Economic Perspectives and Accounting Issues of Japanese Banks' Non-performing Loans

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Abstract: This paper examines the problems of non-performing loans within Japanese banks from the viewpoint of both economic and accounting aspect. In the background of the accumulation of non-performing loans, one cannot disregard the delay of economic recovery and the fall in land prices. I conclude that there are some constitutional problems concerning banking system such as the convoy system, existence of a main bank relationship, and insufficient information disclosures. Although the reforms of accounting regulation and tax law and so on are also advanced, it has not been possible to make this critical balance sheet healthier. Consequently, Banks must implement a policy to convert funds derived from real estate into new available credit in order to substantially improve the balance sheet.

Key words: Disposal of non-performing loans; Allowance for credit losses; Public funds; Interlocking shareholdings; Main bank system; Financial distress

1. Introduction

The recent performance of Japanese banks is slowly declining with the bad debt consequences of the bursting of the bubble, as well as with the future exchange rate remaining uncertain, and share prices still do not show signs of a rebound. Therefore, it becomes difficult that write-off funds for the proposal of non-performing loans are ensured by the sale of stocks, and banks also require escaping from the hidden management. It is anticipated that loan losses not only become a factor that will oppress operating profits of banks throughout a few years in the future, but also constitute a factor that weakens the competitiveness for surviving Japan's Big Bang financial reforms. The European and American economy has brought good corporate results under the healthy financial system. In comparison with those countries, the Japanese financial system in which the disposal of non-performing loans has not ended is unstable. It is therefore vital for their survival, that information technology (IT) investment takes place to enhance competitiveness among Japanese financial institutions.

On the other hand, bank loans have not increased in order to give priority to the disposal of non-performing loans, and the investment trend for a majority of Japanese firms have fallen since share prices stagnated by the disposal of shareholdings.

Economists argue that the banks and the real economy have locked together in a deflationary spiral. Therefore, we cannot forecast that the Japanese economy will recover from recession, even if ten years have passed since the economic bubble burst. As a result of the current problems of the Japanese Economy, banks have taken responsibility and realized the need to attempt converting from the management of scale and share extension to the management of interest rate. Banks must also select the business field in proportion to their own strength and characteristics, and then they have to carry out the mega-reorganization for surviving undefeated. Indeed, the strength of Japanese banks is falling. In terms of profitability and return on equity they are second rate compared to major international banks and it is impossible to say that Japanese banks are currently internationally competitive. If this situation continues, Japanese banks will be greatly left behind compared to foreign financial institutions in the world of international funds trade in regarding ratings as important.

Now many economists are investigating the bank's non-performing loans in connection with economic conditions and bank regulations, because non-performing loans are important issues these days. However the optimal policy that would solve these issues has not been proposed. This issue also relates directly to the accounting aspect. Thus the context of bank's non-performing loans is examined in the following respects. First, I would like to analyze the factors why the disposal of non-performing loans does not promote and provide the fundamental solution measures from the viewpoint of both main bank system and interlocking stockholding. Second, I hope to review some institutional problems of the disposal of non-performing loans concerning accounting regulations.

2. Analysis on the Disposal Amount of Non-performing Loans

The Japanese management supported by the rise in land prices and stock prices, faced crisis after 1990, and it is obvious that the nature of management needs to be changed. Especially, after the economic bubble burst, their businesses rapidly ran into difficulties, and bad debt problems of banks had deeply affected the deterioration of recent corporate results. Non-performing loans are split into different categories including "loans on which interest payments are in arrears by a financially distressed state of borrowing firms" and "loans which they are unrecoverable" in which financial institutions lend. These bad debts consist of three kinds of non-performing loans: risk management loans, loans by assets assessment based on the Financial Reorganization Law, and loans by self-assessment. There are differences of purpose, object loans, division methods, and reserve cover ratio, and so on among these non-performing loans. Currently, the increase of non-performing loans in financial institutions also have a bad effect on the rate of exchange, and the hidden profit of shares is decreasing by the fall in share prices. It has been observed that the strength of Japanese financial institutions is gradually falling. Then, I would like to investigate and analyze the actual non-performing loans (risk management loans with the disclosure duty here) that currently pose a serious problem.

