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PERVERSE MAIN BANK RESCUE IN THE LOST DECADE: PROOF THAT UNIQUE INSTITUTIONAL INCENTIVES DRIVE JAPANESE CORPORATE GOVERNANCE

Dan W. Puchniak[†]

Abstract: Two of the most prominent Japanese corporate governance scholars, Professors Miwa and Ramseyer (“M&R”), have recently published numerous articles and a book setting out their contrarian free-market theory of Japanese corporate governance. According to their theory, contemporary Japanese corporate governance is, and always has been, driven by free-market forces and not government incentives. M&R’s theory is enchanting in its simplicity and universality, as it uses standard economic theory to provide a single, and seemingly logical, solution to a myriad of complex legal, institutional, historical and cultural conundrums that have challenged observers of Japanese corporate governance for decades. Unfortunately, M&R’s theory is also incorrect. This article demonstrates why and by doing so provides evidence against the broader convergence theory that looms large in the comparative corporate governance literature.

M&R’s theory fails to explain the systematic lending of trillions of yen by Japanese banks to “loser firms,” at below-market interest rates, to rescue them from bankruptcy, throughout the lost decade (1990 - 2003). According to M&R’s free-market theory, lending to loser firms at below-market rates is *not* a rational, optimal, or credible governance strategy. Therefore, to claim that such behavior systematically occurred in Japan’s banking system for over a decade would be to create a myth.

A myth it is not. Empirical and case study evidence demonstrates that Japanese banks did in fact systematically lend trillions of yen to loser firms at below-market interest rates to rescue them from bankruptcy. This paper reveals the matrix of institutional incentives that made it a rational strategy for Japanese bank managers to engage in such seemingly irrational behavior. The result is that unique institutional incentives, and not universal free-market forces, drove Japanese corporate governance—which is weighty evidence against the broader corporate governance convergence theory.

I. INTRODUCTION

Academic theories are attractive—especially to academics. When the theory is simple, contrarian, and championed by eminent Tokyo University and Harvard professors, it is almost irresistible. However, when it fails to

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make sense of reality, it quickly loses its appeal. So, despite the temptation to embrace Professor Miwa and Professor Ramseyer's ("M&R") new theory of Japanese corporate governance,¹ that finds decades of research to have constructed "a myth," I resist.²

The story painted by M&R is enchanting in its simplicity and universality. In their world:

Whether in the United States or in Japan, firms raise funds in competitive capital markets, and buy and sell in competitive labor, service, and product markets. Whether here or there, in order to survive, they will need *good governance schemes* The scheme they pick will vary from firm to firm. The fact that they will pick the *optimal scheme* or die will not.³

It all sounds logical, because it is—unless unique and perverse institutional incentives, and not free-market forces, drive corporate governance.⁴ In which case, the incentives for "bad governance" and "suboptimal schemes" may be greater than those for "good governance" and "optimal schemes." Perverse it is, but mythical it is not.

The simple fact that taints M&R's conclusions is that Japan—indeed, every country—is unique and that uniqueness matters in corporate governance. Japan's—again, every country's—unique institutional framework provides incentives that drive the decisions of corporate

¹ Professor Milhaupt in a brief review of one of M&R's earlier articles comments, "M&R will never be accused of pursuing a timid research agenda M&R seek to alter our basic understanding of postwar Japanese economic organization and behavior by attempting to prove that the conventional wisdom is flatly untrue M&R have not given us 'better facts.' Rather, they have presented a new theory." Curtis J. Milhaupt, *On the (Fleeting) Existence of the Main Bank System and Other Japanese Economic Institutions*, 27 LAW & SOC. INQUIRY 425, 425, 435 (2002).

² M&R, in their recent book and articles, claim that the foundational elements of the conventional theory of Japanese corporate governance (e.g., main bank system, *keiretsu*, and lifetime employment) are "myths" or "fables" created by imaginative academics. See generally YOSHIRO MIWA & J. MARK RAMSEYER, *THE FABLE OF THE KEIRETSU* 63-64 (U. Chi. Press, 2006) [hereinafter M&R (2006)]; Yoshiro Miwa & J. Mark Ramseyer, *The Myth of the Main Bank: Japan and Comparative Corporate Governance*, 27 LAW & SOC. INQUIRY 401 (2002) [hereinafter M&R (2002)].

³ M&R (2002), *supra* note 2, at 421 (emphasis added).

⁴ In this paper, the term "institutional incentives" refers to incentives that are created by domestic laws, regulations, institutions, and formal and informal government policies and practices, which provide payoffs for corporate executives to make certain governance decisions. Institutional incentives are often created by governments to achieve a specific political or social agenda and therefore do not always align with (and sometimes run counter to) incentives provided by the free-market. Also, institutional incentives are referred to as "perverse" when they provide a payoff for a governance decision that results in, or reinforce, economically inefficient behavior. Institutional incentives are considered "unique" because the matrix of domestic laws, regulations, institutions, and formal and informal government policies vary from country to country.

executives.⁵ The market in Japan—again, every country's market—is uniquely imperfect in the face of exogenous institutional forces. In theory, economic efficiency guides the “invisible hand” to wash away differences between disparate corporate governance systems. In *practice*, however, institutional forces combine with imperfect markets to create a plethora of unique incentives—some of which lead firms to take suboptimal inefficient actions that M&R's theory, which is based on the supremacy of free-market forces (as opposed to institutional incentives), would not predict.⁶

The reason why M&R's free-market theory fails, and unique institutional incentives matter, is simple. Hardnosed executives—whether downing shots of *shochu* in Shinjuku or whiskey in Manhattan—do not worry about their firms being economically efficient or optimally governed in the abstract sense. Firm survival, and not even profit, is key.⁷

What M&R miss in their analysis is that Japanese firms, in their unique environment, are often driven by perverse institutional incentives to select schemes that may be beneficial to firm survival but may not be optimally efficient.⁸ The consequence of firms responding to such incentives and picking suboptimal schemes is not, as M&R predict above, that they will die. While some may die, others may simply get “sick” and later be bailed out by the government, while a few others may thrive on the perverse incentives. Whatever the result, one thing holds true: firms will adopt inefficient suboptimal schemes when the incentives to do so are greater than the incentives for alternative actions.

⁵ In this paper, “institutional framework” refers to the matrix of laws, regulations, institutions, and formal and informal government policies and practices that have an impact on Japanese corporate governance.

⁶ Milhaupt's brief review of one of M&R's earlier articles supports the view taken in this paper that M&R's theory is based on the supremacy of free-market incentives. Specifically, Milhaupt characterizes M&R's theory as follows: “The theory is that Japanese firms exist in a world of perfect market competition, a world where informal relationships and institutions of all types, including government regulation, are irrelevant in the shadow of the invisible hand and private contracting.” Milhaupt, *supra* note 1, at 436. This paper builds on Milhaupt's review by providing numerous examples from M&R's recent works that confirm that, at its core, M&R's theory is based on the principle that free-market incentives are the driving force in post-war Japanese corporate governance—and that institutional incentives had, and have, a *de minimus* effect.

⁷ The motivation for an executive to ensure that their firm survives is that if the firm fails they will lose their position and all of the benefits that they derive from it (e.g., salary, reputation, and self-worth). The motivation for firm survival is arguably stronger in Japan than in most other countries because the economic future of core employees is tied to the firm through lifetime employment and as such the executive labor market is inactive. See John O. Haley, *Career Employment, Corporate Governance and Japanese Exceptionalism* (Wash. U. Faculty Working Papers Series, Paper No. 04-04-01, 2004), available at <http://law.wustl.edu/faculty/workingpapers/haley/corporategovernance.pdf>.

⁸ In this paper, “optimally efficient” refers to the scheme that a firm can select which produces the greatest possible economic benefits from its free-market transactions. In this sense, assuming a perfect market, if all firms make “optimally efficient” decisions, the result will be Pareto optimality.

This is the perverse story of Japanese banks in the lost decade.⁹ As a result of being mired in nonperforming loans arising from poor lending decisions in the 1980s, banks were on the verge of collapse. Many spent the lost decade treading terribly close to having insufficient healthy capital to continue banking operations. According to American precedent, unhealthy banks tighten lending, causing a “capital crunch.”¹⁰ Unhealthy banks definitely do not increase loans to risky clients. American precedent may apply to America, but it does not apply to Japan.¹¹

American precedent and M&R’s theory go hand in hand. In M&R’s world, sophisticated banks with billions of dollars at stake do not spend good money after bad—especially when there is little hope of recovering part of the bad.¹² With limited capital in a competitive market, standard economic theory would tell us that banks lend to their best clients (those with good governance, who choose optimal schemes and are thus most likely to repay loans), not their worst, or they die. *A priori*, firms that choose suboptimal schemes are deprived of capital and culled from the market. For banks to do the opposite—lend to their worst clients—is not rational in a free-market. Based on M&R’s theory, rational bankers will not

⁹ For a concise overview of the economic position that Japanese banks found themselves in during the lost decade, see generally Takeo Hoshi & Anil K. Kashyap, *Japan’s Financial Crisis and Economic Stagnation*, 18 J. ECON. PERSP. 3 (2004) [hereinafter Hoshi & Kashyap (2004a)]. There is no single definition for the “lost decade.” However, it is generally considered to be the period of stagnation after the bursting of the bubbles in the early 1990s that lasted until the early 2000s.

¹⁰ A “capital crunch” occurs when banks decrease their lending supply for some lender-specific reason. Many American researchers concluded that a “capital crunch” occurred in the US in the early 1990s—worsening the recession at that time. The general consensus is that banks, in particular weaker banks, decreased risky lending and purchased government securities to meet the minimum capital requirements under the Basel Accord. See generally Brian J. Hall, *How has the Basle Accord Affected Bank Portfolios?*, 7 J. JAPANESE & INT’L ECON. 408 (1993); Joseph G. Haubrich & Paul Wachtel, *Capital Requirements and Shifts in Commercial Bank Portfolios*, FED. RES. BANK CLEV. ECON. REV. 2 (1993).

¹¹ According to Peek and Rosengren, “In sharp contrast to the bank capital crunch experience in the United States in the early 1990s, when troubled banks quickly shrank their loan portfolios in order to increase their capital ratios, domestic bank loans in Japan continued to increase until the mid-1990s.” Joe Peek & Eric S. Rosengren, *Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan*, 95 AM. ECON. REV. 1144, 1144 (2005). This is confirmed by Hosono and Sakuragawa who found that “[a]lthough Japanese banks were burdened with huge amounts of nonperforming loans, they did not shrink loans outstanding until 1998.” And after that, “[w]hile Japanese banks shrank their lending to the manufacturing sector, the most profitable sector, they increased their lending to the real estate and the construction sector, which were suffering from the persistent depreciations in land prices.” Kaoru Hosono & Masaya Sakuragawa, *Bad Loans and Accounting Discretion*, 8-9 (Presented at the CIRJE-TCER 7th Macro Conference Program, Nov. 26, 2005), available at <http://fhayashi.fc2web.com/conf/domestic%20macro%2005.htm> [hereinafter Hosono & Sakuragawa (2005)].

¹² M&R (2006), *supra* note 2, at 63-64; M&R (2002), *supra* note 2, at 417; Yoshiro Miwa & J. Mark Ramseyer, *Deregulation and Market Response in Contemporary Japan: Administrative Guidance, Keiretsu, and Main Banks*, 23 (CIRJE Discussion Papers, Paper No. CIRJE-F-267, 2004), available at <http://www.e.u-tokyo.ac.jp/cirje/research/dp/2004/2004cf267.pdf> [hereinafter M&R (2004b)].

take such seemingly self-destructive, economically inefficient, actions.¹³ Therefore, the best explanation is *not* that Japanese bankers *irrationally* took such actions but rather that such actions did not occur at all. To say otherwise, would be to create another “myth.”¹⁴

Yet, in the lost decade, unhealthy Japanese banks did the opposite of what American precedent and M&R would predict. To start, banks lent more not less.¹⁵ This may seem strange, but does not qualify as perverse. What is perverse is that in lending more they increased lending not to their clients who were most likely to pay them back but rather to their clients who were *least likely* to pay them back.¹⁶ Even more perverse is that they did not

¹³ In M&R's words, “The moral is simple: the main bank does not help the least profitable firms.” Yoshiro Miwa & J. Mark Ramseyer, *Does Relationship Banking Matter? Japanese Bank-Borrower Ties in Good Times and Bad* 22 (CIRJE Discussion Papers, Paper No. CIRJE-F-239, 2003), available at <http://www.e.u-tokyo.ac.jp/cirje/research/dp/2003/2003cf239.pdf> [hereinafter M&R (2003)]. See also Yoshiro Miwa & J. Mark Ramseyer, *Conflicts of Interest in Japanese Insolvencies: The Problem of Bank Rescues*, 6 THEORETICAL INQ. L. 301, 338 (2005) [hereinafter M&R (2005)]. M&R (2002), *supra* note 2, at 421.

¹⁴ M&R commonly use the logic that if standard economic theory (i.e., free-market forces and profit maximization) cannot explain the alleged actions taken by Japanese firms, the best explanation is not that free-market forces do not drive the behavior of Japanese firms, but rather that the alleged action never occurred at all. See M&R (2002), *supra* note 2, at 418-19; M&R (2006), *supra* note 2, at 147.

¹⁵ Peek & Rosengren, *supra* note 11, at 1144. Hosono & Sakuragawa similarly find that, following the burst of the bubble, although Japanese banks were burdened by an enormous amount of nonperforming loans they did not start to shrink their lending until the end of the lost decade and, in fact, increased lending to the least profitable sectors (construction and real estate) during that time. Hosono & Sakuragawa (2005), *supra* note 11, at 8-9. These facts dovetail with the surprising finding that, despite deregulation of the Japanese bond market, reliance by Japanese firms on bank lending consistently increased throughout the lost decade. In fact, in 2000, Japanese firms received a higher percentage of their debt from banks than in 1986 – when the bond market was heavily regulated and the main bank system was considered solid. However, as with the total amount of bank lending, to fully understand the overall increase in the reliance of firms on bank lending, one must consider the behavior of profitable and unprofitable firms separately. During the lost decade, the dependence of firms on bank lending in the most profitable sector (manufacturing) actually decreased, while the dependence of firms in the least profitable sectors significantly increased (construction, real estate and retail). Yasuhiro Arikawa & Hideaki Miyajima, *Relational Banking in Post Bubble Japan*, in CORPORATE GOVERNANCE IN JAPAN (Masahiko Aoki et al. eds., 2006) at 6, available at <http://ssrn.com/abstract=818344>. In addition, a recent paper by three leading scholars confirms that despite what would normally be expected in the case of an extremely unhealthy banking industry the “credit crunch explanation” insufficiently describes what occurred in Japan during the lost decade. Richard J. Caballero et al., *Zombie Lending and Depressed Restructuring in Japan*, 28-29 (Working Paper, 2006), available at http://econ-www.mit.edu/faculty/download_pdf.php?id=1241.

¹⁶ See generally Caballero et al., *supra* note 15; Arikawa & Miyajima, *supra* note 15; Peek & Rosengren, *supra* note 11; Shin-ichi Fukuda et al., *Deteriorating Bank Health and Lending in Japan*, (CIRJE Discussion Papers, Paper No. CIRJE-F-364, 2005), available at <http://www2.e.u-tokyo.ac.jp/~seido/output/Fukuda/Fukuda28.pdf>; Bank of Japan, *An Assessment of Financial Stability: Focusing on the Banking Sector*, Financial System Report (Aug. 2005), available at <http://www.boj.or.jp/en/type/ronbun/fsr/data/fsr05a.pdf>; Hosono & Sakuragawa (2005), *supra* note 11; Alan Ahearne & Naoki Shinada, *Zombie Firms and Economic Stagnation in Japan* (Presented at the CGP Conference, Oct. 22, 2004), available at <http://www.fordschool.umich.edu/rsie/Conferences/CGP/Oct2004Papers/Ahearne.pdf>; GILLIAN TETT, *SAVING THE SUN* (2003); Toshitaka Sekine et al., *Forbearance Lending: The Case of Japanese Firms*, 21:2 Monetary and Economic Studies 69 (2003);

charge a premium to their worst clients to compensate for their increased risk.¹⁷ As path dependence would predict, Japan's main banks took the lead in orchestrating the perverse scheme of systematically lending to loser firms, which in essence was "main bank rescue" gone bad.¹⁸ Main banks rescuing loser firms does not sound like banks practicing, or rewarding corporations for, good governance or choosing optimal schemes. Yet in Japan's unique and perverse institutional environment, rescuing loser firms by lending them more at below-market rates made sense.¹⁹

Rescuing loser firms made sense because it ensured survival. To survive, which is the ultimate incentive, banks had to solve two problems: (1) to *appear* to decrease nonperforming loans; and, (2) to *appear* to have enough healthy capital to continue operating. In Japan's unique institutional environment, lending to their worst customers solved both problems. It made nonperforming loans appear as performing ones and increased the *appearance* of healthy capital. Therein lie the perverse incentives—which do not, any longer, seem so perverse. That is, if you were a senior executive of a Japanese bank during the lost decade.

