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INTERNATIONAL CAPITAL MARKETS SECTION

Japanese Banking Reform and the Occupation Legacy: Decompartmentalization, Deregulation, and Decentralization

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Since the end of the occupation in 1952, Japan has had in place a rigidly compartmentalized banking system. Banks were divided by funding source, by activity, and by geography. City banks, the Japanese equivalent of money center banks, had extensive branch networks and raised a large portion of funds through deposits. They could not, however, sell bonds or otherwise access long term funding.

Long term banks, in contrast, could sell bonds but could not solicit retail deposits. Trust banks, along with insurance companies, managed pension plan assets. Regional banks, particularly those in rural areas, had a monopoly over the prefecture in which they operated. Finally, a rigid separation existed between banks and securities companies.

Compartmentalization had considerable significance. It facilitated government control of the financial system. It also effectively limited the ability of foreign banks to compete. Until the mid-1980s, U.S. banks could not engage in a full range of financial activities within Japan. They could not engage in trust[1] or securities activities,[2] had no right to issue

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1. The Japanese government did issue nine trust licenses to foreign banks following the Yen/Dollar Accord in 1984. The Ministry of Finance, however, made clear that no new licenses would issue until Japanese commercial banks received comparable authority. POLITICAL DECISION: NINE FOREIGN BANKS ALLOWED INTO TRUST BANKING FIELD, THE JAPANESE ECON. JOUR., July 2, 1985, at 1.

bonds and lacked the branch network to access retail deposits.[3]

With an almost manicured appearance, therefore, the banking system resembled a Japanese garden, "rigorously tended and artfully arranged, with each component fixed in place and all parts combining to form an agreeably harmonious role."[4] Although the numbers and relative market share of each category shifted over time, the essential divisions did not. The compartmentalized system of city, long-term, trust and regional banks and securities firms remained intact for 30 years.

In 1992, however, the Diet took a major step toward bringing the Japanese financial system into closer alignment with other industrial countries.[5] Legislation provided the mechanism for ending the compartmentalized financial system by eliminating the distinctions between most classes of financial institutions.[6] The laws enabled banks to engage in securities activities and securities firms to engage in banking activities.[7]

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2. In 1986, the Ministry of Finance allowed foreign banks to engage in securities activities through a separate subsidiary. The bank, however, could not own more than 50% of the subsidiary, resulting in some odd pairings. Morgan Guaranty, for example, owned half of the shares of a securities company with Bechtel owning the other half. Barbara Buell, *Deregulation: A Two Way Street*, BUS. WK., June 22, 1987.

3. Through the post-occupation period, the Ministry of Finance prohibited the expansion of foreign banks. No new license was issued to a U.S. bank already in the country until 1981 when Citibank received approval to open two additional branches. The restrictions have largely ended. Citibank, the only foreign financial institution to take advantage of the authority, now has approximately 20 branches. Letter from John J. Skelly, Vice President Citibank (April 1991) (providing opening dates of all Citicorp branches in Japan).

4. EUROMONEY SUPPLEMENT, Aug., 1986, at 21.

5. European financial institutions operate under a system of universal banking. This enables banks to engage in a host of related financial activities such as the sale of securities and insurance. While the United States still separates the banking, insurance and securities industry, those barriers have been lowered through administrative legerdemain. The Federal Reserve Board has, for example, permitted banks to engage in securities underwriting. *See In re J.P. Morgan, Etc.*, 73 FED. RES. BULL. 473 (1987). Similarly, banks have made some inroads into the insurance industry. *See Am. Ins. Ass'n v. Clarke* 865 F.2d 278 (D.C. App. 1988). Japan's reforms reflect this international trend toward the reduction of barriers separating classes of financial institutions.

6. Article 65 of the Securities and Exchange Law originally prohibited banks from engaging in securities activities. Article 65-3 now authorizes the Ministry of Finance to issue securities licenses to companies owned by banks. Article 43-2 now authorizes the Ministry of Finance to allow securities firms to acquire a majority of a banking subsidiary.
See Amendment [Bill] to the Securities and Exchange Law (Pt. I), *CaMRI Review* No. 25, Apr. 30, 1992.

7. Specifically, Article 43-2 provides that "[a]ny securities company may, upon authorization by the Minister of Finance, acquire or held a majority of shares or a majority of equity contribution . . . of a bank, trust company, or such other financial institutions in a foreign country, a foreign company which is engaged in the securities business or such other companies as may be prescribed by an ordinance of the Ministry of Finance." Article 65-2 provides that "[t]he provisions of Article 65 [prohibiting banks from engaging in securities activities] shall not preclude the Minister of Finance from issuing a license . . . to a joint stock company in which a bank, trust company, or such other financial institution as may be prescribed by a Cabinet order owns a majority of its shares."

While allowing banks and securities firms to enter each other's business, including trust

Moreover, securities firms and commercial banks could operate trust subsidiaries.[8]

The change portended more than a realignment in the classification of banks. The shift promised to accelerate the process of consolidation and a return to the pre-war system dominated by a handful of large city banks.[9] Moreover, over the long term, decompartmentalization should reduce the government's ability to micro-manage the financial markets.

Less obvious, the changes essentially eviscerated a regulatory approach developed by United States and more or less imposed on Japan during the occupation. Allied officials, over the initial opposition of the Japanese government, wanted to segment the financial system, primarily to prevent the large Japanese city banks from absorbing smaller competitors.[10] Compartmentalization, therefore, had its roots in U.S. policies. The exegesis was even more notable given the role of compartmentalization a critical barrier to foreign banking activity in the country.

I. PRE-WAR DEVELOPMENT

The Japanese financial system changed considerably after the Second World War. To be sure, certain characteristics of the pre-war system remained. Both periods saw some degree of segmentation. The distinction between long term and ordinary commercial banks predated the war. So did the highly consolidated nature of the banking system, something that had begun in ernest following financial panics in the 1920s.

When the occupation ended in 1952, however, the banking system had changed in a number of material respects. Trust companies had converted to banks. Securities and banking functions were separated. Special banks were eliminated.

These changes resulted in compartmentalization of the banking system, something that enhanced government control. Designed to facilitate economic recovery, the financial system did not allocate capital through market forces. Instead, capital went where the government thought best. Targeted industries benefitted from a constant supply of funds while

banking, barriers continued to remain following the legislation. Long term banks still had the exclusive right to issue bonds and debentures to the public. Commercial banks could raise long term funds only through private placements. Otherwise they were limited to short term funds, particularly deposits. In addition, the legislation did not tamper with the barriers separating financial institutions and the insurance industry, although change in that area is under study.

8. The changes did not completely decompartmentalize the banking system. Barriers continued to separate long term and other commercial banks and barriers remained between financial institutions and insurance companies.

9. At least since the 1960s, the Japanese government has encouraged further consolidation in the banking sector. In addition, no new bank has received a license to operate since the 1950s, with the trust subsidiaries of nine foreign banks the only exception. The result has been a decline in the total number of banks in Japan.

10. *See* discussion *infra* Section IV.

others such as the consumer sector suffered.[11]

Compartmentalization facilitated this process. Each category of banks had its prescribed niche in the recovery process. They raised funds from different sources and funnelled them to designated companies or industries. Each category of banks found themselves beholden to the government for funds and, concomitantly, more willing to follow the government's guidance about the scope and direction of loans.

A. *The Early Days*

The financial sector evolved contemporaneously with the emergence of modern Japan and the Meiji Restoration. At the apex of the financial system rested the Ministry of Finance (MoF). Formed in the 1870s, MoF represented the single most powerful bureaucracy in a country of powerful bureaucracies. In charge of the budget, tax, foreign exchange, customs, securities activities, insurance companies and banks, the MoF performed the functions assigned to a dozen agencies and offices in the United States.[12]

Early banking legislation reflected marked outside influence. The initial pattern was modeled after the national banking system in the United States.[13] Adopted in 1872 and subject to important amendments four years later, the Bank Act regulated commercial banks and authorized them to issue currency.[14]

The legislation initially had little effect; only a small number of banks formed.[15] Amendments adopted in 1876 sought to encourage the organization of banks, primarily by doing away with gold denominated reserve requirements. The amendments accomplished the intended goal, with 157 banks forming over the next four years.[16] Some private financial

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11. The inability to obtain consumer loans for cars or household appliances further spurred savings, as did an inadequate system of retirement income.

12. At one time MoF also had control over industry, trade, agriculture, transportation, communications and supervision of local governments. Those duties were taken away in 1898. *See Ministry of Finance*, 5 KODANSHA ENCYCLOPEDIA OF JAPAN 186-8 (1983).

13. HUBERT F. SCHIFFER, THE MODERN JAPANESE BANKING SYSTEM 15 (1962). *See also generally* Thomas F. Cargill, *Central Bank Independence and Regulatory Responsibility: The Bank of Japan and the Federal Reserve*, 2 MONOGRAPH SERIES OF FINANCE AND ECONOMICS, CENTER FOR THE STUDY OF FINANCIAL INSTITUTIONS (1989). (noting that Japanese system based upon the National Currency Act of 1863 adopted in the United States).

14. WILLIAM WIRT LOCKWOOD, THE ECONOMIC DEVELOPMENT OF JAPAN: GROWTH AND STRUCTURAL CHANGE 1868-1938, at 13 (1954).

15. The law had a number of problems. As one commentator wrote: "First, it made the notes issued by the National Banks against the collateral of government bonds redeemable in metal, which, given the public's attitude toward paper money and the deficits and the current balance payments, made it very difficult to keep the notes in circulation. Second, the terms of the law did not provide the banks with a sufficient margin of profit." RAYMOND W. GOLDSMITH, THE FINANCIAL DEVELOPMENT OF JAPAN, 1868-1977 (1983).

16. The amendments also lowered the interests charged on borrowed money. National banks initially had the authority to issue currency. The currency, however, had to supported by sufficient reserves. By altering the requirement of gold reserves, the Bank Act provided

institutions also formed during that period. In 1876, Mitsui became the first private commercial bank and an ordinary commercial bank following adoption of The Banking Act of 1890.

This early approach to financial regulation, however, ultimately had to be scrapped. A rebellion in Kyushu demonstrated inadequacies with the banking system. The government had to increase spending to handle the emergency, causing rampant inflation. With the need for comprehensive reform clear, the Japanese abandoned the system of national banks in the 1880s, instead opting for a central banking system based upon the European model. Specifically, the country focused on the experiences of Belgium, the country that most recently had set up a central bank.

The Bank of Japan (BoJ) came into existence in 1882 and two years later received the exclusive authority to issue currency.[17] The government owned fifty five percent of the central bank's stock and appointed the Governor, Vice-Governor and a number of other bank officials. The governor tended to be either a career employee within the central bank, a retired official from the MoF, or a private banker, typically from the YSB.

The modern commercial banking law emerged in 1890.[18] Apparently designed to promote expansion, the Bank Act contained few constraints.[19] There were no restrictions on non-banking activities, loan limits, capital or reserve requirements.[20] Deposit insurance did not exist. The result was predictable: rapid growth of rickety financial institutions, an unstable mix that would haunt the financial system until the war.[21]

The number of commercial banks proliferated, at one point climbing to almost 2,000.[22] Most banks were small, with almost half having capital of less than 100,000 yen.[23] This number began a gradual decline after the turn of the century when minimal capital requirements were estab-

considerable impetus for the formation of banks and the issuance of currency. *See* SCHIFFER, *supra* note 13, at 16.

17. The BoJ received the authority with the adoption of the Convertible Bank Note Act of 1884 (law under which "the authority of such national banks was abolished and all notes were unified into the Bank of Japan notes."). *See also* SCHIFFER, *supra* note 13, at 16.

18. FEDERATION OF BANKERS ASSOCIATION OF JAPAN [ZENGINKYO], THE BANKING SYSTEM IN JAPAN 26 (1989).

19. *See Recent Developments in Japanese Banking*, FED. RES. BULL., July, 1923, at 805 ("The reason for the large number of banks to be found in the peculiar banking legislation of Japan, which, in accordance with the desire of the Government to spread banking facilities all over the country, made the opening of banks dependent upon very few requirements.").

20. *Id.*

21. *See* FUJI BANK, LTD., BANKING IN MODERN JAPAN (2d ed. 1967).

22. The precise number of banks at the turn of the century appears to have been 1867. *See* THE BANKING SYSTEM, *supra* note 18, (putting number at 1867 in 1901).

23. G.C. ALLEN, JAPAN'S ECONOMIC EXPANSION 56 (1965). The largest banks, of course, had much greater capital. *See* YASUO MISHIMA, THE MITSUBISHI: ITS CHALLENGE AND STRATEGY 179 (1989) ("In 1915, the capital of the Banking Division [of Mitsubishi] was only Y1 million compared with Y20 million for the Mitsui Bank Y21.5 million for the Dai Ichi Bank Y10 million for the Yasuda Bank, and Y7.5 million for the Sumitomo Bank.").

lished,[24] although the total number of branches continued to grow.[25] Some of the decline came from bank failures, with 956 becoming insolvent between 1905 and 1936.[26] Reduction in numbers also resulted from an increasing number of mergers.[27] The larger banks benefitted from the consolidation process, with deposits and business flocking to healthier financial institutions.