Table 1 shows that the disposal of non-performing loans of Japanese banks slightly advances. However, these figures are based on risk management loans with the disclosure duty by each financial organization. Indeed the numbers are much higher. The real total of non-performing loans has reached more than 100 trillion yen. As a result of advancing the disposals of non-performing loans, some banks were at a loss on their annual accounts in March last year after stock prices suddenly fell. The Japanese government injected 7.5 trillion yen public funds into the 15 large banks at the end of March 1999. Banks that accepted public funds are promising the government that it ensures the fixed profit and that it carries out compulsory restructuring, etc. in "plan for the health of the management". At the beginning, there seemed to be some passive opinions from some financial firms that "there is no necessity" for public funds. However, it is indispensable that banks ensure and maintain public safety guards such as injection of public funds and operation of the deposit insurance law in order to prevent the reheat of anxiety to the financial system under deflationary pressure. At present, the Japanese government has pulled together more than 15 trillion yen of public funds by purchasing non-performing loans from banks in the crisis correspondence account. Public funds should be elastically utilized so that the failure of major banks and management anxiety of small financial institutions does not spread to the whole financial sector.

Table 1 shows that the disposal amount of annual non-performing loans reached their highest levels in March 1999 and that they drastically decreased afterwards. As a result of the financial survey and the examination of the business plan (plan making excellent financial states) submitted to the finance regeneration committee, the reason why the disposal amount rises in 1999 is that banks carried out the positive disposal of non-performing loans in order to satisfy write-off and reserve standards, when they applied for public funds. The assets assessment standard becomes naturally severe, if public funds are injected, and in banks in which the strength is falling by large hidden losses of stocks, this standard will make a great impact on the disposal of non-performing loans in the future. On the other hand, the reason why the disposal amount falls in the year of March 2000 is as follows. If hidden losses come out from annual results in September 2001, it seems to be affecting the disposal of loans shifting to such a new system because one must deduct its 60 per cent from shareholders' equity (reserves) in the market value accounting system.

Table 1 Changes of Disposal Amount of Japanese Banks' Non-performing Loans

(¥ trillion)

	1996	1997	1998	1999	2000	2001
Disposal loss of bad debts	13.4	7.8	13.3	13.6	6.9	6.1
Transfer amount of allowance for credit losses	7.1	3.4	8.4	8.1	2.5	2.7
Direct write-off, etc	6.0	4.3	4.0	4.7	3.9	3.1
Other write-off	0.3	0.0	0.9	0.8	0.5	0.3
Total after 1993	24.1	31.9	45.1	58.8	65.7	71.8
Total of the direct write-off	11.3	15.9	19.9	24.3	28.2	31.3
Risk management loans	28.5	21.8	29.8	29.6	30.4	32.5
Balance of allowance for credit losses	13.3	12.3	17.8	14.8	12.2	11.6
Reserve ratio (vs. bad debt amount)	46.7%	56.4%	59.7%	50.0%	40.1%	35.7%

Financial year ending March 31

Source: Finance Agency announcement (2nd August 2001).

Note: Added a reserve ratio.

Let us consider the background of reasons why non-performing loans balance does not decrease as usual. There seems to be reasons that the restructuring effort of client firms is not helped by the delay of the economic recovery and that the value of the security real estate does not rise because the land price has fallen. Then, as a cause of delay of the disposal by banks, we would like to emphasize on the concept that the so-called convoy system[1] of banks restrained them from the disposal of loans, and that the information disclosure about business activities was insufficient. True, in the nine years from March 1992 to March 2001, banks wrote off 71.8 trillion yen in non-performing loans. In these non-performing loans, the "direct write-off " separated from the book by abandonment of credit and sale of credit remains 31.3 trillion yen that occupy 43.6 per cent. For total 71.8 trillion yen of the non-performing loan's write-off amount (disposal loss), the normal write-off on the accounting system included more than 90 per cent, and a further write-off by disposal system of non-performing loans in a broad sense included about 10 per cent. The other write-off examples are as follows here. Two main methods of such other write-off in facilitating the disposal of non-performing loans can be identified: (1) losses with the sale of loans for the Cooperative Loans Purchase Institution (the following is Purchase Institution), and (2) losses with abandonment of loans for the support of client firms.

According to the announcement of the Finance Agency, the bad debts held by Japan's 137 banks including city banks and regional banks reached a total of 65,671 billion yen in the end of March 2001 (see Table 2). This figure is based on self-assessment by each bank, and this amount is reached by deducting the superior borrower loans from the overall borrowing. In comparison with the accounting results of March 2000, the amount has increased by 2,285 billion yen. On the other hand, Table 2 shows that the total amount of the risk management loans with the disclosure duty become 32,515 billion yen (consolidated base). In comparison with the results of March 2000, this result has also increased by 2,149 billion yen slightly. Likewise, the changes of allowance for credit losses are as follows.