Make no mistake. According to M&R's theory, "good governance" and "optimal schemes" would not include the survival tactics that Japanese banks took in the lost decade. In their world, such behavior would not exist. Their assumption is that free-market forces drive Japanese banks to act in essentially the same manner as their American counterparts: to choose

Kaoru Hosono & Masaya Sakuragawa, *Soft Budget Problems in Japanese Credit Market* (Nagoya City University Discussion Papers in Econ. No. 345, 2003), available at <http://www.econ.nagoya-cu.ac.jp/~oikono/dp/pdfdp/dp345.pdf> [hereinafter Hosono & Sakuragawa (2003)]; Masaya Sakuragawa, KIN'YU KIKI NO KEIZAI BUNSEKI (ECONOMIC ANALYSIS OF THE FINANCIAL CRISIS) (2002); Kotaro Tsuru, *The Choice of Lending Patterns by Japanese Banks During the 1980s and 1990s* (IMES Discussion Paper Series, Paper No. 2001-E-8, June 2001), available at <http://www.imes.boj.or.jp/english/publication/edps/2001/01-E-08.pdf>; Takeo Hoshi, *Naze Nihon wa Ryudosei no Wana kara Nagarerurenainoka? [Why is the Japanese Economy Unable to Get out of a Liquidity Trap]* in ZERO KINRI TO NIHON KEIZAI (ZERO INTEREST RATE AND THE JAPANESE ECONOMY) 233-66 (Mitsushiro Fukao & Hiroshi Yoshikawa eds., 2000); Mitsushiro Fukao, KIN'YU FUKYO NO JISSHO BUNSEKI: KIN'YU SHIJO JOHO NI YORU SEISAKU HYOKA (EMPIRICAL ANALYSIS OF FINANCIAL RECESSION) (2000).

¹⁷ Caballero et al., *supra* note 15, at 5-12. See also Sekine et al., *supra* note 16, at 78; David C. Smith, *Loans to Japanese Borrowers*, 17 J. JAPANESE INT'L ECON. 283 (2003); Bank of International Settlement, 72ND ANNUAL REPORT 133-34 (July 8, 2002), available at <http://www.bis.org/publ/arpdf/ar2002e.pdf> [hereinafter BIS Report 2002].

¹⁸ Peek & Rosengren, *supra* note 11, at 1144-45.

¹⁹ Nishimura and Kawamoto confirm that, from the perspective of standard economic theory, Japanese banks appear to have systematically made non-optimal and non-rational decisions through the lost decade. In their words, "A remarkable feature of Japanese banking problems is the *persistence* of the apparently non-optimal and non-rational behavior of Japanese banks." Kiyohiko Nishimura & Yuko Kawamoto, *Why Does the Problem Persist?* 26 WORLD ECON. 301, 302 (2003). See also *Dead Firms Walking*, THE ECONOMIST, Sept. 23, 2004, at 77, 77-79 [hereinafter ECONOMIST (2004a)].

economically efficient schemes that maximize profits.²⁰ In their world, “the truth about Japan is more logical, more mundane, more boring—and more consistent with standard, old-fashioned microeconomic theory.”²¹ M&R are indeed correct in arguing that, according to standard old-fashioned microeconomic theory, “most banks in the real world try to cultivate a reputation . . . for punishing default debtors [not for rescuing them by lending them more].”²² Unfortunately for M&R’s theory, sometimes incentives created by a country’s unique institutional framework, and not “standard old fashioned microeconomic theory,” explain reality.²³

The point of this paper is not to challenge every specific conclusion made in M&R’s recent research. Indeed, many of the specific conclusions are fascinating and, on their face, supported by some statistical evidence. However, statistics are only as good as the logic that underlies them. This paper calls into question that logic by demonstrating how it fails to predict the rescue behaviour of Japanese banks in the lost decade. In this way, it suggests that M&R’s conclusions may mislead. More importantly, however, by demonstrating the fallibility of M&R’s theory, this paper challenges the assertion that universal free-market forces play a more significant role than unique institutional incentives (i.e. domestic laws, regulations, institutions, and the government’s formal and informal policies and practices) in driving Japanese corporate governance. By doing so, this paper hopes to provide valuable evidence to counter the growing popularity of convergence theory.²⁴

The balance of this paper will proceed as follows. There will be a brief overview of the conventional main bank rescue theory and an

²⁰ According to M&R, “conventional microtheory with its profit-maximizing firms buying and selling in competitive markets does describe Japan. It always did. The fables about Japanese bureaucrats, *keiretsu*, main banks, and systematically misgoverned firms are just that—fables. At root the Japanese economy differs little from the American economy (or, we suspect, from any economy anywhere else). To learn about the Japanese economy one does not need Japan-specific accounts of corporate groups, main banks, and government-led growth. One does need economics.” M&R (2006), *supra* note 2, at 147.

²¹ M&R (2002), *supra* note 2, at 421.

²² *Id.* at 417.

²³ In a brief critique of one of M&R’s earlier articles, Milhaupt reaches a similar conclusion to this paper with regards to the shortcomings of M&R’s new theory. He writes, “‘It takes a theory to beat a theory.’ The theory is that Japanese firms exist in a world of perfect market competition, a world where informal relationships and institutions of all types, including government regulation, are irrelevant in the shadow of the invisible hand and private contracting.” Milhaupt, *supra* note 1, at 435-36.

²⁴ Some American scholars claim that American corporate governance has finished evolving and that economic efficiency will gradually force all other corporate governance systems to converge on the American model. See generally Douglas M. Branson, *The Very Uncertain Prospect of “Global” Convergence in Corporate Governance*, 34 CORNELL INT’L L.J. 321, 331 (2001); Ronald Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 331 (2001); H. Hansmann & R. Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).

explanation of why main bank rescue serves as a useful litmus test for M&R's theory (section two). Then, M&R's critique of rescue theory will be examined to illustrate the logic that underlies much of their recent research (section three). Next, the gap in M&R's logic will be exposed by demonstrating how it fails to predict the perverse rescue behavior of Japanese banks in the lost decade. M&R's failure to acknowledge the incentives created by Japan's unique institutional framework is suggested as the main reason their theory fails (section four). Finally, concluding remarks will explain how this narrow analysis of perverse main bank rescue in the lost decade may provide useful evidence in the more general corporate governance convergence debate (section five).

II. MAIN BANK RESCUE

A. *A Litmus Test for M&R's Theory*

Miwa and Ramseyer have labelled the conventional understanding of Japanese corporate governance "a myth."²⁵ To them, the main bank system, *keiretsu*, lifetime employment and a market-manipulating Japanese government are nothing more than academic pipedreams.²⁶ Although M&R use complex statistics to support their claims, the basic rationale underlying most (if not all) of them is simple: contemporary Japanese corporate governance can be explained by standard economic theory because it has essentially been driven by free-market forces.²⁷ The flipside of the same coin is that unique incentives created by Japan's institutional framework (if they exist at all) do not need to be taken into account because they have had a *de minimus* effect on Japanese corporate governance.

Although M&R's recent research attempts to debunk all of the major elements of the conventional theory of Japanese corporate governance, this paper focuses primarily on one: main bank rescue. The concept of main bank rescue provides an excellent litmus test for M&R's theory for a number of reasons. First, the logic used by M&R to challenge the concept is

²⁵ See generally M&R (2006), *supra* note 2; M&R (2005), *supra* note 13; Yoshiro Miwa & J. Mark Ramseyer, *Direct Credit? The Loan Market in High-Growth Japan*, 13 J. ECON. MGMT. STRATEGY 171 (2004) [hereinafter M&R (2004a)]; M&R (2004b), *supra* note 12; M&R (2003), *supra* note 13; M&R (2002), *supra* note 2.

²⁶ In M&R's words, "The claims about the Japanese main bank system are . . . false . . . Firms and workers did not bargain for lifetime employment. Banks neither promised to rescue defaulting debtors nor monitored debtors on behalf of their rivals. The *keiretsu* had no substance, and the government had little clout." M&R (2002), *supra* note 2, at 420-21.

²⁷ M&R (2006), *supra* note 2, at 147.

representative of their general approach.²⁸ Second, the concept of main bank rescue is of central importance to the conventional theory of Japanese corporate governance.²⁹ Third, the extensive empirical research that examines the lending behaviour of Japanese banks in the 1990s provides a robust tool for testing M&R's theory.³⁰

B. *A Theory Based on the Importance of Unique Legal and Institutional Incentives*

The concept of main bank rescue is rooted in the more general Japanese main bank theory.³¹ According to that theory, Japanese firms borrow from many banks but have a special relationship with only one: their main bank. The relationship that firms have with their main bank differs from that of other banks in a number of important respects—one of which is that main banks make an implicit promise to attempt to rescue failing, but potentially productive, client firms when they encounter financial adversity.³²

It is important to clarify what the “promise to rescue” entails. The promise made by main banks is to attempt—not to guarantee—to help

²⁸ M&R (2006), *supra* note 2, at 160.

²⁹ For a concise overview of the role that the main bank rescue theory plays in the conventional theory of Japanese corporate governance see, Aoki et al., *The Japanese Main Bank System: An Introductory Overview*, in THE JAPANESE MAIN BANK SYSTEM 1-50 (Masahiko Aoki & Hugh Patrick eds., 1994).

³⁰ See generally Caballero et al., *supra* note 15; Arikawa & Miyajima, *supra* note 16; Peek & Rosengren, *supra* note 11; Fukuda et al., *supra* note 16; Bank of Japan, *supra* note 16; Hosono & Sakuragawa (2005), *supra* note 11; Ahearne & Shinada, *supra* note 16; Sekine et al., *supra* note 16; Hosono & Sakuragawa (2003), *supra* note 16; Sakuragawa, *supra* note 16; Tsuru, *supra* note 16; Hoshi, *supra* note 16; Fukao, *supra* note 16.

³¹ In describing main bank rescue this paper largely draws on the recent works of Aoki because he is widely considered the leading scholar in this area and his work is the focus of M&R's critique of main bank rescue theory. M&R (2002), *supra* note 2 at 402, 404-05, 421. See also M&R (2006), *supra* note 2, at 63-64; M&R (2005), *supra* note 13, at 306-07; M&R (2003), *supra* note 13, at 4-6, 18. Although there is not an agreed upon definition for “main bank rescue”, a majority of scholars use a similar definition in which the main bank lends money, resources, and personnel to firms in financial difficulty, and in exchange, the firm must hand over some degree of governance power to the main bank and undertake reforms. See Aoki et al., *supra* note 29, at 25-26; MASAHIKO AOKI, INFORMATION, CORPORATE GOVERNANCE, AND INSTITUTIONAL DIVERSITY 60-94 (2000) [hereinafter Aoki (2000)]; Paul Sheard, *Main Banks and the Governance of Financial Distress*, in THE JAPANESE MAIN BANK SYSTEM 188-230 (Masahiko Aoki & Hugh Patrick eds., 1994); Masahiko Aoki, *Monitoring Characteristics of the Main Bank System: An Analytical and Developmental View*, in THE JAPANESE MAIN BANK SYSTEM 109, 119-21 (Masahiko Aoki & Hugh Patrick eds., 1994) [hereinafter Aoki (1994)]; See also TAKEO HOSHI & ANIL KASHYAP, CORPORATE FINANCING AND GOVERNANCE IN JAPAN: THE ROAD TO THE FUTURE (MIT Press 2001) [hereinafter Hoshi & Kashyap (2001)]; Jonathan Macey & Geoffrey Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan and, the United States*, 48 STAN. L. REV. 73, 85 (1995).

³² See generally Aoki et al., *supra* note 29; Aoki (2000), *supra* note 31, at 60-94; Sheard, *supra* note 31, at 188-230.

restructure potentially productive (not all) firms rather than foreclosing on its loans in a time of financial crisis.³³ The promise is *not* to provide a *carte blanche* for potentially productive firms to receive unconditional financial and managerial assistance in a time of crisis.³⁴ To the contrary, as part of its rescue, the main bank “actively intervenes, punishes and displaces managers, and sometimes the general work force, and oversees or engineers organizational and asset reorganizations” to improve firm productivity.³⁵ To this end, after it is determined that the firm’s financial difficulties are only temporary, or that restructuring is possible, the main bank may take a number of steps, including: (1) providing additional loans; (2) refinancing existing main bank debt; (3) guaranteeing the firm’s other debts; and/or (4) sending members of the bank to act as managers or directors.³⁶ If, however, the main bank’s attempt to make a firm more efficient is thwarted by existing management, the main bank will cease its rescue attempt and let the firm fail.³⁷

Main bank rescue is efficient because the economic value of a potentially profitable firm as a going concern (with its firm-specific tangible and intangible assets) is normally greater than the value of its liquidated parts.³⁸ Thus, society as a whole benefits when potentially productive, but financially distressed, firms are rescued.³⁹ Efficient rescue prevents valuable firm-specific assets from being squandered by premature liquidation and avoids the costs associated with the coordination problems, conflicts of interest, and strategic behaviour that loom large in formal bankruptcies.⁴⁰ However, rescuing a firm is not always beneficial for society. Society suffers when financially distressed firms with no potential for future

³³ Aoki (2000), *supra* note 31, at 71.

³⁴ Sheard, *supra* note 31, at 190; Aoki (1994), *supra* note 31, at 123.

³⁵ Sheard, *supra* note 31, at 211.

³⁶ Aoki (2000), *supra* note 31, at 71; Aoki et al., *supra* note 29, at 25-26; Sheard, *supra* note 31, at 193; TAKATOSHI ITO, *THE JAPANESE ECONOMY* 116 (MIT Press 1992).

³⁷ Aoki (2000), *supra* note 31, at 71; David Gilo, *The Problem of Bank Rescues: A Comment on Miwa and Ramseyer*, 6 *THEORETICAL INQUIRIES* L. 341, 343 (2005). David Gilo’s article provides an interesting brief critique of M&R’s argument on the basis that they do not properly consider the fact that in many cases management has an incentive to thwart the attempt of the main bank to rescue.

³⁸ Aoki et al., *supra* note 29, at 18; Sheard, *supra* note 31, at 190-91.

³⁹ In the American system, the court-led bankruptcy system and the market for corporate control are seen to play the same role as main bank rescue. It is argued that in its heyday, main bank monitoring did this more effectively than the American system and was a factor that contributed to Japan’s higher growth. According to main bank theory, the main bank is in the optimal position to rescue because it does not suffer from collective action and information asymmetry problems suffered by creditors, managers, and shareholders, and is less costly and has better information than the courts or corporate raiders. Sheard, *supra* note 31, at 210-11.

⁴⁰ *Id.*

productivity are rescued. Propping up such firms wastes limited resources on preserving firm-specific assets that are of little value.

The implication for main banks is clear. To be efficient, they must have enough incentive to rescue potentially productive firms but not so much incentive that they indiscriminately rescue every firm—which of course would include those firms with no potential for productivity.⁴¹ According to the conventional main bank theory, the unique institutional environment that existed during Japan's high growth era (1951 to 1973) produced such equilibrium.⁴²

To create the equilibrium, the government had to provide main banks with an incentive to rescue. As illustrated above, rescue is costly. Often, the costs associated with rescue exceed the losses that a main bank would suffer by forfeiting its debts. Micro-economic theory tells us that in such a situation rational bankers will jettison their clients—unwilling to spend good money after bad. This is especially true when the primary lender, such as the main bank, has an informational advantage over other lenders, making early exit feasible. Thus, the government had to provide substantial institutional rents—which are not provided by the free-market—to give banks an incentive to rescue potential profitable firms.⁴³

The government created institutional rents by tightly controlling interest rates, restricting the bond market, and limiting new entrants to the banking industry.⁴⁴ In this unique institutional environment, banks earned above-market rents from clients proportional to their share of deposits. To increase deposits, banks sought more branches. Since the government controlled new branches through issuing licences, it created an incentive for banks who kept their promise to rescue.⁴⁵

There were also many legal and institutional deterrents that the government employed to ensure that main banks did not jettison their clients. The government had the power to withhold branch licenses and dispatch ex-bureaucrats to banks who failed to fulfil their promise to rescue.⁴⁶ In addition, since the institutional environment made main bank rescue the norm, a main bank stood to suffer significant reputational losses

⁴¹ Aoki (2000), *supra* note 31, at 83; Aoki (1994), *supra* note 31, at 126-28.

⁴² Aoki (2000), *supra* note 31, at 88-89; Aoki et al., *supra* note 29, at 46.

⁴³ Aoki (2000), *supra* note 31, at 86; Aoki et al., *supra* note 29, at 26-32; Sheard, *supra* note 31, at 204-10; Kazuo Ueda, *Institutional and Regulatory Frameworks for the Main Bank System*, in *THE JAPANESE MAIN BANK SYSTEM* 89 (Masahiko Aoki & Hugh Patrick eds., 1994).

⁴⁴ Aoki (2000), *supra* note 31, at 87; Aoki (1994), *supra* note 31, at 128-29.

⁴⁵ Aoki (2000), *supra* note 31, at 87; Aoki (1994), *supra* note 31, at 129; Aoki et al., *supra* note 29, at 30-32.