The real turning point and the end of atomistic banking occurred with the panic of 1927. The collapse of the Bank of Taiwan sent shock waves through the Japanese financial system.[28] The Bank had lent considerable sums to Suzuki & Co., the newest industrial group. With Suzuki tottering, a number of Japanese banks called in short term loans to the Bank. Unable to raise funds, the Bank of Taiwan turned to the BoJ. When funds were not forthcoming, the bank collapsed. As one government report put it: "This caused great alarm and resulted in runs on banks throughout the whole country."[29]

With no system of deposit insurance, any threat to the integrity of the financial sector sparked panic. The failure of the Bank of Taiwan proved no exception. Depositors began to withdraw funds. The BoJ pumped money into the system to ensure liquidity, but the need for more systematic reform was clear.[30] The government responded with the Banking Law of 1927.[31]

The 1927 Law gave the government considerable control over the financial sector. All banks operating within the country had to obtain a license and could not open, close or move a bank branch without approval of the Ministry of Finance. The Law also attempted to establish a bank-

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24. The decree established minimum levels of 500,000 yen for joint stock banks and 250,000 yen for private banks. ALLEN, *supra* note 23 at 56.

25. By the end of 1920, the number of branches had increased to 5,097. *Id.*

26. Hugh Patrick, *Japanese Financial Development in Historical Perspective, 1868-1980, in* COMPARATIVE DEVELOPMENT PERSPECTIVES (Gustav Ranis, et al. eds., 1984).

27. *Id.* at 312 (noting that between 1905 and 1936, 956 banks failed; 1,333 were merged). *But see supra* note 19, at 2 ("The collapse of small, unsound banks accounted for a greater part of the decline, which consolidation was a minor factor.").

28. An earlier run apparently resulted from discussions in the Diet over the government's desire to delay payments under guaranties that arose out of the Great Earthquake of 1923. Schiffer, *supra* note 13, at 20. In addition, competence in the financial system was shaken by publicity that certain large banks, including the Bank of Taiwan, were unsound because of a deteriorating loan portfolio. DILEMMAS OF GROWTH IN PRE-WAR JAPAN 247 (James W. Morley ed., 1971).

29. *Annual Report of the Bank of Japan*, FED. RES. BULL., May 1928, at 331.

30. *See id.* at 331 ("When the panic broke out, first in March and again in April, we disregarded our usual practice and gave liberal accommodation to all banks applying for funds to meet withdrawals of deposits; we extended credits directly and freely even to institutions which had no previous business connections with us; and in cooperation with the Government and leading banks we endeavored to tide over the crisis and stabilize the situation.").

31. The Law was substantially revised in 1981. *See* The Banking Law, Law No. 59 of June 1, 1981, Arts. 8 & 9 (Japan).

ing system based upon short term loans,[32] by restricting commercial banks to limited duration loans, leaving long term credit to special institutions.[33] Additionally, the law imposed limitations on non-banking activities, although not securities activities.

The Banking Law of 1927 remained in place, without significant change, until 1981.[34] The longevity had one major explanation: ambiguity. The Law contained little more than an outline of a regulatory scheme, providing MoF with considerable discretion. With little or no regulatory augmentation, MoF used the 1927 Law to totally reshape the financial system after the war.

Commercial banking was not the only financial sector to experience reform and consolidation. The 1920s also saw efforts to reform trust companies. Subject to almost no regulation, trust companies had proliferated. As with banks, economic uncertainties in the 1920s precipitated a number of failures. The adoption of the Trust Law and the Trust Business Law in 1922 subjected the companies to extensive regulation. The 1922 Law gave MoF authority to license trust companies, and was used aggressively to pare numbers. Most large trust companies formed during this period, including Mitsui, Yasuda, Sumitomo, Mitsubishi and Nippon.[35] Able to pay higher yields than banks, the companies thrived. They grew in size and rivaled the large commercial banks.[36]

Following adoption of the legislation, trust companies witnessed a dramatic decline in numbers. The number fell from 488 to thirty seven by 1928 and to six by the end of the war.[37] The decline in numbers did not, however, mean a diminishing market share. Quite the contrary. Trust companies, perceived as a haven from the uncertainties confronting banks and deposits, actually grew as their numbers decreased.[38]

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32. *See* Henry C. Wallich, and Mabel I. Wallich, *Banking and Finance*, *in* ASIA'S NEW GIANT 279 (1976).

33. *Id.*

34. *See* The Banking Law, *supra* note 31.

35. Mitsui was formed in 1924; Yasuda and Sumitomo in 1925 and Mitsubishi and Nippon in 1927.

36. *See The Capital Market*, THE ECONOMIC DEVELOPMENT OF JAPAN AND KOREA: A PARALLEL WITH LESSONS 165 (Chung H. Lee and Ippei Yamazawa eds. 1990).

37. *See* Fujino, *A Comparison of Trusts in the United States and Japan*, CENTER FOR INTERNATIONAL AFFAIRS AND THE REISCHAUER INSTITUTE OF JAPANESE STUDIES 87-17, at 10 (1987).

38. MONEY AND BANKING IN JAPAN, BANK OF JAPAN, ECONOMIC RESEARCH DEPARTMENT, (S. Nishimura trans. L.S. Pressnell ed., 1973). *See also Annual Report*, *supra* note 29. ("Following financial panic of 1927, there 'was an active transfer of funds from the secondary and minor banks to the larger banks, trust companies, and the Post Office Savings Banks;"). Three trust companies controlled the bulk of the business. *See* MISHIMA, *supra* note 23, at 253 ("The percentage Mitsui, Mitsubishi, and Sumitomo accounted for among the total trust properties, also increased from 47% in 1927 to 53% in 1928 and to 54% in 1929.").

B. *Special Banks*

In addition to commercial banks and trust companies, the Japanese financial system rested on a bed of specialized financial institutions. Special banks served particular functions such as financial services in occupied territories, foreign exchange, and long term lending to particular segments of the economy. Special banks represented the primary vehicles for government intervention into the financial system.

Representing the first of the special banks, the Yokohama Specie Bank (YSB), to a large degree set the pattern. The YSB addressed a specific void in the financial system. Designed to engage in international trade activity, the bank was intended to weaken the monopoly of foreign banks over trade finance in Japan.[39] Formed in 1880, the YSB again demonstrated the government's willingness to rely on foreign models. The Bank patterned it's charter after the one used by the Hong Kong & Shanghai Bank.[40] In forming the bank, the government retained considerable influence over the institution, appointing the President and Vice-President,[41] supplying one-third of the bank's initial capital, and providing advantageous low interest loan financing.[42]

The YSB quickly became heavily involved in trade finance, ultimately creating an extensive network of foreign offices. The Bank opened a London office in 1884 and by 1902 had branches in France, the United States, India, Hong Kong and China.[43] An overseas presence allowed the YSB to compete with the foreign banks. Particularly during the First World War, the YSB seized considerable business from European competitors.[44]

The Hypothec Bank of Japan filled another void in the financial system. Authorized to issue long-term debt, the bank primarily made agricultural loans, secured by real property, for terms as long as fifty years.[45]

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39. G.C. ALLEN, A SHORT ECONOMIC HISTORY OF MODERN JAPAN 1867-1937 53 (1962). *See also* GOLDSMITH, *supra* note 15, at 50. The bank received the authority to engage in foreign exchange activity six years after formation.

40. *See* FRANK H.H. KING AND CATHERINE E. KING, *The Hong Kong Bank in the Period of Imperialism and War 1885-1918*, THE HISTORY OF THE HONG KONG AND SHANGHAI BANKING CORPORATION, 94-96 (1987- 1991).

41. ALLEN, *supra* note 39 at 53. The only serious competition for trade finance came from branches of foreign banks. *Id.* at 108.

42. *See* SCHIFFER, *supra* note 13, at 17 (noting that ⅓ of initial capital provided by government with additional funds from Treasury; after government funding ended, Bank of Japan authorized to make low interest loans).

43. JAPANESE FINANCE DEPARTMENT, AN OUTLINE OF BANKING SYSTEMS IN JAPAN 12 (1905).

44. *See* FED. RES. BULL., *supra* note 19, at 804, 806. ("The European war and the fluctuation of most European currency is after the war restricted and hampered to a large degree the activities of the European banking institutions, with the result that their business was taken over by Japanese banks.").

45. *See* SCHIFFER, *supra* note 13, at 18. The Hypothec bank could issue long-term debt, although not in excess of ten times capital.

The Hypothec Bank could raise funds by issuing debentures but had only limited deposit taking authority.[46] This restriction on deposits began the practice of dividing banks by funding source, something that would remain an attribute of the post-war banking system.

The Hypothec Bank also worked closely with the agricultural and industrial banks, a network of agrarian based financial institutions located in each prefecture.[47] Once again, the government retained considerable control over the bank and guaranteed the dividend payment for the first ten years of its existence.

Formed four years later, the Industrial Bank of Japan (IBJ) had as its principal goal the extension of long-term loans to Japanese industry, typically for five year periods. The IBJ channelled funds to "established large industries, especially for shipbuilding companies, iron and steel factories, and public utilities."[48] To obtain the long term financing necessary for the loans, the IBJ received debenture issuing authority.

In addition to servicing industry, the IBJ to some degree facilitated foreign investment. A large portion of its capital came from overseas.[49] The bank floated bonds in England and France in 1908 and in New York in 1924.[50] As with the other special banks, the government's guiding hand was readily apparent, including a dividend guarantee comparable to that received by the Hypothec Bank.[51]

Intended to facilitate development of Japan's northern most island, the Hokkaido Takusiyoka Colonial Bank received debenture issuing authority. The government also formed financial institutions in occupied territories including the Bank of Taiwan and the Bank of Chosen in Korea both of which acted as central banks for those areas.[52]

Special banks maintained close ties with the government. In addition to dividend guarantees and some financing, MoF typically appointed key officers.[53] The banks also performed tasks assigned by the government. The Bank of Japan conducted activities in overseas territories through the YSB. MoF, by comparison used the IBJ to implement domestic policies. Following the great earthquake in 1923, the IBJ at the behest of the government funneled aid to small borrowers. Similarly, after the financial crisis of 1927, the government again channeled funds to small borrowers through the IBJ. At the end of 1929, IBJ had more than Y35 million in

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46. *Id.*

47. ALLEN, *supra* note 39, at 54. The Hypothec Bank gradually took control of these banks after 1921, operating them as branches. *Id.* at 108.

48. SCHIFFER, *supra* note 13, at 18.

49. *Id.* at 19.

50. Herbert M. Bratter, *Japan's Special Bank for Industrial Financing*, THE FAR EAST REV., Oct. 1930, at 574. The article also contains a list of companies financed by the IBJ.

51. ALLEN, *supra* note 39, at 54.

52. SCHIFFER, *supra* note 13, at 19.

53. ALLEN, *supra* note 23, at 55.

loans to "petty merchants and manufacturers."[54]

C. *Control and Consolidation*

In addition to reforming the financial system, the Banking Law of 1927 also accelerated the process of consolidation in the banking community. Capital standards were raised and a policy was announced favoring further "amalgamation" of commercial banks. Over half of the existing banks did not meet the new capital standards requiring them to either find the necessary capital, merge or liquidate.[55]

From a high of almost 2000 banks at the turn of the century, the number of banks began to fall, a process that accelerated as the war began.[56] The number of commercial banks fell from 683 in 1931 to 377 in 1937 and sixty one in 1945.[57] By the end of the conflict, the four zaibatsu banks, Teikoku (a combined Mitsui and Dai-Ichi), Yasuda (Fuji), Mitsubishi and Sumitomo, held 74.9 percent of all bank loans.[58]

The trend toward consolidation did not exempt larger banks. Sanwa, a name meaning three harmonies, formed in 1933 as an amalgamation of three banks Osaka, Yamaguchi and Konoike.[59] Tokai formed in 1941 through the combination of three banks in the Nagoya area. More spectacularly, Mitsui and Dai-Ichi, two of the largest and oldest banks united under the Teikoku banner in 1943. Nor was the trend limited to urban centers. MoF continued to push for consolidations outside of cities under the premise of "One Prefecture, One Bank."[60]

The consolidation policy was not primarily motivated by efficiency; control represented the preeminent concern. "The aim was not so much to consolidate the banks' business as to strengthen financial control, such as the promotion of the Easy Money Policy, the improvement of government bond marketing, and the provision of funds for munitions industries."[61]

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54. BRATTER, *supra* note 50, at 575.

55. JAPANESE FINANCE DEPARTMENT, *supra* note 43, at 2.

56. KOZU YAMAMURA, ECONOMIC POLICY IN POST-WAR JAPAN 24 (1967).

57. Pressnell, *supra* note 40, at 26 & 39. Of the five largest banks at the end of the War, only one, Sanwa, was a non-Zaibatsu bank.

58. Yasuda (1880), Mitsui (1876), Sumitomo (1895), Mitsubishi, and Dai Ichi (1872), had 28.1 percent of all deposits held by commercial banks in 1930. SCHIFFER, *supra* note 13, at 21. *See also* PATRICK, *supra* note 27, at 312 (stating that "Big 5" had 30 percent of all bank loans and deposits by 1930).

59. The bank also ultimately absorbed Sanwa Trust Company.

60. *See* Takeshi Otsuki, *The Banking System of Japan*, ORIENTAL ECONOMIST, July 7, 1951, at 521 ("As a result, a financial administrative principle of having only one bank for each prefecture was set up, and legal measures to facilitate the merger of banks were adopted."). A number of large banks emerged from the process. Bank of Kobe was formed in 1936 from a merger of seven banks in Hyogo Prefecture; Saitama in 1943 from the four largest banks in Saitama Prefecture.

