# Preference Formation, Negotiations and Implementation:

# Japan and the Basle Capital Accord

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Ph.D Thesis

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## ABSTRACT

The aim of this thesis is to elucidate the position of Japanese bank regulators in the international harmonising process of the capital standards set by the Basle Committee on Banking Supervision and in the domestic politics of banking regulation. An attempt is made to test a two-level-game model that positions Japanese regulators as the link between international and domestic politics. The thesis systematically assesses the strengths and the weaknesses of the two-level approach, and considers the validity of alternatives—systemic- and domestic-level approaches. The selection of case studies is made on such a basis: the case of negotiation processes and that of implementation. On the one hand, a close look at Japanese regulators' preference formation and behaviour through a filter of the two-level-game framework allows us to better understand their behaviour at the negotiation process. The thesis presents a counterexample to mainstream systemic-level explanations about the forces leading to the Japanese Ministry of Finance's negotiating position. The MoF was tactically motivated to use the internationally agreed rules and norms to legitimise its domestic policies and to shore up its position in the domestic politics. On the other hand, the thesis points out limits to the logic of two-level-game approach concerning implementation and compliance issues. The hypotheses derived from the logic of two-level-game approach do not sufficiently explain ineffectual Japanese compliance with the Basle Accord. Both domestic institutional "capacity" and the "willingness" of regulators are important in determining the degree of compliance. These institutional and intentional factors underline the possibility that the Basle rules can be sabotaged by vested interests at the implementation phase. With regard to implementation issues, therefore, more persuasive explanations come from the domestic-based argument that dysfunctional domestic institutions hampered Japanese credible commitments to the Basle Accord.

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## Abbreviations and Acronyms

| | |
|---|---|
| BoE | Bank of England |
| BoJ | Bank of Japan |
| CAD | Capital Adequacy Directive, the European Union |
| CDs | certificates of deposits |
| EE C | European Economic Community |
| EU | European Union |
| FBAJ | Federation of Bankers' Associations of Japan |
| Fed | Federal Reserve Board |
| FDIC | Federal Deposit Insurance Corporate |
| FDICIA | Federal Deposit Insurance Corporate Improvement Act |
| FRNs | floating Rate Notes |
| FSA | Financial Supervisory Agency, Japan (June 1998-March 2001) |
| FSA | Financial Services Agency, Japan (March 2001-) |
| FSA | Financial Services Agency, the U.K. |
| FSRC | Financial System Research Council, Japan |
| G-7 | group of seven major developed economies (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States) |
| G-10 | group of eleven major IMF contributors (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States) |
| G-30 | Group of Thirty |
| IAS | International Accounting Standards |
| IASB | International Accounting Standards Board |
| IASC | International Accounting Standards Committee |
| IBJ | Industrial Bank of Japan |
| IIF | Institute of International Finance |
| IMF | International Monetary Fund |
| ISDA | International Swaps Dealers' Association |
| LIBRO | London interbank interest rate |
| LTCB | Long-term Credit Bank of Japan |
| LDP | Liberal Democratic Party |
| MAFF | Ministry of Agriculture, Forestry and Fisheries, Japan |
| MoF | Ministry of Finance, Japan |

| | |
|---|---|
| NIFs | note issuance facilities |
| NPLs | non-performing loans |
| OCC | Office of the Comptroller of the Currency |
| PCA | prompt corrective action |
| PARCO | risk-adjusted return on capital |
| RUFs | revolving underwriting facilities |
| VAR | value at risk |

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# Chapter 1

# Introduction: Japan and International Banking Regulation

## 1.1 Japan and the Basle Banking Regulation

### *1.1.1 Theme*

The aim of this thesis is to elucidate the position of Japanese bank regulators in the international harmonising process of the capital standards set by the Basle Committee on Banking Supervision (the Basle Committee, hereafter) and in the domestic politics of banking regulation.[1] An attempt was made to test a two-level-game model that positions Japanese regulators as the link between international and domestic politics. The thesis systematically assessed the strengths and the weaknesses of the two-level approach, and considered the validity of alternatives—systemic- and domestic-level approaches. The selection of case studies was made on such a basis: the case of negotiation processes and that of implementation.

The two-level-game approach is one of the most popular theoretical frameworks in

the discipline of International Relations.[2] It is based on assumptions that privilege neither domestic nor international factors. One of its distinctive hypotheses is that the interaction between domestic and international politics gives state actors a political tool to strengthen their autonomy and improve their maneuverability over domestic politics. To what extent does this hypothesis hold in the case of Japanese participation in an international regime for banking regulations?

On the one hand, the negotiation phase brings the strengths of the two-level-game approach into relief. In particular, the argument presents a counter-example to a "redistributive logic" of the Basle Accord: The American and British policymakers, whose banks were confronting a challenge from Japanese banks, exercised financial power to push Japan into an unfavourable multilateral framework; thereby forcing Japanese banks to raise their capital ratios.[3] The two-level-game approach also differs from a bank-centred analysis emphasising market pressure as the driving force behind emulation of the regulatory standards initiated by the U.S. and U.K.[4] Moreover, the approach provides additional evidence for the notion of Japan being a "reactive state", while also refining and revising that concept.[5] Even in the area of banking regulation, where bureaucracy has been often deemed to enjoy a high degree of autonomy, the Japanese Ministry of Finance (MoF) was exposed to societal interests and had incentives to use external pressure, or *gaiatsu*, to attain its domestic goals.

On the other hand, the implementation phase highlights the weaknesses of the two-level-game approach. Although the international and domestic interplay gave Japanese bank regulators some degree of leverage at the beginning of the international regulatory harmonisation process, domestic reforms became almost irrelevant once capital adequacy got enmeshed in domestic bureaucratic and political processes during implementation stage. The latter point challenges the logic of two-level games, and requires us to consider possible alternative hypotheses about institutional inertia or the "stickiness" of domestic institutions.[6] This domestic institutional stickiness again throws doubt on the existing analyses that emphasise systemic-factors such as market pressure.[7] The way in which the Basle Accord was implemented in Japan came short of the spirit of the international regulatory standards throughout the 1990s in the face of international market pressures. The two-level-game approach and the systemic-level approach must then be strongly qualified at the implementation phase.

The argument based upon the two-level games is a modified version of Kapstein's account of the Basle Accord, viewed through the eyes of a country that negotiated its way into an international regulatory agreement launched by the U.S. and the U.K.[8] Kapstein explains how a regulatory dilemma between keeping domestic banks competitive and the financial system stable led to the Basle Accord. The thesis considers how Japanese regulatory officials dealt with a similar dilemma by

participating in international negotiations. In addition, it addresses the issue of implementation and compliance, which Kapstein does not sufficiently examine. In developing the argument, the thesis examined Japanese regulators' preferences, negotiations, and implementation of international agreements. *Preferences* are defined as specific policy choices that actors believe will serve and satisfy their fundamental objectives or interests. As Chapter 3 elaborates, such interests for regulators include economic, domestic political, and international relational objectives. Regulators choose a particular set of policies, which is supposed to be good enough to meet the objectives, within the confines of the present perceptions and evaluations. In this regard, the thesis assumes that individuals operate with bounded rationality,[9] and differs from the two-level-game framework developed by Helen Milner, within which state negotiators are assumed to be rational actors maximising their goals by choosing the best or optimal course of action from all possible alternatives.[10] The notion of bounded rationality is suggestive, especially when we examine the preference formation and behaviour of Japanese regulators in the dramatically changing environments of the late 1980s and the 1990s.

The terms *negotiation* and *bargaining* are used interchangeably, and refer to "a sequence of actions in which two or more parties address demands and proposals to each other for the ostensible purposes of reaching an agreement and changing the

behaviour of at least one actor".[11] Under the two-level-game framework, Japanese regulators are assumed to be involved in both international and domestic negotiations. *Implementation* refers to a sequence of actions by regulators to carry out the terms of an agreement with their foreign counterparts. It includes the effect that such an official agreement may have later on the behaviour of regulators and that of banks. It is one thing to negotiate rules, some of which are of a fairly general nature, and even to adopt them as national standards; it is another for countries to implement them effectively. In order to comprehend the process of development of banking regulations, it is important to examine how Japanese regulators actually behave, rather than how they change banking regulations.

### *1.1.2 Financial Globalisation and Capital Regulation*

The re-emergence of global finance has posed substantial political and economic challenges to states. One of them is how to regulate financial institutions and markets. The expansion of cross-national financial transactions has created more closely integrated national financial systems, which made it extremely difficult, if not impossible, both technically and politically for individual states to effectively regulate financial activities on a unilateral basis. The high degree of integration means that an incident in one country, in effect, has an impact on other countries; therefore, a bank's

failure in a country may have negative consequences on national banking systems of the others. Domestic regulatory efforts to make banks less likely to fail, by themselves, cannot adequately cope with this externality.