⁴⁶ Aoki (2000), *supra* note 31, at 87; Aoki (1994), *supra* note 31, at 129; Aoki et al., *supra* note 29, at 30-32.

by letting an inordinate number of firms fail. Specifically, if a main bank developed a reputation for jettisoning financially distressed clients it stood to lose depositors (who would question the bank's ability to manage their funds), clients (who would doubt the bank's commitment to rescue), and business with other financial institutions (who may fear entering into a financing consortium with a bank prone to adverse selection).⁴⁷

In sum, according to the conventional main bank theory, in the high growth era, the cost of rescue combined with institutional rents and deterrents resulted in an equilibrium where banks had an incentive to rescue potentially productive firms.⁴⁸ Since main banks attempted to rescue potentially productive firms *ex post*, it made their promise to rescue credible *ex ante*. In addition, the high cost of rescue provided a strong incentive for main banks to avoid adverse selection by taking measures to lend to productive firms (*ex ante* monitoring) and by helping existing client firms to avoid financial difficulties (interim monitoring).⁴⁹

Most conventional main bank theorists suggest that Japan's institutional framework has irreversibly changed since the mid 1970s—reducing the institutional incentives that motivated main banks to rescue potentially productive firms.⁵⁰ The 1970s and 1980s saw the end of regulated interest rates, the phasing out of restrictions on bonds, and the globalization of markets.⁵¹ This new institutional environment deprived main banks of the necessary rents to provide them with an incentive to rescue potentially productive firms (*ex post* monitoring) and to perform their other important *ex ante* and interim monitoring functions. The breakdown of the main bank system (of which efficient rescue was a critical part) is suggested by many scholars as a significant factor in the creation of the bubbles, their bursts, and the lost decade that followed.⁵²

⁴⁷ Aoki (2000), *supra* note 31, at 87; Aoki (1994), *supra* note 31, at 129-30.

⁴⁸ Aoki (2000), *supra* note 31, at 82-89.

⁴⁹ *Id.*, at 79-89.

⁵⁰ *Id.*, at 89-92; Aoki (1994), *supra* note 31, at 135-37. See also Hoshi & Kashyap (2001), *supra* note 31, at 219-66; BAI GAO, JAPAN'S ECONOMIC DILEMMA: THE INSTITUTIONAL ORIGINS OF PROSPERITY AND STAGNATION 186 (Cambridge U. Press 2001); Takeo Hoshi & Anil Kashyap, *The Japanese Banking Crisis: Where Did it Come From and How Will It End?* 4 (Nat'l Bureau of Econ. Research, Working Paper No. 7250, July 1999), available at <http://www.nber.org/papers/W7250> [hereinafter Hoshi & Kashyap (1999)].

⁵¹ Aoki (2000), *supra* note 31, at 89-90.

⁵² *Id.*, at 89-92.

C. *Japan's Unique Institutional Framework Is at the Core of Rescue Theory*

A core concept of main bank rescue theory, which cannot be overlooked, is the critical role played by Japan's unique institutional framework. This unique framework provided the incentives that drove the decision of banks to rescue potentially productive firms. Although much has been written about main bank rescue, at its core the theory is simple: for rescue to occur the incentive to rescue must be greater than the incentive not to rescue. As explained above, due to the high cost of rescue, it only became feasible when Japan's unique institutional framework provided the necessary incentives that made it in the best interest of main banks to do so.

In this sense, rescue theory is built on the notion that quantifiable incentives and rational decision making drive corporate governance. It leaves no room for vague notions of main bank managers choosing to rescue floundering firms based on some nebulous concept such as *samurai* culture. Most main bank theorists would agree with M&R that it is absurd to think that a sophisticated bank would voluntarily rescue a distressed client when the cost of rescue is greater than the potentially recoverable debt—that is, if it were not for institutional incentives. Thus, the core difference between the conventional main bank rescue theory and M&R's free-market theory is that institutional incentives matter in the former but not in the latter.⁵³

III. M&R'S CRITIQUE OF CONVENTIONAL MAIN BANK RESCUE: PUTTING THEIR LOGIC ON DISPLAY

A. *The Logic of M&R's General Theory*

Strip away the statistics and the thrust of M&R's recent research becomes simple: free-market forces drive Japanese corporate governance and institutional incentives are *de minimus*.⁵⁴ The story told is of an invisible hand guiding firms through perfect markets that “track[] the contours of standard economic theory.”⁵⁵ As they see it, “in post-war Japan . . . firms bought and sold, borrowed and lent, and thrived or failed—on highly competitive markets.”⁵⁶ No doubt economists fantasize about

⁵³ In Aoki's words, “The way the main bank system functioned in the high growth period differs from the neo-classical competitive norm built on the assumptions of perfect information and complete markets.” Aoki (1994), *supra* note 31, at 131. See also Aoki (2000), *supra* note 31, at 86-89.

⁵⁴ M&R (2006), *supra* note 2, at 147.

⁵⁵ See M&R (2004a), *supra* note 25, at 202.

⁵⁶ M&R (2004b), *supra* note 12, at 30.

markets where firms freely compete for capital, banks rationally allow failing borrowers to fail, regulations expose banks to market competition, and the law flexibly allows firms to move to Pareto optimal governance schemes. Unfortunately, fantasies are not reality—especially those as farfetched as perfect markets in Japan.⁵⁷

To make their theory plausible, M&R are forced to create a world in which Japan's institutional framework (i.e., laws, regulations, institutions, and formal and informal government policies and practices) is irrelevant. Create they have. According to M&R, the government has been "congenitally unable" to regulate the market.⁵⁸ Even in cases "where the Japanese government tried [its] hardest," free-market forces hopelessly overwhelmed it as firms "flouted" government regulations "all the way to the bank."⁵⁹

The rationale used by M&R to explain the government's inability to create an institutional framework that provides meaningful incentives to influence corporate behavior varies. In some instances, they suggest incompetence—that the government's ill-conceived regulations "did not bind."⁶⁰ In other instances, they suggest a lack of formal and informal power—the government "lacked the means" to regulate.⁶¹ In still other instances, more confusingly, they suggest that the government regulated merely for show. It created regulations it "never seriously tried" to enforce,⁶² or that were "enforced haphazardly, if at all"⁶³ or that were merely made "in principle" but allowed for gaping exceptions.⁶⁴ Ironically, this last description of a *honnetatemae* government seems more "culturalist" than "Chicago School of Economics." However, in the end, whether by incompetence, inability or face-saving, M&R always find a way to reach the same conclusion: the government had, and presumably still has, "little clout"⁶⁵ in regulating the market and "virtually no say in who invested how much in what."⁶⁶ In sum, whether Japan's institutional framework is unique

⁵⁷ Milhaupt, in a brief critique of one of M&R's earlier articles, highlights this weakness in M&R's theory. Milhaupt, *supra* note 1, at 435-36.

⁵⁸ M&R (2004a), *supra* note 25, at 172.

⁵⁹ M&R (2006), *supra* note 2, at 140-41; M&R (2004a), *supra* note 25, at 192-99; M&R (2004b), *supra* note 12, at 17.

⁶⁰ M&R (2004a), *supra* note 25, at 185, 191, 202.

⁶¹ *See id.*, at 202. *See also* M&R (2006), *supra* note 2, at 127.

⁶² M&R (2006), *supra* note 2, at 128; M&R (2004b), *supra* note 12, at 8.

⁶³ M&R (2006), *supra* note 2, at 127; M&R (2004b), *supra* note 12, at 8.

⁶⁴ M&R (2006), *supra* note 2, at 136-37; M&R (2004a), *supra* note 25, at 179.

⁶⁵ *See* M&R (2002), *supra* note 2, at 421.

⁶⁶ M&R (2004a), *supra* note 25, at 172. M&R's claim that the Japanese government is totally ineffective raises a number of obvious questions, with no obvious answers. What government anywhere,

is moot because it had, and has, a *de minimus* effect on corporate governance.

M&R use their free-market theory as a tool to demonstrate why the conventional main bank model is fundamentally flawed. The manner in which they apply their general theory to the specific tenets of the main bank model is evident in their attempt to debunk the conventional theory of main bank rescue.

B. M&R's Free-Market Theory Applied to the Conventional Theory of Main Bank Rescue

Miwa and Ramseyer claim that the conventional theory of main bank rescue is a concept created by academics who “ostensibly. . .write [articles] to understand the world we live in” but have no basis in reality.⁶⁷ To M&R, rescue theory is flawed from the outset because it runs counter to their notion of a post-war Japan that is so easily explained by standard economic theory, which is governed by profit maximization, efficiency, and free-market forces.⁶⁸ The so-called main bank rents or incentives that the government provided to banks to encourage rescues either never existed or were ineffective in providing an incentive in the face of free-market forces.⁶⁹ They admit that the government may have tried to create such incentives but conclude that the free-market determined the actual environment in which banks made their decisions.⁷⁰

Miwa and Ramseyer use their free-market theory to develop numerous specific arguments for why conventional rescue theory is a myth. They have four primary arguments: (1) there normally is little incentive for main banks to rescue; (2) rescue only occurs when banks can profit from rescue or banks fail to monitor; (3) if there was a promise to rescue it would have been made in writing (although it was not); and (4) if rescue were to have occurred the banks would not have been the ones to rescue.

let alone among the world's most developed economies, is completely ineffective? Who would want to work in such a government? Why did some of the most talented people in Japan want to do so?

⁶⁷ See M&R (2002), *supra* note 2, at 401.

⁶⁸ In M&R's words, “the story of Japan's economic emergence . . . is a story about competition among profit-maximizing firms in decentralized markets.” M&R (2006), *supra* note 2, at 156.

⁶⁹ See M&R (2004a), *supra* note 25, at 202; M&R (2002), *supra* note 2 at 421; M&R (2003), *supra* note 13, at 7-8, 22; M&R (2002), *supra* note 2, at 417.

⁷⁰ M&R (2004a), *supra* note 25, at 202.

C. *There Is Normally Little Incentive for Main Banks to Rescue*

M&R claim that main banks normally have little incentive to rescue because “a bank that sends good money after bad usually loses both.”⁷¹ Further, banks stand to benefit from allowing failing firms to fail because by doing so they “cultivate a reputation . . . for punishing default debtors.”⁷² Such a reputation decreases adverse selection and moral hazards, which maximizes profits.⁷³

Miwa and Ramseyer ultimately conclude that since rational banks normally have little incentive to rescue, they usually do not. They tell us that Japanese bankers act “[l]ike bankers elsewhere”⁷⁴ and pull their loans from failing debtors “before their competitors noticed the trouble.”⁷⁵ Obviously, if main banks “do not try to save *ex post* . . . they cannot credibly . . . promise to save *ex ante*.”⁷⁶ On this basis, they find the promise to rescue to be a “figment of the academic imagination.”⁷⁷

Indeed, standard neoclassical economic theory lends some support to M&R’s assertion.⁷⁸ As M&R point out, considering the high cost of rescue, “a bank that implicitly agrees to supply such aid potentially faces a subgame-imperfect strategy.”⁷⁹ Rational businesses do not choose such strategies—those that do fail. Obviously, Japan’s multibillion-dollar, sophisticated banks normally act rationally. Thus, the only logical conclusion that M&R leave us with is that Japanese banks do not employ such subgame-imperfect strategies. If they did, after all, they would not be multibillion-dollar sophisticated banks. So their argument goes.

Miwa and Ramseyer’s argument makes perfect sense when the factors that are used to determine what is “optimal” are limited to the costs and benefits that directly flow from the discrete financial relationship between the bank and the failing client firm. However, the theory breaks down when

⁷¹ See M&R (2004b), *supra* note 12, at 23.

⁷² M&R (2002), *supra* note 2, at 417.

⁷³ With little to gain and much to lose, M&R also posit that providing money and resources to failing firms is in many cases tantamount to charity. They jest that “at the point of insolvency . . . [t]he firm’s employees and shareholders will welcome additional funds [and] enjoy the obvious charity,” but “[t]he banks will not.” M&R (2005), *supra* note 13, at 339.

⁷⁴ See M&R (2006), *supra* note 2, at 63-64; M&R (2005), *supra* note 13, at 338; M&R (2002), *supra* note 2, at 421.

⁷⁵ See M&R (2006), *supra* note 2, at 63-64; M&R (2005), *supra* note 13, at 338; M&R (2002), *supra* note 2, at 421.

⁷⁶ M&R (2005), *supra* note 13, at 309.

⁷⁷ See M&R (2004b), *supra* note 12, at 19.

⁷⁸ This paper does not dispute that M&R’s theory describes a banking industry that “tracks the contours of standard economic theory.” See M&R (2004a), *supra* note 25, at 202.

⁷⁹ M&R (2005), *supra* note 13, at 307.

one takes a broader perspective and considers the institutional incentives that make it in the best interest of main banks to rescue.⁸⁰ From this perspective, the critical question for determining when main bank rescue will occur is, in what circumstances do institutional incentives outweigh the discrete financial costs of rescue?

Obviously, to M&R, this question is moot. According to their theory, institutional incentives either do not exist or have a *de minimus* effect on corporate governance. How could such incentives exist when the very institutional framework that purportedly creates them is impotent? The assumption that Japan's unique institutional framework has a *de minimus* impact on corporate governance is thus the glue that holds M&R's critique of main bank rescue together.

The importance of M&R's assumption of the irrelevancy of Japan's unique institutional framework cannot be over emphasized. Bank rescue is only a sub-game imperfect strategy if institutional incentives either do not exist or insufficiently compensate main banks for the risk they assume when they promise to rescue. If one assumes that the institutional incentives, which main banks receive for rescue, outweigh the costs of rescue, then it is in the best interest of banks to rescue (even when they stand to suffer financial losses on the discrete bank/firm transaction). In game-theory lingo, the bank's threat to rescue becomes a credible action—an action that bankers will rationally choose.

D. If Rescue Occurs, It Is Only When Banks Can Profit from Rescue or Banks Fail to Monitor

Miwa and Ramseyer have carefully tailored their critique of main bank rescue to explain away considerable case study and anecdotal evidence of main bank rescue.⁸¹ They dismiss this evidence by suggesting that banks everywhere lend default debtors extra funds (or renegotiate bad debts) where it will “cut the bank's losses.”⁸² The rationale is simple: sometimes it pays

⁸⁰ See *infra*, section two.

⁸¹ M&R summarize the main bank rescue theory as follows: “[A]ccording to most Japan ‘experts,’ main banks do implicitly agree to rescue borrowers. Typically, the experts claim that the banks rescue by lending the firms funds that they otherwise would not lend. Even when the loan is not financially advantageous, main banks lend.” M&R (2005), *supra* note 13, at 324. However, M&R claim that despite the acceptance of this theory by numerous notable academics, no one has presented systematic evidence to support it. M&R argue that the main bank rescue theory is merely supported by anecdotes that “show only that some banks sometimes rescue some firms—and that, of course, is beside the point.” M&R (2003), *supra* note 13, at 18-19. See also M&R (2006), *supra* note 2, at 78. For an extensive case study of Japanese main bank rescue, see Sheard, *supra* note 31, at 188-230.

⁸² “Once a bank faces the prospect of a large loss on an outstanding debt, it often has an incentive to lend a bit more (or to cut the interest rate, or to write off a bit of the debt) to nurse the firm back to health.”

to gamble. When faced with the potential of losing their original loan, sometimes it makes sense to risk lending more to a failing firm with the hope that the firm can be revived and will pay back its debts. This is consistent with M&R's argument that main banks will only engage in rescue when they stand to make profit (or cut losses) from the *discrete* bank/firm transaction—without consideration of institutional incentives.

Miwa and Ramseyer also attempt to discredit examples of rescue where the main bank had no realistic chance of benefiting from the discrete bank/firm rescue transaction. They suggest that sometimes banks, as a result of incompetent interim monitoring, do not recognize that a firm is failing. In such a case, they may lend money, not because they have an incentive to do so, but rather because of their incompetent monitoring, "it was too late to pull their loans."⁸³ Presumably, main banks that commit this mistake too often will fail in Japan's "highly competitive market."⁸⁴ Therefore, main bank incompetence would not result in a sustainable equilibrium where the promise to rescue becomes the norm.

Either way, M&R's conclusion is the same. Free-market forces, devoid of any meaningful influence from institutional incentives, control rescue behaviour. Banks do not choose to rescue because of institutional incentives—such incentives either do not exist or are *de minimus*. Microeconomic theory predicts that banks will make every attempt to avoid rescue and will only reluctantly rescue when it is a sub-game perfect strategy based on the potential of maximizing profits from the discrete bank/firm relationship.

E. If Main Bank Rescue Exists, It Should Be in Writing

Miwa and Ramseyer claim that if main banks were to promise to rescue their clients such agreements would be in writing.⁸⁵ They suggest that since there are no such agreements in writing, the agreements must not exist. The logic they use to explain why such agreements would be in

M&R (2002), *supra* note 2, at 417. "Japanese banks may sometimes bail out troubled firms—but after all, here or there, doing so sometimes lets a bank cut its losses *ex post*." M&R (2003), *supra* note 13, at 25. See also M&R (2006), *supra* note 2, at 78.