61. L.S. Pressnell, at 38. *See also* GOLDSMITH, *supra* note 15, at 118 ("The process of concentration proceeded through the 1930s and accelerated during the war, being fostered by the government and becoming practically compulsory during the second half of the pe-

As the conflict war in accelerated, so did government control over the banking system. To some degree, the large Zaibatsu banks had represented counterweights to government influence. They could count on capital and deposits from member companies and, in an unstable financial environment, the balance of individual deposits.[62] Not dependent upon the BoJ for funds, these financial institutions had considerable practical independence from government oversight.[63]

As Japan shifted to a wartime economy, however, the role of government greatly expanded. The government, particularly the MoF, aggressively intervened into the financial markets to pursue war related policies. Commercial banks became government controlled conduits for funneling capital to war related industries. The MoF encouraged this process by guaranteeing loan repayments. While the role of particular banks varied, the entire financial system generally operated to facilitate the government's military exploits.[64]

Similarly, the relatively high degree of independence enjoyed by the BoJ came to an end.[65] Loss of independence occurred in 1942 with the adoption of a law acceding to the Ministry the authority to order the BoJ to implement particular policies.[66] In the post-war period, control would be further tightened through the practice of appointing retired MoF officials as Governor of the central bank.

Thus, by the time the war ended, certain distinct attributes had appeared that would remain central to the post-war banking system.[67] In-

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riod, as the government felt that the financing of rearmament and war could be more efficiently handled by a smaller number of large banks, which could be more easily controlled by the government.")

62. Samuel E. Neal and Raymond Vernon, *Japan Has a Bank Problem*, BANKING, Oct., 1946, at 46 ("And finally the prestige of the Zaibatsu name, bearing with it a reputation for soundness and stability which carried great appeal for people plagued with bank failures and defalcations, served the clinch the Zaibatsu position in the competitive race for deposits.").

63. Some even viewed the Ministry as a captive of the Zaibatsu banks. *See id.* at 45, 118 ("Until the middle 1930's this control by the Zaibatsu was overt and absolute. The Finance Minister almost invariably was a career employee of one of the Zaibatsu families. After 1930, the control of the Ministry by the Zaibatsu was more discrete but hardly less effective.").

64. For a more detailed discussion of the government subjugation of banks during the war, see W. TSUTSUI, BANKING POLICY IN JAPAN 13-17 (1988).

65. *See* TAKAFUSA NAKAMURA, THE POSTWAR JAPANESE ECONOMY 139 (1981) (noting that prior to the war, "the Bank of Japan had preserved a relatively independent position vis-a-vis the Ministry of Finance . . . .").

66. *See* Art. 42 of Bank of Japan Law (BoJ "under the supervision of the competent Minister [of Finance]."). *See also* RICHARD A. BANYAI, MONEY AND BANKING IN CHINA AND SOUTHEAST ASIA DURING THE JAPANESE MILITARY OCCUPATION 1937-1945 (1974); T.F.M. ADAMS & IWAU HOSHII, A FINANCIAL HISTORY OF JAPAN 99 (1972) (noting the MoF received authority to approve discount rate and fix note issue limit and to "direct the bank . . . to undertake any business, to change its statutes, or to take any other necessary action.").

67. For a discussion of charges in the financial system immediately before and during the war, see Yasuo Noritake, *The Development of Monetary and Banking System in Ja-*

creasingly, banks became divided by function. Long term banks, foreign exchange banks and trust companies all performed specialized functions. At the same time, the financial industry emerged from the conflict highly concentrated and subjected to considerable government control.

II. REFORM AND THE OCCUPATION

The post-war system of financial regulation can only be understood in the context of the immense capital shortage that occurred in the aftermath of the Second World War. War-torn, an empire sheared away, Japanese industries confronted the herculean task of rebuilding and converting to civilian production. Doing so required capital; capital that could not be repaid until retooling had finished and markets reestablished.

Raising capital posed immense hurdles. With individuals primarily concerned about food and shelter, the thought of investing limited resources into risky ventures such as corporate stock had little appeal.[68] The ability to sell stock was also constrained by dysfunctional markets and the absence of a history of this type of investment. In addition, allied policies designed to break up the Zaibatsu, the large Japanese industrial complexes, flooded the market with shares, further crowding out companies attempting to raise funds.

Still, something had to be done. Japanese companies desperately needed capital. The primary answer was to be banks. Companies had historically relied on banks for most of their capital needs. Resort to bank financing in the post-war period was not simply a return to the past. Use of banks as capital purveyors went well beyond earlier levels. Dependency upon bank financing evolved into a system of credit rationing and government control of industrial policy.

During the occupation, a rigid regulatory structure descended. With other investment alternatives unavailable, individuals had little choice but to deposit excess yen in banks. The funds were lent to capital starved companies. The aggregation of small deposits supplied a significant portion of the capital needs of corporate Japan.

Deposits, however, were not enough. Funds had to come from somewhere else. The solution was to be the government, specifically the Bank of Japan. Through the discount window, the government provided city banks with considerable additional funding. The practice, however, also created leverage. The threat of reduced funding enabled the government to dictate to banks which companies and industries were eligible for credit. Control of credit permitted control of industrial policy.

Compartmentalization facilitated control. The financial system con-

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pan, 1932-1945, 1 KOBE U. ECON. REV. 69 (1955).

68. *See* THOMAS PEPPER, MERIT E. JANOW & JIMMY W. WHEELER, THE COMPETITION DEALING WITH JAPAN 146 (1985) ("World War II and the postwar financial difficulties virtually destroyed private accumulations of capital in Japan.").

tinued to divide banks both by source of funding and by function. Commercial banks were meant to be a source of short term financing for Japanese industry, although as a practical matter loans were constantly renewed. They could not sell debentures or otherwise raise long-term funds.[69] Funds came almost entirely from deposits, with loans from other financial institutions and the BoJ playing an important role.[70]

Special banks were eliminated. In their place however, appeared three long-term banks. These financial institutions arose out of the need to provide Japanese businesses with longer term financing. They were allowed to sell debt with maturities of one year or five years and were expected to provide corporate Japan with financing of a more significant duration.[71] The authority to sell bonds came at a price. The banks could not accept retail deposits.[72] Given the insatiable need for capital, the three long term banks had commercial relationships with most, if not all, of the leading Japanese corporations.

The occupation also saw the creation of additional classes of banks. Specifically, trust companies were given increased authority and allowed to operate as banks.[73] Trust banks raised funds neither through debentures nor, in significant amounts, through deposits.[74] Instead, the primary mechanism was the loan trust certificate, funds left with the bank for a term of three years at fixed interest rates. The funds were then lent to industries designated by the MoF, effectively providing another source of long term financing for corporate Japan.[75]

MoF also segmented banks geographically. City banks generally

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69. *See* 20 MINISTRY OF FINANCE FINANCIAL HISTORY SECTION, THE FINANCIAL HISTORY OF JAPAN, THE ALLIED OCCUPATION PERIOD 1945-1952, at 65-66 (1982). As a practical matter, Japanese commercial banks consistently renewed short-term loans, effectively transforming them into long-term financing. *Id.* at 33.

70. *Id.* The call money market involved short-term loans among banks. To the extent a financial institution had excess, unused funds, they would lend them to other over-loaned banks, particularly city banks. The government exercised considerable influence over the market, including the determination of interest rates. *Id.* at 68.

71. Long Term Bank Credit Law, Law No. 187 of 1962.

72. *Id.* at 39. They could, however, accept certain government deposits and deposits from borrowers. The three long-term banks are the Industrial Bank of Japan, the Long-Term Credit Bank of Japan and the Nippon Credit Bank. *Id.*

73. Trust banks are commercial banks with trust authority. Commercial banks received the authority to engage in trust activities during the war. *See* Commercial Bank's Additional Operation of Trust and Savings Bank Business Act, Law No. 43 of 1943. Following the occupation, however, the Ministry of Finance used administrative guidance to force most city and regional banks out of the area. That left the trust business to a specialized class of commercial banks.

74. MoF did this in large part by limiting the number of trust bank branches.

75. Only one city and seven trust banks had the power to manage and invest client funds, eliminating a source of profits for other institutions. Trust banks also managed pension plan assets, a lucrative business shared with insurance companies. The seven trust banks are: Mitsubishi Trust, Sumitomo Trust, Mitsui Trust, Yasuda Trust, Toyò Trust, Chuo Trust, and Nippon Trust. Daiwa represents the only ordinary commercial bank with trust powers.

could expand only in the principal urban centers, particularly Tokyo and Osaka, and only on a limited basis. Regional banks, typically smaller, tended to operate in a single prefecture. These banks essentially amounted to conduits for deposits in less urban areas. Often unable to find sufficient corporate borrowers, regional banks lent excess funds to cash starved city banks. City banks in turn lent them to industries designated by the government.

The post-war system also preserved distinctions between domestic and international banks. The MoF severely restricted the overseas expansion of Japanese banks. The Bank of Tokyo, the successor to the YSB, became the only bank registered under the Foreign Exchange Bank Law and obtained the greatest share of overseas offices.[76] Only the largest city banks could maintain an international presence, and even that occurred on a limited scale. MoF did not permit long term or trust banks to go abroad until the early 1970s.[77]

Finally, commercial banks were prohibited from selling securities, an activity left to the emerging class of Japanese brokers. With origins traceable directly to comparable provisions in the U.S., the ban meant that banks could not sell stocks or bonds for corporate clients.[78] The loss of this potential source of profits made the banks more dependent upon commercial lending and more susceptible to government control. The restrictions also helped stymie development of the stock market and gave rise to a group of securities firms that would ultimately prove fierce competitors of the banks.

Not entirely a Japanese creation, the system of compartments was implemented with the explicit support of United States officials running the country during the occupation. Compartmentalization had a dual purpose. Foremost, it increased competition, a noticeable attempt to undo some of the concentration in the financial sector that had occurred during the war.

The other purpose was more subtle. Compartmentalization also facilitated credit rationing. Credit rationing allowed funds to be directed to industries considered by allied officials to have high priority in the economic recovery process. The U.S., therefore, encouraged and became at least in part responsible for the shape of the post-war financial system and the high level of government involvement in the system.[79]

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76. *See* discussion *infra* note 211.

77. Long term and trust banks only began opening overseas branches in the 1970s. Most were concentrated in New York and London.

78. Although the separation was imported from the United States, the purpose was entirely different. The separation of securities and banking functions in the U.S. arose in part out of the belief that the intertwining of the two caused the Great Depression. In Japan, the U.S. separated the two industries entirely to prevent city banks from monopolizing the brokerage business, thereby creating an additional class of competitors. *See* text *infra* note 183.

79. Government control was consistent with the articulated SCAP policy first of favor-

A. *The Occupation Descends*

The United States initially wanted no responsibility for the economic and social chaos that followed termination of the war. In line with this early approach, occupation officials received explicit instructions not to assume control of the financial system.[80] The stated goal of the occupation was "demilitarization and democracy." Military officials, therefore, had as a primary purpose the denuding of Japan's means to make war and transformation of the autocratic government into a democracy. In other words, the early goals did not include Japanese economic reconstruction.[81]

Financial sector oversight fell to the Economic and Scientific Section (ESS) of the Supreme Commander of Allied Powers or, more commonly, SCAP. ESS had responsibility for oversight of economics, labor, finance, and science and included "[a]ll of industry, foreign trade, price control, rationing, antitrust activities, and economic statistics . . . ."[82] With respect to banking, however, the ESS initially had relatively constrained authority.

The ESS was to take "no steps to maintain, strengthen, or operate Japanese financial structure except insofar as may be necessary for achievement of provisions of this directive."[83] Officials could shut down banks involved in the war efforts but otherwise could do so "only for purposes of introducing control, removing objectionable personnel or taking measures connected with blocking [the] program, . . ." and were instructed to "re-open[] these banks as promptly as possible; . . ."[84]

SCAP, therefore, had been told essentially to leave control of the financial system to the Japanese. This meant working closely with the BoJ

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ing specified industries critical to the country's recovery and later those promoting exports.

80. JCS 1380/15, paras. 13, 13a, and 35a, *cited in* THEODORE COHEN, REMAKING JAPAN: THE AMERICAN OCCUPATION AS NEW DEAL 139 (1987).

81. *See* United States Initial Post-Defeat Policy Relating to Japan: SWNCC 150-3, Aug. 22, 1945, *reprinted in* THE FINANCIAL HISTORY OF JAPAN, *supra* note 70, at 65-66 ("The policies of Japan have brought down upon the people great economic destruction and confronted them with the prospect of economic difficulty and suffering. The plight of Japan is the direct outcome of its own behavior and the Allies will not undertake the burden of repairing the damage.").

82. COHEN, *supra* note 81, at 87. The reach of the Section was extraordinarily broad. As Cohen noted, "[i]ts responsibilities reached into every cranny of Japanese everyday life, and its chief was pulled into almost every problem of significance." *Id.* Through most of the occupation (1946-1952), Major General William F. Marquat headed the Section.

83. *Id.* The ESS also had the authority to take "such financial measures as may be deemed necessary" including "[t]he closing of banks."

