of an efficient and stable payment system. Meanwhile, Supervision Department continues to be responsible for conducting on-site examinations of financial institutions.

(2) Since then, BOJ has never extended uncollateralized loans to financial institutions for the purpose of rescuing troubled financial institutions.

(3) All mergers are subject to the restrictions and limitations provided in the Prohibition of Private Monopoly and Preservation of Fair Trade Act. Two or more companies would not be allowed to merge, if such merger would result in effectively restricting the competition in any particular trade sectors or is consummated by or through any unfair practice.