⁸³ "Try as creditors might to avoid the quandary, sometimes they find that lending a defaulting debtor extra funds or renegotiating a debt will cut their losses. That they sometimes do either does not mean they agreed to rescue *ex ante*. It may just mean they failed to notice the firm's travails until it was too late to pull their loans." M&R (2003), *supra* note 13, at 19.

⁸⁴ In post-war Japan's economy, "firms bought and sold, borrowed and lent, and thrived or failed—on highly competitive markets." M&R (2004b), *supra* note 12, at 30.

⁸⁵ "[G]iven all these problems, if banks did negotiate these terms, one would think they at least would do what insurance companies do with their own obligations: draft fine-print contracts about each." M&R (2004b), *supra* note 12, at 23.

writing if they existed is that “[g]iven the resulting risks that [banks] will renege [on their promise to rescue], rational firms and banks should at least negotiate legally enforceable claims” and put these claims in writing.⁸⁶ After all, according to M&R, sophisticated Japanese banks “regularly fell forests” to paper other similar transactions, so why leave unwritten what are essentially “billion-dollar insurance contracts?”⁸⁷

Again, the assumption made by M&R is that banks have no incentives to rescue—leading them “to renege.”⁸⁸ Obviously, if one assumes that institutional incentives are insignificant, then written contracts would be necessary to force banks to carry out rescue agreements that are not in their best interests. However, assuming institutional incentives make it in the best interests of banks to rescue then there is no need for contractual coercion. Banks will willingly promise to rescue because it is in their best interest to do so. The risk of banks renegeing on their promise becomes *de minimus*. The cost of contracting becomes unnecessary.⁸⁹

F. *If Rescue Occurs, Banks Would Not Be the Ones to Rescue*

Miwa and Ramseyer claim that if rescue were to occur, other related firms (not main banks) with some connection to the failing firm (either a partner or firm in the same industry) would be the rescuer.⁹⁰ To M&R, simple economic theory suggests that related firms can perform rescue more efficiently than main banks. This is because related firms “would know better than bankers how to revamp the firm.”⁹¹ They could use valuable industry specific knowledge and skills to more efficiently guide the restructuring process. Banks do not possess such knowledge or skills, and it would be costly, if not impossible, for banks to acquire them.

This may be the case, in a perfect market. However, due to the path dependent nature of economic development in post-war Japan, banks, and

⁸⁶ M&R (2006), *supra* note 2, at 64; M&R (2005), *supra* note 13, at 307.

⁸⁷ M&R (2002), *supra* note 2, at 416-17.

⁸⁸ See M&R (2004b), *supra* note 12, at 23.

⁸⁹ M&R's written contract argument also lacks persuasive logic. According to M&R's theory, when it is in the best interest of main banks to rescue (i.e. when the economic incentives in the discrete firm/bank transaction outweighed the costs), they rescue. M&R's conclusive claim that the promise to rescue does not exist is more accurately a claim that there is no incentive for main banks to rescue. In this sense, M&R's written contract argument is tautological: (1) because main banks have no incentive to rescue, the contract must be in writing; and (2) because it is not in writing, main banks must have no incentive to rescue.

⁹⁰ “By simple logic, if any entity were to ‘rescue’ a firm, it would not be a bank.” M&R (2005), *supra* note 13, at 338.

⁹¹ See *id.*

not firms, have been at the center of the governance model.⁹² For better or worse, banks receive institutional rents for rescue, not related firms. Thus, related firms would not have the necessary incentives to commit to rescue. At the risk of being monotonous, M&R's logic once again assumes that Japan's unique institutional framework does not provide any significant incentives for banks to rescue. The free-market is the only *significant* factor driving corporate governance. Take away this assumption, and the logic that related firms and not banks should rescue is flawed.

IV. PERVERSE MAIN BANK RESCUE IN THE LOST DECADE—PROOF INSTITUTIONAL INCENTIVES MATTER

A. *The Lost Decade: A Robust Litmus Test for M&R's Free-Market Theory*

The dramatic burst of Japan's stock and real estate bubbles in the early 1990s, followed by over a decade of economic malaise, was one of the major economic events of the twentieth century. The main bank system, which is often seen as a crucial component in the meteoric rise of Japan's post-war economy, has been the focus of many economists who try to explain Japan's sudden economic collapse in the early 1990s and prolonged stagnation that lasted until the early 2000s. The volume and sophistication of the literature analyzing the role played by Japan's banking system, in what has been dubbed "the lost decade," is impressive.⁹³ Numerous studies use econometrics to provide a clear picture of how bank-lending practices contributed to the economic stagnation during this period.⁹⁴ These studies provide a robust litmus test for M&R's free-market theory.

⁹² Path dependence theory suggests that the conditions existing at the time when an institution is formed will influence its functioning far into the future. As applied to the evolution of a country's system of corporate governance, the theory posits that the forces of economic efficiency are limited by each country's particular legal, institutional, political, and historical "starting points"—which existed when the system of corporate governance first emerged. In Japan, many commentators see the institutional framework that developed immediately following the war as the "starting point" for the contemporary system of corporate governance. See Gilson, *supra* note 24, at 334; TETT, *supra* note 16, at 59; Dan W. Puchniak, *The 2002 Reform of the Management of Large Corporations in Japan: A Race to Somewhere?*, 5:1 AUSTL. J. ASIAN L. 42, 70-71 (2003).

⁹³ There is no single definition for the "lost decade." However, it is generally considered to be the period of stagnation after the bursting of the bubbles in the early 1990s that lasted until the early 2000s.

⁹⁴ See generally Caballero et al., *supra* note 15; Arikawa & Miyajima, *supra* note 15; Peek & Rosengren, *supra* note 11; Fukuda et al., *supra* note 16; Bank of Japan, *supra* note 16; Hosono & Sakuragawa (2005), *supra* note 11; Ahearne & Shinada, *supra* note 16; Sekine et al., *supra* note 16; Hosono & Sakuragawa (2003), *supra* note 16; Sakuragawa, *supra* note 16; Tsuru, *supra* note 16; Hoshi, *supra* note 16; Fukao, *supra* note 16.

At first blush, looking to the lost decade for evidence of main bank rescue may appear to be misguided. Indeed, following market liberalization in the 1980s and 1990s, the general consensus is that there was significant erosion of the main bank system and, in turn, the promise to rescue.⁹⁵ As a result, the literature examining the relevance of the main bank system in Japanese corporate governance, M&R included, normally focuses on the high growth era, and in many cases explicitly avoids the lost decade.⁹⁶

This paper departs from the normal approach for the following reasons. First, as will be illustrated below, main bank rescue played as fundamental a role in prolonging Japan's recession during the lost decade as it did in propelling its growth during the high growth era. In this sense, the lost decade provides weighty evidence of the importance of main bank rescue—and by inference, Japan's unique institutional framework—in shaping Japanese corporate governance. Second, M&R do not limit their free-market theory to a particular sub-period in post-war Japan, or even post-Meiji Restoration. They claim that free-market forces, and not Japan's unique institutional framework, are responsible for the evolution of modern Japanese corporate governance.⁹⁷ Therefore, their theory, if accurate, should explain the actions taken by main banks during the lost decade. Indeed, M&R boldly claim in their recently published book that their explanation of how free-market forces drove the evolution of Japanese corporate governance post-Meiji Restoration will give the reader “the tools and instincts with which to analyze what went wrong” during the lost decade.⁹⁸ Third, other academics, such as Aoki, have already skilfully examined the relevance of main bank rescue in the high-growth era—one more article is unlikely to resolve the “he said, she said” debate sparked by M&R's recent research.

⁹⁵ Aoki (2000), *supra* note 31, at 89-92; Aoki (1994), *supra* note 31, at 135-37; Aoki et al., *supra* note 29, at 30-32. See also Hoshi & Kashyap (1999), *supra* note 50, at 4; GAO, *supra* note 50, at 186.

⁹⁶ See M&R (2006), *supra* note 2, at 67, 84; M&R (2005), *supra* note 13, at 316.

⁹⁷ See M&R (2006), *supra* note 2, at 147. Specifically, with regard to M&R's view of pre-war Japanese corporate governance, see M&R (2006), *supra* note 2, at 38-60.

⁹⁸ *Id.*, at 4. Interestingly, M&R spend less than fifteen pages in their recently published book, *The Fable of the Keiretsu*, explaining how their free-market theory explains the lost decade. Perhaps, this is because to them it is obvious—the answer is the same as the answer that one arrives at after analyzing any period in Post-Meiji Restoration Japan: free market force determined Japanese corporate governance. It is also interesting that M&R fail to comment on the extensive body of literature that has found that banks systematically lent to losers during the lost decade. Regardless of the reasons for this, it makes the application of this “new evidence” to M&R's theory worthwhile. See M&R (2006), *supra* note 2, at 147-60.

B. *Rescuing Loser Firms: An Empirical Reality That Eludes M&R's Free-Market Theory*

Apply M&R's free-market theory to bank lending during the lost decade and the story told is a fairytale of neoclassical economics in practice. Japanese banks were motivated to maximize profits. As such, they withdrew credit from less profitable, poorly performing firms which were hurt by the collapse of the bubbles, and reallocated it to more profitable, well performing firms. By doing so, the banks pressured poorly performing firms to adjust to changing market conditions or shut down. As a result, in the face of the dramatic asset devaluation, efficient banks did what they could to maximize profits and at the same time efficiently reallocated capital throughout the economy. Inefficient banks, which did not take such profit-maximizing actions, were culled from the market and the firms they supported died. In the end, creative destruction occurred in banking and industry, credit was efficiently reallocated and the economy swiftly adjusted to continued growth.⁹⁹

Like any fairytale, this one, based on M&R's free-market theory, remains a wishful fantasy. What should have been a fairytale of creative destruction was a long drawn-out recession punctuated by a banking nightmare. What should have been a banking crisis that was resolved in four years (when compared with other similar banking crises) lasted for well over a decade.¹⁰⁰ What should have been a period of rampant creative destruction in a speculative banking industry (similar to what occurred in the US savings and loan and 1990s Nordic banking crises) was instead a period where the banking industry maintained its asset value.¹⁰¹ The bill for the Japanese

⁹⁹ This description of how M&R's free-market theory would explain bank lending in the lost decade is consistent with the manner in which M&R describe firm performance in the lost decade. According to M&R, "the facts suggests a much more mundane tale: the best firms grew rapidly in the booming 1980s and weathered the troubled 1990s; the worst firms grew only haphazardly in the 1980s, and floundered badly in the 1990s." M&R (2003), *supra* note 13, at 24.

¹⁰⁰ In the 1990s, both Finland and Sweden went through more serious asset market collapses than Japan. Korean markets were also hit hard by the Asian currency crisis. In each case, like in Japan, the respective countries' banking systems had to deal with eroded healthy capital and massive amounts of non-performing loans. All of the countries resolved the fundamental problems in their banking systems in less than four years. This is consistent with comparative banking crisis research, which finds that the average banking crisis lasts for 3.9 years. Hosono & Sakuragawa (2005), *supra* note 11, at 2. See also *Time to Arise from the Great Slump*, *ECONOMIST*, July 22, 2006, at 71, 71 [hereinafter *Economist* 2006]; Michael Hutchison et al., *Empirical Determinants of Banking Crisis: Japan's Experience in International Perspective*, in *WHY DID JAPAN STUMBLE?* 157, 176 (Craig Freedman ed., 1999); Michael Hutchison & Kathleen McDill, *Are All Banking Crises Alike? The Japanese Experience in International Comparison* 13 *J. JAPANESE & INT'L ECON.* 155, 156 (1999).

¹⁰¹ Japanese domestic banking assets shrunk by less than 1 percent between December 1993 and December 2003—a stark contrast to the asset shrinkage that occurred in the US savings and loan industry

taxpayer, that should have been much less than the bill for American taxpayers to resolve their banking crisis after the relatively more severe Great Depression, ended up being for twice as much.¹⁰² What should have been a decade where nonperforming loans (“NPLs”) were written off was a decade that saw NPLs balloon.¹⁰³ It is clear that all of the things that “should have happened,” according to M&R’s free-market theory, did not.¹⁰⁴ When economists became tired of examining the “should haves” and began examining reality, the institutional framework that was maintaining Japan’s uniquely costly and prolonged recession came into focus.

As the 1990s ended, it became increasingly clear that the bursting of the bubbles and economic stagnation that followed had not affected all industries equally. Industries such as real estate and construction—which expanded rapidly during the 1980s and relied heavily on the value of land—suffered far more during the lost decade than other industries such as manufacturing.¹⁰⁵ The significant losses suffered by hard hit industries made bank loans to these troubled industries more risky and less profitable.¹⁰⁶ The

which shrunk by 43 percent between 1988 and 1993, the Finnish domestic banking system which shrunk by 33 percent between 1991 and 1995, and the Swedish domestic banking system which shrunk by 11 percent between 1991 and 1993. Takeo Hoshi & Anil K. Kashyap, *Solutions to Japan’s Banking Problems: What Might Work and What Definitely Will Fail* 23 (Aug. 27, 2004) (draft manuscript, presented at the US-Japan Conference on the Solutions for the Japanese Economy, June 2004), available at <http://www.esri.go.jp/jp/workshop/040903/040903Kashyap.pdf> [hereinafter Hoshi & Kashyap (2004b)].

¹⁰² During the lost decade, Japan’s worst annual growth rate was minus 2 percent, whereas during the Great Depression, the United States suffered a negative growth rate of more than 6 percent in each year between 1930 and 1932. By inference, one would expect that the banking crisis in the United States during the Great Depression was much more severe than the one in Japan during the lost decade. The opposite is true. During the Great Depression, the total amount lost by bank depositors was 2.2 percent of GDP, whereas the cost to Japanese taxpayers of their banking crisis was 4 percent of GDP. The Japanese government injected more than 10 trillion yen into the banking system with relatively little success. Hoshi and Kashyap (2004a), *supra* note 9, at 4-6.

¹⁰³ Astonishingly, over the course of the lost decade NPLs in Japan actually increased—despite massive injections of capital from the government. Hosono & Sakuragawa (2005), *supra* note 11, at 29.

¹⁰⁴ According to the *Economist*, increased lending by Japanese banks to failing firms “has proved one of the most durable, distorting and deliberate compacts in modern economic history. It has set Japan apart from other countries stricken with financial crisis and greatly prolonged its economic suffering . . . during financial crises elsewhere bankers typically stop lending to unviable borrowers.” *ECONOMIST* (2004a), *supra* note 19, at 77-78. See also Nishimura & Kawamoto, *supra* note 19, at 302.

¹⁰⁵ Ahearne & Shinada, *supra* note 16, at 3-4. See also Hosono and Sakuragawa (2005), *supra* note 11, at 9.

¹⁰⁶ According to Hosono and Sakuragawa, one way to measure the risk and profitability of loans is to examine the average period in an industry that a bank can expect its loan to be repaid. “This measure captures the borrowers’ insolvency and is supposed to be negatively related to the profitability of loans. The estimated years of debt repayment increased sharply in the early 1990s for real estate and commerce, and in the middle of the 1990s for construction. They reached as high as 36 years and 14 years for real estate and construction, respectively, on average over the 1990s. This insolvency measure increased slightly for manufacturing in the 1990s but the average remained as low as 9 years. The upward trend in the estimated years of debt repayment reflects the fact that the sharp decline in land prices reduced the loan profitability to real estate, commerce and construction.” Hosono & Sakuragawa (2003), *supra* note 16, at

obvious question that arose was whether Japanese banks were efficiently reallocating credit away from less profitable industries and towards the more profitable ones—as M&R’s free-market theory would predict. The short answer is no. In fact, the opposite is true—they were systematically rescuing failing firms.

In the 1990s, Japanese banks *increased* lending to their clients that were *least likely* to pay them back and *decreased* lending to their clients that were most likely to pay them back.¹⁰⁷ Even more surprisingly, they did not charge a higher interest rate to their worst clients to compensate for increased risk.¹⁰⁸ As path dependence would predict, Japan’s main banks took the lead in orchestrating the perverse scheme of systematically lending to loser firms.¹⁰⁹ Since M&R’s free-market theory explicitly rejects the possibility that Japan’s unique institutional framework drives the lending decisions of bank managers, one is left with the absurd conclusion that, for over a decade, Japanese bank managers systematically chose to *irrationally* “spend good money after bad” to support unprofitable firms. Perhaps the shots of *shochu* in Shinjuku were different from the shots of whiskey in Manhattan after all.

Shochu aside, this paper suggests a more rational theory based on a wealth of empirical research. Japanese bank managers *rationally* decided to lend to their worst clients because Japan’s unique institutional framework gave them an incentive to do so. However, before describing the unique institutional framework that drove Japanese bank managers, it is necessary to examine the empirical research that confirms that banks did in fact systematically engage in “lending to losers.”