84. Incoming message WX61967 Washington radio, General Headquarters U.S. Army Forces Pacific, Adjutant General's office. Radio and Cable Center, SCAP Records, Suitland, Md. (Sept. 9, 1945). *See also* Monograph No. 39, Money and Banking, GHQ, SCAP, at 1 ("The basic Occupation directives required the Japanese authorities, rather than SCAP, to plan and direct the reform of Japan's banking system so that it could make its full contribution to the development of a democratic, peaceful and stable economy capable of supporting the Japanese people and maintaining trade relations with the free nations of the world.").

and MoF. Officials in the Economic and Scientific Section supported the approach. They knew that anything foisted upon the MoF without its consent would be undone as soon as the occupation ended. Cooperation was therefore deemed crucial.[85]

Day to day oversight remained in the hands of Japanese regulators, although the Finance Division regularly reviewed and often modified the actions of the MoF and Central Bank. SCAP occasionally intervened directly. Occupation officials prohibited mergers absent express approval.[86] In the end, however, the Japanese exerted considerable influence over the direction of financial reforms.[87]

MoF retained its position as the critical voice in the financial markets in large part due to its deliberate decision to deal with SCAP directly. Most other ministries relied on the central liaison office, an office primarily staffed by officials from the Ministry of Foreign Affairs who spoke English. Unwilling to accept them as intermediaries, the proud MoF instead set up a liaison office of its own. Lacking sufficient staff with fluency in English, officials were, for the first time, hired laterally. Equally unusual, MoF agreed to accept a number of personnel who had not graduated from an Imperial University.[88]

MoF, with considerable assistance of the liaison office, retained a close working relationship with occupation officials.[89] The liaison made frequent visits to the Economic and Scientific Section of SCAP, with meetings often occurring twice a day. In addition, the Minister of Finance met with ESS officials on a weekly basis. Interaction between the two groups was extensive.

> [The staff of the Finance Division] had very close contact [with Japanese banking officials]. We saw representatives of the Ministry of Fi-

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85. Interview with Tristan Beplat, Chief, Banking Section, ESS (Mar. 1992). One commentator concluded that the decision to leave the Japanese government in place resulted from "the grossly insufficient number of Japanese-language personnel among the Allied powers and because of lack of familiarity with Japanese administrative procedures, . . ." ELEANOR M. HADLEY, ANTITRUST IN JAPAN 67 (1970).

86. *See* Merger of Financial Institutions, SCAPIN 759, Feb. 21, 1946. MacArthur Museum, Norfolk, Va. (prohibiting any bank merger, consolidation or amalgamation absent SCAP approval). *See also* Memorandum from Walter K. LeCount, Chief, Finance Division, Re: Merger of Seiwan Savings Bank with Aomori Shogyo Bank, To: Ministry of Finance, 004.2 ESS/FIN, SCAP Records, Suitland, Md. (Jan. 29, 1949) (approving merger).

87. *See* CHALMERS A. JOHNSON, MITI AND THE JAPANESE MIRACLE (1982).

88. By the time the war had begun, the practice of accepting personnel almost exclusively from the University of Tokyo had become entrenched. A handful of exceptions to this practice had occurred, however. Ikeda Hayato, future Finance Minister and Prime Minister, joined the Ministry of Finance in 1925 after graduating from the law faculty at Kyoto University. Nonetheless, even these exceptions all involved one of the prestigious imperial universities. The hiring of Gengo Suzuki, who graduated from a University in Taiwan, to work in the liaison office was an exception even to the usual practice of hiring from imperial universities.

89. The liaison office was first headed by Takeo Fukuda, who later became Prime Minister, then Nobutane Kiuchi, who later headed the Foreign Exchange Control Board.

> nance, Bank of Japan and the banks everyday. For example, there was a group in the Finance Division that was responsible for dealings with the Trust Banks Association. . . . It was also in the Finance Division a special section that dealt with the Ministry of Finance. There was a group that had daily liaison with the Bank of Japan. When it came time to reorganize the banks, the Finance Division studied every reorganization plan and then went over it again with the Bank of Japan. Each proposal that came out of the Finance Division was carefully gone over before it was approved.[90]

A weekly meeting was also held between the MoF and General Marquat, head of ESS.[91]

The MoF played a critical role in shaping the banking system. Officials within the ESS relied extensively on Ministry input. This reflected in part a lack of expertise and part prudence. Any reforms imposed over MoF's objection would simply be reversed when the occupation ended. The ESS, therefore, worked hard at devising reforms that gained the acquiescence of the MoF.

Not surprisingly, the system that emerged preserved many pre-war vestiges. Special banks survived, albeit in a slightly altered form. Despite their role in the war efforts, the Industrial Bank of Japan and Bank of Tokyo (ne Yokohama Specie Bank) survived. Concentration remained pronounced; comprehensive reform of the entire financial system never occurred.

B. *The Penalty Phase*

Consistent with the initial approach toward Japan, early banking polices were largely punitive. Occupation officials wanted to ensure that the pre-war system in Japan did not return. Initial efforts focused upon disbanding the institutions associated with the war effort and expunging the individuals deemed responsible. Elimination of the Zaibatsu freed the core banks to make loans to companies not in the industrial complex.[92] Occupation officials also closed and liquidated most special banks.

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90. THE OCCUPATION OF JAPAN: ECONOMIC POLICY AND REFORM, (Lawrence H. Redford ed. 1978) (statement by Tristan Beplat, former Chief of the Banking Section of the Economic and Scientific Section of SCAP).

91. Conversation with Gengo Suzuki, Former Chief, Liaison Office, Ministry of Finance, Tokyo, (Mar. 1992).

92. In November 1945, SCAP approved a plan in which shares owned by the four largest Zaibatsu, Mitsui, Mitsubishi, Sumitomo and Yasuda, were to be transferred to the Holding Company Liquidation Committee and ultimately sold. The HCLC did not actually begin selling the shares until August 1946. ADAMS & HOSHII, *supra* note 66, at 23. Teikoku Bank was the principal bank for the Mitsui Zaibatsu. The bank formed from an amalgamation of Mitsui and Dai-Ichi banks in April 1943. Monograph No. 39, *supra* note 84, at 9 n.2. Until creation of the Commission, the status of designated companies could not change and shareholders could not sell stock in the companies. Ultimately, several hundred firms were designated as "Restricted Concerns." ADAMS & HOSHII, *supra* note 66. The Commission began functioning in August 1946, *id.*, and was dissolved five years later. *Id.* at 24.

Application of these policies to the financial sector began almost immediately upon cessation of hostilities. By memorandum dated September 30, 1945,[93] allied forces announced the closing of "all banks and other financial institutions whose paramount purpose has been financing of war production or control of financial resources of occupied territories."[94] The Japanese government received instructions to "immediately close and not allow to reopen" the designated institutions. The principle officers were to be "discharge[d] and summarily remove[d] from office . . ."[95] MoF had to "present at the earliest possible date proposals for the liquidation of all closed institutions,"[96] with the BoJ ultimately overseeing the process.[97]

The unremarkable decision was dramatized by the method used to publicize the closings. After the business day ended, military personnel swiftly occupied twenty one Japanese financial institutions, including The Bank of Taiwan, Bank of Chosen, BoJ, The Hypothec Bank, the YSB,[98] and the only two foreign banks remaining in the country.[99] The action occurred without warning; employees were ordered out of the building without time to clear their desks.[100] The occupying forces also prohibited overseas communication absent their approval,[101] cutting off contact with

93. The closing of the financial institutions in the occupied territories was intended to be the first step in economically separating Japan from those countries. *See* Cincafpac-Adv. to Comgen Usafik-Opnl priority, SCAP Records, Suitland, Md. (Sept. 29, 1945) ("At 1600 hours in 30 September CMA wartime finance banks in Japanese branches of foreign banks CMA including Bank of Chosen and Bank of Taiwan will be closed by direct action of this headquarters PD you should insure adequate publication in Korea to emphasize the closing of Japanese branches of Bank of Chosen is an integral part of the program to separate Japanese and Korean economy and to divert Japanese of all control over Bank of Chosen and its assets PD you should keynote the fact that the closing of Japanese branches will improve the position of the Bank of Chosen in Korea.").

94. Extract of Allocation of Staff Responsibilities for Execution of JCS Directives, SS Responsibilities in Japan, SCAP Records, Suitland Md. (Mar. 4, 1947). *See also* Draft Financial Directive for Japan, inter-office communication (for information), Treasury Department, from Mr. White, Assistant Secretary of the Treasury, to Secretary Vinson, Aug. 28, 1945, *reprinted in* THE FINANCIAL HISTORY OF JAPAN, *supra* note 69, 2-23, at 143.

95. Closing of Colonial and Foreign Banks and Special Maritime Institutions, SCAPIN 74, Sept. 30, 1945. MacArthur Museum, Norfolk, Va. *See also* Supplemental Instructions pertaining to the Closing of Financial Institutions, SCAPIN 104, Oct. 8, 1945. MacArthur Museum, Norfolk, Va. (detailing practices with respect to employees of closed institutions).

96. Oral Instructions Given to Ministry of Finance on 30 Sept. 1945, SCAPIN 73 MacArthur Museum, Norfolk, Va. (Sept. 30, 1945). *See also* Appointment of a Liquidator of Branches, SCAPIN 163 MacArthur Museum, Norfolk, Va. (Oct. 20, 1945) (appointing BoJ as liquidator of closed institutions and directing prompt submission of plan of liquidation).

97. Monograph No. 39, *supra* note 84, at 15 (noting that by beginning of 1946, BoJ had become fiscal agent for all closed institutions).

98. Lindesay Parrott, *Americans Sieze 21 Banks in Japan and Oust Officials*, N.Y. TIMES., Oct. 1, 1945, p.1, col.8, *cont'd* at p.6 col.5. For a complete list of the financial institutions closed, see SCHIFFER, *supra* note 13, at 35 n.19.

99. These included the German Deutsche Bank and the Banque Franco-Japonaise, a Vichy controlled bank, *Id.* at p. 6, col. 5.

100. JUSTIN WILLIAMS, SR., JAPAN'S POLITICAL REVOLUTION UNDER MACARTHUR: A PARTICIPANT'S ACCOUNT 6 (1979).

101. *McArthur Extends Curbs on Finance*, N.Y.TIMES., Oct. 4, 1945, p. 8, col.3.

correspondent banks and branches located abroad.[102]With one swift act, remaining international operations of Japanese banks ended.

Most of the seized banks were simply liquidated. The YSB, however, presented a more complex concern. Complicity in the war effort was clear. During the conflict, the bank became an active participant, advancing the government interests. Foreign branches "operated under the direct control of the local military administration . . ."[103] Moreover, the bank had, in the words of occupation officials, "become the principal instrument in the Government's complicated system of currency manipulation in occupied countries."[104]

The bank's international operations, however, played a unique role in the financial system. The YSB had an extensive overseas network, with branches in Asia, Europe and the United States. No other Japanese bank had anything comparable. Moreover, unlike the other special banks closed by SCAP, the YSB had a significant domestic presence. The Japanese government, therefore, lobbied hard to save the bank.

The circumstances surrounding the attempted closing of the YSB illustrated the often successful tactics used by the MoF to ameliorate occupation policies designed to restructure the financial system. Often unhappy with approaches developed by SCAP, MoF first tried to delay implementation. Officials usually engaged in a lengthy debate over the practicality of a particular policy. They sometimes asserted that various legal and other barriers prevented execution. Either way they bought time. Gradually, SCAP abandoned the offensive policy or, in the case of the YSB, accepted cosmetic changes.[105]

At the behest of the Japanese government, SCAP temporarily exempted the YSB from the mandatory closings. Thereafter, what to do with the YSB caused much bureaucratic teeth gnashing, something that caught the attention of the State Department.[106] On the one hand, occupation officers were committed to the elimination of all special banks. On the other, they were concerned about the impact on the economy of any untoward activity.[107]

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102. *MacArthur Extends Curbs on Finance*, N.Y. TIMES., Oct. 4, 1945, p. 8, col.3. Most of the occupied financial institutions never reopened.

103. Monograph No. 39, *supra* note 84, at 4. Although not a government bank, the YSB had played an important official role during the war, handling many of the BoJ's functions in the occupied territories, *see* BANYAI, *supra* note 66, at 8; *see also* PEPPER, *supra* note 68, at 147 n.7.

104. The currency manipulations in part enabled the Japanese to fund the cost of the military occupation.

105. In general, SCAP in the financial area tried to convince rather than impose. Interview with Sherwood Fine, Head of Finance Division, SCAP (Nov. 1991). This provided considerable room for negotiation.

106. *See* Incoming Message From War Dept., to CINCFE, NR W 86092, Sept. 12, 1947. SCAP Records, Suitland, Md. ("State Dept. Inquires Re: Status Yokohama Special Bank Report Requested").

107. SCAP officials from the Finance Division wanted to eliminate the final vestiges of

MoF ultimately prevailed. The MoF submitted a liquidation plan for the YSB in April 1946 that called for the transfer of YSB assets to a new financial institution. SCAP modified the plan by imposing a number of cosmetic steps, including the requirement that the resulting bank operate under a new name bearing no resemblance to the YSB.[108] SCAP also prohibited certain YSB officials from associating with the new institution.[109]

The modified reorganization plan effectively preserved the domestic assets of the YSB, but in a newly formed entity.[110] The Bank of Tokyo (BoT) emerged from the reorganization as an ordinary commercial bank.[111] The BoT, however, still had the most significant international experience of any Japanese bank. When the banks returned abroad, the BoT would be at the forefront, acting as the country's principal international agent.[112]

Occupation officials, however, made certain that the BoT had no monopoly over foreign operations by carefully preserving the right of other banks to engage in overseas activities.[113] Moreover, personnel of the defunct YSB had scattered among the other banks, ultimately becoming the nucleus of their international departments. Nevertheless, through the 1970s, the BoT remained the top Japanese international bank, receiving preferential treatment from MoF in the realm of oversees expansion.