Cross-national regulatory disparities also generate competitive inequity that raises political concerns over distributive issues. Banks in less restrictive national regulatory systems can take advantage of the regulatory differentials. In other words, banks that are subject to unilaterally strict regulations in their home country will find themselves at a competitive disadvantage to international rivals. In the mid-1980s, for example, seriously competitive pressures from Japanese banks' low-capitalisation led American bankers to turn to politicians and policy makers to nullify the unilateral effort to reinforce American banks' capitalisation.[12]

In the field of international banking, several factors increased pressure on national regulators to establish common regulatory rules in order to respond to the challenges facing them. The Basle Committee, consisting of bank regulators representing the Group of Ten countries and Luxembourg, was a vehicle for advancing internationally common banking regulations.[13] One of the major developments in this realm is the establishment of international bank capital adequacy standards. Capital adequacy standards refer to a type of regulation that requires banks to hold sufficient capital against the risks of potential and unexpected losses arising from their business

operations. This is normally measured as the ratio of capital to some quantum of on- and/or off-balance sheet engagements as variously defined. In 1988, the Basle Committee agreed on a common regulatory framework with minimum capital requirements for credit risk—the risk that those whom banks lent to might go bankrupt—undertaken by internationally active banks. This was known later as the 'Basle Capital Accord'. In 1996, in response to the rapid involvement of banks in the securities' markets, whether directly or through affiliated firms, the Accord was amended to incorporate market risk—the risk of losses in on- and off-balance sheet positions arising from movements in market prices. This was called "the 1996 Amendment to the Basle Accord to Incorporate Market Risk".

Participation in international regulatory harmonisation has inherent domestic political implications; Japan is no exception. Each national regulator has developed its own regulatory system in line with its financial structure, tax system, and accounting practices. Banking regulation is not an isolated system, but rather it is deeply rooted in a broader domestic institutional context. Specifically, since capital adequacy standards were not tightly enforced in Japan prior to the 1988 Basle Accord, Japan's participation in the international agreement had significant domestic political and economic consequences. Furthermore, the 1996 Amendment put emphasis on the greater role of the market in regulation and on the self-responsibility of regulated

groups, which was fundamentally different from the traditional practice of Japanese banking regulation. These regulatory developments at the international level had implications for the domestic politics of rule change, adoption, and implementation in Japan.

The Basle Capital Accord was a high-profile event in Japan. Not only financial circles but also even ordinary people knew it. After the 1990 collapse of the financial bubble in Japan, Japanese banks could no longer pursue market-share as they had in the 1980s with little concern for profitability and due capitalisation, in order to maintain the required capital-to-asset ratios. Outcries against the Basle Accord broke out from the Japanese banking industry.[14] An editorial of a leading Japanese financial magazine, *Kin-y□Zaisei Jijy□*, was concerned about the impact of the Basle Accord on Japanese banks. Parodying *the Manifesto of the Communist Party*, it said, "A spectre is haunting the world of international finance—the spectre of the Basle Accord".[15] Furthermore, in the midst of the 1990s' financial and banking disasters, the "second defeat" or "money defeat" argument became popular.[16] Japan's post-war economic prosperity sometimes conveyed the impression that Japan was an ultimate winner of World War II, but, according to the argument, in reality Japan lost the post-war competition over economic wealth at a fundamental level. Throughout the post-war era, the international monetary and financial system had been structured as the one

through which Japanese wealth was transferred to support the U.S. hegemony. In this argument, the Basle Accord was compared to the Battle of Midway, which was a turning point on the Pacific front of World War II.

Despite the above eccentric arguments, Japanese banks are still operating with weak capital structures, and the degree to which the Basle Accord affected Japan is questionable. At the same time, under the sluggish economy, difficulties for Japanese banks in meeting the Basle standards have been growing. In addition, the severity of the domestic banking problems of the late 1990s politicised the issue of capital adequacy requirements and activated politicians, who were less keen to strictly comply with international regulatory standards. Since capital adequacy requirements were frequently seen as a main source of a credit crunch, and in a country already suffering financial distress, their strict implementation was expected to lead to the deterioration of the existing credit crunch.[17] Such factors explain the importance of correctly understanding how the preferences and bargaining positions of Japanese actors were formed and to what extent the Basle Accord was effectively carried out in Japan. The thesis attempts to answer the above questions by testing the two-level-game framework and several alternative systemic- and domestic-level approaches, as well as providing a detailed case study.

The existing literature in International Political Economy on the Basle process is

relatively inadequate in terms of providing a comprehensive survey covering Japanese domestic politics.[18] Most of the literature highlighted the role of international regulatory regimes in improving the international financial stability, the issue of international distributional problems, or the role of market forces. In addition, while the process through which American domestic politics triggered the U.S. initiative in promoting international regulatory co-operation has been well examined, Japan is usually treated as a unitary actor pursuing harmonised and monolithic preferences, particularly with regard to the international competitiveness of Japanese banks. By stressing tensions between the preferences of Japanese regulators and those of private banks, however, this study marks a departure from the view of Japan as a unitary actor.

## 1.2 Potential and Limits of a Two-level-game Analogy

### *1.2.1 The MoF's Position in the Basle Negotiation Process*

A two-level-game framework demonstrates how the interplay between international and domestic politics affected the preference formation and bargaining behaviour of the Japanese Ministry of Finance (MoF). The two-level-game approach hypothesises that the MoF simultaneously pursues different international and domestic goals. According to the hypothesis, on the one hand, the ministry can negotiate with its foreign counterparts the specifics of the Basle standards in order to protect the

international competitiveness of Japanese banks. On the other hand, the MoF can use foreign pressure to pursue its domestic goal of legislating for capital adequacy rules, which the ministry is unable to put in place due to opposition from banks. The two-level-game framework itself is not novel, but this perspective sheds light on the behaviour of the MoF in the Basle negotiations; little attention was given to this analysis in the existing literature.

The question of where Japanese regulators stood on the process of international banking regulation was addressed by several systemic-level approaches. Most researchers of International Political Economy who study the 1988 Basle Accord focus on its distributional impact. Thomas Oatley and Robert Nabors provide the strongest form of the distributional argument in their account of the "redistributive logic" of the Basle Accord: a powerful state, driven by domestic concerns, disproportionately shapes an international regime to serve its domestic groups' interests at the expense of those of other states.[19] This logic "parsimoniously" illustrates the significant role of U.S. domestic interests in generating the U.S. initiatives. It argues that the Accord was intentionally designed by the U.S. policymakers to "transfer income from Japanese commercial banks to compensate American commercial banks for the costs of [otherwise unilateral] regulation", and was successfully negotiated "*only* through U.S. policymakers' use of financial market power".[20] Oatley and Nabors assert that the

Japanese were the "primary targets".[21]

In a highly integrated international financial system, asymmetrical interdependence among states is a source of power.[22] Typically, the ability to grant market access to financial institutions, or, alternatively, to threaten market closure underlines the power resources of the U.S., which possesses the largest and most dynamic financial markets in the world. The importance of the U.S. financial markets causes asymmetrical international interdependence from which "vulnerability" of other states and potential power of the U.S. derive. This suggests that, despite Japan's creditor status and international expansion of Japanese financial firms, the systemic weakness of Japan in the realm of international finance came from asymmetry of vulnerability of Japanese banks vis-à-vis the American counterparts. This weakness pushed Japan into an unfavourable multilateral framework; thereby forcing Japanese banks to raise their capital ratios in the case of the 1988 Basle Accord, and forcing Japanese regulators to adopt a set of new regulatory norms and methods based on the 1996 Amendment. According to this account of the redistributive logic, the Japanese were as a whole the losers of the Basle process.

Although the Basle Accord adversely affected Japanese banks after the 1990 collapse of the financial bubble, the Basle negotiation process did not completely correspond to the redistributive logic in the way Oatley and Nabors assert. The

importance of the U.S. power does not necessarily mean that the U.S. foisted its preferences on an unwilling Japan. Nor does it mean that the U.S. preferences overwhelmingly determined the actual content of the multilateral accord. When we decide who exercised power over whom, we need to know something about the *ex ante* preferences of the actors. While Oatley and Nabors treat Japan as a unified front seeking competitive advantage, Japanese regulators and private banks did not have identical preferences toward the Basle process and the regulators had domestic reasons for strengthening their capital adequacy rules. The treatment of Japan as a monolithic actor by Oatley and Nabors cannot adequately explain the MoF's behaviour.

While the redistributive logic highlights the most powerful states' motivation to establish international banking regulations, another variant of systemic-level approaches focuses on market pressure as a driving force behind emulation of developments in international regulatory standards. With regard to Japanese banks' rapid increase in their capital ratios in the late 1980s, Beth Simmons posits the influence of "market pressure logic".[23] She argues that the 1987 U.S.-U.K. bilateral proposals for common capital adequacy requirements promoted the regulatory innovation as a focal point for other countries' regulators to emulate. Specifically, regulatory changes in the dominant financial centre gave the rest of the world not only competitive incentives to catch up with the regulatory change in order to maintain or

attract business, but also market pressures for conforming to the regulatory environment of the dominant centre. This implies that Japanese participation in the Basle rules is market-driven, rather than politically- or institutionally-driven. Japanese banks themselves were aware of the costs, in terms of credit ratings and international business reputation, of adopting lax capital adequacy rules. This argument from market pressure logic, however, clouds the dynamics of the domestic politics in which the MoF attempted to solve the regulatory dilemma. A focus on the MoF better illuminates the true dynamics at play than the theory of market pressure logic can.