C. *Overwhelming Empirical Evidence Indicates That Banks Systematically Lent to Losers*

There is overwhelming empirical evidence that during the lost decade Japanese banks systematically lent to inefficient and unprofitable firms.¹¹⁰

1. In another article Hosono and Sakuragawa note, “This shift in bank loan portfolios is inconsistent with the behavior of profit-motivated banks, suggesting that Japanese banks continued to extend loans to unprofitable firms and industries even though it was unlikely that those loans would be recovered.” Hosono & Sakuragawa (2005), *supra* note 11, at 9.

¹⁰⁷ Peek & Rosengren, *supra* note 11, at 1144, 1162-64; Hosono & Sakuragawa (2005), *supra* note 11, at 8-9; Hosono & Sakuragawa (2003), *supra* note 16, at 1-2.

¹⁰⁸ Caballero et al., *supra* note 15, at 5-12. *See also* Smith, *supra* note 17; Sekine et al., *supra* note 16, at 78; BIS Report 2002, *supra* note 17, at 133-34.

¹⁰⁹ For empirical evidence that the main bank system played a central role in the systematic lending by banks to losers firms throughout the lost decade, *see* Peek & Rosengren, *supra* note 11.

¹¹⁰ Peek & Rosengren, *supra* note 11 at 1164-65. *See generally* Caballero et al., *supra* note 15; Arikawa & Miyajima, *supra* note 15; Peek & Rosengren, *supra* note 11; Fukuda et al., *supra* note 16; Bank

More importantly, the evidence is clear that institutional incentives motivated the decision to lend to losers—not profit maximization.¹¹¹ There are four findings that have been repeatedly confirmed by a sophisticated body of empirical research that support this conclusion: (1) banks disproportionately increased lending to unprofitable industries; (2) banks disproportionately increased lending to firms with lower profit rates and poor stock returns; (3) the future performance of firms that received additional loans was worse than average; and (4) banks increased lending to firms at below-market interest rates.

D. *Banks Increased Lending to Unprofitable Industries*

In 2000, Hoshi published the first paper suggesting that banks were systematically lending to losers during the lost decade.¹¹² His research, which is based on industry level data, found that during the lost decade the loan share of banks increased to the least profitable industries (such as real estate and construction) and decreased to the most profitable industries (such as manufacturing).¹¹³ Numerous studies, which also rely on industry level data, have confirmed Hoshi's general findings.¹¹⁴

Research based on industry level data, while convincing, is not foolproof. Such research may obscure an important reality of bank lending—that it takes place at the firm, and not industry, level. It is easy to see how one could put a “free-market spin” on these empirical findings by suggesting that industry level data may reveal the strategic decision of banks to focus their lending on profitable firms in undervalued industry—not to

of Japan, *supra* note 16; Hosono & Sakuragawa (2005), *supra* note 11; Ahearne & Shinada, *supra* note 16; Sekine et al., *supra* note 16; Hosono & Sakuragawa (2003), *supra* note 16; Sakuragawa, *supra* note 16; Tsuru, *supra* note 16; Hoshi, *supra* note 16; Fukao, *supra* note 16. For a concise overview of the recent empirical research in this area, see Hoshi & Kashyap (2004a), *supra* note 9, at 14-15; Hoshi and Kashyap (2004b), *supra* note 101, at 4-7.

¹¹¹ Hosono & Sakuragawa (2003), *supra* note 16. Hosono and Sakuragawa conclude, based on their empirical analysis of Japanese bank lending in the lost decade, that “Japanese banks seem to have extended bad loans to real estate-related industries for any other motive than profit-maximization over the 1990s.” *Id.*, at 19.

¹¹² Hoshi, *supra* note 16, at 233-66.

¹¹³ *Id.* Specifically, Hoshi found that bank loans to real estate developers continued to grow in the 1990s, long after the profitability of the industry had dramatically declined because of the bursting of the real estate bubble—while at the same time loans to firms in the more profitable manufacturing industry steadily declined. Hoshi suggests that the reason for the increased loans to poorly performing real estate companies was so that they could pay the interest on the loans so that they would not be classified as non-performing. *Id.*

¹¹⁴ Fukao, *supra* note 16; Sakuragawa, *supra* note 16, at 99-126; Hosono & Sakuragawa (2003), *supra* note 16; Tsuru, *supra* note 16. Interestingly, a recent study done by the Bank of Japan, which uses industry level data, suggests that evergreening from banks continued to escalate from the time of the bursts in 1990 until 2001, at which time it appears to have started to subside. Bank of Japan, *supra* note 16, at 30.

intentionally lend to losers. However, research using firm level data fails to support this free-market conclusion.

E. Banks Increased Lending to Less Profitable Firms with Lower Stock Returns

Firm level data confirms that banks systematically lent to losers throughout the lost decade. In 2005, Peek and Rosengren published what is arguably the most systematic study to date on the misallocation of bank credit during the lost decade.¹¹⁵ Their study uses firm-level data to show that firms with low profit rates and poor stock returns were more likely to receive additional loans from banks during the lost decade.¹¹⁶ The clear implication is that banks were systematically choosing to lend to unprofitable firms rather than strategically picking profitable firms in undervalued industries. Other studies, which also use firm level data, have confirmed Peek and Rosengren's general conclusion.¹¹⁷

Admittedly, if one tries hard enough, it is possible to stretch M&R's free-market theory even to make sense out of the findings based on firm-level data. It is conceivable that rational bankers, motivated by profits, used their informational advantage to "cherry pick" undervalued firms with a high potential for future profits. In Japan's recessionary economy, it is plausible that bank managers facing depressed profits and fewer lending prospects opted to lend to poorly performing firms as a last ditch strategy to increase profits by extracting above-market interest rates from undervalued firms. Arguably, main banks would have been in the ideal position to cherry pick because of their informational advantage. The cherry picking story is appealing, but it is also unsupported by empirical research.¹¹⁸

If banks were using their informational advantage to cherry pick, then during the lost decade those firms that received additional loans should have subsequently outperformed firms that did not receive additional loans. In fact, the opposite is true. Peek and Rosengren find that the future

¹¹⁵ Peek & Rosengren, *supra* note 11.

¹¹⁶ *Id.* at 1149, 1154.

¹¹⁷ Caballero et al., *supra* note 15. A study done by Caballero, Hoshi, and Kashyap uses industry and firm-level data to show that the percentage of zombie firms (firms that are kept alive by subsidized credit from banks) hovered between 5 and 15 percent until 1993 and then rose sharply over the mid 1990s so that the zombie percentage was above 25 percent for every year after 1994 until their study concluded in 2002. They also found that zombie firms increased in the late 1990s in every industry and the increase was the largest in non-manufacturing firms (which were the least profitable firms). Ahearne & Shinada, *supra* note 16. Research done by Ahearne and Shinada shows, using firm-level data, that during the lost decade inefficient firms—which were being sustained in large part by financial support from Japanese banks—gained market share in inefficient industries. See also Sekine et al., *supra* note 16, at 78.

¹¹⁸ Peek & Rosengren, *supra* note 11, at 1148-50.

performance of firms that received additional loans was worse than those that did not receive additional loans.¹¹⁹ Further, during the lost decade, despite the severe problems faced by Japan's banking sector, firms unexpectedly increased their reliance on banking loans relative to bonds. If the story of cherry picking were true, one would expect those firms that were "picked" by banks from the bond market would outperform other bondholders. Again, the opposite is true. Firms that were picked by banks were less profitable than those that stayed in the bond market.¹²⁰

F. *Banks Lent at Discount Rates to Risky Firms*

The interest rate paid by Japanese firms during the lost decade confirms that the motivation for lending to losers was not profit-maximization. According to standard economic theory, rational banks should have charged higher interest rates to less profitable firms to compensate for the increased risk of default. Indeed, if Japanese banks had charged an above-market interest rate to compensate for the increased risk of their new stable of unprofitable borrowers it may suggest a profit-maximizing motive. However, once again there is no empirical evidence that finds support for such a strategy.¹²¹ During the lost decade, banks increasingly charged below-market interest rates to risky firms.¹²²

G. *Case Study Evidence Confirms the Reality of Banks Lending to Losers*

As convincing as the empirical evidence is, it is no substitute for case study evidence which confirms the reality that banks, without regard for profits, systematically lent to losers. Tett documents numerous cases of such behavior.¹²³ Particularly compelling are the cases reviewed by Tett where

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ In fact, the empirical research suggests that the opposite strategy was employed—weaker firms were subsidized by the banks by being charged below market interest rates. Caballero et al., *supra* note 15 at 5-12. See also Smith, *supra* note 17; Sekine et al., *supra* note 16, at 78; BIS Report 2002, *supra* note 17, at 133-34.

¹²² Smith, *supra* note 17. During the lost decade, the number of firms receiving loans at below market interest rates increased. Specifically, Smith finds that during the lost decade Japanese banks in Japan charged lower (risk adjusted) spreads when compared with foreign banks in Japan to Japanese businesses—suggesting that Japanese banks were subsidizing loser Japanese firms. Caballero et al., *supra* note 15. Caballero et al. also find that the percentage of firms that received direct interest rate subsidies from banks increased dramatically during the lost decade. More importantly, the subsidies were far more common in non-manufacturing firms when compared to manufacturing firms—further evidence of banks using below-market interest rates to support loser firms and industries. See also Hosono & Sakuragawa (2005), *supra* note 11, at 9; Hoshi and Kashyap (2004b), *supra* note 101, at 5-6; Sekine et al., *supra* note 16, at 78.; BIS Report 2002, *supra* note 17, at 133-34.

¹²³ Tett, *supra* note 16.

firms were forced to open their books for inspection as a result of bankruptcy. An example of such a case involved Sogo, one of Japan's most prestigious retailers, which officially declared bankruptcy in 2000.¹²⁴

The story of Sogo is a classic tale of a loser firm which, but for bank lending, would have closed its doors years prior to its official bankruptcy. In Sogo's case, sales growth turned negative in 1992 and continued a steady steep decline for almost a decade until it closed.¹²⁵ According to M&R's free-market theory, Sogo's lenders should have pulled their loans "like bankers everywhere else" and jettisoned the fledgling retailer soon after it began its trend of declining yearly sales and mounting losses.¹²⁶ In fact, the opposite happened.

As Sogo's finances deteriorated, banks considerably increased lending.¹²⁷ Overall, seventy-three banks decided to continue to pour valuable capital down the Sogo drain right up until the moment it officially declared bankruptcy.¹²⁸ Interestingly, the lenders with the largest exposure to Sogo—those that presumably had the most accurate information about Sogo's finances—increased their share of Sogo's debts as its finances plummeted.¹²⁹ This is a far cry from the story that M&R's theory would predict of a profit driven bank acting rationally in the free-market to exploit its informational advantage and cut its losses.

When Sogo finally declared bankruptcy in March 2000, it wrote off fifty-nine percent of its assets and owed creditors 1.9 trillion yen.¹³⁰ It is unfathomable, especially in the last few years, that the coalition of seventy-two banks and IBJ (Sogo's main bank that held close to thirty percent of its debt) actually believed that they were making loans that would eventually reap profits or even cut losses.¹³¹ Preventing Sogo's bankruptcy—not maximizing profits or cutting losses—was the motive for lending.

Lending to Sogo may have continued until today if it were not for a few idiosyncratic forces that altered the lending relationship between Sogo

¹²⁴ For an overview of the Sogo case, *see id.* at 208-20.

¹²⁵ For statistical data relating to Sogo's sales and loans during the lost decade, *see* Peek & Rosengren, *supra* note 11, at 1146-47.

¹²⁶ M&R (2006), *supra* note 2, at 63-64. *See also* M&R (2005), *supra* note 13, at 338; M&R (2002), *supra* note 2, at 421.

¹²⁷ Peek & Rosengren, *supra* note 11, at 1147.

¹²⁸ Hoshi & Kashyap (2004a), *supra* note 9, at 14. *See also* Tett, *supra* note 16, at 208.

¹²⁹ Hoshi & Kashyap (2004a), *supra* note 9, at 14.

¹³⁰ Peek & Rosengren, *supra* note 11, at 1147; Tett, *supra* note 16, at 208.

¹³¹ Peek & Rosengren, *supra* note 11. According to Peek and Rosengren: "it is hard to believe that these banks thought that they were making positive net present value loans to Sogo over all these years." *Id.*, at 1147. Tett also concludes that banks knew they were evergreening: "by 1999 it was clear the retailer could never repay its debts." Tett, *supra* note 16, at 209.

and its creditors. In fiscal 1999, new accounting rules changed the institutional framework that protected Sogo from disclosing its inefficiencies and forced it to reveal its substantial negative net worth.¹³² This made IBJ scramble to orchestrate a debt forgiveness agreement among Sogo's creditors to ensure that it did not go bankrupt.¹³³ IBJ's plan likely would have succeeded if it had not been for foreign-owned Shinsei bank refusing to accept it.¹³⁴

Even after the forgiveness plan failed, Sogo still had the chance to stave off bankruptcy through government assistance.¹³⁵ However, Sogo's fate was sealed because political pressures on the government would not allow it to orchestrate a standard bailout. Much of Sogo's debt had already been passed onto taxpayers through an unpopular deal that the government had entered into with the American investors who bought Shinsei Bank, so the political repercussions of throwing yet more money at Sogo would have been severe.¹³⁶ In the end, and somewhat ironically, it appears that the feared loss of political capital, not economic capital, was what brought Sogo down—after almost a decade of banks lending “good money after bad” to a loser firm.

Some may claim that the Sogo case is atypical because of Sogo's enormous debt, the involvement of a foreign controlled bank, and the unique political drama. Although each case is obviously unique, the accounts of numerous other Sogos in the literature and the empirical evidence described above demonstrate that Sogo was not an aberration. It was the norm.¹³⁷

As shown above, it is possible to stretch M&R's free-market theory to make sense out of *some* of the empirical research and perhaps even *a few* case studies. However, M&R's free-market theory is ill equipped to provide a workable explanation for the evidence as a whole. In light of the weight of

¹³² Peek & Rosengren, *supra* note 11, at 1147.

¹³³ *Id.*; Tett, *supra* note 16, at 208-09.

¹³⁴ Tett, *supra* note 16, at 208-20.

¹³⁵ *Id.*, at 209. Indeed, as Tett notes, the government had attempted to do everything it could to bail out Sogo in the past: “when the FSA had conducted its audit of the LTCB loans in early 1999, it labeled the Sogo loans as almost normal. Ripplewood subsequently challenged the classification but the FSA refused to reassess the loans. Instead, the bureaucrats quietly agreed to give the bank an extra Y100 billion of provisions to keep the Sogo loans on its books. This made a mockery of the FSA's own rules, since ‘near normal’ loans were not supposed to need such a high level of provisions.” *Id.*

¹³⁶ *Id.*, at 208-20; Peek & Rosengren, *supra* note 11, at 1147.

¹³⁷ Tett, *supra* note 16, at 58-59. This is consistent with the empirical research presented above and a number of other related findings. For example, Tett notes that surprisingly few firms went bankrupt following the bursts of the bubbles. See also ECONOMIST (2004a), *supra* note 19, at 77-78, which tells the story of how banks have kept Daiei (formerly a leader in Japan's retailer industry) alive more out of concern for making Daiei *appear* like a healthy borrower than actually making it become a profitable business. The Daiei saga is strikingly similar to that of Sogo.

the evidence, even M&R may be bashful to conclude that since lending to losers does not accord with free-market theory, the best explanation is that lending to losers did not happen at all. The fact is it did happen. The unique institutional framework that made it happen is explained below.

H. *The Institutional Framework in the Lost Decade: the Incentives That Drove Main Banks to Rescue*

During the lost decade an institutional framework emerged that provided incentives that drove banks to systematically lend to losers. Under this institutional framework, profit-maximization and efficiency took a back seat to bank managers motivated by survival to keep banks open and, more importantly, ensure their lifetime employment at all costs. Indeed, normally making a profit is the best way to ensure firm survival—that is unless a firm does not have a realistic chance of actually making a profit, in which case *appearing* to make a profit is the next best option.

There are several ways that a firm can go about creating the false perception that it is making a profit. However, most methods are either criminal or short-term strategies, at best. For Japanese banks, to decide that creating the appearance of profits was a viable long-term strategy, when trillions of yen were at stake, sounds more like an act of *hara-kiri* than a rational management strategy. Unless of course, there was government help. And help, the government did.

Luckily for the fledgling banks, the Japanese government had political motives that aligned with their survival agenda. The government was in no position to see large inefficient banks and/or unprofitable firms go under on a grand scale.¹³⁸ Thus, political realities, not economics, drove the creation of an institutional framework that allowed banks to select lending to losers as a viable long-term strategy (in many cases, the *only* strategy) for survival.

¹³⁸ Caballero et al., *supra* note 15, at 2. The difficult position that the government has been in following the bursts is exemplified by their persistent attempts to deny that the banking crisis existed and to delay making any substantial reforms. As Caballero, Hoshi, and Kashyap note: “the political and regulatory response was to deny the existence of any problems and delay any serious reforms or restructuring of the banks. Aside from a couple of crisis periods when regulators were forced to recognize a few insolvencies and temporarily nationalize the offending banks, the banks were surprisingly unconstrained by regulators.” The authors also note that, “in 1997, at least 5 years after the problem of non-performing loans was recognized, the Ministry of Finance was insisting that no public money would be needed to assist banks. In February 1999 then Vice Minister of International Finance, Eisuke Sakakibara, was quoted as saying that the Japanese banking problem ‘would be over within a matter of weeks.’ As late as 2002, the Financial Services Agency claimed that Japanese banks were well capitalized and no more public money would be necessary.” *Id.* See also, Peek & Rosengren, *supra* note 11; Tett, *supra* note 16, at 68-69.