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the special banking system that existed prior to the war. *See* Memorandum from Walter K. LeCount, Chief, Finance Division to Chief, Economic and Scientific Section, SCAP Records, Suitland, Md. (July 28, 1948) ("It is agreed that the special bank system should be eliminated at the earliest practicable opportunity. . . . This can be accomplished by each of the now existing special banks [reorganizing as ordinary commercial or debenture-issuing banks]."). Moreover, allied officials did so only after determining that reorganization would have little harmful effect on the financial markets. *Id.* ("It is not contemplated that this program if undertaken will have an appreciable effect on the total amount of credit available.").

108. *See* Dissolution Plan for Yokohama Specie Bank, SCAPIN 1049 (July 2, 1946), MacArthur Museum, Norfolk, Va. ("The name of the new institution will bear no similarity either in Japanese or in foreign translation, to that of the Yokohama Specie Bank.").

109. *See* Monograph No. 39, *supra* note 84, at 16 (noting that directors and executive officers of new bank could not be persons associated in similar capacities with YSB since 7 July 1937 or subject to purge).

110. Completion of the liquidation of the YSB apparently did not occur until 1949. *See* Dissolution Plan for the Yokohama Specie Bank, SCAPIN 1049/1 MacArthur Museum, Norfolk, Va. (June 28, 1949) (terminating "Trust Relationship" between YSB and BoJ).

111. Monograph No. 39, *supra* note 84, at 18. The BoT opened on Jan. 4, 1947. *Id.* According to Tristan Beplat, the government submitted a whole list of names, with BoT ultimately selected.

112. *See* discussion *infra* text accompanying note 211.

113. *See* Letter from W.F. Marquat, Chief, Economic and Scientific Section, to W.J. Sebald, Chief, Diplomatic Section, (undated), SCAP Records, Suitland, Md. ("The Yokohama Specie Bank, Ltd., which had monopolized the Japanese Foreign Exchange Business, had been placed in liquidation prior to the reorganization of the other Special Banks. To avoid further monopolistic controls by any one institution, plans were made at that time whereby all Japanese banks properly staffed with foreign exchange specialists would take over would take over the foreign exchange functions at such time as SCAP would authorize the reopening of the foreign exchange business.").

III. FROM PUNISHMENT TO PRESERVATION

A. *Firm Financial Footing*

Early policies focussed on closing banks and purging officials. By the middle of 1946 SCAP underwent a pronounced shift in approach. Punitive oriented reform shifted to preservation. The banking sector had emerged from the war in a precarious state.[114] Without a more benevolent approach, instability in the financial system likely would impede economic recovery.

Bank balance sheets brimmed with worthless assets. Following the end of the war, they had incurred "the loss of overseas assets, the losses arising from insurance cancellation on fire and bomb-damaged plants, and attendant losses following the Japanese surrender."[115] Lavish loans to munitions and other "essential" industries during the war remained unpaid. The banks also held debentures issued by the Wartime Finance Bank, a lender of last resort for military oriented businesses, with repayment guaranteed by the government.[116]

The government had agreed to indemnify the banks in the event of default. By the war's end, claims reached Y25 billion.[117] Payment, however, would have resulted in economic disaster. Resorting to the printing presses to create yen needed for repayment threatened to stoke already high inflation. Payment also had an unsavory flavor, giving the appearance of rewarding those banks that had financed the war effort.[118]

To put the banks on a more sound financial footing, occupation officials wanted to eliminate the indemnification payments. The Japanese government fought the proposal. Non-payment appeared to renege on prior commitments.[119] Tanzen Ishibshi, the Finance Minister, opposed the plan, particularly when occupation officials insisted that cancellation be at Japanese initiative. His efforts irritated SCAP and contributed to the decision to have him purged later that year.[120]

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114. R. FEAREY, THE OCCUPATION OF JAPAN SECOND PHASE 1948-50, 67 (1950) ("These [zaibatsu] Banks, with a total of about 800 branches through-out Japan, have not been broken up, mainly because of the injury to the stabilization and recovery programs which their dissolution would have entailed.").

115. *See* Letter from W.F. Marquat, Chief, Economic and Scientific Section to the Hon. W.J. Sebald, Chief, Diplomatic Section, SCAP Records, Suitland, Md. (undated).

116. ALLEN, *supra* note 23, at 63.

117. Monograph No. 39, *supra* note 84, at 20. Others put the figure at three times that amount. *See* Memorandum from R. Fearey, Division of Japanese Affairs, to H. Borton, Division of Japanese Affairs, Oct. 14, 1946, *reprinted in* THE FINANCIAL HISTORY OF JAPAN, *supra* note 82, at 689 ("The Japanese Government had obligated itself by July, 1946 to indemnify individuals and corporations for various types of war losses to a total of 75 billion yen.").

118. *See, e.g.*, Memorandum to H. Borton, *supra* note 117, at 689-90.

119. Opposition arose out of both a desire to make good on prior commitments and a desire to continue to pump money into the economy. *See* TSUTSUI, *supra* note 65, at 28.

120. Interview with Takeshi Watanabe, Former Chief, Liaison Office, Ministry of Finance, Tokyo (Mar. 1992).

MacArthur and his staff remained adamant about cancellation of the indemnity payments. As a compromise, occupation officials allowed the guarantees to remain in place but imposed a 100 percent tax on amounts paid.[121] The net effect was to render the indemnification payments worthless.[122] With the stroke of a pen, the assets of most banks evaporated. That left the problem of repaying depositors.

SCAP solved the concern by essentially confiscating deposits. Prior to indemnity tax implementation, SCAP officials froze yen deposits in excess of a family allotment,[123] affecting approximately forty percent of all deposits.[124] The deposits were used to offset elimination of the indemnity payments.

The Law for the Reconstruction and Reorganization of Financial Institutions in October 1946[125] required banks to accurately value assets and to submit to the government a reorganization plan.[126] Banks had to write off loans made to insolvent companies and worthless overseas investments but could deduct the losses from profits, capital, frozen deposits and, if necessary, free deposits.[127] Thus, banks expunged assets and eliminated comparable liabilities, emerging as much smaller but sounder.

With the balance sheets relatively clean, the banks were now in a better position to contribute to the country's economic recovery. As part of the reorganization and a symbolic break with the wartime era, most changed their names.[128] While some took back their original appellation after the occupation, Daiwa[129] and Fuji[130] did not.[131]

B. *Deconcentration*

With banks on a firmer financial footing, and the problem of special bank taken care of, SCAP turned to the matter of competition. The de-

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121. *See* War Indemnity Special Measures Law, Law No. 38 of 1946; *see also* Monograph No. 39, *supra* note 84, at 20.

122. Not completely, however. Because of exemptions from the tax, Y18 billion was in fact paid as indemnities. *See* FUJI, *supra* note 21, at 191.

123. Withdrawals from the accounts had essentially been blocked since issuance of the Emergency Financial Measures Ordinance in February 1946. Under the Ordinance small amounts could be withdrawn each month.

124. *See* TSUTSUI, *supra* note 64, at 30.

125. Law for the Reconstruction and Reorganization of Financial Institutions, Law No. 39 of Oct. 1946.

126. *Id.* art. 39.

127. Only a handful of banks needed to dip into free deposits. Rather than let this occur, the government paid these amounts. *See* Letter from W. F. Marquat, *supra* note 117. ("A government indemnity was given to those banks unable to absorb the final loss by 100% reduction of the capital account and the old account deposits, the amount of the indemnity being based upon the difference between the total asset loss and the total capital account and deposit reduction."); *see also* FUJI, *supra* note 21, at 191-92.

128. Mitsubishi for example became Chiyoda Bank.

129. Known as Nomura Bank before the war.

130. Known as Yasuda Bank before the war.

131. PEPPER, *supra* note 68, at 147 n.6.

struction of the Zaibatsu left the core Japanese banks largely unaffected. While some had changed their names and had high ranking officials purged,[132] the banks largely remained outside the early restructuring of the economy, despite obvious levels of concentration.[133] To some degree, they even received preferential treatment. This could be seen most clearly with the adoption and execution of the two laws designed to promote competition: The Anti-Monopoly Law and the Deconcentration Law.

The Law Concerning the Prohibition of Private Monopolies and Methods of Preserving Fair Trade of 1947, or the Anti-Monopoly Law, attempted to ensure competition among Japanese companies.[134] To prevent recurrence of the Zaibatsu, the enactment barred corporations from owning shares of one another, essentially outlawing holding companies.[135] The law also imposed a number of specific restraints on banks, including a prohibition on interlocking directors.

In general, however, banks received less onerous treatment than other industries. Exempted from the prohibition on stock purchases, they could own up to five percent of the shares of other companies, although not financial institutions.[136] The ability to acquire the shares solidified relationships with Japanese companies and facilitated the rise, of the kieretsu system.[137] According to at least one SCAP official, this result was not foreseen.[138]

The first case brought under the Anti-Monopoly Law was against financial institutions. On December 22, 1947, the Commission ordered twenty seven financial institutions in the Tokyo area to "abolish the

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132. *See* Law for Termination of Zaibatsu Family Control, Law No. 2 of Jan. 7, 1948; *see also* Monograph No. 39, *supra* note 84, at 23 ("Under this law all bank officials were screened and if they had exerted controlling power on behalf of the Zaibatsu's interest, they were removed from office and barred from key positions for ten years.").

133. The six largest banks, including the four Zaibatsu banks, made 30 percent of all commercial loans by private banks. *See* ORIENTAL ECONOMIST, Oct. 30, 1948.

134. Law Concerning the Prohibition of Private Monopolies and Methods of Preserving Fair Trade, Law No. 54 of Apr. 12, 1947.

135. Originally, the Law banned corporate ownership of shares entirely, excepting only banks. This harsh and unworkable requirement ultimately had to be modified. ADAMS & HOSHII, *supra* note 66, at 25. The law was amended in 1949 to do away with the prohibition on intercorporate stockholdings. *See* The Anti-trust Monopoly Law, Law No. 214 of June 18, 1949. *See also* HADLEY, *supra* note 85, at 198.

136. *See* Article 11 of the Anti-Monopoly Law, Law No. 214 of 1947 ("Any company whose business is financial shall not own stocks in a company with which it is competing and which operates in the same field of financial business. No company whose business is financial and whose total assets (excluding unpaid-up capital stock, unpaid-up partnership share or claims rights) exceed five million (5,000,000) yen shall acquire stock of another company in case, by doing so, it holds in excess of five percent (5%) of the total issued stock of said company."), *reprinted in* YAMAMURA, *supra* note 58, at 204-205. The percentage was later increased to ten percent, *id*, and returned to five percent in the 1970s.

137. The decision to permit bank ownership of shares in non-financial companies has been criticized. *See* HADLEY *supra* note 85, at 187 ("The toleration of bank holdings in industrial, commercial, and mining companies was unfortunate, . . .").

138. Beplat interview, *supra* note 85.

agreement on interest rates," a practice that had been going on since before the war.[139] At least with respect to deposits, control over rates transferred to the government with the adoption of the Temporary Interest Rate Law.[140]

Preferential treatment for Japanese banks became more clear, however, with the implementation of the Law for the Elimination of Excessive Concentration of Economic Power, better known as the Deconcentration Law.[141] The law slated the largest Japanese firms for break-up.[142] Administration of the law ultimately fell to the Holding Company Liquidation Commission (HCLC).[143] Although covered by the explicit terms of the Act, banks were in practice exempted.

The treatment of the banks under the Law was brought to MacArthur's attention in late 1947. In addition to other objections, Prime Minister Katayama requested that MacArthur exempt banks.[144] Although reassuring the Prime Minister about the affects of the law, MacArthur refused the request.

> [s]ince a blanket exemption of such [banking] institutions from the dissolution program manifestly could be construed as tantamount to preserving one of the major influences from which stemmed the prewar monopolistic and militaristic controls, the adoption of your recommended procedure is inadvisable. The impact of reorganization upon economic recovery is to be a primary consideration in the reorganization planning for each institution, including financial, and therefore there should result no serious interference with normal financing methods. Further, wholly owned government institutions are not to be included in the deconcentration program.[145]

The General had spoken, the issue was closed. The Deconcentration Law would not exempt banks. MacArthur confirmed the position in a radio message to the Department of the Army the following January.[146]

With the Law in place, SCAP officials discussed what to do with the banks. Considerable sentiment within SCAP supported the break-up of the large banks. Only sixty one commercial banks remained after the war. Even more concentrated than the statistic indicated, seven banks, includ-

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139. Shunsaku Nishikawa, *The Banking System: Competition and Control*, JAPANESE ECON. STUD. 3 (Spring 1974). The agreement involved the determination of maximum rates paid to depositors and charged to borrowers.

140. The Diet adopted the law in direct response to the case. *Id.*

141. Law for the Elimination of Excessive Concentration of Economic Power, Law No. 207 of Dec. 18, 1947.

142. For a copy of the law, see THE FINANCIAL HISTORY OF JAPAN, *supra* note 81, 6-30, at 386.

143. *Supra* note 142.

144. Letter from Tetsu Katayama to Douglas MacArthur, SCAP Records, Suitland, Md. (Sept. 4, 1947).

145. Letter from Douglas MacArthur to Prime Minister Tetsu Katayama, SCAP Records, Suitland, Md. (Sept. 10, 1947).

146. HADLEY, *supra* note 85, at 163.

ing those from the defunct Zaibatsu, controlled the vast majority of banking business.