Table 2 Comparison of Non-performing Loans of Financial Institutions

(¥ billion)

Kinds of loans	Risk management loans		Self-assessment		Financial reorganization law's loans
Number of bank=[ ]	2001	2000	2001	2000	2001
Large city banks [18]	19,281(6,939)	19,772(7,678)	42,152	40,908	20,008
Regional banks [64]	9,563(3,384)	9,463(3,357)	17,030	16,199	9,838
Secondary regional banks [55]	3,671(1,232)	3,013(1,195)	6,488	6,279	3,784
Total [137]	32,515(11,555)	30,366(12,230)	65,671	63,386	33,630

Financial year ending March 31

Source: Finance Agency announcement (2000-2001).

Note: The numbers reported in the parentheses are balance of allowance for credit losses.

The Finance Agency carried out a special survey for large banks at the end of October 2001. The purpose of the special survey by the Finance Agency judges whether loan division in the main borrower is proper, and the indulgent loan division is to increase the proper allowance, if required, in this instance.

On the other hand, share's hidden profits of banks (major 16 city, trust and long-term credit banks) announced their annual results in March 2001 are also decreasing rapidly. According to trials of private stockbroker affiliated think-tanks, 10 banks are at "hidden losses", and banks which were able to maintain "hidden profits" are merely 6 banks such as Sanwa Bank and Sumitomo Bank (*Yomiuri*, 31st March 2001). The disposal amount of non-performing loans of major banks in March 2001 stages is the total amount 6 trillion yen scale in 2.7 times in September 2000. The "Indirect write-off" which keeps the reserve to provide for loan losses is mainly done here. In the future, the effect on the disposal of non-performing loans will surface in banks in which the strength is falling due to hidden losses. Besides, each bank must carry out the restructuring and IT investment in order to raise the profitability, otherwise it would be difficult to secure the surplus at the end of March 2002.

Share price stagnation has much effect on not only annual results of banks but also the finance of the general business company. According to one estimate by the private credit rating company Daiwa Research Institute (Daiwa Soken), share's hidden profits (affiliated company is removed) which possess the March annual results of 1503 companies listed on the Tokyo First and Second Market Stock Exchange (except for financial and insurance firms) become 6,442 billion yen at the sum total. It clearly shows in their estimates that one decreased 32.4 per cent in comparison with 9,530 billion yen in the year of 31 March 2000. Due to the fall in share prices for one year, hidden profits of the firms had also fallen in value more than three trillion yen, when it is simply estimated.

3. Cases of the Disposal of Non-performing Loans in British and American Financial Crisis

In Britain, small financial institutions such as Finance Houses,[2] etc. that did the installment sale finance fell into serious managerial crisis in the mid-1970s, and these institutions experienced what is called a secondary banking crisis. It spread to the rescue of Cedar Holding, which is another secondary bank, and this crisis expanded to all secondary banks soon.[3] Further this situation deteriorated, because British Government had a plan to impose even higher taxation at the end of 1973, and real estate prices that are rising by the middle of the year fell sharply. The Bank of England worried about this situation, and it established the commission (one calls this by the name of ' Lifeboat ') for the rescue of London and Scotland Clearing Banks at the end of the same year. The Lifeboat launched on so-called ‘ rescue ‘ operations on secondary banks. The following three standards relate to an object of this rescue financing Lifeboat operation. One is to anticipate that there is no solvency problem in financial institutions after the rescue reinforces the liquidity. A second is that these financial institutions are banks that are suitable for designating the rescue plan, and being a section 123rd bank (describe it later on), which accepts the deposit of considerable amounts from the general public. A third standard is that these financial institutions do not have any institutional investors with interests which expect the necessary rescue.[4] Then, out of the 26 financial institutions, which were rescued, 8 financial institutions went bankrupt or were merged into other financial institutions.

Again, it is clear that the managerial distress of secondary banks has a close relation to the fall of housing and real estate prices in 1974, and there is no doubt that this managerial distress also has a close relation between the bank supervision and legal system by the government. In short, because banks having an obligation to report to the Bank of England have been few, secondary banking crisis had spread further wounds of the crisis. On section 123rd banks (financial firms who admitted exclusion of application from the regulation of section 123rd Corporate Law), it was one of the causes of the secondary banking crisis that the appropriate supervision did not carry out. After all, such a rescue operation had been made under the assistance of the government and central bank, and there was a significant feature in the different points with "Competition and Credit Control" system mainly on the conventional interest rate adjustment. Therefore, based on this experience, the reflection on the bank supervision system had also heightened in Britain. A Bank Act in 1979 was a turning point in reform of the financial system in Britain.