In retrospect, three watershed events sparked the emergence of the perverse, institutionally driven equilibrium of lending to losers in the lost decade.

First, in the early 1990s, the bubbles burst.¹³⁹ The collapse of the real estate and stock markets significantly eroded healthy bank capital. Losses were magnified by the fact that Japanese banks, in contrast to their American and English counterparts, relied extensively on real estate to collateralize loans and held significant stock portfolios.¹⁴⁰ The battered stock markets also made it extremely difficult for banks to issue equities to raise much needed new capital. This shifted the focus of bank managers from expanding market share to retrenching and ensuring bank survival.

Second, in fiscal 1992, the risk-based capital standards based on the 1988 Basel Capital Accord (“the Basel Accord”) came into force.¹⁴¹ The Basel Accord required that Risk-Based Capital, the ratio of capital to risk weighted assets (“the RBC ratio”) held by Japanese banks not fall below a certain level.¹⁴² Although there are no explicit penalties in the Basel Accord for falling below the RBC ratio, achieving the hurdle was viewed as a must for banks.¹⁴³ Failing to achieve the hurdle can result in the Financial Services Agency (“FSA”) taking control of the bank, international regulators curtailing overseas operations, and market discipline.¹⁴⁴ The incentive for a

¹³⁹ Hoshi & Kashyap (2004a), *supra* note 9, at 5-6; Tett, *supra* note 16, at 62-63; *Passing Go*, THE ECONOMIST, Oct. 9, 2004, at 73 [hereinafter Economist 2004b]. From 1990 to 1991, asset prices declined rapidly in Japan. The Nikkei 225 stock price index reached its 38,915 peak on the last business day of 1989 and then collapsed. By October 1, 1990, the Nikkei hovered barely above 20,000—a decline of almost 50 percent in 9 months. It then floated around the 15,000 level for the balance of the 1990s—with some considerable fluctuations. The Nikkei entered the new millennium with a brief climb up to 20,000 and then plummeted again to its post-war low of 7,607 on April 28, 2003—which was less than 20 percent of its bubble peak. Most observers consider 2003 as the end of the lost decade. Since that time, a recovery has been in progress. At the time of writing this paper, the Nikkei stands around 15,000. Land prices began to fall in late 1991, and by 1995 prices were half of their peak values. They continued to fall for 15 straight years until 2005. At the time of writing this paper, it appears that land prices are slowly starting to climb. Hutchison et al., *supra* note 100, at 157; Hoshi & Kashyap (2004a) *supra* note 9, at 5; Economist 2006, *supra* note 100, at 72-73; Economist 2004b. From 1990 to 1991, asset prices declined rapidly in Japan.

¹⁴⁰ Tett, *supra* note 16, at 62.

¹⁴¹ Though the Basel Accord was agreed upon in 1988, the capital standards became effective in Japan from fiscal year 1992—after a five-year transition period. Heather Montgomery, *The Effect of the Basel Accord on Bank Portfolios in Japan*, 19 J. JAPANESE INT’L ECON. 24, 25 (2005). See also Takatoshi Ito & Yuri Sasaki, *Impacts of the Basle Capital Standard on Japanese Banks’ Behavior*, 16 J. JAPANESE INT’L ECON. 372, 373 (2002).

¹⁴² Montgomery, *supra* note 141, at 25; Ito & Sasaki, *supra* note 141, at 373-74.

¹⁴³ Wako Watanabe, *Does a Large Loss of Bank Capital Cause Evergreening? Evidence from Japan*, 3 (2006), available at <http://www.bis.org/bcbs/events/rtf06watanabe.pdf> [hereinafter Watanabe 2006a]; Hosono & Sakuragawa (2003), *supra* note 16, at 3-4; Ito & Sasaki, *supra* note 141, at 373-74.

¹⁴⁴ At the end of fiscal 1997, the Ministry of Finance (“the MOF”) formalized the consequences of failing to meet the minimum RBC ratio by implementing the prudential policy guidelines for prompt corrective action (“PCA”), which allows regulators (then MOF and now the FSA) to intervene in banks

Japanese bank manager to avoid such consequences is clear: ensure the bank meets the minimum capital requirement or lose lifetime employment.¹⁴⁵

Third, as the decade progressed and Japan's NPL problem materialized, market participants began to regard ratios of NPLs of Japanese banks as an important indicator of bank health.¹⁴⁶ Banks that failed to keep NPLs in check were quickly punished by an increasingly skeptical market and seen as prime candidates for mergers or FSA intervention.¹⁴⁷ For bank managers, this meant that keeping the NPL ratio down was as important as meeting the minimum RBC ratio; the objective had to take priority over all others including profits.

Considered together, the incentives for Japanese bank managers in the lost decade were straightforward: remain solvent, stay above the minimum RBC ratio, and keep NPLs down or lose their jobs. However, exactly how bank managers were to achieve these objectives proved to be more complex.

Bank managers were not making their decisions in a game theory model played out in a Tokyo University or Harvard laboratory. They had to pragmatically determine which actions would have the highest chance of achieving their objectives based on the implementation of the Basel Accord, Japan's unique regulatory and accounting practices, institutional pressures, and bank finances. What complicated the decision for bank managers even more was that, in many cases, actually achieving their objectives was extremely unlikely and, in some cases, virtually impossible.¹⁴⁸ With an institutional framework that facilitated and encouraged creating the façade of profitability, it became rational for bank managers to aim for the more attainable objective of *appearing* to achieve their objectives rather than the unlikely possibility of *actually* achieving them. Indeed, the payoff of continued lifetime employment for bank managers was the same for both.

As the empirical evidence described above suggests, the optimal strategy for most Japanese bank managers was to continue to lend to loser

with an RBC ratio below the minimum 8 percent (4 percent in the case of banks that were not internationally active). Watanabe 2006a, *supra* note 143, at 3; Ito & Sasaki, *supra* note 141, at 373-74.

¹⁴⁵ Hosono & Sakuragawa (2003), *supra* note 16, at 3-4. As Hosono and Sakuragawa note: "The Basel capital standards strengthened the tendency for managers to roll over bad loans because they could stay as managers only by disclosing the capital ratio above the minimum level of 8%." *Id.* See also Hosono & Sakuragawa (2005), *supra* note 11, at 4.

¹⁴⁶ Fukuda, et al., *supra* note 16, at 7. See generally Tett, *supra* note 16.

¹⁴⁷ Fukuda, et al., *supra* note 16, at 7. See generally Tett, *supra* note 16.

¹⁴⁸ Hoshi & Kashyap (2004a), *supra* note 9, at 16-18. This is confirmed by Hoshi and Kashyap's recent research that found that, after adjusting for various gimmicks used to artificially inflate bank capital "almost no private capital remain[ed] in the banking sector." *Id.*, at 16. They further found that at the end of the lost decade, private sector analysts were "unanimously of the view that the banks [were] bankrupt and that the losses for the taxpayers [would] be substantial." *Id.*, at 18. See also Peek & Rosengren, *supra* note 11, at 1144-45.

firms to keep them from defaulting on their loans—a practice referred to as “evergreening.”¹⁴⁹ By systematically practicing evergreening, bank managers achieved all of their objectives. This is because in Japan’s unique institutional environment evergreening made it appear to outsiders as if banks were: (1) solvent; (2) had RBC ratios above the minimum requirement; and (3) were keeping their NPLs in check. The balance of this section will explain how Japan’s unique institutional framework ensured that evergreening bank managers would achieve these results.

I. Japan’s Unique “Enforcement” of the Basel Accord—An Incentive to Evergreen

As mentioned above, in fiscal 1992, the Basel Accord went into force in Japan.¹⁵⁰ Internationally, the objective of the Basel Accord was to standardize capital requirements for banks around the world in order to make the international banking system more resilient to adverse market shocks.¹⁵¹ From the standpoint of Japanese banks, the timing of the Basel Accord coming into force in Japan could not have been worse. Meeting the minimum capital requirements set out in the Basel Accord appeared easily attainable at the time Japan entered into the accord—before the stock market bubble burst.¹⁵² Post-burst, the story was very different and the Japanese government and banks were forced to “cooperate” and devise a scheme to make it appear as if the minimum capital requirements in the Basel Accord were being met by Japanese banks. To understand the effect of the Basel Accord and the response to it from the Japanese government and banks calls for some elementary mathematics.

The primary requirement of the Basel Accord is that banks in member states must maintain a certain amount of healthy capital in proportion to their risky assets—which is called the RBC ratio.¹⁵³ The Basel Accord

¹⁴⁹ Hosono & Sakuragawa (2003), *supra* note 16, at 2-6; Hosono & Sakuragawa (2005), *supra* note 11, at 8-9; Peek & Rosengren, *supra* note 11.

¹⁵⁰ Montgomery, *supra* note 141, at 25.

¹⁵¹ Ito & Sasaki, *supra* note 141, at 373.

¹⁵² On July 11, 1988, when the final agreement of the Basel Accord was signed, Japan was approaching the peak of its stock market bubble. Japanese negotiators successfully argued that since Japanese banks held large amounts of long-term cross shareholdings, which were not meant to be traded, they should be able to include a portion of the capital gains on those stocks as part of the regulatory capital that was needed to satisfy the Basel Accord’s minimum capital requirement. When stocks plummeted, by more than 50 percent within 9 months of the burst, it dramatically decreased the regulatory capital of Japanese banks and made it difficult for many of them to meet the minimum requirements. Ito & Sasaki, *supra* note 141, at 374.

¹⁵³ Montgomery, *supra* note 141, at 25; Ito & Sasaki, *supra* note 141, at 373-74.

defines the RBC ratio as capital divided by risk weighted assets.¹⁵⁴ The Basel Accord requires internationally active Japanese banks to maintain an RBC ratio of at least eight percent.¹⁵⁵

Capital, the numerator of the RBC ratio, consists of tier I (or core) capital and tier II (or supplementary) capital.¹⁵⁶ Tier I capital is composed of stock issues and disclosed reserves, including share premiums and retained earnings.¹⁵⁷ Tier II capital is composed of undisclosed reserves, including unrealized capital gains on securities, provisions for general loan losses and subordinate debt with maturities exceeding five years. Tier II capital cannot exceed tier I capital in its contribution to total capital.¹⁵⁸

Risk-weighted assets, the denominator of the RBC ratio, is composed of bank assets, which are weighted according to their degree of risk. Risky assets such as loans receive a 100 percent weighting and riskless assets such as government bonds receive a zero percent weighting. Secured loans, which are seen as moderately risky, “fall in between with a weighting of fifty percent.”¹⁵⁹

Arithmetically, the choice that bank managers have to increase the RBC ratio is limited. They can either increase capital (the numerator) by issuing new equities, subordinate debts, or preferred stock; or by increasing general loan loss reserves; or they can decrease risk-weighted assets (the denominator) by reducing heavily weighted assets such as loans or equity holdings and substituting them with safe assets such as government bonds.¹⁶⁰

The rationale for compelling banks to meet the RBC ratio is to force banks, especially weak banks, to decrease their overall risk so that they can more easily withstand market shocks. The drafters of the Basel Accord believed that the RBC ratio would achieve this by compelling banks with low RBC ratios to increase tier I and II capital and/or decrease risky assets. Indeed, banks around the world have largely acted as the drafters of the Basel Accord intended.¹⁶¹

¹⁵⁴ For a brief overview of the requirements of the Basel Accord in the context of bank lending in the lost decade *see*, Hosono & Sakuragawa (2005), *supra* note 11; Montgomery, *supra* note 141.

¹⁵⁵ Banks that are not internationally active are allowed, under the Accord, to maintain an RBC ratio of at least 4 percent. Montgomery, *supra* note 141, at 25.

¹⁵⁶ Hosono & Sakuragawa (2005), *supra* note 11, at 6.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ Montgomery, *supra* note 141, at 25.

¹⁶⁰ It is important to distinguish between the effect of adding to *general* loan loss reserves, which increases capital, and *specific* loan loss reserves, which decreases capital. Specific loan loss reserves are treated similar to write-offs, which create an incentive for banks facing a capital shortage to under-allocate for them.

¹⁶¹ David Jones, Emerging Problems with the Basel Accord: Regulatory Capital Arbitrage and Related Issues, 24 J. BANKING FIN. 35, 36 (2000).

In fact, if anything, history has shown that the RBC ratio has worked too well in making banks stable and instead, in some cases, has made them risk adverse.¹⁶² Normally, it is difficult and costly for weak banks to raise new capital (the numerator in the RBC ratio). As such, weak banks that are at risk of falling below the RBC ratio have resorted to shifting assets from loans (100 percent weighted) to riskless assets such as government bonds (0 percent weighted)—thereby decreasing the denominator of the RBC ratio—while at the same time cutting commercial lending.¹⁶³ In the early 1990s, when the United States was in the midst of a recession, many blamed the RBC ratio for driving banks to indiscriminately cut commercial lending causing a phenomenon that became known as a “capital crunch.”¹⁶⁴ The “capital crunch” in the United States, during the early 1990s, is suggested by many academics as a major factor in the deepening of the recession in the United States at that time.¹⁶⁵ Even considering American critiques, the conventional wisdom is that the RBC ratio drives banks to decrease risk—if anything too much.

However, during Japan's lost decade, bank managers did not respond as the drafters of the Basel Accord, American precedent, or M&R's free-market theory would predict.¹⁶⁶ Japanese banks found themselves in the unique position where government regulations and incentives, coupled with their battered balance sheets, made evergreening, rather than cutting risky

¹⁶² *Id.*; Wako Watanabe, *Prudential Regulation and the “Credit Crunch*, OHIO STATE UNIVERSITY J. OF MONEY CREDIT & BANKING 4 (forthcoming 2006), available at http://www.econ.tohoku.ac.jp/~watanabe/credit_crunch_wp_032206.pdf [hereinafter Watanabe 2006b].

¹⁶³ Watanabe 2006b, *supra* note 162, at 4. (“Theoretical works have shown that asymmetric information—involving investors, a bank, and borrowers—makes issuing new equity costly. Therefore, undercapitalized banks failing to satisfy the regulatory minimum may raise the (risk based) capital to asset ratio by cutting back on lending (a denominator of the ratio) rather than raising equity capital (a numerator of the ratio) in order to immediately clear the regulatory hurdle. The easiest way to raise the risk-based capital to asset ratio is to shift the asset portfolio away from lending that is assigned the highest risk weight of all asset classes (100% risk weight) to assets with less weight, such as the government bonds of OECD countries (0% risk weight”). See also Jones, *supra* note 161, at 36.

¹⁶⁴ See generally Hall, *supra* note 10; Haubrich & Wachtel, *supra* note 10.

¹⁶⁵ See generally Hall, *supra* note 10; Haubrich & Wachtel, *supra* note 10.

¹⁶⁶ Hall, *supra* note 10; Haubrich & Wachtel, *supra* note 10; Economist (2004a), *supra* note 19. It should be noted, that the issue of whether there was a capital crunch in Japan during the lost decade is unsettled. There are a few studies that have found that there may have been a capital crunch at some period during the lost decade, which could have been caused by the Basel Accord. The strongest evidence for a capital crunch is in the years following the 1997 banking crisis. However, the vast majority of these studies suggest that even if there was a capital crunch, for a period of time during the lost decade, that evergreening still likely occurred. In other words, the two conclusions are *not* mutually exclusive. Firms obviously can lend less overall but still misallocate the credit they do lend to loser firms by continuing to advance them funds to make interest payments. The evidence against a capital crunch (especially in the period from 1991 to 1997) is much stronger and is the view taken in this paper. See Hoshi & Kashyap (2004a), *supra* note 9, at 6-7; Caballero et al., *supra* note 15, at 28; Montgomery, *supra* note 141, at 35; Watanabe 2006b, *supra* note 162, at 23-24.

loans, a more effective strategy for meeting the RBC ratio.¹⁶⁷ Conveniently, this strategy also meant that NPLs would not be reported—an effective way of keeping the NPL ratio down.