One proposal was to divide the country into three regions (Tokyo, Osaka and Northern Japan) with prohibitions on bank expansion into more than one area. The approach amounted to an import from Germany, where the country had been divided into three separate regions. As military officials went from Germany to Japan, they brought their occupation experiences with them.[147] Other proposals were more blunt. They simply wanted the larger banks dismantled. One called for the subdivision of the banks into "no less than two and no more than three separate, independent banks."[148]

None of these proposals ever saw the light of day. A fierce bureaucratic struggle occurred within SCAP over the proper treatment of Japanese banks under the Deconcentration Law. In general, the Antitrust and Cartels Division wanted to divide the Japanese banks, something vigorously opposed by the Finance Division. Welsh, Chief of the Antitrust and Cartels Division, constantly reminded General Marquat, head of the Economic and Scientific Section, of his obligations to subject banks to review under the Deconcentration Law.[149] To Welsh and others in the Antitrust Division, concentration threatened to handicap the nascent development of democracy.[150]

Welsh, however, ultimately lost, with Marquat siding with the Finance Division.[151] The General opposed the break-up and favored proposals designed to exempt them from the auspices of the HCLC.[152] The decision arose out of SCAP's fears over the continued solvency of financial

147. Beplat interview, *supra* note 85.

148. HAMM, DECONCENTRATION OF ECONOMIC POWER. JCS 1380/15, paras 13, 13a, 35a, *quoted in* COHEN, *supra* note 80, at 24.

149. *See, e.g.*, Memorandum from Edward C. Welsh, Chief, Antitrust and Cartels Division to Chief, Economic and Scientific Section, SCAP Records, Suitland, Md. (Apr. 26, 1948) ("SCAP is operating under basic directives (ref. JCS 1380-15, FEC 014, FEC 015) which state: 'You will require plans for dissolving large Japanese industrial and banking combines . . . . (and) . . . . you will establish and maintain surveillance, until satisfactory plans for reorganization have been approved over (such) Japanese businesses.' ").

150. Conversation with Eleanor Hadley, Former Official, Antitrust and Cartels Division, ESS (June 26, 1991). She indicated that some within SCAP had the fear that high concentrations of wealth would impede the development of democracy.

151. Some have criticized the division of authority over banks between the two Sections. *See id.* at 72.

152. *See* Memorandum for the Record, Economic and Scientific Section, SCAP Records, Suitland, Md. (Apr. 18, 1948) ("The General [Marquat] stated that necessary steps should be taken to dissolve such concentrations of power but that this did not necessarily require a breaking up of the banks themselves. He said that the operating structure should be looked into on this basis. He further stated that such action should be taken immediately to clarify the bank situation so that an announcement may be made in the near future to the effect that banks designated under the deconcentration law have been divested of any excessive concentration of financial control and were no longer subject to the provisions of the act.").

institutions.[153] As one SCAP document noted:

> Breaking up these banks [Yasuda, Teikoku, Mitsubishi, Sanwa and Sumitomo] would be almost certain to cause a loss of public confidence. Division of these banks would produce a group of smaller banks, the deposits in each of which would be insufficient to serve adequately the loan requirements of large borrowers. The ratio of money on deposit to money in circulation is already low. Breaking up these banks would further aggravate this condition. Moreover, each of these banks is now under-capitalized and is faced with the necessity of raising additional equity capital. A break-up would increase the difficulties of attracting this capital.[154]

With these concerns in mind, SCAP announced that banks would be exempt from application of the Deconcentration Law.[155] To pay lip service to the legislation, however, allied officials required banks to take steps to eliminate "those characteristics which tend to classify them as excessive concentrations of power."[156] In practice, however, that amounted to little.

The exemption from the Deconcentration Law did not go unnoticed. The banking sector remained highly concentrated, generating criticism.[157] The criticism engendered an almost defensive tone from SCAP officials.

> [I]t must be pointed out and emphasized that the development of large banks, (as well as small banks) based on sound banking principles and appropriate controls, is most essential in any modern economy. The objective is not to limit the development of properly managed institutions — be they large or small. The aim since the inception of the bank reorganization program has been the elimination of malpractices of all banks. The concept that an institution is evil merely because it is large is rejected. As an economy expands — as the tempo of recovery is speeded up with the accompanying increase in the size and activity of its component parts, it is necessary, normal and desirable that financial institutions serving that economy

153. HADLEY, *supra* note 85, at 242.

154. Memorandum from Roy S. Campbell, Deconcentration Review Board to SCAP (July 2, 1948), SCAP, *reprinted in* THE FINANCIAL HISTORY OF JAPAN *supra* note 81, 6-37, at 403.

155. YAMAMURA, *supra* note 58 ("In July, 1948, SCAP announced that the former Zaibatsu banks would be excluded from Law 207 [the Deconcentration Law], since, as SCAP stated, these banks had been divorced from the holding companies and were then in the purview of the Anti-Monopoly Act.").

156. Memorandum from W. F. Marquat, Chief, Economic and Scientific Section, for E. C. Welsh, Chief, Antitrust and Cartels Division (May 7, 1948), SCAP Records, Suitland, Md. The memorandum further required that "the banking institutions will submit plans for accomplishment of the above objectives, upon acceptance of which they will be free to continue operation without being subject to further reorganization under provisions of the deconcentration law." *Id.*

157. *See* Memorandum from W.F. Marquat, Chief, Economic and Scientific Section of SCAP, SCAP Records, Suitland, Md. (Mar. 4, 1950) ("[That] Japan had 71 ordinary banks having deposits of Y 705,564 million (Jan. 1950) of which ten banks controlled approximately 63 percent, as of 1 February 1950, would appear to compare favorably with respect to both a dispersion of economic power and fair inter-bank competition.").

should correspondingly develop in size and ability to serve the expanded requirements.[158]

Despite the controversy, SCAP never seriously reconsidered the position.[159] The big banks remained big.

IV. COMPARTMENTALIZATION

The fight over application of the Deconcentration Law was not the last word. Even those officials opposing breakup remained committed to increased competition. With only a small number of commercial banks, something had to be done.[160] The Finance Division within SCAP made the deliberate decision to lessen the influence of the small number of big banks by encouraging the recovery of a handful of additional financial institutions and by creating new classes of competitors.

Increased competition had a number of justifications. Despite the success in saving banks from the Deconcentration Law, SCAP officials were quite aware that a small number of large banks was prone to government manipulation. Competition also promised to ensure a more equitable distribution of loans. Despite elimination of the Zaibatsu, banks continued to favor preexisting clients and former members of the industrial groups.

By creating a new class of competitors, SCAP hoped to provide a source of lending not beholden to these relationships. Unlike the pre-war Zaibatsu banks, the new classes would have no preexisting business relationships. Those borrowers not in a Zaibatsu could therefore turn to the new banks for credit. This was particularly important given the difficulties confronted by small businesses obtaining loans.[161]

Increased competition was also expected to benefit the city banks. With other sources of capital, the multitude of companies from a former Zaibatsu no longer had to look exclusively to the group's lead bank for

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158. Letter from W.F. Marquat, Chief, Economic and Scientific Section to the Hon. W.J. Sebald, Chief, Diplomatic Section, SCAP Records, Suitland, Md. (undated).

159. *See* Memorandum from W.F. Marquat, Chief, Economic and Scientific Section, SCAP Records, Suitland, Md. (Mar. 4, 1950) ("Reference is made to an article contained in the Nippon Times of 2 March 1950 (copy attached) in which it was reported that, at the 108th meeting of the Allied Council, the British Commonwealth member made the following statements: (a) that his Mission has information that eight of Japan's banks 'control 80% of the industrial and economic life of this country.' (b) that SCAP 'may have' dissolved the Zaibatsu but (he asked) whether if (destroying one evil) another one - the bank's - had been established.").

160. *See* Monograph No. 39, *supra* note 84, at 30 (noting that in 1949, the ten largest banks were Fuji, formerly Yasuda (186 branches); Teikoku (100 branches); Dai-Ichi (81 branches); Bank of Tokyo (39 branches); Chiyoda, formerly known as Mitsubishi (158 branches); Tokai (205 branches); Daiwa, formerly known as Nomura (101 branches); Sanwa (194 branches); Osaka, formerly known as Sumitomo (159 branches); and Kobe (166 branches).

161. *See, e.g.*, Memo from R. E. Phillips, Credit Policy Unit, Finance Division, ESS, Re: Foreign Trade Financing, SCAP Records, Suitland, Md. (Oct. 9, 1947).

financing. Not representing the exclusive source of financing for all of the companies within the industrial complex, city banks could concentrate on particular industries and particular lenders.[162]

Simply creating additional financial institutions was not, however, enough. The size and dominance of the city banks meant that new entities could be easily elbowed aside. SCAP, therefore, embarked on a deliberate policy of compartmentalizing the banking system. This essentially involved the walling off of different areas from encroachment by the city banks. Under the tutelage of SCAP, city banks found that they could not engage in securities activities, have trust departments, or sell debentures. Compartmentalization ensured survival; companies or banks performing these tasks did not have to fear absorption and domination by the large commercial banks.

The broad approach of creating new competitors had to overcome the stiff opposition within the MoF.[163] In general, MoF's goal was to oppose further concentration. Since the 1920s, MoF had been engineering a reduction in the number of banks. Ultimately, however, the MoF accepted compartmentalization, in part because the practice enhanced bureaucratic authority.

The first public statement promoting an increase in the number of competitors apparently emerged from the report of the Edwards Mission. More formally labeled the State-War Mission on Japanese Combines, the group consisted of representatives of a handful of agencies and departments (and one law professor). They descended on Japan in 1946, primarily to study the Zaibatsu. Among other things, the Mission recommended that "the number of independent sources of credit should be increased substantially. . . ."[164] The only specific example provided in the report, however, was divestiture of banks forcibly amalgamated by the government and the division of the largest banks.

ESS accepted the recommendation but not the method of implementation. Instead of downsizing existing banks, SCAP favored the creation of new classes of financial institutions. Occupation officials, therefore, continuously looked for ways to increase the number of participants in the financial sector. Conversion of savings into commercial banks and the expansion of the number of regional banks all facilitated competition.[165]

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162. *See* Letter from W.F. Marquat, Chief, Economic and Scientific Section to the Hon. W.J. Sebald, Chief, Diplomatic Section (undated). SCAP Records, Suitland, Md. ("The increase of the number of independent sources of credit has broadened the borrower's choice of selection among the lending institutions. This has made it possible for the large banks, including the former Zaibatsu banks, to better serve basic industries through being relieved of the necessity of servicing the numerous industrial affiliates formerly controlled by Zaibatsu interest.").

163. Beplat interview, *supra* note 85.

164. *See Policy on Excessive Concentrations of Economic Power in Japan, Report of the Mission on Japanese Combines*, May 12, 1947, *reprinted in* THE FINANCIAL HISTORY OF JAPAN, *supra* note 81, at 350, 355.

165. Letter from W.F. Marquat, Chief, Economic and Scientific Section to the Hon.

Teikoku Bank, formed through an amalgamation of Mitsui and Dai-Ichi Bank in 1943, dissolved in October 1948, generating two additional financial institutions.[166]

International operations represented another area affected by SCAP's pro-competition policy. Elimination of the Yokohama Specie Bank paved the way for other Japanese banks into the international arena. SCAP, however, went to great lengths to ensure that the newly formed BoT and small handful of city banks did not obtain a stranglehold over international activities.[167]

The Japanese government divided banks into two classes. Class A banks could engage directly in international activities by entering into correspondent bank relations and opening accounts with foreign financial institutions. Class B banks, in contrast, had to operate through those in Class A.[168] The classification, therefore, amounted to a limitation on the scope of international activities.

MoF initially attempted to limit those in Class A to eight city banks, five from the defunct Zaibatsu. SCAP, however, would have none of that. Designation of Japanese financial institutions as foreign exchange banks required SCAP approval, providing considerable leverage.[169] To address the concerns, MoF added four other banks to the list.[170] Occupation officials also contemplated that, as Class B banks obtained international expertise, they would move to Class A.[171]

Trust activities represented another area compartmentalized as a result of efforts by SCAP. In the aftermath of the war, trust companies had largely seen their business evaporate and their assets become worthless.[172]

W.J. Sebald, Chief, Diplomatic Section, (undated). SCAP Records, Suitland, Md.

166. HADLEY, *supra* note 85, at 119.

167. *See, e.g.*, Memorandum attached to letter from W. F. Marquat, Chief, Economic and Scientific Section, to The Honorable W. J. Seabald (undated). SCAP Records, Suitland, Md. ("The Yokohama Specie Bank, Ltd., which had monopolized the Japanese foreign exchange business, had been placed in liquidation prior to the reorganization of the other Special Banks. To avoid further monopolistic controls by any one institution, plans were made at that time whereby all banks properly staffed with foreign exchange specialists would take over the foreign exchange functions at such time as SCAP would authorize the reopening of foreign exchange business.").

168. KEN BIEDA, THE STRUCTURE AND OPERATION OF THE JAPANESE ECONOMY 147 (1970).

169. *See, e.g.*, Memorandum from Chief of Fund Section, Account Bureau, Board of Trade to Mr. Cleveland, Fund Control Division, ESS, GHQ, SCAP, BOTA # 8825-II-25, SCAP Records, Suitland, Md. (Aug. 17, 1948) (requesting approval for designation of Hokkaido Colonial Bank as foreign exchange bank).