In comparison with many Japanese financial institutions suffering from a vast amount of non-performing loans in the 1990s, the United States savings and loan (S&L) crisis of the 1980s attempted the improvement on cash flow using the technique of various liquidations in respect of bad loans. Then, S&L of the small management scale which went successively into the bankruptcy boldly underwent structuring and liquidation. As a result, it is said that S&L became a traction force for the economic recovery of the United States. There are three main reasons why the United States' banks recovered early, contrary to prior expectations.[5] To begin with, the first point is that securities houses developed financial instruments related to real estate which met the needs of investors. The second point is that banks cooperatively developed a sale method of real estate meeting the needs of investors with securities houses. The third point to make is that the United States' Federal Recovery Trust Corporation (RTC) sold the assets that were requisitioned from S&L and commercial banks on an all-American scale by auction. Besides, it is said that public funds of 183.1 billion dollars were injected for the institutional crisis solution of S&L into this RTC. The possible lessons that can be learned from this cases were as follows: (1) that the disposal of real estate of the United States' banks was advanced with securities houses; (2) that real estate prices had fallen within the range which has attracted investors by meeting the needs of many investors; (3) that the RTC was involved in the auction contributed for activating the real estate market through the assets sale.

In addition, Sweden's banks faced a bank crisis by the increase of non-performing loans, which has rarely been seen in recent years in the early 1990s. Then, the Swedish government took the drastic countermeasure to recover order of the banking system. In fact, the government adopted measures for financing, guarantees, capital offers and so on based on the economic principle. As a result, earning power and the finance of banks were greatly improved in 1993. Japan should have drawn many such lessons of financial reform from the United Kingdom, the United States, and Sweden who overcame the bad debts' crisis once. Moreover, Japanese banks also engineer major restructuring plan by the self-help effort, and must promote their reengineering and IT investment for the business efficiency improvement as issues in all financial institutions.

4. Interlocking Shareholdings and Main Bank System

The Japanese banks had greatly depended on a vast sum of share's hidden profits as depreciation funds for investments and non-performing loans. The difference between book value and market value of stocks were retained in the form of hidden profits, and it was possible for banks to materialize and allocate hidden profits for supplementary funds for losses and loans in annual results, when the performances suddenly deteriorates. However, banks became the deficit constitution in the slump of share prices, and the ratio of stockholder's capital to equity that shows the soundness of the finance also falls below the standard. Therefore the matter had caused a severe situation where re-injection of large public funds cannot be avoided. There seems to be an existence of structural dilemmas in the Japanese financial system itself. The financial system in Japan is confronted with an acute policy dilemma. In this context, let us indicate two dilemmas that seem to be of importance.

To begin with, the first is that banks both own a significant fraction of its shares in borrowing firms and have a long-term relationship with these firms. As a result, the performance of banks is greatly influenced at share prices, and financial services itself of the main business is also affected by cross-shareholdings. Moreover, it is almost inevitable to make an on-balance sheet of the appraised loss of the equity holding by the introduction of the market value accounting system that adapts International Accounting Standards (IAS) from the next financial year. The second is to not advance the last disposal of non-performing loans. It is said that the disposal amount of Japanese banks' non-performing loans reached 71.8 trillion yen from March 1993 to March 2001, as we mentioned earlier. This amount of non-performing loans is more than triple the level prevailing during the United State's S&L crisis of the 1980s, and is about 14 per cent of gross domestic product in Japan. However, the balance of non-performing loans became a total of 32,500 billion yen in March 2001, and this increase is more than a total of 29,800 billion yen in March 1998 of three years ago. Banks wrote off 71.8 trillion yen in bad loans during the 1990s, but new ones are continually being created. The non-performing loans will swell in the bank financing, when value of collateral security for a loan decreases by the fall in land prices, and when the performance of borrowings deteriorates. It is not sufficient for banks to keep books on allowance for credit losses to provide for non-performing loans. After banks dispose it, a vicious loans-disposal spiral will be repeated again and again. What is to stop the results from spiraling when they dispose? Banks need to make healthy financial states that are not influenced by share prices. In summary, it is very important that banks should exclude the non-performing loans from the assets on the books and arrange a management environment that can finally dispose of this. Public safety guards such as public funds injection and payoff protection will have to be made perfect, while such measures are adapted.