A third type of systemic-level explanation highlights the existence of an international regime—set of norms and rules on which states' expectations converge in certain issue-areas—in banking regulation.[24] Some argue that the international regime helps states to mitigate collective action problems among them and enables participating states to enjoy collective gains, such as a more stable international financial system. Others suggest that the regime promotes the trans-national diffusion of regulatory norms, which are eventually embodied in domestic regulatory systems. It is argued that through this process of ideational diffusion, the regime constrains and shapes domestic rules, practice, and behaviour. Surely, the role of the regime in affecting the behaviour of states should be considered, but, like other systemic-level explanations, the regime explanation does not sufficiently focus on domestic factors,

such as the interests of domestic banks and domestic political structure. In short, the regime explanation should be supplemented by analysis of domestic and international factors.[25]

*1.2.2 Implementation Issues*

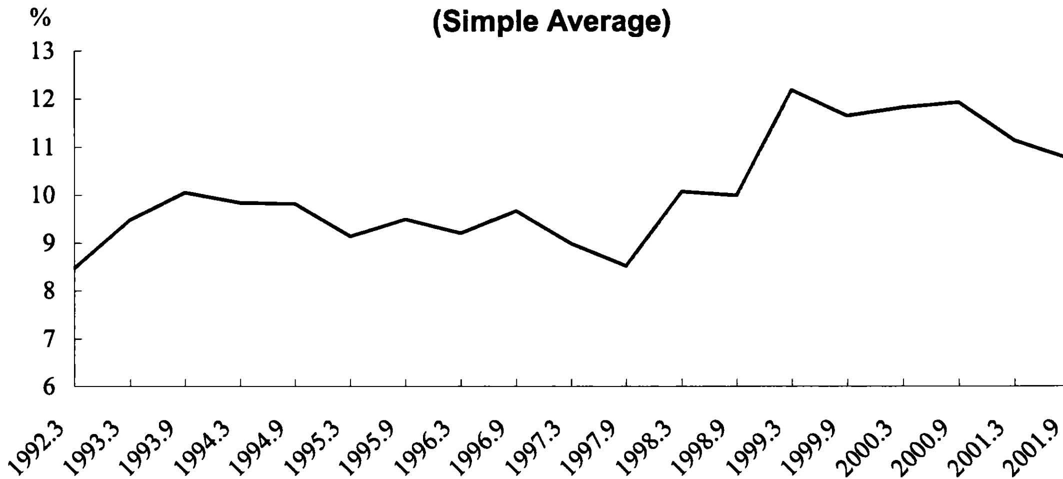
The above section shows the potential of the two-level-game approach to contribute to the understanding of how international and domestic political forces interact to produce policy outcomes, and to offer an explanation different from systemic-level explanations about forces leading to the Japanese MoF's negotiation position. However, the state of the weak capital structures of Japanese banks in the 1990s (i.e., implementation issues) challenges or qualifies the validity of the two-level-game approach.

In October 2002, Takenaka Heizo, the newly appointed Joint Minister for Economy and Financial Services, officially admitted that Japanese banks were in a much worse shape than the repetitive claims of Hakuo Yanagisawa, his predecessor, and in need of drastic reform.[26] His initial ideas for reform, which have been subsequently emasculated by political pressure, included a wide array of stringent measures, ranging from a stricter assessment of loan classification and better provisioning against bad loans to a cap on deferred tax assets, which amounted to

about half of big banks' core capital.[27] It is widely believed that the banks need more than two or three times their current loan-loss reserves to be adequately provisioned.[28] Reclassifying non-performing loans certainly reveals that the banks are under-provisioned and under-capitalised. In essence, subtracting them would send many banks' capital adequacy ratios below the 8 percent level that the Basle Accord requires.

Such state of Japanese banks means that a country that adopts international standards for prudential regulation as national standards does not necessarily follow the spirit of such international standards. Although proposed changes to the Basle Accord have been made to come into effect in 2006 or 2007, the Basel Capital Accord has been a keystone of a global regime for financial regulatory standards. It has now been adopted by over 100 countries. Apparently, as Figure 1.1 shows, major Japanese banks managed to meet the 8 percent minimum capital requirements in the 1990s. However, this numerical compliance with the Basle rules in itself does not ensure that the international standards of capital adequacy were strictly carried out in Japan nor that Japanese regulatory policies were geared up to deliver on internationally accepted supervisory practices. One of crucial problems of international regimes is the capacity to enforce or deliver on decisions.

**Figure 1.1 Shift in Japanese Major Banks' Basle Capital Ratios (Simple Average)**




Notes: The simple average of the risk asset ratios of the major banks (city banks, long-term credit banks, and trust banks), of which the number of those adopting the Basle rules is 21 (1992.3 -1996.3), 20 (1996.9-1997.3), 19 (1997.9), 18 (1998.3), 17 (1998.9), 16 (1999.3), 14 (1999.9), 12 (2000.3), 11 (2000.9-2001.3), and 10 (2001.9).

Source: various issues of *Analysis of Financial Statements of All Banks,* Japanese Bankers Association.

A source for this considerable slippage between actual and putative capital originates in the nature of the Basle Capital Accord as a set of international regulatory standards for capital adequacy requirements: “Standards relevant for sound financial systems set out what are widely accepted as core principles, good practices, or guidelines in a given segment of the financial system and cover specific functional aspects of the system”.[29] For standards to be accepted widely, they are often formulated in a fairly general form of broad guidelines. Under the framework of the Basle Accord, several important elements are placed at national discretion. Reaching

an agreement on international standards and even adopting them as domestic standards, therefore, are different from effectively implementing them. Furthermore, for the Basle minimum capital adequacy requirements, numerical compliance with that minimum ratio (i.e., 8 percent) does not mean effective implementation. Various factors, including the accounting principles, affect the risk-weighted capital ratios, and therefore national regulators can help their banks to achieve the minimum ratio by adopting lenient policies. Assessments of implementation need to be interpreted using various policy areas related to the capital bases and assets of banks.

Implementation and compliance issues serve as a test for the logic of two-level games, because, as seen above, the state of Japanese capital adequacy requirements fell short of the spirit of the Basle Accord throughout the 1990s. Although the two-level-game approach hypothesises that developments in international standards towards prudential regulation give bank regulators external leverage to cope with domestic status quo interests and to deliver on what they agree with foreign counterparts, a shift in the Japanese banking regulatory system towards prudential regulation has not sufficiently occurred yet. It is true that by emphasising a potential tension between state negotiators and their domestic actors, the two-level-game framework points out the possibility that the credibility of an official commitment to an international agreement is low. However, it is important to know why and under

what conditions defection from international regimes can happen. Systemic-level approaches provide poor explanation for the Japanese compliance issues either.

In Japan, where banking regulation based upon informal but institutionalised networks among regulators, banks and politicians (as opposed to arm's length regulation) had prevailed and a severe credit crunch was observed in the latter half of the 1990s, strict implementation of capital adequacy ratios was on a collision course with the status quo interests. If the international and domestic interactions did not give Japanese regulators incentives and/or political leverage to carry out prudential capital adequacy requirements, it is necessary to offer alternative possible hypotheses addressing the problem of bureaucratic politics and implementation. A network state hypothesis, which argues that various actors concerned were embedded in an informal regulatory network in Japan and policy behaviour began to be constrained by the embedment in the 1990s, provides alternative explanations for the issue of implementation.[30]

### 1.3 The Plan of the Thesis

The thesis is divided into two parts. Part I, consisting of Chapters 2 and 3, considers theoretical background of international banking regulation. Following an argument on the economic rationale for banking regulation, Chapter 2 explores a political and

economic view of capital adequacy requirements. A focus is on the roles that bank capital plays in both prudential regulation and banks' competitiveness. The chapter also provides a brief history of the Basle Committee, and presents a concise explanation of capital adequacy requirements of the 1988 Basle Accord and the 1996 Amendment.

Chapter 3 offers hypotheses on bank regulators' behaviour in the process of international regulatory harmonisation. To this end, the chapter first outlines a set of policy behaviours and economic outcomes against which to test the hypotheses. The chapter then develops three sets of hypotheses: a model based upon the logic of two-level games; a model emphasising the centrality of domestic institutions in defining the probable course of regulatory policy; and systemic-level models assigning greater emphasis to either inter-state power relations or market forces.

Having established an analytical basis for exploring Japanese commitment to the Basle process, the thesis turns in Part II to an empirical consideration of the 1988 Basle Accord, the 1996 Amendment, and the implementation of the Basle capital requirements. Chapter 4 provides a historical overview of the development of capital adequacy requirements in Japan, and the Basle Committee's efforts to deal with issues of bank capital adequacy in the early and mid-1980s. The chapter sheds light on the learning process at the Basle Committee that facilitated a relatively synchronous and

coherent response to the proliferation of off-balance sheet activities (a consensus on a system of risk-weighted capital requirements) and developed a new method of the tiered framework of capital. Such developments affected Japanese regulators' perception of capital adequacy requirements, but the Chapter points out their abortive attempts to introduce effective domestic capital rules in the Japanese institutional and political context.

