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The paradox of limited deposit insurance under the *amakudari* practice in the Japanese banking system

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Abstract

Changing deposit insurance from full to limited in 2005 is expected to discipline Japanese banks' behaviour because depositors will start monitoring their banks. However, this discipline effect may be overturned due to the *amakudari* practice in the Japanese banking system where regulatory officials obtain post-retirement jobs in private banks. We consider a signalling game where depositors and banks have asymmetric information regarding banks' riskiness, and banks use *amakudari* officials to signal their riskiness. In order to create more post-retirement employment opportunities, the regulatory authority may weaken prudential regulation, which results in less discipline in the banking industry.

JEL classification: G21; G28

Keywords: *Amakudari*; Signalling; Japanese banking system

1. Introduction

The Japanese economy has witnessed a large-scale regime change in the regulatory framework of the financial industry since the financial crisis that arose in 1997 with the collapse of large financial institutions. For example, the once-mighty Ministry of Finance (the MOF) was deprived of the regulatory authority over the financial industry. The authority is now in the hand of the newly established regulatory organisation called the Financial Services Agency (the FSA). Unsurprisingly, the deposit insurance system was also forced to change because the old system was built on

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the assumption of the "convoy system." The most important feature of the new deposit insurance system is an introduction of limited deposit insurance or the so-called "payoff system."

The Japanese deposit insurance system can be split into three phases: implicit full deposit insurance, explicit full deposit insurance, and limited deposit insurance.[1] The limited insurance system *nominally* existed as early as in 1971 and covered deposits up to one million yen (1st phase). This figure was raised to ten million yen in 1986. However, under the "convoy system," all types of deposits were *effectively* fully insured. That is, whenever banks became insolvent, the MOF rescued them by arranging a takeover by healthier banks. In essence, it was an *implicit* full deposit insurance system, which was based on the assumption that the failure of banks was sporadic and small in scale. However, following the spread of credit uncertainty after the collapse of credit co-operatives in December 1994 and other incidents, the MOF decided to freeze the limited insurance system (although it was nominal and payoff had never been exercised) until April 2001, and the implicit full insurance system turned into the explicit (2nd phase). However, the freeze eventually was partially lifted with the cap being imposed upon saving-type deposits, such as time deposits, in April 2002, while ordinary deposits were reprieved for two more years until March 2005. From April 2005, the limited deposit insurance system has been in place (3rd phase).

The limited deposit insurance system is expected to serve for two well-known objectives. First, depositors play an active role in disciplining banks' behaviour in line with depositors' interests. That is, limited deposit insurance gives depositors strong incentives to monitor banks. For depositors with large-scale deposits, lenient bank monitoring may end up with losing most of their deposits. Second, the limited cover of deposits prevents depositors from free-riding behaviour. Under full insurance, people are willing to deposit their funds in banks that offer higher interest rates regardless of their riskiness. In fact, behaviour of this kind was observed in the Cosmo Credit Union case in the 1990s in Japan. Limited deposit insurance surely discourages depositors' free-riding behaviour.

Limited deposit insurance also has tremendous effect upon banks themselves. Banks now have to take into account depositors' response to their actions. Under the full deposit insurance system, there was no reason for depositors to be concerned with riskiness of banks because their deposits were fully insured in any event. For banks, this meant that they could take any risks because it would not have changed depositors' behaviour. However, under the new deposit insurance system, banks' behaviour directly affects the interests of depositors through the partial insurance. Banks that take excessive risk may face a massive outflow of deposits and may be forced to close down. Hence, the limited deposit insurance system makes depositors an important player in the financial sector in Japan.

As a consequence, depositors should become extremely concerned about behaviour and quality of banks. Depositors will try obtaining as many pieces of information as they can regarding banks' riskiness, profitability and financial health, which potentially influence their deposits. Amongst those, our focus is the relationship between banks and the regulatory authority. Namely, we focus upon a well-known custom in the Japanese banking industry — the *amakudari* practice. For a long time, many Japanese regional banks have been accepting retiring officials from the financial regulatory authority as senior managers, members of the managerial board or presidents. This practice is often referred to as the *amakudari* practice and those officials are called *amakudari* officials.

[1] Regarding the evolution of the Japanese banking system, see Nakaso (2001) for example.