In Japan, interlocking shareholdings among firms have its own peculiar character, and they have contributed to accumulating the enormous amount of hidden profits in firms by adapting the accounting system based on cost and realization basis. A feature of interlocking shareholdings is that firms hold each other's shares as stable shareholders.[6] Stockholding relations between banks and its client firms are present in any main bank relationship. On another plane, the large securities appraised loss arises by such system every year, and it has became one of factors that make the finance of firms and banks more unhealthy with non-performing loans. On the other hand, there will be few merits in contributing to enhancement of competitiveness and economic development, while the relationship between firms and banks gives the incentive, which commit long-term investments to the management of firms through interlocking shareholdings.[7] Of course, not only did interlocking shareholdings play an important part in the implementation of stable shareholding arrangements and maintaining of trade relation but also became institutional measures to avoid the threat of international capital markets, i.e. take-over bid (TOB), mergers and acquisitions (M&A) etc.

In any case, the mechanism of interlocking shareholdings delicately influences the relationship between banks and firms. The issue of interlocking shareholdings is not irrelevant to the disposal of banks' non-performing loans. What banks exclude from assets on a balance sheet as "bad debts" is to stop the financial relation with firms, and as the case may be, they may also force a client firms into bankruptcy. There are the complicated mechanisms in the main bank system, which we must clarify its mechanisms. The features of the Japanese financial system were that both firms and banks established an interdependent relationship under the powerful administrative guidance, and the fund's distribution system by the main bank was a result of attempting the growth by minimizing risk and enabling the excessive financing. Although we can consider this system the regulatory intervention of the Government, this system is traditionally the indirect finance based on the banking system, and can also be compared with direct financing based on the Anglo-American type securities market.[8]

Then, while the United States economy is sustained by the stock market mainly on Wall Street and the United Kingdom economy is sustained by stock market mainly in the City, the Japanese economy, by contrast, is based on a bank-oriented financial system. Ratio of the bank financing balance to gross domestic product (GDP) in Japan shows 2.5 times compared with the United States. Japanese banks hold shares of many borrowing firms as stable shareholders, and monitor the management conditions of their firms. This close bank-firm relation is called the main bank system. The main bank is expected to rescue firms from bankruptcy when they are in financial distress namely, financial distress is defined in terms of operating income being insufficient to cover interest income over a given period (Sheard [1994b]p.189). In fact many companies in Japan develop such ties with the main bank, where such a main bank relation has continued for a long time.

Indeed, the main bank system is developing as efficient means that reduces agency costs of the management of the firm. Then, stable interlocking shareholdings have functioned as a defense means for 'hostile take-over' to Japanese firms.[9] On the other hand, it has also been verified that the firm can borrow funds from the main bank under comparatively good conditions, when a firm belonging to corporate grouping needs funds. Also, the firms that established close ties with banks can recover more quickly from financial distress by intervention of the main bank, when a firm fell into financial distress.[10] However, in performing the rescue operation, Aoki, Patrick, and Sheard (1994) report that, the main bank sometimes assumes non-performing loans by other lenders in addition to a burden relative to its original loan share in writing off non-performing loans, and so on. As a result of this reason, the main bank normally bears more than proportionate costs of refinancing.[11] All the same, the reason why banks cannot boldly carry out the disposal of non-performing loans is that many main banks maintains such ties with their firms. Particularly the last disposal of non-performing loans cannot be decided, since the interests do not agree between private banks when multiple banks become a main bank. Although the linkage between main bank and firms are relatively stable, there is a competition in the long term for the main bank position including the opportunistic withdrawal behavior of firms. This puts a constraint on the way it reduces the main bank's loan balances.[12]

However, less dependence on bank borrowing means a relatively weakening of bank ties since the 1980s. In other words, main bank relationship will undoubtedly evolve, but the system may be becoming more diversified in the direction having weaker core bank relationship with multiple banks[13]. Actually, after the 1980s, the large firms reduced their dependence on the bank financing, and this means that financial relations with the bank have considerably weakened. And then, recently, there is not the once-observed strength for the finance of both banks and firms at one time. Moreover, the introduction of market value accounting that keeps books on the appraised loss of the equity holding to annual results is required; each bank has positively sold the interlocking shareholdings as measures. It is said that the shares of large banks sold during February 2001 recorded past maximum 570 billion yen. This puts more pressure on share prices falling. The regulation authorities should take realistic measures for limiting the firm's share holdings by banks further in order to cut off the bank management from share prices fluctuations. Of course, it was one of the features of the bubble economy that the careful management to client firms by the main bank has weakened.