Having developed an in-depth understanding of the historical context, Chapter 5 examines Japanese regulators' preference formation, international and domestic bargaining positions in the negotiations leading up to the 1988 Basle Accord. Analytical concerns are over Japanese regulators' pursuit of different objectives at the international and domestic levels: internationally, they tried to mitigate negative impacts of the new rules on the international competitiveness of Japanese banks, and domestically, they attempted to introduce statutory capital adequacy requirements that private banks had fended off.

Revealing the political process that led up to the 1996 Amendment, Chapter 6 considers a new configuration of the Basle regulation-making process. Such a new configuration reflected two developments. First, financial regulation became esoteric, thereby increasing the importance of knowledge as a source of power. Second, a domestic banking turmoil affected Japanese regulators' preference formation and

bargaining positions. Simultaneously, the chapter considers how new Basle-inspired regulatory norms were used as a domestic political tool by the MoF in the midst of banking disasters.

Chapter 7 examines the implementation aspects of the Basle capital adequacy requirements in Japan, and critically challenges the logic of two-level games as well as that of systemic-level approaches. The chapter argues that inadequate institutional capacity to deal with non-performing loans held by banks renders the Japanese compliance weak since the Basle rules came into effect in March 1993. In addition, the banking crisis in November 1997, in general, and the onset of a credit crunch which severely hit the LDP's constituencies, in particular, politicised the issue of capital adequacy rules and led to further deviation from the international regulatory standards.

Chapter 8 concludes the thesis by summarising the main arguments and findings. The thesis brings the strengths and the weaknesses of the two-level-game approach into light. On the one hand, the two-level-game approach has the potential to contribute to a better understanding of how international and domestic political forces interact to produce policy outcomes at the negotiation stage. The thesis finds that the two-level-game model can present a counterexample to the existing analyses that emphasise systemic-factors such as inter-state power relations and market forces. On the other hand, there is room for qualifying the validity of the two-level-game

approach, especially during implementation. The approach fails to adequately explain domestic stumbling blocks to implementation of and compliance with the Basle Accord. An approach assigning more weights to domestic politics and institutions can provide more explanatory power. After discussing various findings, the concluding chapter presents their broader implications for international regulatory standards.

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[1] The town of Basle, in which the Basle Committee is located, is officially spelled Basel (in German), Bâle (in French) and Basilea (in Italian), being the three main languages of Switzerland. To avoid confusion the anglicised Basle is used throughout this thesis.
[2] Putnam (1988).
[3] Oatley and Nabors (1998).
[4] Simmons (2001).
[5] Calder (1988).
[6] See, for example, Aymx (2001).
[7] See Simmons (2001).
[8] Kapsetin (1994).
[9] On the concept of bounded rationality, see Simon (1997).
[10] Milner (1997).
[11] Odell (2000).
[12] Kapsetin (1994) and Reinicke (1995).
[13] In 1961, to exercise more control over their IMF contributions the Group of Ten was originally established by ten countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom and the United States. It retained its name even after the participation of Switzerland increased its membership to eleven. See Strange (1976: 113).
[14] See, for example, *Kin-yū Zaisei Jijyō*, 18 December 1991, 26-31; *Tokyo Business Today*, October 1992, 34-35.
[15] *Kin-yū Zaisei Jijyō*, 18 December 1991.
[16] Kikkawa (1999). See also Leyshon (1994) for a geo-political interpretation of the post-war development of international monetary and financial system.
[17] Santos (2000) presents a wide literature review on capital adequacy requirements and credit crunches.
[18] Many works examine the political process leading up to the Basle minimum capital standards. See, for example, Kapstein (1989; 1991; 1992; 1994), Cooke (1990), Vernon, Spar and Tobin (1991), Underhill (1991; 1997b), Porter (1993), Reinicke (1995; 1998), and Oatley and Nabors (1998). With regard to compliance with the Basle rules, see Rosenbluth and Schaap (2000) and Simmons (2001). Granirer (1994) is exceptional in investigating the Japanese domestic politics with regard to the Basle Accord. For a serious journalistic reading, Shiota (1999) covers the story from a Japanese perspective.
[19] Oatley and Nabors (1998).
[20] Oatley and Robert Nabors (1998: 36, emphasis added).
[21] Oatley and Robert Nabors (1998: 51).
[22] See Keohane and Nye (1989).
[23] Simmons (2001).
[24] On international regimes, see Krasner (1983).
[25] Haggard and Simmons (1987) and Milner (1988: 13-14; 1992).

[26] *Asashi Sinbun*, 23 October, 2002

[27] Deferred tax assets represent the estimated amount of future tax reduction and are currently booked as core equity capital.

[28] See Posen (2002) and *The Economist*, 5 October 2002.

[29] Sundararajan, Marston, and Sasu (2001: 6).

[30] See Amyx (2000).

# Part I Theoretical Background

# Chapter 2

## Politics of International Banking Regulation

### 2.1 Introduction

Until the mid-1970s, there was no significant international mechanism for exchanging information among national bank regulators, let alone co-ordinating national regulatory arrangements. [1] Peter Cooke of the Bank of England once noted, "Supervisors were still very much domestically orientated within the framework of different national banking systems".[2] Regulatory and supervisory practices of banks functioned purely on a national basis. However, changes occurring in the structure of the international financial market operations in general, and the magnitude of bank failures of which impacts effectively went beyond national boundaries in particular, called into question the domestically-orientated premises on which banking regulation had been based. The rapid growth of cross-border financial transactions increased

pressures upon major countries to agree to some form of common rules to regulate and supervise the international financial market.

Since the late 1950s when the offshore Eurocurrency market gathered momentum, international finance has witnessed the accelerating process through which a greater degree of freedom was allowed to banks and, accordingly, international capital mobility has increased. By the mid-1980s, Peter Drucker observed "the emergence of the 'symbol' economy—in capital movements, exchange rates and credit flows—as the flywheel of the world economy, in place of the 'real' economy—the flow of goods and services".[3] However, this evolution of freer financial markets did not consist only of an overwhelming force in reducing and removing regulatory rules. In fact, the introduction of more competition within a market requires increasing the strength of regulation and supervision for more competitive markets to mitigate market failures.[4] In 1974, in response to the increasing cross-border financial transactions and successive failures of internationally active banks, the Basle Committee on Banking Supervision was set up as an international body bearing responsibility for exchanging information and co-ordinating national banking regulations. Although the framework for international banking regulation had been developed on an *ad hoc* basis and consequently a patchy international regulatory scheme was established so far, the Basle Committee over the next three decades drew the line of responsibility for

supervising internationally active banks, set up the specified qualitative principles of effective banking supervision, and established international standards for capital adequacy requirements.

This chapter aims at discussing basic ideas about capital adequacy requirements and the Basle Committee. The first section will review economic rationale for banking regulation and examine politico-economic views on banking regulation with special reference to capital adequacy requirements. The second section will briefly sketch the process of establishing the Basle Committee. The gist of the 1988 Basle Accord and the 1996 Amendment to Incorporate Market Risk will be presented.

## 2.2 Theory and Practice in Banking Regulation

### *2.2.1 Economic Rationale for Banking Regulation: Protecting Public Interests*

As per a textbook, the two main reasons for bank regulation are to provide consumer protection and to ensure the systemic stability of the credit order.[5] The fundamental characteristics of financial intermediation under conditions of imperfect and asymmetric information underpin these two theoretical rationales. Consumer protection is necessary: first, because the financial institution in which depositors hold their funds may fail; and, second, because of the possible unsatisfactory conduct of business of a financial institution with its clients. Individual customers, especially in

the retail sector where the costs of acquiring information are particularly high and the ability and opportunity to do so is also limited, are not in a perfect position to assess the safety and soundness of financial institutions. In addition, when principals and agents are not equally well informed, more informed agents are able to take opportunities and not to carry out appropriate business practices in dealing with less informed principals. Bank regulation, including certain guidelines of information disclosure, is designed to mitigate these market failures under imperfect information.

The other rationale for bank regulation derives from the necessity to safeguard the payments system from possible systemic shocks. Systemic regulation is regarded as necessary because the social costs of the failure of an individual bank might possibly exceed the private costs for the bank's shareholders. The possibility that a run on a bank gives rise to a destructive impact on the whole of a nation's economy stems from the unique features of banks' operations: the pivotal position of banks in the economy; the dense interconnectedness of banks in their gross positions in clearing systems and in inter-bank deposits; the nature of bank contracts (contracts for liquid deposits that finance the acquisition of non-liquid assets of uncertain value); and adverse selection under asymmetric information. As a result of these characteristics of the banking industry, bank regulators give careful consideration to problems of a possible chain reaction triggered by a single bank's failure. The probability that the failure of a single

bank will cause a systemic problem may be low, but, if systemic failure were to occur, the social and political costs could be enormous. From this standpoint, the public provision of a "safety net", such as deposit insurance and lender of last resort facilities, is justified in order to prevent runs on banks. Regulatory capital is also required for banks in order to cushion the probability of insolvency and to restrict banks' imprudent risk taking.

