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Financial regulation in Japan: a sixth year review of the Financial Services Agency

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Abstract

The paper provides a critical review of the Financial Services Agency (FSA) of Japan since its establishment in June 1998 (as the Financial Supervisory Agency) to June 2004. During the six year period, the FSA faced the challenge of addressing severe insolvency problems in banking as well as life insurance industries. The paper argues that the initial separation of the supervisory role (in the Financial Supervisory Agency and the Financial Reconstruction Commission) and the policy planning role (in the Ministry of Finance) was useful in the sense it allowed the FSA to have a firm stance on the insolvency problem that was partially created by the failure of the past financial regulatory policy. Even after the creation of the FSA, the Bank of Japan remained as another bank supervisor. This seems have made the central bank reluctant in relaxing monetary policy out of the fear that such loose monetary policy would actually discourage re-organization of banking industry. This suggests a problem of having the central bank as a bank supervisor. For the life insurance companies, the FSA (both old and new) has not been successful in intervening (using prompt corrective action) before the failures. Finally, the paper also points out the important role of the leadership at the FSA that shapes the financial regulation, and suggests a problem of appointing a politician to this role.

Keywords: Financial regulation; Financial Supervisory Agency; Financial Services Agency; Financial Reconstruction Commission; Ministry of Finance; Non-performing loans problem; Prompt corrective action; Bank closures

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1. Creation of FSA in Japan

On June 22, 1998, the Financial Supervisory Agency (old FSA), a predecessor of the Financial Services Agency, was established by separating financial supervisory functions from the Ministry of Finance (MOF). This was a monumental step for the Japanese authorities in splitting the powerful ministry. Following the enactment of the Financial Reconstruction Act of 1998, which provided a framework for dealing with large insolvent banks, the Financial Reconstruction Commission (FRC) was established in December 1998. The FRC was placed under the Coordination Minister (later a part of the Cabinet Office) and the mandate of FRC was to give general directions to the old FSA. In July 2000, the old FSA was reorganized to form the Financial Services Agency (FSA). After a brief transition period, the FRC was dissolved and its function was absorbed by the FSA in January 2001.

The Japanese FSA is an integrated supervision agency, in charge of supervision of most financial institutions, such as banks, securities firms, insurance companies, and smaller financial institutions. The coverage is slightly larger than what the MOF used to cover, including some of smaller institutions (credit cooperatives which used to be supervised by respective prefectural governments).

The old FSA was praised for its swift move to nationalize the Long-Term Credit Bank of Japan (LTCB) and Nippon Credit Bank (NCB) in 1998, and to successfully stabilize the precarious positions of Japanese banks. After a round of capital injections to major banks of March 1999, the Japanese banks appeared to have regained its strength, or at least patched up weakness. Japan premium subsided in April 1999, and no banks failed from 1999 to 2001.

However, the weakness of Japanese banks emerged again in 2001. The crisis deepened as the stock prices sank further. The Japanese banks held a large portfolio of equities, and the decline in stock prices from mid-2001 to 2002 caused unrealized capital losses in their equity portfolio. When the capitals of Japanese banks were adjusted to reflect the unrealized losses, severe undercapitalization of most banks became obvious.

Yet, the head of FSA in mid-2002, Hakuo Yanagisawa, insisted that the Japanese banks were solvent and did not suffer from any serious capital shortage. In September 2002, Heizo Takenaka became the first head of FSA who is not a politician. He set up a new reform plan and started to pressure the banks to strengthen their capital positions and accelerate their efforts to resolve the non-performing loans. The new plan was not very much different from an old plan on paper, but the FSA under Takenaka has been more aggressive in its implementation.

This paper studies the performance of the new financial regulatory structure in Japan, which is at the end of the sixth year counting from the establishment of the old FSA (June 1998) as of this writing (June 2004). Next section reviews the motivations behind the establishment of the new regulatory structure and identifies interesting organizational changes that the structure has gone through. Section 3 looks at the performance of the new regulatory institutions and examines if the organizational changes identified in Section 2 had any visible influence on the performance. Section 4 concludes.