Sometimes the main banks write off large amounts of the financing loans as "bad debts" on the understanding that they force the borrowing firms into bankruptcy. Banks do not know the determination of write-off amount till the firms go into bankruptcy by the legal liquidation through insolvency and special calculations etc. If banks write off in too much of a hurry, there seems to be a judgment that bankruptcy occurs in succession and the deflation progresses further. However, the existing asset reorganization is not useful for restructuring financially distressed firm, and it has ended only in prolonging a problem in vain. Japanese banks must fundamentally change present financing methods concerning the risk management, that is, all the bank need to switch the way from the financing of whole firm to the financing of every project. Also, it continues financing as long as the firm is performing well, but in times of corporate failure restructuring by the main bank can be expected with techniques such as company system. Therefore, banks reduce the problem loans to a minimum, and it means the continuation of the firm. For this reason, legal improvements including a tax system would be necessary in the future.

5. Accounting Write-off Method and Legal Reforms on Bad Debts

The disposal method of Japanese banks' non-performing loans is greatly divided into a direct write-off and an indirect write-off. First of all, the indirect write-off is the disposal method that keeps books on allowance for credit losses to provide for bad debts, when a firm cannot meet its loans in critically distressed financial states and bankruptcies of the borrowing firms. The banks keep books as a reserve on the amount for example, in case of the failed firm loans, full amount of the part which may be unrecoverable by a collateral's disposal in proportion to the degree of a risk which may be unrecoverable against financial distress and bankruptcy.[14] On the other hand, the direct write-off is the disposal method that eliminates bad debts from balance sheet of banks. In such a method, there are recovery of loans, renunciation of loans, sale of loans, and so on. The government intends to promote "early disposal" of non-performing loans, through the promotion of such a direct write-off. Therefore a main condition for disposals is to promote banks to carry out the large-scale restructuring such as abandonment of loans for distressed large firms and arrangement of unprofitable departments. However, the vicious circle of economic stagnation may be repeated through restructuring of the firm and financing recovery to small sized company, even if the promotion by such method has been done to major general contractors and large banks.

So far Japanese financial institutions have carried out the disposal of non-performing loans with the tax-oriented write-off system. On Japan's corporate tax law, the direct write-off of loans to failed debtor (firm) has been accepted as loan losses of financial institutions. In respect of loans regarded as being substantially unrecoverable, these loans have been accepted as the tax-free write-off from the taxation authorities if financial institutions have received the "non-performing loans' write-off proof" from the finance securities surveyor of Ministry of Finance (the present Department of the Economic Treasury) (See corporate tax law basic letter).

Corporate tax law (revised in 2001) regulates loans losses inclusion in transfer-limited cost to allowance for credit losses. In Japan, blue declaration systems that were established after World War II had the intention for properly keeping these records as special tax measures for firms. The aim of this system was that the taxpayer properly calculates and personally pays an income and a tax amount with a tax law. The fact was in the background where such regulation (being based on the regulation for tax law in loan losses inclusion of allowance for credit losses) was institutionalized. However, a tax reform in April 1998 decided that the provision should be gradually phased out by 2002, by abolishing the regulation of legal transfer ratio which uniformly includes the fixed ratio of allowance, for credit losses to loans losses. It made a meaningful advance that its tax reform made a different judgment from accounting regulation for the first time. After all, since the regulation of tax law is merely a result of determining the requirement which shows their ability to write off bad debts by tax free, firms need to keep books an allowance for credit losses even if they pay tax on the amount which seems to be unrecoverable.

In Japan, as the "administrative guideline on non-performing loans problem of financial institutions" which the Ministry of Finance announced on 8th February 1994 has demonstrated, we take the position that the guideline must adopt the standpoint that encourages and promotes the dutiable allowance. In other words, this viewpoint is the "acceptance" of allowance and write-off. In the United States, by contrast, allowance and write-off are "enforcement", and bad debts are understood to mean that financial institutions must be wrote off in "appropriate time", when those adapt to the condition. There seems to be an important difference in the approach on the recognition of allowance for credit losses between Japan and the United States. The United States standard has required the setting of the reserve except for the objectively recoverable amount,[15] while Japanese standard has required the setting of the reserve of the objectively unrecoverable amount. In short, the subjective judgment of bank manager intervenes in an estimate of losses by the difference between two viewpoints on "objectivity of the loss", and it appears to become a difference of enormous allowance amounts on business.[16]