As far as they go, the economic rationales take account of the destructive blow of potential bank runs on the economy, as well as asymmetric information and principal-agent problems concomitant with financial services. These rationales can be naturally applied to international banking. "Financial globalisation" implies that a collapse of an international bank may possibly trigger negative externalities through the international interdependence of the payments system and the inter-bank market. This is one of the challenges that financial globalisation has posed to regulators, since regulatory systems have traditionally functioned on a domestic basis.

The economic rationales for banking regulation suppose that regulatory authorities are providing public goods, i.e., the maintenance of the systemic stability of the credit order and the protection of consumers. However, in reality, there is a large array of interests which influence the regulation-making process. Such interests may well be pulling in different directions since regulation not only provides public goods, such as

safety nets, but also constructs institutional arrangements of markets that can potentially confer asymmetric advantages upon some and costs upon others.[6] Thus, the regulation-making process in itself is inherently the subject of political conflict among various interests. Tracing such a political process helps us to understand and explain the question of why a certain form of international regulation has emerged.

*2.2.2 Political Perspectives of International Banking Regulation*

This section considers the various motives that drive regulators and private banks to take part in the international regulation-making process. First of all, a bank regulatory authority is a bureaucratic organisation. As most studies of bureaucracies show, on the one hand, regulators act to increase their organisational powers. Morton Halperin and Arnold Kanter identify five goals of bureaucratic organisations: first, to defend the bureaucracy's essential mission or purpose; second, to defend/expand the bureaucratic "turf"; third, to maintain the organisation's autonomy; fourth, to maintain morals within the organisation (which serves to make sure the organisation functions well); and fifth, to make sure that the organisation's budget grows.[7] As for bank regulators, stressing their duty of maintaining the sound and stable credit order serves as the first bureaucratic goal, and the pursuit of effective regulatory measures is associated with the second and third goals.

On the other hand, the "regulatory capture" approach of economics demonstrates that the bureaucracy, the economic regulatory authority in particular, is likely to be held "captive" by well-organised specific private interests.[8] According to this perspective, the ability of the regulator to maintain autonomy in formulating and implementing policies vis-à-vis the regulated group is open to question, and the regulation-making process is subject to the economic interests of the regulated group. The key insight of these different approaches to the bureaucracy's role is that bank regulators have to deal with various elements that are pushing and pulling the regulatory policy in different directions. These multiple objectives pursued by regulators are put into several hypotheses in Chapter 3.

International co-ordination of national regulatory systems possibly resolves problems of balancing national regulators' multiple objectives in highly integrated financial markets. Firstly, as Richard Cooper argued, policy co-ordination among nations is an increasingly important means for state policy-makers to pursue their domestic goals in an interdependent world.[9] The system of nationally-regulated financial systems leads to a situation where different banks are subject to different regulations. Regulatory imbalance makes it difficult to pursue the soundness and stability of a national banking system in a highly integrated and competitive international banking market. This is because disparities in national regulations will

induce banks to engage in regulatory arbitrage and cause several harmful consequences to national banking supervision. International co-ordination to eliminate such regulatory imbalance, *ceteris paribus*, could contribute to an improvement in financial systemic stability.

Secondly, in terms of inter-state distributive implications, a multilateral approach to regulatory harmonisation seems the best means of resolving a policy dilemma with which the increasing necessity of imposing prudential regulation presents national regulators.[10] On the one hand, the increase in banks' risk-taking as a result of international operations propounds the necessity of reinforcing regulatory means of curbing imprudent risk-taking by banks. The failure to contain banks' reckless risk-taking would lead unavoidably to an explosion in the costs of keeping the public safety nets for the banking industry in place, since the authority would be forced to bail out a growing number of troubled banks. This concern prevents bank regulators from pursuing a simple policy of "competition in laxity" or a "race to the bottom", and motivates them to adopt countervailing regulatory measures.

On the other hand, given a regulatory authority's interest in protecting and promoting the international competitiveness of the national banking industry, it would be undesirable for such regulatory authorities to impose unilateral regulatory restrictions. Thus, regulators confront a dilemma: more regulated financial systems

may be safer, but their banks under stricter domestic regulations also operate at a competitive disadvantage. In addition, cross-national differences in government-bank relations make it more complex. In the case of banks' capital adequacy, in the 1980s market agents recognised lax capital rules in Japan and France, but credit rating agencies saw the strong protection of banks by national governments in these countries as a source of high ratings. In this situation, international regulatory co-ordination could ensure some sort of a competitive "level playing field" for international banks, while permitting national regulators to keep the costs of the public safety nets under control.[11]

From the viewpoint of private banks, the issue of a level playing field sparks off the self-interested behaviour of banks. Without globally homogeneous regulation, there will be competitive imbalance in the system, with different banks subject to a different national structure of banking regulation. Certain groups of banks subject to lax regulations can take advantage of this imbalance. This raises the question of competitive inequality. When banks find themselves at a competitive disadvantage against international competitors that allegedly enjoy regulation-induced advantage at home, they tend to turn to their home governments in pursuit of what they call a "fair" or level playing field. Creating this level playing field could eliminate some sources of regulation-induced advantage, by imposing extra regulatory costs on the banks that

enjoy such an advantage.

A mismatch between markets and political frameworks in terms of market governance, which has been produced by the globalisation of banking activity, has also motivated internationally active banks to engage in building common rules and standards for self-governance.[12] Until recently, compared with the securities industry in which self-regulation practices have traditionally been established, the banking industry did not develop international self-regulatory bodies.[13] However, the rapid development of private banking operations, which outpaced the ability of regulators to grasp it, has recently induced such private organisations as the Group of Thirty and the Institute of International Finance (IIF) to call for self-governance for the banking industry. They committed themselves to lobbying vis-à-vis the inter-state regulatory body, the Basle Committee.

The Group of Thirty, established in 1978, which includes senior representatives from regulatory authorities, the private sector and academia, cover a wide range of international financial problems and it is not a narrowly focused banking association.[14] Yet, as seen below, it has recently become eager to establish private-sector-led regulatory schemes in international finance. The IIF (founded in 1983 in Washington by major commercial banks from North America, Europe and Japan) is a private initiative acting to exchange information between borrowing countries and member

banks, and it has been active in the developing and transition economies' debt deals in the 1980s and 1990s.[15] It was not until the early 1990s that the IIF started to play a significant lobbying role in mediating between leading international banks and the Basle Committee on behalf of the former.

Private interests have the motivation to complement or replace inadequate inter-state regulatory co-operation. Given the differences in national structures, history, culture, interests and viewpoints, any international harmonisation of banking regulation turns out to be a political compromise. From the private banks' point of view, it is both unsatisfactory from the outset and simultaneously not flexible enough to amend in the light of changing financial environments. This image of inter-state regulatory co-operation as counterproductive was recently expressed in a report by the Group of Thirty:

> Even with full understanding of these new challenges and the best of intentions to address them [changing financial environments], supervisors find themselves hemmed in by national legislative mandates and agency practices, often based on a sectoral approach. They face political constraints arising from the issues of the moment when legislation is drafted. Such legislation may compel supervisors to act in a fashion which is unnecessarily at odds with the market unless they receive specific legislative authority to change the way they do business.
>
> So cooperation among national and functional supervisory agencies alone is unlikely to produce adequate oversight of global institutions on the time scale that the problem demands. As new issues arise, each supervisor will adopt its own reporting requirements to deal with them. Not only will reporting vary from country to country as it has in the past, but it may be inconsistent with the practices of private managements and markets.[16]

The report explicitly suggests that the formulation and application of standards be better assigned to private sector initiatives.[17] The point of this argument is that by improving market efficacy, private sector regimes with better expertise and more flexibility can more efficiently provide an international public good than national regulators.[18] Even in the name of the improvement of market efficiency or the provision of international public goods, however, less altruistic considerations are clearly underlying motivations for private banks in constructing a self-governance regime. After all, it will be in an initiator's interest to establish a regulatory standard in its own favour. Several leading banks' appeal for the regulatory use of their internal risk models to set capital adequacy limits in the 1990s thus largely stemmed from this motivation. As banking regulation has become more knowledge-demanding, private banks with expertise obtained the ability to present regulators with "problem-solving guides" of how to achieve their regulatory goals, thereby becoming more influential in determining the direction of regulation.

The distributional bias of regulation underpins one aspect of the politics of banking regulation. Recognition of its importance leads private banks, along with regulatory authorities, to actively participate in the regulation-making process, thereby highly politicising it. A formation of, or a change in, international regulation has inherently distributive consequences for the domestic polity and within the international system

once we understand that our attention is drawn to a political process in which competing interests interact with one another in pursuit of favourable distributional outcomes. The regulatory structure is constructed through political processes, and inevitably reflects the configurations of power relations among relevant social groups.