170. Bank of Kobe, Daiwa Bank, Tokai Bank and Nippon Kangyo Bank were all added at the behest of SCAP officials, THE OCCUPATION OF JAPAN, *supra* note 90, at 238. Trust banks and a number of regional banks were also encouraged by SCAP to become Class B foreign-exchange banks. *Id.* at 234 n.48.

171. This amounted to another example of wishful thinking. Once the occupation ended, international expansion remained a monopoly of the Bank of Tokyo and a small number of city banks, much the way it had been before the war.

172. *See* Monograph No. 39, *supra* note 84, at 23 ("A large part of their portfolios consisted of securities issued by closed institutions, restricted corporations and special ac-

Post-war inflation and a prohibition on securities activities further eviscerated their business.[173] The companies also suffered from the entry of commercial banks into the trust business during the war.

To ensure solvency, SCAP wanted MoF to increase the powers of the trust companies by allowing them to engage in banking activities.[174] SCAP officials ran into a brick wall, with MoF resisting the entreaties. The MoF wanted the large city banks to absorb the trust companies, eliminating them as a separate class of institutions.[175] The Banking Bureau stonewalled, claiming that legislative changes by the Diet were necessary to implement the plan.[176]

With an impending change of personnel at SCAP, however, the Ministry had a change of heart. The replacement might not be so accommodating or might insist on unacceptable terms. The Director General of the Banking Bureau suddenly announced that in fact, MoF had the administrative authority to extend banking powers to trust companies. With a wave of the wand, the SCAP reforms were implemented and trust companies received banking powers.[177] Six of seven trust companies reorganized as banks with one opting to become a securities firm.[178]

Acceding banking powers to trust companies did not guarantee survival. The possibility that city banks would dominate the trust area still remained a concern. Occupation officials encouraged MoF to force commercial banks out of the trust business.[179] Furthermore, at SCAP's insistence, trust banks received the authority to issue long term loans. Companies flocked to the new banks in search of financing.

Finally, the separation of banking and securities functions further illustrated to the compartmentalization process. Adopted during the occupation, Section 65 of the Securities and Exchange Law prohibited banks from selling stocks, bonds and other securities. The separation represented an oddity with broad consequences.

Unable to sell corporate stock or debt, banks lost an obvious revenue source. That in turn solidified dependence upon the BoJ as a source of

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counting companies and the utilization of these securities was for all practical purposes impossible.").

173. *See* Monograph No. 39, *supra* note 84, at 26. The prohibition was contained in the Securities Transaction Law of 1948. ADAMS & HOSHII, *supra* note 66, at 109.

174. Beplat, *supra* note 85, at 239.

175. Beplat interview, *supra* note 85.

176. B.C. KOH, JAPAN'S ADMINISTRATIVE ELITE 208 (1989).

177. Beplat interview, *supra* note 85.

178. Sumitomo (Fuji Bank and Trust Co., Aug. 2, 1948); Mitsui (Toyo Bank and Trust Co., Aug. 2, 1948); Mitsubishi (Asahi Bank and Trust Co., Aug. 2, 1948); Yasuda (Chuo Bank and Trust Co., Aug. 2, 1948); Dai-Ichi (Dai-Ichi Bank and Trust Co., July 12, 1948); and Nippon (Nippon Bank and Trust Co., July 12, 1948).

179. *See* FEDERATION OF BANKERS ASSOCIATION, *supra* note 18, at 15, ("After the war, however, the GHQ and the Ministry of Finance intervened with the policy that once again separated banking and trust businesses.").

funds.[180] The separation also deprived financial institutions of any incentive to encourage companies to pursue alternative capital sources such as the sale of stock. The elimination of banks from the securities markets retarded development of the stock market and contributed to an immense concentration in the brokerage community.[181]

The separation, at first blush, seemed to have an ethnocentric explanation. The United States had in place a comparable requirement. Congress separated securities and banking functions in 1933, having concluded that the Great Depression resulted at least in part from risky securities ventures by banks. In fact, however, article 65 arose not out of a desire to replicate the extent regulatory system in the United States, but to increase competition.[182] Prohibiting banks from engaging in securities activities guaranteed that an independent class of brokers firms would emerge. The plan worked with unparalleled success. By the 1970s, brokers had become so successful that they rivaled commercial banks in financial and political power, generating considerable conflict.

Occupation officials also approved the division of banks on the basis of short term and long term lending capacity, although only after a number of embarrassing shifts in policy. The three pre-war debenture issuing banks, Hypothec Bank, Hokkaido Colonial Bank, and the Industrial Bank of Japan (IBJ), were initially slated for closing.[183] SCAP had little interest in preserving the special authority of these institutions. Debenture issuing banks designed primarily to provide long term financing also seemed unnecessary. Occupation officials expected an invigorated stock market to eliminate the need for a special class of banks designed to more long term loans.[184]

After some thought and government opposition, SCAP decided against liquidation. Upon "mutual agreement," SCAP gave the banks the

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180. Depriving banks of authority to underwrite was also consistent with the separation of long and short term financing. Permitting involvement in the sale of corporate securities would have resulted in the anomalous situations of commercial banks prohibited form making long term loans but permitted to facilitate long term financing through the sale of corporate stocks and bonds.

181. Four brokerage firms ultimately monopolized the market: Nomura, Daiwa, Nikko and Yamaichi.

182. Beplat interview, *supra* note 85. *See also* FEDERATION OF BANKERS ASSOCIATION, *supra* note 18, at 16 ("The law was based on a desire to protect and strengthen Japanese securities companies, . . .").

183. *See* Memorandum from J.R. Allison, Director of Finance (acting), to Chief, Economic and Scientific Section, SCAP Records, Suitland, Md. (Mar. 29, 1950) "the initial approach toward the debenture issuing banks from 1945 was directed toward necessary reforms to be applied to the Japanese banking structure - designed to eliminate malpractices and control devices. FEC 230, 12 May 1947, ¶ 12d states: 'the functions and powers of special banks should be defined and limited by law and these banks should not be allowed to engage in ordinary banking. The need for the existence of the special banks should be reviewed in order to determine whether certain of these banks might not revert to the status of ordinary banks.' ").

184. *See* Pressnell, *supra* note 38, at 204.

choice of reorganizing either as a long term or a commercial bank.[185] In 1948, the Hypothec and Hokkaido Colonial Bank converted to ordinary commercial banks while the IBJ opted for bond-issuing powers. Viewed as a transitory measure,[186] SCAP expected the IBJ to eventually convert to an ordinary commercial bank.[187]

When the stock market did not recover Japanese companies, desperate for capital, began to look increasingly to commercial banks. The weak state of Japanese industry made the loans unattractive. As MoF officials noted:

> Private financial institutions lately are showing a strong tendency to limit lending to relatively large enterprises in order to avoid troubles and risk in giving loans to petty business. Such a tendency can be seen even in small-scale local banks. In spite of the fact that our country's industrial structure is founded largely on the basis of small and medium height and size enterprises and farming, forestry and fishing industries also are operating, in the main, on a small scale, and most of them are worthy of continued existence, they have been neglected by financial institutions and been suffering from shortage of money.[188]

For banks to provide capital in necessary quantities, two things had to occur: they needed funds beyond what could be generated through deposits and they needed increases assurances of repayment.

To alleviate the risk and encourage lending, the BoJ provided an implicit guarantee of repayment. To the extent funds went to appropriate companies, the central bank stood ready to repay in the event of default. Banks no longer had to worry about risks associated with an uncertain economy. These policies encouraged banks to step up lending activities.[189]

The next problem was funding. The deposit base proved inadequate.

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185. *See* Memorandum from Walter K. LeCount, *supra* note 87, (discussing options of special banks; to be given choice of reorganizing as ordinary commercial bank or as a debenture issuing corporation).

186. *Id.* ("Under the prevailing conditions of the debt issuing market, the idea also is considered inadvisable in relations to the supply of long-term industrial funds. For these reasons, it is believed advisable to adopt such transitory measures as will be enumerated below, so that the Industrial Bank may be allowed to bolster its functions as a deposit bank under certain restriction and at the same time authorized for the time being to issue its debenture.").

187. *See, e.g.*, Letter from H. Ichimada, Governor, Bank of Japan to General W.F. Marquat, Chief, Economic and Scientific Section, (July 16, 1948) SCAP Records, Suitland, Md. ("Although it is believed advisable for the Industrial Bank of Japan to develop itself into an ordinary bank in the future, considerable difficulties will have to be encountered in materializing such a plan all at once today in view of the present conditions of the same bank.").

188. JAPANESE MINISTRY OF FIN., ON SOME MEASURES FOR CORRECTING THE CURRENT TIGHTNESS IN MONEY MARKET, SCAP Records, Suitland, Md. (1948).

189. The over loan situation had also been a characteristic of the financial system in the early Meiji era. By the end of World War I, however, Japanese commercial banks were no longer dependent on loans from the BoJ. As one writer described, the banks viewed dependence on the central bank as "shameful." YOSHIO SUZUKI, MONEY AND BANKING IN CONTEMPORARY JAPAN 9 (1980).

SCAP knew about the shortage of yen and favored giving all commercial banks the authority to issue debentures.[190] Adopted in 1950, the Law Concerning Debenture Issues of Banks did exactly that.[191] The Law theoretically ended the pre-war distinction between short and long term banks. With the simultaneous abolishment of special banks,[192] Japan temporarily had "an undifferentiated system of commercial banks."[193]

The legislation did not work as expected. Although permitted to issue debentures, most commercial banks did not.[194] Moreover, dependent on deposits and other short term sources of funding, commercial banks were increasingly asked to absorb greater amounts of long-term debt.[195] This threatened to cause financial instability.

In response, SCAP shifted gears. Rather than leave long-term lending to the banking system as a whole, occupation officials opted for a class of banks specifically for that purpose.[196] Taking the steps required a somewhat embarrassing policy shift. After all, the decision essentially res-

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190. *See* Marquat Letter, *supra* note 113 ("The inception of this program [the Dodge line] brought into sharp focus the shortage of any urgent necessity for a most substantial volume of long-term credit. The generation of an increased long-term capital funds can most properly an expeditiously be implemented through full employment of bank debentures. Accordingly, legislation is currently before the Diet authorizing all banks to issue debentures up to 20 times capital.").

191. Most of the bonds were purchased by the BoJ. *See* SCHIFFER, *supra* note 13, at 75.

192. The adoption of the Law Abolishing the Hypothec Bank of Japan Law etc., in 1950 permanently ended the system of special banks. *See* Pressnell, *supra* note 38, at 48.

193. NAKAMURA, *supra* note 65, at 140.

194. *See* Pressnell, *supra* note 38, at 205 (noting that debentures were issued only by the Nippon Kangyo Bank, the Industrial Bank of Japan, the Hokkaido Takushoku Bank, the Central Co-operative Bank of Agriculture and Forestry, the Central Bank for Commercial and Industrial Co-operatives and the Bank of Tokyo). *See also* G.C. ALLEN, JAPAN'S ECONOMIC RECOVERY 44 (1958) ("It is true the legal distinction between those banks and the ordinary banks was destroyed in 1950 when all banks were given the right of issuing debentures within certain limits. In practice, however, the privilege was exercised only by three of the former Special Banks, and by them only because the government subscribed to there stocks and debentures form the United States Aid Counterpart Fund and from the Treasury Deposits Bureau.").

195. *See* Memorandum from Joseph M. Dodge to Major General W.F. Marquat, Re: Banking and Bank Credit - Private Debt - Capital Funds Availability, SCAP Records, Suitland, Md. (Nov. 29, 1950) ("The normal and establisher specialized banking mechanisms for supplying long-term credit (viz., Industrial Bank and others) largely had been eliminated and the banking system reduced solely to one of commercial banks, the latter had been forced to absorb a larger amount of long-term credit than their fundamental status should require.").

196. By the end of 1950, Dodge had come around to this view. *See* Memorandum from Joseph M. Dodge to Major General W. F. Marquat, Re: Industrial Financing, SCAP Records, Suitland, Md. (Dec. 3, 1950) ("I believe that it is generally agreed among the Japanese financial officials and authorities that there is a need in Japan for the Industrial Banks to resume its exclusive functions of industrial financing of a long-term nature . . . . I have told Mr. Ichimada, the head of the Industrial Bank, and Mr. Ikeda that if the idea of reestablishing this bank as exclusively a long-term loan bank is valid and the initiative for this move was to come from them rather than from us, I believe it might receive favorable consideration.").

urrected the carefully and deliberately eliminated "special banks."[197] Nevertheless, economic exigencies and Joseph Dodge compelled the return of long term banks.[198]

Under the auspices of SCAP, the Diet adopted the Long-Term Credit Banks Law in 1951. The law provided for a class of long term banks to provide capital needs of companies. Commercial banks simultaneously lost the power to issue debentures.[199] The IBJ predictably chose to organize as a long term bank. The IBJ had been acting in that capacity since the end of the war.

The other two pre-war banks with debenture issuing authority, the Nippon Kangyo Bank and Hokkaido Takushoku Bank, opted to remain ordinary commercial banks. They did, however, assist in the formation of, and contribute assets to, the Long-Term Credit Bank, with Nippon Kangyo Bank essentially contributing its investment banking operations. The Nippon Credit Bank, the last of the long term banks, emerged five years later out of the remnants of the Bank of Chosen to provide capital for smaller companies.[200]

V. THE AFTERMATH

The immediate post-occupation period saw a flurry of legislation ratifying existing division within the banking system. Tilting to reality, the government codified the de facto distinction between long term and commercial banks.[201] The Long-Term Credit Law of 1952 authorized designated banks to issue five year bonds and one year discounted debentures.[202] Only banks organized under the law could issue the debt.