Now, it was determined that financial institutions properly carry out write-off and allowance by the law, because it introduced "early remedial measures" from April 1998. This must be a financial administration technique that finance supervision authorities order fixed remedial measures for financial institutions in which the objective index falls below a certain standard. The intention of these "measures" is as follows. Bank Law etc. were revised by "law on the improvement of the relevant legal for the health security of the management of financial institutions etc. " (the following is Early Health Law) that was concluded in June 1996, and it is correspondent in the introduction from April 1998. For this reason financial institutions would demand the following two requirements. The first point to make is that financial institutions carry out the self-assessment at their every financial year. The second and more important condition is that accounting auditors (certified public accountants (CPA) or audit corporation) must audit in more detail the appropriateness of financial statements than he did before.

On the one hand, for banks of the lender who holds non-performing loans, it is important to improve the scheme in order to dispose and prevent failed firms on financial institutions with public funds, but on the other hand for firms of the borrower who fell into the financial distress, it is important to improve the legal system which implements the smooth disposal of non-performing loans and restructuring of the firm. On the former, there are the following measures etc., that is, "Financial Reorganization Law" and " Early Health Law " in October 1998 which determines time limit measures by the end of March 2001, and "Deposit Insurance Law (amendment)" in May 2000 which permanently determines the failing firms' disposal system of financial institutions after April 2001 (however, the enforcement of a payoff scheduled since April 2001 has been postponed for one year). On the latter, there are the following measures etc., that is, enactment of "Civil Reorganization Law" with the abolition of Composition Law in April 2000 and enactment of "Specific Arbitration Law" in December 1999 etc.

Especially, Civil Reorganization Law for the reorganization of firm which fell into financially distressed has had a large effect on banks. Therefore, stakeholders who surround the firms from each standpoint must attempt the firm's restructuring by measures with high transparency: (1) managers pursue one's own management responsibility; (2) employees carry out the organization reform; (3) stockholders receive a given responsibility by the capital reduction; and (4) financial institutions execute the loan abandonment. There seems to be able to expect the following effect, when Civil Reorganization Law that aims for the firm's restructuring is applied. First, the liquidity of the interlocking shareholdings can be anticipated. Second, it is possible to prevent the financing amount abnormally swelling by the disposal of loan losses in the distressed firm early.[17]

6. Implications and Conclusions

This paper has considered two key aspect of non-performing loans: (1) the reason of retarding the disposal of non-performing loans was analyzed from the relationship between main bank and borrowing firms, and was examined from the economic role of the interlocking stockholdings, (2) the institutional problem of the disposal was investigated concerning the legal reforms.

The accumulation of non-performing loans today has thrown doubt on the efficiency of Japanese banks. Surely in the background of the accumulation of non-performing loans, the following problems are raised: restructuring effort of client firms is not helped by the delay of economic recovery, and the value of collateral security does not rise due to the fall in land prices. Regulators, however, should be also correspondents in the more early time, and the idea of attempting the natural solution of the non-performing loans problem by the rise of land price with economic recovery caused the policy mistake. The reason why the bank side was retarded for the correspondence of the disposal is that the consciousness in which all the banks grew at about the same pace restrained the disposal, and banks cannot boldly reduce the financial balance because the main bank is involved, and that banks' information disclosure was insufficient. Of course, although the improvement of accounting institutional aspect is also advanced, there is a limit in the present write-off system. At present, the mitigation of tax law has not achieved the desired effect and banks are not getting the situation that makes this critical balance sheet healthier. In fact, the cover ratio of allowance for credit losses to bad debts that amount in substance are merely about 40 per cent in Japan, while 35 major banks in the United States considerably exceeded 200 per cent. On the other hand, there are some regulations that simply cannot be met, even if banks want to set the reserve by the subjective judgment there. Banks are also having difficulty making enough money in interest on loans because short-term interest rates are practically close to zero.

In a second-best phase, banks need to carry out the following scheme in order to improve the management efficiency:

1. Raising the loan rate, and developing the new commission rate business.
2. Reducing costs such as branch and salary overhead, namely implementing drastic organizational and asset restructuring.
3. Disposing non-performing loans which remain the disposable allowance, and trying to make poorly managed banks more profitable as higher-yielding business.