*2.2.3 Role of Bank Capital: A Politico-Economic View*

The concept of capital adequacy requirements (i.e., the regulation requiring banks to hold the minimum amount of capital in relation to their assets) is not an entirely novel idea. However, given financial liberalisation and the widely recognised deterioration of banks' capital bases, the renewed interest in bank capital requirements has been observed since the late 1970s. Although the technical approach to capital adequacy requirements has changed according to innovation in international finance, the importance of capital adequacy as a linchpin of prudential regulation still remains.[19]

If the establishment of banking regulation in general is the subject of political conflicts, how does the regulation of bank capital adequacy in particular matter in the politico-economic context? Among other regulatory measures, why did the harmonised standards for capital adequacy become a major policy issue? Answers to these questions are found in regulatory and competitive implications that bank capital has.[20]

From the viewpoint of regulators attempting to curb the potential of the systemic risk of the banking system, the importance of bank capital derives from the roles it plays in depositors' confidence, banks' soundness and banks' risk-taking incentives. First, the proportion of capital to deposits is seen as an indication of the extent to which depositors are underpinned by shareholders. It sustains the confidence of depositors by demonstrating the existence of a basic fund for absorbing loss. Second, the relation of capital to certain categories of assets is an important indicator of a bank's ability to withstand adversity. Technically, capital resources are deemed to play a "buffer" role against unidentified losses, so that capital must be freely available to meet future, unexpected losses.[21] Thus, by requiring banks to hold a minimum capital level, there is less likelihood of bank failure, *ceteris paribus*.

Finally, a risk containment aspect of capital adequacy requirements is assigned to its role by relating capital adequacy to risk-weighted assets (risk asset ratios). The mere addition of capital to the bank's balance sheet without due sensitivity to the risk exposure of individual banks may cause a reshuffling of the bank's portfolio from less risky to riskier assets and/or off-balance sheet assets.[22] However, by relating capital to the varying degrees of risk involved in the spectrum of bank assets and in the contingent liabilities off the balance sheet, the risk asset ratios affect the structure of the balance sheet, the maturity pattern of assets and liabilities, and the quality of the

asset portfolio. These aspects of capital adequacy have been regarded as increasingly important in an era of financial liberalisation.

The strict framework of banking regulation, of which the origins were traced back to the 1930s in many countries, has begun to erode.[23] As a result of deregulation in many countries, banks gained a greater degree of freedom to engage in various financial services. In addition, several parallel developments in monetary issues added greater volatility to interest rates and asset prices, and led to greater uncertainty.[24] Countervailing supervision appeared necessary in order to deal with this apparent increase of risks and risk-taking associated with the greater freedom of banks and a turbulent financial environment. It was against this background that revamping or re-introducing capital adequacy requirements emerged as a regulatory policy response to liberalised banking in many countries.[25] Particularly, the importance of bank capital as both a buffer against unexpected losses and as risk containment increased since liberalisation advanced.

Attempts to strengthen capital adequacy rules, however, tend to provoke political reactions from the banking industry. As seen above, the process of changing the regulatory framework involves a shift away from a particular balance of costs and benefits for the actors involved towards another pattern. In particular, a change from competition-restricting regulations such as interest rate ceilings and the segmentation

of financial systems towards stricter capital adequacy requirements meant that some of the costs of regulatory protection are transferred to the banks themselves. In the case of Japan in the early and mid-1980s, regulators tried to revamp the existing capital adequacy requirements as a countervailing measure against financial liberalisation, but this ended in failure due to strong political opposition from the banking industry. Private banks had vested interests in lax capital adequacy requirements. They did not want to bear the costs that the new stricter capital ratio regulation would have generated. Such political conflict over regulation-induced costs and benefits represented the problem of who would bear the costs of financial liberalisation.

Political conflicts over capital adequacy requirements are fuelled by intensive international competition—a significant feature of the modern banking industry. The role that capital plays in affecting banks' international competitiveness sheds light on the "level playing field" argument. Since the regulation requires banks to put aside certain amounts of capital in relation to assets, the level of capital affects the return required by shareholders. A bank with a lower capital requirement would be able to price its products more competitively, as its threshold return would be lower. Thus, lax national capital requirements would generate a source of competitive advantage vis-à-vis those banks subjected to more rigid national capital rules. By the same token, cross-sectoral disparities in capital requirements, for instance, between securities

houses and banks also have become a matter of concern as the dividing line between the two industries has increasingly blurred. In short, the influence of capital on the competitiveness of banks highlights a political aspect of capital adequacy requirements. In other words, the international harmonisation of capital adequacy rules inherently causes a new pattern of gains and losses within the international financial system. This distributional implication pushes regulators and private banks into negotiations and bargaining in the regulatory harmonisation process.

It should be noted, however, that low capital ratios are not the only source of regulation-induced cost advantage for banks. Banks can benefit from other domestic regulation-related factors, such as market entry restrictions and ceilings on interest rates for deposits. Therefore, the importance of capital in affecting banks' competitiveness cannot alone explain why capital adequacy requirements emerged on the international agenda in the 1980s. It is necessary to consider the regulators' perspective of bank capital as a vital regulatory tool under the advancement of financial liberalisation. Thus, the politics of capital requirements should be examined in a dynamic context encompassing economic interests and regulatory norms.

## 2.3 Creation of the Basle Committee: Economic and Political Conditions

### *2.3.1 International Financial Turmoil in the Early 1970s*

The Basle Committee on Banking Supervision, until 1990 called the Committee on Banking Regulations and Supervisory Practices, was founded by the Group of Ten countries at the end of 1974 in response to the Bankhaus Herstatt Crisis. The Basle Committee comprises representatives of the central banks and supervisory authorities of the G-10 countries and Luxembourg—arguably because of its importance as a banking "safe haven". The Committee provided a forum to improve information exchange among bank regulators and to develop general principles for bank supervision.

Until the establishment of the Basle Committee, there was little communication among bank supervisory authorities of the major financial powers, let alone co-ordination or co-operation. Even the mutual understanding of one another's regulatory and supervisory systems was usually limited and of academic rather than practical value.[26] Given the basic premise that banking was a "domestic" industry, not surprisingly, banking regulation had been a purely domestic function. Banks took most deposits by, and made most loans to, residents denominated in the domestic currency. While there were banks with branches and subsidiaries overseas, those branches and subsidiaries engaged in local markets in which they were located, and their assets were

mainly financed by local deposits.[27] Overseas operations of this type had relatively limited impact that those branches and subsidiaries negatively affected their parent banks in home countries, and so limited impact that would pose concerns with the regulatory authority responsibility for that parent bank.

Growing offshore pools of U.S. dollar deposits and the rapid growth of the multinational companies, however, gave rise to fundamental changes in the structure of the banking industry in the early 1960s.[28] Domestic regulatory constraints pushed British and American banks to engage in offshore dollar business for their corporate clients in the late 1950s and during the 1960s, respectively. Since then, the Eurocurrency market gathered momentum and the growing interdependence of banks through the interbank market transcended national boundaries. The interbank market is a feature of the contemporary financial system: banks takes funds from, and lends them to, not only their customers, but also each other through various money markets. Thanks to the development of interbank market, banks could engage in loan business and foreign exchange trading with not only funds at their disposal but also those borrowed from other banks or financial institutions. In the early 1980s, interbank funds amounted to around 70 percent of the international banking market—much larger than the comparable ratio for the U.S. domestic banking market.[29]

Though the volume of foreign exchange trading was large enough to put severe

pressure on the Bretton Woods system of fixed exchange rates, it was not until major countries' foreign exchange rates had been left to float that its volume truly grew. The quantitative hike in foreign exchange trading was associated with high volatility of foreign exchange rates. When government intervention and capital controls constrained an exchange rate at a fixed level despite market pressures, as under the Bretton Woods system, the market was normally unanimous on both the destination and timing of fund movements. Funds tended to flow in one direction and to stay in the strong currency until devaluation occurred. In contrast, when rates became free to float, market expectations diverged substantially and capital movements became highly sensitive to shifts in expectations. New information tended to induce rapid reversals of positions. The rate fluctuated continuously and sometimes destructively as news was interpreted and reinterpreted. Each time this happened, large quantities of funds could be switched into or out of a particular currency. The result was a much greater volume of trading and volatility of exchange rates.[30]

While sharp currency movements provided banks with the new possibility of enormous profits, foreign exchange business introduced new risk profiles.[31] Speculation on the direction of a currency movement offered high risk/high return opportunities, and foreign exchange dealing became a major source of revenue. Excessive foreign exchange speculation in theory could be curbed by relevant

managerial measures and internal controls: clear limits on a bank's position in various foreign currencies; internal controls to ensure the obeisance of such limits; and a system of credit analysis to ensure borrowers could repay their foreign loans.