From an accounting perspective, it is easy to explain how evergreening creates the façade that a bank is meeting its RBC ratio. When a poorly performing firm is unable to pay the interest on its loan for a certain length of time (three months since March 1998, and six months previously) the loan becomes non-performing.¹⁶⁸ The NPL first appears on a bank's financial records as a loan loss reserve (a liability contra-asset account) on a bank's balance sheet before being written off. If the bank's income is low and/or the level of NPLs is high, its loan loss reserve charge may exceed its income. This requires the bank to reduce its book capital.¹⁶⁹ During the lost decade, as banks suffered from massive amounts of NPLs and low incomes, when a bank wanted to call in its NPLs it normally had to write off existing capital, which in turn pushed the bank up against the minimum RBC ratio requirement.¹⁷⁰

In theory, to avoid this result is simple. Before a poorly performing firm's loan becomes non-performing, the bank can evergreen by lending the

¹⁶⁷ Hosono & Sakuragawa (2003), *supra* note 16, at 3-6. Hosono and Sakuragawa find that: "The theoretical literature on bank regulation argues that capital requirements should discipline bank managers to take safer and more profitable loan portfolios that accord more with the interest of shareholders. The practice in Japan was at odds with this theoretical prediction. The Basel capital standards, together with the discretionary accounting practice, do not seem to have worked effectively in disciplining a bank's behaviour. As a matter of fact, Japanese regulatory authorities seemed to make every effort to let banks, especially major banks, keep capital adequacy requirements by manipulating regulatory frameworks and accounting standards." *Id.*, at 3. See also *Don't Feed the Zombies*, THE ECONOMIST, Apr. 8, 2006, at 58, 58 ("[Japanese] banks were throwing good money after bad in this way because twisted regulations made it simpler to prop up weak borrowers than cut them off").

¹⁶⁸ Patricia Jackson & David Lodge, *Fair Value Accounting, Capital Standards, Expected Loss Provisioning, and Financial Stability*, Bank of England Financial Stability Review 105, 111 (June 2000), available at <http://www.bankofengland.co.uk/publications/fsr/2000/fsr08art5.pdf>. During most of the lost decade, the Japanese definition for NPLs was much narrower than the international standard. Prior to Financial Year (FY) 1995, the definition for NPLs included only loans to bankrupt companies and loans past due for six months or more. In FY1995, the definition was broadened slightly to include restructured loans (but only those where the interest rate was reduced to below the Bank of Japan's discount rate). In FY1997, the definition was broadened again to include loans past due more than three months and all restructured loans. However, this definition did not include loans where, even though no payment problems had occurred, the bank had serious doubts about the ability of the borrower to fulfill its future obligations—allowing evergreened loans to continue to be excluded from the definition of NPLs. In FY1998, the FSA finally introduced a more comprehensive regime for identifying NPLs that more closely reflected international accounting standards. However, even under this new definition many independent observers believe that the level of NPLs remained grossly underreported throughout the lost decade. See Hoshi & Kashyap (2004a), *supra* note 9, at 15-16.

¹⁶⁹ Kathryn L. Dewenter and Alan C. Hess, *Are Relationship and Transactional Banks Different?*, EFMA 2004 Basel Meetings Paper, Nov. 25, 2003, at 12-13, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=478101.

¹⁷⁰ Caballero et al., *supra* note 15, at 2.

firm enough funds to pay the interest on its loan. This kills two birds with one stone—it keeps the loan “performing” and the *reported* RBC ratio from falling.¹⁷¹ During the lost decade, Japan’s ultra-low interest rates made this a relatively inexpensive strategy.¹⁷²

Regardless of how low interest rates are, evergreening is a Ponzi scheme that free-market forces normally rout out.¹⁷³ As poorly performing firms continue to underperform they require more bank loans to both continue their inefficient operations and cover their interest payments, causing risky assets (the denominator in the RBC ratio) to increase. At the same time, evergreening banks are deprived of real interest income, which eventually will cause capital (the numerator in the RBC ratio) to fall. When the market becomes aware of evergreening, raising new capital becomes next to impossible and bank-financing charges rise, which further impairs capital. Thus, under normal free-market conditions, which M&R’s theory assumes, evergreening is not a viable option because it merely delays capital erosion in the short-term and ultimately inflates capital losses when market-forces compel disclosure or drives the firm to bankruptcy—that is, without government help.

During the lost decade, the Japanese government created an institutional framework that allowed banks with significant NPLs and insufficient healthy capital to use evergreening as a long-term strategy.¹⁷⁴ The government ensured that free-market forces would not come to bear on evergreening banks by creating a matrix of laws, regulations, policies, and direct government funding to maintain evergreening and the façade that it helped create. The institutional framework neutralized market-forces by: (1) artificially inflating bank capital by creating and sanctioning accounting gimmicks; (2) preventing disclosure of evergreening by implementing a forbearance regulatory policy; (3) ensuring bank management that

¹⁷¹ Sekine et al., *supra* note 16, at 71 (summarizing the findings of Sakuragawa’s research as follows: “a bank, under an opaque accounting system, has an incentive to disguise its true balance sheet so as to satisfy the Basel minimum capital requirement. In this case, a bank without sufficient loan-loss provisioning tries to put off disposal of NPLs to avoid decreasing its own capital in an accounting sense”).

¹⁷² Caballero et al., *supra* note 15, at 6-7. It should be noted that evergreening did not always take place simply by extending loans to cover interest payments. There were various methods that were used to subsidize loser firms by restructuring their loans, such as: interest rate concessions, debt-equity swaps, debt forgiveness, and moratoriums on loan principle and interest. Restructuring helped banks meet the minimum capital requirement because “without such restructuring, banks would be forced to classify the loans to those borrowers as ‘at risk’, which usually would require the banks to set aside 70 percent of the loan value as loan loss reserves. With restructuring, the banks need only move the loans to the ‘special attention’ category, which requires reserves of at most 15%.” *Id.*

¹⁷³ Dewenter and Hess, *supra* note 169, at 13.

¹⁷⁴ Peek and Rosengren, *supra* note 11, at 1144-45; Hosono & Sakuragawa (2003), *supra* note 16, at 2-6; Caballero et al., *supra* note 15, at 2.

evergreening would not result in bankruptcy; and (4) providing capital at below-market interest rates.

This seems like a lot of effort for a government to maintain a façade—it was. But for the government, the political incentives loomed large. With a mushrooming budget deficit¹⁷⁵ and a voting public that was weary of funding bank bailouts and were fearful of increasing unemployment, the government could ill afford the political fallout of major banks or large loser firms failing on a grand scale.¹⁷⁶ Thus, political motives, which seldom “track the contours of standard economic theory,” drove the creation of the instructional framework that supported evergreening.¹⁷⁷

J. Government Accounting Gimmicks Facilitated Evergreening

During the lost decade, the government created and sanctioned numerous accounting gimmicks that prevented free-market forces from disciplining evergreening banks.¹⁷⁸ Accounting regulations were implemented to artificially inflate banks’ regulatory capital, which made it possible for banks to carry on evergreening as a long-term, as opposed to short-term, strategy.¹⁷⁹ The most effective government orchestrated accounting gimmicks were: (1) to manipulate fair-value and historical-cost accounting standards to suit market fluctuations; (2) to allow double gearing with insurance companies; and (3) to permit massive amounts of deferred taxes to count as capital.

¹⁷⁵ *The Viagra Economy*, THE ECONOMIST, Sept. 24, 2005, at 12 (“With growth weak and prices falling, tax revenues plunged. For the past ten years the budget deficit has been running at an average of 6 percent of GDP, and Japan’s levels of government debt are now by far the highest of any rich country”). See also Tett, *supra* note 16, at xxiv; *Chronic Sickness*, THE ECONOMIST, June 2, 2001, at 73.

¹⁷⁶ Peek & Rosengren, *supra* note 11. According to Peek and Rosengren: “Although banks have an incentive to evergreen loans, their ability to pursue such policies aggressively requires government complicity. The government faced with a growing budget deficit and a voting public weary of funding bank bailouts, has an incentive to allow, or even encourage banks to continue their policies of forbearance in order to avoid the alternative scenario of massive firm and perhaps bank failures and, in particular, the associated costs both financially and politically.” *Id.*, at 1145. See also Mitsuhiro Fukao, *Financial Sector Profitability and Double Gearing* 3 (Nat’l Bureau of Econ. Research, Working Paper No. 9368, 2002), available at <http://www.nber.org/papers/w9368>; Caballero et al., *supra* note 15, at 2-3.

¹⁷⁷ As described above, M&R’s theory tells the story of an invisible hand guiding firms through perfect markets that “tracks the contours of standard economic theory.” See M&R (2004a), *supra* note 25, at 202. Interestingly, Hoshi and Kashyap conclude that the sectors that have the most evergreening have the strongest political protection, which makes perfect sense considering that evergreening is ultimately driven by political motives. Hoshi and Kashyap (2004b), *supra* note 101, at 6. See also Hosono & Sakuragawa (2003), *supra* note 16, at 3.

¹⁷⁸ For a detailed examination of the interaction between accounting regulations and evergreening see, Hosono & Sakuragawa (2005), *supra* note 11.

¹⁷⁹ Hosono & Sakuragawa (2003), *supra* note 16, at 3.

The historical account of how the Japanese government manipulated fair-value and historical-cost accounting standards to inflate banks' regulatory capital is laughable. The government's manipulation started in the early 1990s, when the stock market bubble collapsed but stock prices were still relatively high. At this time, the government determined that the best way to help banks increase their capital was to allow them to apply fair-value accounting standards to their securities (i.e. to take advantage of the rise in stock values) which produced large latent capital gains. Such manipulation would have had no effect on the regulatory capital of banks in most other countries because latent capital gains are generally prohibited from being counted as part of regulatory capital.¹⁸⁰ Despite this, in 1991, the Ministry of Finance ("MOF") allowed Japanese banks to include forty-five percent of their latent capital gains generated from the application of fair-value accounting to be included as part of tier II regulatory capital. And so, just like that, the regulatory capital of Japanese banks ballooned overnight. Real capital and banking risk, of course, was left unchanged.

Then, in 1997, when stock prices dropped sharply, and fair-value accounting no longer resulted in inflated regulatory capital, the MOF reversed its position. Now, conveniently for Japanese banks, the MOF allowed historical-cost accounting to be used so that the value of stocks could be counted at their acquisition price. This allowed the banks to avoid the unrealized capital losses that would have decreased their regulatory capital.¹⁸¹ To add to the façade, at the very same time, the MOF allowed banks to use fair-market accounting to value land. Predictably, this resulted in increasing banks' regulatory capital because most banks acquired a large proportion of their land long before it appreciated in the late 1980s.¹⁸² The result was that large unrealized capital gains from land holdings could be included in tier II capital. Again, overnight-reported regulatory capital ballooned. And again, such gimmicks left the actual capital and stability of evergreening banks unchanged.

Another accounting gimmick that was allowed by the government to help protect evergreening banks from market-forces by artificially inflating regulatory capital, was "double gearing."¹⁸³ In the most popular form of

¹⁸⁰ For example, in the United Kingdom and United States, banks are prohibited from including capital gains in regulatory capital. Ito & Sasaki, *supra* note 141, at 374.

¹⁸¹ Hosono & Sakuragawa (2005), *supra* note 11, at 7.

¹⁸² *Id.*

¹⁸³ Hoshi & Kashyap (2004a), *supra* note 9, at 18-19; Hosono & Sakuragawa (2005), *supra* note 11, at 6-7. For a more detailed overview of double gearing during the lost decade see, Hanh B. Tran, *Double Gearing Between Japanese Banks and Insurance Companies*, ELECTRONIC J. CONTEMP. JAPANESE STUD.] (2006), <http://www.japanesestudies.org.uk/articles/2006/Tran.html>; Fukao, *supra* note 176.

double gearing, banks issued subordinate debt¹⁸⁴ (which increases tier II capital) to *keiretsu*-affiliated life insurance companies. This allowed the banks to raise cash and then use that cash to buy subordinate debt issued by the life insurance companies, so that the life insurance companies could then buy the subordinate debt in the first place.¹⁸⁵ To the credit of Japanese banks, they mastered the twisted art of double gearing during the lost decade and, in the process, created trillions of yen of bogus capital.¹⁸⁶

Is double gearing an accepted international practice? Of course not. The international norm is that domestic regulators prohibit double gearing.¹⁸⁷ The international financial community criticized Japanese regulators when the practice of double gearing was eventually revealed.¹⁸⁸ Despite this, in 2000, when Chiyoda Life failed and Tokai Bank lost seventy-four billion yen, the FSA actively encouraged double gearing. Curiously, Shokichi Takagi, the Director of FSA's Supervision Department, publicly stated that double gearing among financial institutions is highly beneficial to enhance public confidence—but this statement about double gearing only makes sense after a double shot of *shochu*.¹⁸⁹

In 1999, a year after a few Japanese banks collapsed, regulators desperately scrambled to devise yet another plan to maintain the façade that the banking system was healthy in order to ensure that evergreening continued. The new gimmick was to count deferred taxes (i.e. tax credits from past losses that the bank expected to claim in the future) as tier I capital. This was a boon for evergreening banks because, once again, it caused artificially inflated regulatory capital to balloon.

According to Japanese tax law, deferred taxes expire five years after losses are incurred. This means that if poorly performing banks do not become profitable the deferred taxes are worthless. As capital is supposed to serve as a buffer for unexpected losses, it does not make sense—aside from artificially inflating regulatory capital—to count deferred taxes as part of regulatory capital because they are useless precisely when the buffer is needed.¹⁹⁰ For this reason, in the United States, regulators limit deferred tax assets to ten percent of tier I capital. However, and somewhat predictably, in

¹⁸⁴ Subordinate debt is, in case of bank insolvency, senior to equity but junior to any other debt including other bonds and insured deposits and counts as tier 2 capital.

¹⁸⁵ Hoshi & Kashyap (2004b), *supra* note 101, at 3.

¹⁸⁶ In March 2001, as the lost decade was in its last few years, life insurance companies held 10.5 trillion yen of subordinated debt issued by banks, while banks held 2.0 trillion yen of subordinated debt issued by life insurance companies. Hoshi & Kashyap (2004a), *supra* note 9, at 19.

¹⁸⁷ *Id.*

¹⁸⁸ BIS Report 2002, *supra* note 17, at 135.

¹⁸⁹ Fukao, *supra* note 176, at 2-3.

¹⁹⁰ Hoshi & Kashyap (2004a), *supra* note 9, at 15. *See also* BIS Report 2002, *supra* note 17, at 133.

Japan there was no such limit. In March 2003, deferred taxes accounted for a whopping forty percent of Japanese banks' book value capital.¹⁹¹

The net result of government-sanctioned accounting gimmicks is that during the lost decade, banks' RBC ratios considerably diverged from actual capital ratios.¹⁹² Several sources confirm that as the lost decade progressed, years of accounting gimmicks caused actual bank capital to be a mere fraction of the reported regulatory capital.¹⁹³ A striking example can be seen in the reported RBC ratios of Hokkaido Takushoku Bank and Long-Term Credit Bank of Japan in 1997. At that time, both banks had reported RBC ratios above the minimum eight percent. Two years later, both banks were bankrupt.¹⁹⁴ The government's ability to artificially inflate the RBC ratios of banks allowed evergreening to continue unchecked. In this sense, evergreening was driven by Japan's unique institutional framework. M&R's free-market theory fails to explain these facts.

K. *Regulators Turning a Blind Eye Made Evergreening Feasible*

The Japanese government's forbearance policy was carried out by regulators who turned a blind eye to evergreening—allowing evergreening banks to avoid free-market pressures.¹⁹⁵ Throughout the lost decade, regulators misclassified loans as sound when they were clearly troubled and non-performing. This allowed banks to continue evergreening by understating their nonperforming loans and to avoid making adequate loan loss provisions, which artificially inflated regulatory capital.¹⁹⁶

¹⁹¹ Hoshi & Kashyap (2004a), *supra* note 9, at 16-17.

¹⁹² An empirical study by Hosono and Sakuragawa finds that as a result of accounting gimmicks that were allowed by the government, banks' "regulatory capital considerably diverged from true economic capital." Hosono & Sakuragawa (2005), *supra* note 11, at 7.

¹⁹³ *Nationalized Once, Nationalized Again?*, THE ECONOMIST, July 6, 2002, at 71. Even Masaru Hayami, the Governor of the Bank of Japan, admitted to Parliament that the capital ratios of Japanese banks in March 2001 would have been only 7% rather than the reported 11% had they been held to U.S. standards of capital adequacy. Phred Dvorak, *Japan's Banks Face Debate on What Counts as Capital*, WALL ST. J., Nov. 20, 2001, at C1.

¹⁹⁴ Hosono & Sakuragawa (2003), *supra* note 16, at 21-22. According to Tett: "In the days following the collapse [of Hokkaido Takushoku Bank] the government admitted that . . . the bad loans were more than twice as large as previously published data." Tett, *supra* note 16, at 105.

¹⁹⁵ "Aside from a couple of crisis periods when regulators were forced to recognize a few insolvencies and temporarily nationalize the offending banks, the banks were surprisingly unconstrained by the regulators." Caballero et al., *supra* note 15, at 2.

¹⁹⁶ Some scholars are of the view that the government miscalculated the cost of its forbearance policy and that after it realized its mistake following the severe banking problems in the late 1990s, it changed its course, resulting in regulators more closely scrutinizing the banks in the late 1990s and early 2000s. For example, Peeks and Rosengren suggest that in the early 2000s the FSA may have been stricter with forcing banks to properly classify loans—although they still did not force any banks below the RBC ratio (suggesting that the FSA may still be allowing forbearance to some extent). Peek & Rosengren, *supra* note 11, at 1165 n.16. See also Sekine et al., *supra* note 16, at 83.