4. Carrying out information disclosures that meet the needs of the stakeholder.

Japanese banks must implement a policy to convert funds derived from real estate into new available credit, because the balance sheet of banks cannot be substantially improved under the existing conditions. Banks can dispose non-performing loans by making security real estate and lending loans into securities, without causing bankruptcy in a legal sense. Then, it is securities of the security real estate to consider as measures.[18] It is effective measures to attempt the liquidation of loans by issuing securities that hold a mortgage on non-performing loans, and selling to the investor in respect of bank loans. This has the features that funds can be procured based on the credit to the profit which assets of the security produces. Especially, there are considerable merits by doing securities for banks in which the financial ability is inferior, since the financing cost is lower than usual financing means. The securities by publication of the discount bond and sale of real estate investment trust, etc. can be planned, if real estate produces the cash flow a little.[19] Of course, it becomes possible by arranging some conditions that has been done, for the formation of a distribution market that can effectively sell them for institutional investors, and the construction of infrastructures such as tax systems that can achieve the tax effect.

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Notes

[1] Aoki, Patrick, and Sheard (1994), pp.27-30.
I am using this term in Aoki et al. (1994)'s sense to refer to the system in which all incumbent city banks grew at about the same pace, and it was substantial with sufficient rents and the interest rate spread.

[2] See Economists Advisory Group (1981) on a detailed survey of Finance Houses.

[3] See Reid (1982) on the background and causes of Britain's secondary banking crisis.

[4] Saito (1994), p.99.

[5] Mizuno (1994), pp.26-27.

[6] Sheard (1994), pp.312-313.

[7] See Kobayashi (1993). He describes risks and features of interlocking stockholding of Japan in detail.

[8] Lapavitsas (1997, pp.429-435) describes the issue of the finance in East Asia, and explained that Japanese financial systems can be characterized as bank-based financial system there, in contrast with the market-based financial systems in Britain and the U.S. In addition, see Corbett & Jenkinson (1996).

[9] See Sheard (1994) on hostile take-over's functions of interlocking shareholdings in Japan.

[10] Hoshi (1994), p.296.

[11] Aoki, Patrick, and Sheard (1994), p.18.

[12] Sheard (1996), p.206.

[13] Aoki, Patrick, and Sheard (1994), p.48.

[14] In case of the disclosure loans on Financial Reorganization Law, the proportion for setting the reserve has further concretely been defined as follows: bankruptcy rehabilitation loans are 100 per cent, dangerous loans are 70 per cent, necessary management loans are 15 per cent. By comparison, on the other hand, in the self-assessment, the allowance proportion has defined 100 per cent on loans to bankrupt firms or loans to technically bankrupt firms, 70 per cent on loans where there is great concern about their recoverability, 3-5 per cent on loans where fears concerning problems associated with recoverability exist, zero per cent on recoverable loans to borrowing firms.

[15] FASB No.5 "Accounting for Contingencies" regulates the accounting processing of allowance for credit losses. According to this Statement, it has required to keep the estimate amount in allowance of credit losses as a result of generating the impairment when a loan seems to satisfy the following two conditions (see para. 8).
That it be probable that an asset has been impaired or a liability has been incurred as of the financial statements preparation day.
That amount of loss is reasonably estimated.
A loan is impaired when it is probable that a creditor will be unable to collect all amounts due. Here, the Statement defines probable that is unable to collect as a range of the likelihood that a future event will occur. The Statement have classified from probable to remote, as follows: Probable (= likely to occur), Reasonably possible (= more than remote but less than likely), and Remote (= slight) (see para. 3).
On the other hand, the Accounting by impairment of loans is regulated in FASB No.114 "Accounting by Creditors for Impairment of a Loan." According to this Statement, impairment of loans is measured based on the present value of expected future cash flows discounted at the loan's effected interest rate as a principle, when a loan is recognized as impairment (that is, as defined in paragraph 8 of this Statement No.114, it is probable that a creditor will be unable to collect all amount

due according to the contractual terms of the loan agreement). And then, a creditor can measure impairment based on the fair value of the collateral when the creditor determine that foreclosure is probable (see para.13).

[16] Naito (1994), p.68.

[17] Ohara (2000), pp.65-66.

[18] According to Atkinson (1995) that proposes the technique of the securities by the collateral disposal, he says that there are the following six merits in the securities. The following is his point, that is to say, (1) the creation of the liquidity, (2) the improvement on the balance sheet, (3) the increase in non-interest income, (4) the reduction in credit risk, (5) the diversification of financing, (6) the lowering of financing cost.

[19] See Hoshino (1995, pp.65-69) on examination and idea for the securities of the security real estate.