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197. *See id.* ("If I am correctly informed, I believe the change of [the Industrial Bank of Japan's] functions from industrial financial banking was at least partially initiated by this headquarters. That places us in a somewhat embarrassing position of having to reverse a previous action, if this is to be done.").

198. Dodge, a Detroit banker, had been sent to Japan to devise a strategy for returning the country to a sound economic footing. The so called "Dodge Line" called for, among other things, a balanced budget, something that remained in place until the mid-1960s. *See generally* COHEN, *supra* note 80, at 431.

199. With city banks no longer having the authority to issue debentures, they were dependent for financing on deposits, loans from other banks and the government. The government did not let them down. The BoJ expanded credit to banks by 60%. COHEN *supra* note 80, at 438. As Cohen noted, without the overloans, "Japanese business would have been left gasping like fish washed up on the beach." *Id.*

200. YOSHIO SUZIKI, MONEY AND BANKING IN CONTEMPORARY JAPAN 102 (1980). In addition to government ownership of shares, capital for the bank came from assets of the liquidated Bank of Chosen. The Bank had a slightly different purpose than the other long term banks. "[T]he chief business of this bank is the supply of equipment funds and long-term working capital secured by mortgages to small enterprises." *Id.* at 104.

201. Extending debenture issuing powers to all banks simply did not work. The IBJ did issue debentures and make long term capital loans, much as it had before the war. Most other banks failed to take advantage of the authority. Only the Nippon Kangyo Bank, the IBJ, the Hokkaido Takushoku Bank, the BoT and a handful of specialized institutions issued debentures under the law. *See supra* note 200, at 128.

202. The BoT eventually received the authority in the 1960s to issue debentures with

Legislation in the immediate post-occupation period also confirmed the position of trust banks. With the revival of investment trusts (mutual funds), trust banks were allowed to act as trustee, a highly lucrative position.[203] More importantly, the Diet adopted the Loan Trust Law authorizing the banks to collect long term funds (two to five years) to make loans for a specified purpose.[204] Loan trust certificates resembled certificates of deposit, something city and regional banks could not issue for almost 30 years. MoF, of course, carefully controlled the loans, insuring proper direct flow to "critical industries,"[205] primarily shipping, electricity, coal, iron and steel.[206] By 1962, trust banks also received the authority to manage pension plan assets.[207]

The 1950s also saw completion of the process of separating trust and commercial banking activities, something begun during the occupation.[208] Four city and seven regional banks had continued to engage in trust activities.[209] Although "encouraging" commercial banks to divest their trust activities since 1954, the Banking Bureau within the MoF ordered complete separation by city banks only as the decade ended. By 1966, the last redoubts among regional banks disappeared.[210]

No legislation decreed the separation. Quite the contrary. City banks received express authority to engage in trust activities through legislation adopted during the war. That mattered little to MoF. Trust banks needed protection. Divestiture also tightened MoF's grip over the banking sector. Deprived of trust activities, commercial, particularly city, banks lost another source of revenue. This made them even more dependent upon lending activities and, concomitantly, borrowings from the BoJ.

The early post occupation years also saw the codification of the preeminent international position of the BoT. The Foreign Exchange Bank Law of 1954 provided for a specially designed foreign exchange bank, primarily for export financing. The law was adopted with the expectation that only the BoT would register. Having absorbed much of the staff of the YSB, the BoT presented the only Japanese bank with the expertise

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maturity of three years. For a brief discussion of debt issuing authority by long term banks, *see* TAKEDI YAMASHITA, JAPAN'S SECURITIES MARKETS, A PRACTICAL GUIDE 160 (1989).

203. The resurgence of the investment vehicles coincided with the adoption of the Securities Investment Trust Law in 1951.

204. Funds raised under the Loan Trust Law were deposited for a fixed period of time. With minimum deposit amounts of 10,000, the principal and interest of the deposits were guaranteed. *See* ADAMS & HOSHII, *supra* note 66, at 111.

205. *See* NAKAMURA, *supra* note 65, at 141. *See also* Pressnell *supra* note 38, at 225.

206. SUZUKI, *supra* note 200, at 114 (plan of trust property administration must be submitted to MoF for approval); *see also* Pressnell, at 226 (noting that at one time MoF had restricted loans to industries other than those five).

207. ADAMS & HOSHII, *supra* note 66, at 110.

208. Beplat interview, *supra* note 85; *See also* THE BANKING SYSTEM *supra* note 18, at 15 ("After the war, however, the GHQ and the MoF intervened with a policy that once again separated banking and trust businesses.").

209. THE BANKING SYSTEM, *supra* note 18, at 15.

210. *Id.*

and depth capable of handling extensive international activities.

By the early 1950s, the BoT had already begun spreading abroad. The bank had offices in New York, London, California, India and Pakistan.[211] Designation under the law ensured favorable treatment in opening overseas branches. The MoF also used the bank as an agent for various activities abroad. In committing to the international arena, however, BoT paid a price. Domestic operations were restricted with the bank forced to close all offices not related to trade finance.

VI. THE PRESENT

Despite some initial opposition, MoF came to agree with SCAP's vision of the banking system, although with a twist. While originally preferring increased consolidation, the MoF gradually recognized the value of a compartmentalized financial sector. The functional divisions gave each category of banks a particular niche in the financial system, something that appealed to MoF's sense of order.

Not coincidentally, compartmentalization also increased MoF's ability to control activities in the financial markets. City banks could not regain the size and influence of the old Zaibatsu banks, making them less capable of standing up to MoF influence. In addition, by dividing banks on the basis of funding, they became dependent upon the government largess, particularly the BoJ, for additional funds to lend.

MoF used the control to maintain order throughout the financial system. Relying upon "administrative guidance" or informal advice, the MoF insisted that banks pre-clear all major developments.[212] This gave MoF extraordinary power to control the course of events before they occurred, an opportunity MoF used with vigor. Most notably, MoF invoked guidance to force commercial banks out of the trust business notwithstanding express legal authority to emerge in the activity.

Banks followed MoF advice in part because they feared the consequences of not doing so. Primarily through the power to approve or disapprove the establishment of new branches, the MoF had the ability to limit the expansion of recalcitrant banks.[213] Daiwa Bank suffered exactly those consequences after refusing to follow Ministry guidance and divest

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211. Interview with Seishichi Itoh, Senior Managing Director, Bank of Tokyo, Tokyo (Mar. 1992).

212. In Japanese the phrase is *gyosei shido*. *See* Allan D. Smith, *The Japanese Foreign Exchange and Foreign Trade Control Law and Administrative Guidance: The Labyrinth and the Castle*, 16 LAW & POL'Y INT'L BUS. 417, 418 n. 6 (1984); *see also* Yoriaki Narita, *Administrative Guidance*, 2 LAW IN JAPAN 45, 54 n. 13 (1968) ("Fundamentally, circulars are employed as a means of direction and supervisor over interior administrative structure, but they are also issued to inform juristic persons and associations outside the administrative structure as to definitive matters."). For a legal discussion of the subject, *see* Young, *Judicial Review of Administrative Guidance: Governmentally Encouraged Consensual Dispute Resolution in Japan*, 84 COLUM. L. REV. 923, 953 (1984).

213. *See* The Banking Law, *supra* note 31.

trust activities.[214]

The banks accepted the stifling degree of administrative control not only out of fear. A broad consensus existed within the banking community and society as a whole that government manipulation of the financial system to promote economic growth was acceptable. More to the point, banks flourished under the system.

In return for regulatory submissiveness, financial institutions received assured profitability. By restricting available alternative investment vehicles, individuals had little choice but to deposit surplus funds with banks. Controls on interest rates ensured depositors an anemic return. With loan demand kept high, particularly through restrictions on other types of corporate borrowing, and cost of funds low, Japanese banks had no difficulty turning a profit.[215] Even the risks associated with high levels of corporate borrowing were ameliorated by implicit repayment guarantees.[216]

Through the 1990s, little was done to alter this basic framework. Reforms occurred in each decade, but they amounted to mere refinements rather than wholesale revisions.[217] Compartmentalization seriously eroded only with the adoption of reforms in 1992 and only after MoF determined that segmentation no longer had the same benefits.

The more modern story of the decompartmentalization process warrants a story in and of itself. For one thing, the domestic process of achieving a consensus on the changes entailed an eight-year struggle that essentially involved a pitched conflict between banks and securities firms. Brokers rightfully feared that banks, with their close relationships to corporate Japan and extensive branch networks, would provide considerable competition for securities business.

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214. Daiwa's president refused to give up the trust activities, apparently feeling that they were too critical to the bank's future. The validity of his reasoning aside, the practical effect was that he resisted the guidance of the Ministry. Daiwa's approach was not well received. Future branch applications received a cold shoulder. Daiwa was also effectively excluded from the Loan Trust Law and appartenly had difficulties getting approval for branch licenses. The message was clear: ignore the Ministry's guidance at great peril.

215. The system also provided other advantages. As Chalmers Johnson has noted, emphasis on lending as the primary source of profits also imposed on banks considerable incentive to uncover growth companies that would provide new sources of loans. JOHNSON, *supra* note 87, at 206.

216. James C. Abbelgan & William V. Rapp, *Japanese Managerial Behavior and 'Excessive Competition'*. 8 THE DEVELOPING ECONOMIES 430 (Dec. 1970). MoF's control also extended to the BoJ. Legislation passed during the war gave MoF explicit authority to review the actions of the Central Bank. *See* Bank of Japan Law, *supra* note 66. In practice, however, the authority was never invoked. Control also emanated from the practice of having a retired ministry official serve as Governor of the Central Bank every other term.

217. The 1950s saw the addition of reserve requirements; the 1960s laws facilitating mergers; and the 1970s the inclusion of a deposit insurance scheme. Even in 1980, when the Banking Act was amended comprehensively for the first time since 1927, the changes did little to alter the basic regulatory scheme. *See generally* FRANCIS MCCALL ROSENBLUTH, FINANCIAL POLITICS IN CONTEMPORARY JAPAN (1989).

Foreign pressure also played a significant role in the reforms. As a result of government pressure, primarily from the United States, foreign banks were, in the mid-1980s, allowed to engage in trust and securities activities. They permanently fractured the symmetrical system of banking compartments. With the changes, extension of comparable authority to Japanese banks became a foregone conclusion.

The reforms will also, over the long term, impact the relationship between the MoF and the private sector. In the short term, deregulation will, ironically, enhance MoF authority. MoF has made clear that the decompartmentalization process will be carefully managed. While banks will have the authority to engage in securities activities, initially they will be limited to primary offerings of debt securities, and they will not be able to underwrite equity securities or engage in stock brokerage activities.[218]

MoF also imposed firewalls designed to separate the securities subsidiary from the parent bank. This included restrictions on the bank personnel that could work for the subsidiary and limits on the exchange of information between the two entities. The securities subsidiary could not operate out of the headquarters of the bank. Finally, city banks could not set up a subsidiary for the first year after the effective date of the law, giving an advantage to trust and long term banks.[219]

With respect to trust bank subsidiaries, banks and securities firms were allowed to engage in certain designated money trusts. They were, however, barred from the most lucrative areas, particularly pension trusts. MoF also imposed firewalls separating the trust subsidiaries from the parent bank or securities firm.[220]

These restrictions will likely end over time. Until then, however, the legislation has given MoF additional leverage. Banks and securities firms seeking expanded authority will need to maintain strong relations with the Mof and to observe the government's guidance.

Over the long term, however, decompartmentalization will result in a reduction in MoF control over the financial system. Banks will have greater operating latitude, capable of obtaining profits from a more diverse group of activities, including trust and securities activities. They will also have additional funding sources, particularly loan trust certificates. When the decompartmentalization process has been completed, banks will also end up with some type of bond issuing authority.

All of this will reduce bank dependency on government policies. The

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218. Additional restrictions also apply. Initially a securities subsidiary will not even be able to lead manage a debt offering where the company has less than Y500 billion in net assets and the parent was the commissioned bank during the previous two years. *See* JAPANESE MINISTRY OF FINANCE, DETAILED ARRANGEMENTS OF THE FINANCIAL SYSTEM REFORM, PROVISIONAL UNOFFICIAL SUMMARY, (Dec. 1992).

219. *Id.*

220. *Id.*

additional funding sources will reduce dependency on branch license and borrowings from the BoJ, two important sources of government leverage. Additional activities will reduce the need to follow government guidance in order to ensure adequate levels of profitability.

More intriguing, the growing strength of city banks, a trend arrested by the occupation-inspired policy of segmentation, may resume. Whether through competition or acquisition, city banks will have the wherewithal and the contacts to make considerable inroads into other segments of the financial markets.[221] Some classes of banks, trust banks, for example, may disappear altogether.

As the size and strength of city banks grows, they remain less permeable to MoF influence. Indeed, they may actually emerge as effective counterweights to MoF authority, a function similar to the one served by the Zaibatsu banks before the war. The net effect would be a fundamental realignment in the role of the government in the financial markets.

221. While MoF currently opposes acquisitions, this clearly does not apply in the context of an ailing bank or broker. City banks may be allowed to acquire existing entities if necessary to stave off insolvency.