In the early 1970s, these measures, in reality, faced several difficulties. Intense competition among banks tended to lead managers to set lax foreign exchange limits in order to meet the demand of clients. There were also technological difficulties at that time. In the earlier stages of the floating exchange rates system, most banks had not yet developed internal accounting and operating systems giving managers "real-time" data on the banks' foreign exchange positions. Given the lack of experience, the volatility of asset prices, and the difficulty of cross-border credit checks, credit judgements for international business was far more difficult than that used in purely domestic lending. Furthermore, there remained difficulties of shielding themselves from fraudulent or imprudent behaviour by some account officers and traders.[32]

In fact, losses caused by unauthorised foreign exchange dealing were particularly heavy in the early 1970s. Union Bank of Switzerland lost approximately 150 million dollars in this way, Lloyds Bank International lost 77 million dollars, and Banque de Bruxelles something less than 40 million dollars.[33] These instances of huge losses international banks incurred indicated the difficulty of foreign exchange business and the importance of relevant banks' internal control procedures and adept experience.

Only a year after exchange rates began to float did the combination of the growing interbank transactions through the euromaket with the expanding foreign exchange dealing in an imprudent manner propound a serious challenge to bank regulators. The Bankhaus Herstatt, a German bank, incurred 450 million dollars of foreign exchange losses, and West German authorities closed it on 26 June 1974. The abrupt manner in which the bank was shut down made matters worse by bringing foreign exchange transactions conducted between Herstatt and foreign banks (i.e., part of the transaction involving Herstatt's payment to the foreign banks) to a sudden halt. The foreign banks were not able to receive payments for currency that they had forwarded to the German bank immediately prior to its close. This brought about a temporary crisis of confidence in both international foreign exchange markets and interbank markets. All but the most well known and respected financial institutions, were excluded from foreign exchange transactions and interbank loans.[34]

### *2.3.2 The Basle Committee: Its Political Origin and Development*

The failure of Herstatt revealed not only the vulnerability of international banks and potential cross-border repercussions of bank failures, but also the cross-national asymmetrical distribution of the costs generated by such bank failures. While the former served as a catalyst for much rethinking of traditional, domestic-oriented

attitudes within bank regulatory authorities, the latter had political implications, particularly for the dominant international financial centres. States with international financial centres were more exposed to the powerful international contingent effects of banking crises than others. In particular, the United Kingdom, where the City of London hosted more than two hundred branches and subsidiaries of foreign banks by the early 1970s was concerned with the clarification of regulatory responsibility for international banks.[35] Against this political background, the Basle Committee was established by the Governors of the G-10 countries under the strong initiative by the Bank of England.

The Committee consisted of representatives from central banks and from some other banking regulatory authorities. Table 2.1 shows the composition of the Basle Committee membership in 1988. Regulator meetings of the Basle Committee are usually held three to four times a year at the Bank for International Settlements (BIS) headquarters, which also provides a secretariat and administrative support. A detail often overlooked or confused is that the Committee is not actually part of the BIS. There is also a chairperson who does not act as one of the representatives of his own country, but who is responsible to the Governors as a body and who reports to them on the committee's activities.

### Table 2.1 Membership of the Basle Committee on Banking Supervision (1988)

| Member States | Representative Institutions |
|---|---|
| Belgium | Banking Commission<br>National Bank of Belgium |
| Canada | Office of the Superintendent of Financial Institutions<br>Bank of Canada |
| France | Banking Control Commission<br>Bank of France |
| Germany | Federal Banking Supervisory Office<br>Deutsche Bundesbank |
| Italy | Bank of Italy |
| Japan | Bank of Japan<br>Ministry of Finance |
| Luxembourg | The Luxembourg Monetary Institute |
| Netherlands | The Netherlands Bank |
| Sweden | Sveriges Riksbank<br>Royal Swedish Banking Inspectorate |
| Switzerland | Swiss National Bank<br>Swiss Federal Banking Commission |
| United Kingdom | Bank of England |
| United States | Federal Reserve Board<br>Federal Reserve Bank of New York<br>Office of the Comptroller of the Currency<br>Federal Deposit Insurance Corporation |
| Secretariat | Bank for International Settlements |

Source: Porter (1993) Table 3.1 p. 57.

The Basle Committee was founded as a permanent standing committee to exchange information among bank regulators on international banking activities. The Committee operates without any extensive formal mandate or any constitution or bylaws, and serves as an informal forum for ongoing co-operation on banking regulatory matters. Its decision-making is based upon consensus among its members.

This decision-making mechanism carries weight with the importance of mutual understandings and learning at the Committee.

Initially, the Basle Committee did not attempt to harmonise the existing national regulatory systems, because of a heterogeneous membership and the diversified regulatory practices among them. In order to mitigate flaws in the existing system, most of which derived from a lack of information exchange among national regulators, instead, the committee set forth three principles. First, the Committee attempted to identify gaps in the supervisory coverage of international banking. Second, it provided an opportunity for banking supervisors to learn from one another and thereby contribute to the stability of the international banking system. Third, it provided a forum in which potential dangers within national banking system could be addressed before they led to a crisis.[36]

The first fruit of the Basle Committee's work was to agree upon a framework for allocating regulatory responsibility, particularly in respect of solvency, liquidity, and foreign exchange operations and positions, for the large networks of internationally active banks (i.e., subsidiaries, branches and joint ventures).[37] The 1975 Basle Concordat placed primary responsibility for the supervision of international banks' solvency on the regulatory body of the home country where the parent bank was headquartered; while it assigned primary responsibility for the supervision of liquidity

to the authorities of the host country. In the case of subsidiaries, the host authorities should bear primary responsibility for the supervision of solvency.[38]

While the Concordat was seen as a first step towards establishing an internationally accepted approach to banking regulation, there were many important problems unsolved. The problems included, for example, which central banks should act as a lender of the last resort, how to sort out a troubled bank committing a serious fraud, and how to iron out cross-national differences in the effectiveness to carry out regulation and supervision. Being faced with these practical difficulties, the 1975 Concordat was revised in 1983 and 1992, in the wake of the 1982 scandal of the Banco Ambrosiano and the 1992 scandal of the Bank for Credit and Commerce International, respectively. Through these revisions, the Concordat re-emphasised home country control, but simultaneously strengthened the position of a host country authority, especially regarding the right to gather information on branches and subsidiaries from home country authorities and to impose restrictive measures necessary to satisfy its prudential regulatory concerns. This essentially reflected American preferences.[39] The focus was on reducing the costs of financial failures to states with the major international financial centres, notably the U.S.

From the 1974 establishment of the Basle Committee until the early 1980s, Japanese regulators played a subordinate role. The rapid post-war economic growth

facilitated Japan to participate in international financial institutions since the early 1960s. When the Group of Ten, the club of industrial countries that discussed the creation of additional IMF reserves, was established in 1961, Japan was one of its members and took part in the creation of the General Arrangements to Borrow. In 1964, Japan restored convertibility on current account, and became a member of the Organisation for Economic Co-operation and Development. However, during the 1974 crisis of confidence in both international foreign exchange markets and interbank, the so-called "Japan premium" loomed. It reflected the fact that Japanese banks did not yet build the basis of international operations. Japanese regulators also did not play an important role in coping with the international financial instability during this period.[40]

In parallel with the development of the Basle Concordat, the Basle Committee began to be concerned about the erosion of bank capital levels since the early 1980s, and played an important role in harmonising national capital adequacy standards over time. The proliferation of a certain type of capital adequacy requirements, i.e., risk asset ratios, among the member states by the mid-1980s was attributed to the learning process at the Committee. Japan and the U.S., of which domestic capital rules were relatively underdeveloped, began to adopt this particular type of capital adequacy requirements. As Chapter 4 examines in more detail, the Japanese effort to update domestic capital adequacy rules failed due to the domestic opposition, but it indicates

that regular study and discussion of the regulatory systems used in each of the member states enabled Japanese regulators to learn about new developments in regulatory techniques.

To say that the Basle Committee has provided an institutional framework for the learning process, however, is not to suggest that the regulatory development in the Basle Committee was politically neutral. To the contrary, the development of the international harmonisation of capital adequacy requirements reflected the interests of the powerful states with the major international financial centres. As mentioned above, international standards for capital adequacy requirements have the asymmetrical distribution of costs and benefits within and across countries. This distributional consequence should be taken into account.

The idea of "fairness" is central to understanding the domestic politics of international banking in the American context.[41] As Kapstein points out, on the one hand, the American initiative in the Basle Accord can be seen as a long-term stabilisation strategy of strengthening international banks in the wake of the serious debt crisis in the early 1980s.[42] For American banks, on the other hand, the goal of creating a level playing field is to establish a fair competitive environment in which foreign banks cannot explore the advantage of their lax domestic regulations. This logic underlined American banks' intense lobbying against unilaterally strict capital

rules in the U.S. and for harmonising cross-national differences. Given this political background, American regulators decided to take the initiative in pursing collective action at the Basle Committee.[43]

It should be noted, however, that European integration had significant effects on the Basle process prior to the American initiative. Following the first EEC Banking Co-ordination Directive of 1977, the EEC Advisory Banking Committee defined a number of observation ratios in 1980, and 'risk asset ratios' was one of them. European regulators developed the idea of the risk-weighted capital adequacy on which the Basle Committee drew when initiating its own work on capital adequacy requirements in the early 1980s.[44] Furthermore, in order to level a playing filed between the banking and securities industries, the Capital Adequacy Directive (CAD) was established in 1993. The CAD became a base for the 1993 Basle proposals for market risk regulation. In order to reduce the costs of adjustment, European members of the Basle Committee had a strong incentive to make Basle capital rules compatible with European rules.