The lost decade is rife with evidence of regulatory blindness.¹⁹⁷ A study by the *Nikkei* newspaper found that nearly seventy-five percent of loans to Japanese firms that declared bankruptcy in 2000 had been classified as sound or merely in need of monitoring.¹⁹⁸ Similarly, the put options granted to Shinsei and Azzora associated with the purchase of supposedly cleaned-up banks were awarded to the buyers of the failed banks because the government prevented the bidders from inspecting the banks' books. The government's idiosyncratic bidding system was created because it feared that if bidders could inspect the banks' books, evergreening would be exposed and other banks evergreening the same underperforming borrowers would be forced to come clean.¹⁹⁹

The complicity of regulators with evergreening banks curbed the ability of market forces to discipline Japan's bank managers. In this way, the government's political concerns altered the result that would have been achieved in M&R's utopian Japanese free market.²⁰⁰ This allowed bank evergreening to continue on a massive scale for over a decade despite its negative impact on banks' profitability and the economy as a whole.

L. Government Insurance Buffered Evergreening Banks from Free Market Forces

Another mechanism the government used to allow banks to continue evergreening was to ensure banks that they would not fail and to guarantee bank deposits. Until the late 1990s, it was widely accepted that the Japanese government would not let banks fail, especially large banks.²⁰¹ This allowed bank managers to continue to engage in evergreening with the assurance that if the Ponzi scheme eventually did collapse, the government would be there to catch them.²⁰²

In the late 1990s, when it appeared that some market discipline might come to bear on evergreening banks— as the “no-fail policy” was threatened by the collapse of Hokkaido Takushoku Bank (and Sanyo and Yamaichi in

¹⁹⁷ Hoshi and Kashyap note that in the late 1990s and early 2000s, “every time a bank has failed, the losses uncovered are substantially above those expected based on the most-recent regulatory review.” Hoshi & Kashyap (2004b), *supra* note 101, at 19.

¹⁹⁸ *Mere Fiddling*, THE ECONOMIST, June 30, 2001, at 69.

¹⁹⁹ *Reborn, Remade, Resold*, THE ECONOMIST, Jan. 17, 2004, at 64.

²⁰⁰ “The political concerns associated with having to deal with the official recognition that the banking system was severely undercapitalized and the consequences of banks severely limiting credit to troubled firms provided bank supervisors with the incentive to continue their forbearance policies toward banks.” Peek & Rosengren, *supra* note 11, at 1165.

²⁰¹ This became known as the government's “too big to fail policy.”

²⁰² Hosono & Sakuragawa (2003), *supra* note 16, at 6.

the securities industry)— the government reformed the Deposit Insurance Act. In 1996, the Act was amended, lifting the existing ten million yen limit on deposit insurance so that all deposits were covered. The limit was supposed to be reintroduced on April 1, 2001 but was postponed until April 1, 2002. Non-interest bearing loans remained fully protected until April 1, 2005.²⁰³ This allowed banks to continue to attract cheap capital in the form of deposit accounts, while engaging in inefficient profit reducing behaviors such as evergreening.²⁰⁴

M. When All Else Failed, Taxpayers' Money was Used to Help Banks Evergreen

When all else failed, the government simply pumped taxpayers' money into the banks so that they could use it to evergreen.²⁰⁵ By some accounts, in 1998 and 1999, almost one half of the public funds injected into the banking system were passed on to troubled construction companies in the form of debt forgiveness.²⁰⁶

The government did not merely turn a blind eye to mass evergreening with taxpayers' funds—it pressured banks to do it. The FSA mounted severe pressure on foreign owned Shinsei Bank (widely regarded as the only bank in Japan that has seriously applied credit risk analysis in its lending decisions) to continue lending to severely troubled firms.²⁰⁷ Specifically, when Shinsei Bank was deemed to be “behaving improperly” by pulling loans from troubled firms, the FSA warned Shinsei that it was government policy for banks to support category two²⁰⁸ (deeply troubled but operating) firms regardless of how risky they might be.²⁰⁹ Category two firms, which

²⁰³ Hoshi & Kashyap (2004b), *supra* note 101, at 19.

²⁰⁴ According to Hoshi and Kashyap, “by repeatedly delaying the reform of the deposit insurance to limit its coverage, the government allowed even the worst banks to continue to attract financing and support their insolvent borrowers.” Hoshi & Kashyap (2004a), *supra* note 9, at 9. In another paper, Hoshi and Kashyap further conclude that by guaranteeing bank deposits the government effectively allowed banks to continue evergreening, which prevented unemployment from rising. However, in their opinion, this was a very inefficient mechanism for the government to sustain employment. Hoshi & Kashyap (2004b), *supra* note 101, at 19.

²⁰⁵ Hosono & Sakuragawa (2005), *supra* note 11, at 28-29.

²⁰⁶ Gillian Tett & David Ivison, *Tokyo May Have to Support Banks*, FIN. TIMES (London), Sept. 14, 2001, at 3.

²⁰⁷ For a detailed overview of this case, see Tett, *supra* note 16, at 227-37.

²⁰⁸ Virtually bankrupt or bankrupt firms were labeled “category three” and “category four” firms, respectively.

²⁰⁹ Tett, *supra* note 16, at 233-37. Soji Mori, the FSA commissioner, is quoted as saying, “Shinsei should behave in line with other Japanese banks,” Jason Singer & Phred Dvorak, *Shinsei Bank Pressured to Keep Shaky Loans*, The Wall St. J., September 26, 2001, at C1.

have come to be known as “zombies,” were typically firms kept alive by evergreening and accounted for the bulk of Japan’s NPLs.²¹⁰

When the government could not pump taxpayers’ money into evergreening banks directly, it did so indirectly. Since 1990, when the MOF changed its regulations to allow banks to issue subordinated debts to raise their capital ratios, the government subsidized banks by purchasing subordinate debt at below-market levels.²¹¹ Subordinate debt, if fairly priced in the market, can act as a disciplining mechanism on unprofitable banks. However, subordinate debt was not fairly priced to reflect banks’ default risk, as the purchasers were most often associated life insurance companies and the government, who never sold the debt in the market.²¹² The government often repaid subordinated debt holders on behalf of insolvent banks, thereby removing risk-based pricing from the market.²¹³ These observations suggest that subordinate debt did not play any disciplinary role but was used as another mechanism to allow evergreening to continue.²¹⁴

The government’s direct and indirect use of taxpayers’ money to fund evergreening turned what started out as a bank-based Ponzi scheme into a national Ponzi scheme. It dragged out the recession for over a decade. In the process, the government accumulated unfathomable deficits unmatched by any other OECD country.²¹⁵ M&R’s free-market theory would have predicted none of this.

²¹⁰ Tett, *supra* note 16, at 234.

²¹¹ Hosono & Sakuragawa (2005), *supra* note 11, at 8; Hosono & Sakuragawa (2003), *supra* note 16, at 15.

²¹² Hosono & Sakuragawa (2005), *supra* note 11, at 8; Hosono & Sakuragawa (2003), *supra* note 16, at 15.

²¹³ In fact, since 1995, creditors of subordinate debt of failed banks have been protected by the government. The case of Hyogo Bank, a regional bank that failed in 1995, is the last one when creditors of subordinate debt were not protected. Hosono & Sakuragawa (2005), *supra* note 11, at 8, 8 n.8.

²¹⁴ Hosono & Sakuragawa (2005), *supra* note 11, at 8; Hosono & Sakuragawa (2003), *supra* note 16, at 15.

²¹⁵ By the end of 2002, Japan’s debt to GDP ratio had risen to over 140% and its credit rating was downgraded to the same level as Botswana. Tett, *supra* note 16, at xvi-xvii, xxiv. As the decade moved on, evergreening became self-reinforcing. By the end of the lost decade, some experts suggested that if all of the accounting gimmicks and regulatory aids provided by the government were stripped away, almost no actual private capital actually would have remained in the banking system. Without any real capital there is no other option but to evergreen. Shifting risky loan assets to government bonds (the denominator) does nothing to improve the RBC ratio if there is no capital (the numerator). In the dismal market, raising sufficient capital through issuing new equities was also not an option. Hoshi & Kashyap (2004a), *supra* note 9, at 16-18.

N. *Empirical Evidence Confirms That the Institutional Framework Drives Evergreening*

As if all of the aforementioned evidence is not enough, there is now empirical evidence that directly supports the hypothesis that evergreening is driven by Japan's unique institutional framework. Hosono and Sakuragawa, in their recent paper, examine the relationship between the government allowing the use of accounting gimmicks to artificially inflate regulatory capital (which they call "accounting discretion") and evergreening.²¹⁶ Based on a number of statistically significant results, which demonstrate the relationship between accounting discretion and evergreening, they arrive at a definitive conclusion:

Severely capital-constrained Japanese banks, particularly major banks, extended bad loans in order to inflate regulatory capital under the accounting rule, which allowed banks to hide latent loan losses. The government responded to the perverse behaviour of banks by allowing the discretionary enforcement of minimum capital requirements which softened the banks' capital constraints and contributed to the increase in bad loans.²¹⁷

Enough already. The point is simple: self-interested bank managers lent to loser firms to meet regulatory requirements so that they could keep their lifetime employment—not to make banks more profitable. Self-interested Japanese government officials facilitated this behaviour to avoid the political repercussions of massive bank and industry failures. The effect of free-market forces was *de minimus*. And now, M&R have to contend with empirical evidence that proves it.

O. *The Main Bank System Shaped Evergreening in the Lost Decade*

As powerful as Japan's government was, the main bank system also played an indispensable role in driving banks to evergreen. In fact, empirical evidence suggests that without the main bank system in place the government's ability to persuade banks to evergreen would have been extremely limited.²¹⁸ The main bank system, developed following the war, was the most important factor in determining which banks evergreened and to whom.

²¹⁶ Hosono & Sakuragawa (2005), *supra* note 11, at 8-9.

²¹⁷ *Id.*, at 28.

²¹⁸ Peek & Rosengren, *supra* note 11, at 1144.

From the perspective of the conventional main bank theory, evergreening makes perfect sense—it is merely conventional rescue theory gone bad. As explained in section two above, rescue theory is based on the premise that banks promise to rescue because the institutional framework provided the necessary incentives to make rescuing in the best interest of banks. As the theory goes, in the high growth era, the government provided an optimal level of incentives to drive banks to an efficient equilibrium where they only rescued potentially productive firms.

Similarly, in the lost decade, the institutional framework created by the government (and not free-market forces) drove “rescue” behaviour. However, the incentives provided by the government were not to rescue only potentially productive firms but, perversely, to rescue habitually unproductive firms to achieve a political agenda. In other words, the same mechanism that drove efficient rescue ultimately drove evergreening—the only difference was the level of incentives provided by the government to rescue were much greater and the agenda was different.

Peek and Rosengren, in their recent research, conclude that during the lost decade the main bank system played an integral role in facilitating evergreening. They find, using a host of empirical measures, that main banks were more likely than secondary banks or other lenders to provide additional loans to failing firms (i.e. to evergreen) and that this effect was even stronger if the firm was in the same *keiretsu*.²¹⁹

Peek and Rosengren’s research also suggests that the government specifically encouraged main banks, as opposed to other lenders, to fulfil their traditional role as “the rescuer” by evergreening failing firms. They find that government lenders were more likely to increase loans to firms that had troubled main banks. This suggests that the government attempted to aid unhealthy main banks that were keeping their promise to evergreen.²²⁰

The only group for which Peek and Rosengren were unable to confirm a pattern of evergreening in the lost decade was non-bank lenders that were not in the same *keiretsu* as the borrowing firm.²²¹ This makes perfect sense, as these firms were not driven by either government-created incentives (which were specifically directed towards banks) or incentives that were provided to main banks to rescue failing firms.

The lost decade is often characterized as an era in which the main bank system had a diminished impact on Japanese corporate governance. In fact, the opposite is true. During the lost decade, in spite of the deregulation

²¹⁹ *Id.*, at 1161.

²²⁰ *Id.*, at 1162.

²²¹ *Id.*

of the bond market, Japanese firms relied more on bank financing than they did during the bubble years.²²² During this period of increased reliance on bank financing, “loser firms” disproportionately increased their reliance on main banks when compared with healthy firms.²²³ The conclusion: as much as main banks drove growth in the high growth era, they stifled it in the lost decade.

The theory espoused by M&R appears even more untenable in light of the evidence of a link between evergreening and the main bank system. This should not surprise. It would be astounding for a simple theory based on the lone assumption of free-markets to explain the complex interaction between Japan's unique institutional framework (i.e. its matrix of laws, regulations, institutions and formal and informal government policies and practices) and one of the most complex economies in the world. Unfortunately, the world is not as simple as M&R's theory suggests. Moreover, to assume that it is so simple leads us to erroneous conclusions. Indeed, according to M&R, “the moral is simple: the main bank does not help the least profitable firms. If anything, it avoids them.”²²⁴ It would be difficult to construct a less accurate description of bank lending in the lost decade.

V. CONCLUSION: JAPANESE BANK LENDING IN THE LOST DECADE— EVIDENCE AGAINST CONVERGENCE

M&R's recent research does a magnificent job of breathing new life into the Japanese corporate governance debate. Indeed, these eminent scholars have raised questions that challenge the conventional theory of Japanese corporate governance that many academics recite as gospel. However, M&R have gone too far. A passage from the concluding chapter in their recently published book, *The Fable of the Keiretsu*, says it all:

conventional microtheory with profit maximizing firms buying and selling in competitive markets does describe Japan. It always did. The fables about Japanese bureaucrats, keiretsu, main banks, and systematically misgoverned firms are just that—fables. At root, the Japanese economy differs little from the American economy (or, we suspect, from any economy anywhere else). To learn about the Japanese economy one does

²²² Arikawa and Miyajima find that the ratio of bank borrowing to total debt consistently increased throughout the lost decade. Astonishingly, the ratio in 2000 was 70.7%, which was higher than in 1986 when bond issuance was heavily regulated. Arikawa & Miyajima, *supra* note 15, at 6.

²²³ *Id.*, at 11.

²²⁴ M&R (2003), *supra* note 13, at 22.

not need Japan-specific accounts of corporate groups, main banks, and government-led growth. One does need economics.²²⁵

Although I respect M&R's scholarly abilities, I am curious as to how they will tell the story of main bank rescue in the lost decade without any "Japan-specific" accounts. I suspect that the story will not be a non-starter: "that it did not exist" and that this author has "created another myth."

Miwa and Ramseyer repeatedly suggest that the picture they paint of Japan is mundane and boring because it predictably tracks the contours of old-fashioned standard economic theory.²²⁶ Boring? Mundane? I think not. If correct, they have uncovered something that has eluded legions of venerable scholars—that standard economic theory alone can explain Japan's (or any other country's) complex system of corporate governance. Indeed, their story is an exciting fairytale of perfect markets which droves of successful American businesses that have failed to succeed in Japan only wish were true.

Sadly, the prize for boredom must be claimed by this author. Simply, Japanese corporate governance is driven by many different factors including laws, regulations, institutions, formal and informal government policies, economics, culture, history and a bit of random chance. This is not a novel theory. Professor Milhaupt suggested it in his brief review of one of M&R's earlier attempts to espouse their logic. As Milhaupt noted, Douglas North received a Nobel Prize years ago for taking a similar approach.²²⁷

As boring or mundane as this conclusion may be, it may pique the interest of some scholars engaged in the debate over the convergence of corporate governance.²²⁸ Banking has become one of the most internationally integrated fields in the global economy. The same general law, the Basel Accord, ostensibly governed Japanese banks as it did banks in the United States and in other developed countries. The lost decade was marked by deregulation that allowed free-market forces more power than at anytime in Japan's post-war history. The scenario screams for convergence—but the reality was divergence.

For over a decade, Japanese banks acted in precisely the opposite manner than the drafters of the Basel Accord, American precedent, or standard economic theory would have predicted. The result was a unique

²²⁵ M&R (2006), *supra* note 2, at 147.

²²⁶ M&R (2003), *supra* note 13, at 24; M&R (2002), *supra* note 2, at 421.

²²⁷ Milhaupt, *supra* note 1, at 426.

²²⁸ See generally, Branson, *supra* note 24, at 331; Gilson, *supra* note 24, at 331; Hansmann & Kraakman, *supra* note 24, at 439.

system that drove the actions of the largest businesses and financial institutions in the world's second largest economy for over a decade. Japan's unique institutional framework and path dependence—not the Basel Accord or free-market forces—ruled the day. Those who fail to consider “Japan-specific accounts” are left with only absurd conclusions for how this could have occurred.

A final point must be made with respect to M&R's use of statistics. They remind readers on several occasions of a famous Harvard professor's words. “‘Know thy data,’ Zvi Griliches told generations of budding Harvard econometricians. Office-chair theorists would do well to learn a little data too.”²²⁹ I must agree. However, perhaps more importantly, armchair theorists must know thy theory that underlies thy data—or else thy data may be all for naught.

²²⁹ M&R (2004b), *supra* note 12, at 30. *See also* M&R (2006), *supra* note 2, at 160.