As regards Japanese participation in the international regulatory harmonisation process, several principals and pressures for participation are deemed to work. At the international level, they include regulators' concerns over financial stability, pressure exerted by the United States, and market pressure. At the domestic level, political, economic and institutional factors affected the course through which regulators

participate in the international harmonisation process. In Japan, domestic capital rules were not institutionally developed and private banks took the advantage of such lax regulations before the Basle Accord, and the economy plunged into severe recession in the 1990s. Such domestic factors were crucial in determining regulators' preference formation, negotiation positions, and implementation. Several hypotheses on consequences of international and domestic factors and their interactions will be examined in Chapter 3. The following sections will provide rough sketches of the 1988 and 1996 capital adequacy regulations.

### *2.3.2 The 1988 Capital Adequacy Accord*

While these initial works of the Committee focused primarily on the delineation and co-ordination of regulatory responsibilities, the Committee's attention turned to the substance of prudential regulatory norms. This led up to the establishment of a set of common capital adequacy requirements, the Basle Capital Accord. As in the case of the initial Committee's works, the focus on the importance of solvency in the supervisory processes was observed in the following discussion of ways of measuring and setting standards of capital adequacy.[45] As the domestic politics of capital rules prior to the Basle Accord and Japanese participation in the Basle negotiations will be considered in detail in Chapters 4 and 5 respectively, only the gist of the minimum

capital standards is given here.

As Figure 2.1 shows, internationally active banks were required to keep the ratio of capital to risk-weighted assets (a risk asset ratio) more than 8 percent. Under the Basle rules, regulatory capital, which was the numerator, consisted of two parts: core capital (Tier I) and supplementary capital (Tier II). Tier I was defined as shareholders' equity and disclosed reserves, and had to account for at least half of the bank's total capital. Tier II comprised less "pure" capital, i.e., undisclosed reserves, general provisions, asset revaluation reserves, hybrid capital instruments and long-term subordinated debt. Meanwhile, the bank's assets, or its credit exposure in more general terms, were the denominator. Bank's assets on the balance sheet and its off-balance sheet exposure were divided into broad categories, and each of the categories was weighted according to risk. For example, while the multiplier 1 (100 percent) was placed as a risk-weight on corporate loans, the multiplier 0 (0 percent) was placed on cash and OECD countries' national bonds. These asset categories were then simply added together.

Figure 2.1 The 1988 Basle Capital Accord

$$\frac{\text{Capital (Tier I + Tier II)}}{\text{Risk-weighted Assets: (cash, OECD bonds} \times 0\%) + (\text{mortgage loans} \times 50\%) + (\text{loans} \times 100\%) \text{ etc.}} \geqq 8\ \%$$

Notes: Tier I capital consists of capital stock, capital reserve, retained earnings, and etc.
Tier II capital consists of 45% of unrealised capital gains, general provisions, subordinated debt and etc.
Tier I capital must account for at least half the numerator.

The Basle Accord was not an international treaty but rather a "statement" or a set of "recommendations", therefore it was not legally binding. The Basle Committee also did not state any sanction about the banks' failure to meet the required ratio of 8 percent. The implementation of the minimum standard was left to the national government's discretion. Although the Basle Accord was directed to the committee member countries, the Committee made every effort to have the Accord recognised by as many non-member countries as possible. In 1988, the International Conference of Banking Supervisors, consisting of bank regulators representing about 100 countries, was held in Tokyo and discussed the world-wide promotion of the Accord.[46]

*2.3.3 The 1996 Amendment to Incorporate Market Risk*

The rapid involvement of banks in the securities markets, whether directly or through affiliated firms, propounded serious regulatory concerns and led bank regulators to

develop prudential mechanisms for the control of the additional risk incurred by the banks in this manner. In 1996, the Basle Committee agreed on the amendment of the Basle Capital Accord in order to address the problem of banks' involvement in the securities markets. While the 1988 Basle Capital Accord required banks to set aside a minimum amount of capital to guard against the risk that those they lent to might go bankrupt (so-called credit risk), the 1996 Amendment applied capital charges to the risk of losses in on- and off-balance-sheet positions arising from movements in market prices (so-called market risk). Chapter 6 addresses the negotiation process of the Amendment and Japanese participation.

As Figure 2.2 shows, while under the 1988 Basle Accord the ratio of capital was related to risk-weighted assets that were measured by the single method, bank assets were divided into trading and banking books under the rules of the Amendment. Risk exposure in each book, and in turn required capital, were separately measured. The trading book consisted of short-term transferable securities; the banking book comprised the rest of financial business. The banking book was still subject to the existing 1988 rules. New measurement methods, either the standardised method or banks' internal model, were used for the trading book. With regard to capital, a new category of capital, Tier III, was added only to cover market risk (see Figure 2.3). Tier III was short-term subordinated debt. Under the 1988 rules, only long-term

subordinated debt was allowed to be counted as part of Tier II. Yet, as securities regulators widely allowed securities houses to regard short-term subordinated debt as part of capital, the Basle Committee permitted banks to count it as capital that only covers market risk.

Figure 2.2 Conceptual Pictures of the 1996 Amendment

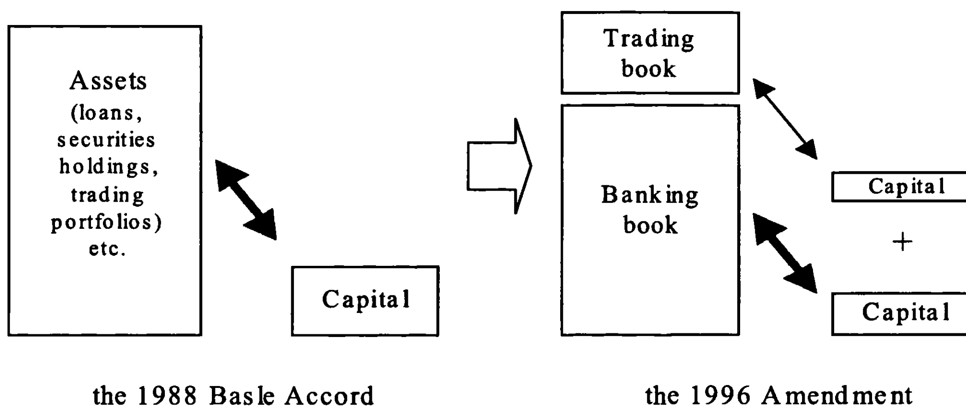


Figure 2.3 The 1996 Amendment

$$\frac{\text{Capital (Tier I + Tier II)}}{\Sigma\text{ (asset categories in banking book} \times \text{risk weights)}} + \frac{\text{Capital (Tier I + Tier II + Tier III)}}{\text{market risk in trading book}} \times 12.5 \geqq 8\ \%$$

Notes: Tier I capital consists of capital stock, capital reserve, retained earnings, and etc.
Tier II capital consists of 45% of unrealised capital gains, general provisions, long-term subordinated debt and etc.
Tier III consists of short-term subordinated debt, and is allowed to be counted as part of capital only to cover market risk.
Mark risk in trading book is measued by either standardised methods or banks' internal models.
12.5 is the reciprocal of 8 %.

The 1996 Amendment represented a milestone in the development of international banking regulations in terms of regulatory methods: for the first time, banks were allowed to use their own risk models for estimating capital requirements for market risks that they were taking. Such regulatory facilitation of banks' internal risk models was the first contribution to the on-going overhaul of the 1988 Basle Capital Accord, which will come into effect in 2006 or 2007. The proposed new Basle Accord will use the banks' own internal ratings where these are judged robust, and effectively allow banks with sophisticated risk management systems to hold less capital.[47] Among regulators, bankers, and economists, it is frequently claimed that given the growing complexity of financial transactions and the development of private sector risk management, one-rule-fits-all type capital adequacy requirements are no longer efficient for regulating leading banks possessing sophisticated risk management skills and, therefore, there is no alternative but to delegate part of the regulatory functions to the banks. Thus, the 1996 Amendment stood at the crossroads in the development of international banking regulation. It signalled a shift towards a new division of labour between the regulators and the regulated, and a more sophisticated approach to regulation which would be compatible with both banks' in-house control models and their internal risk management systems.

## 2.4 Conclusion

This chapter argued economic rationales for and political implications of international banking regulation, with special reference to capital adequacy requirements. Banking regulation never emerges in a political vacuum. Given a general trend towards financial liberalisation and external economic shocks such as the debt crisis, regulatory importance of capital brought capital requirements into the spotlight. Namely, while banks gained a greater freedom of operations throughout the 1980s, they continued to reduce their capital-to-asset ratios that were deemed as buffers against unexpected losses and risk containment. It sparked off regulatory concerns by regulators. At the same time, competitive conditions of banks are uniquely sensitive to the level of capital requirements. This nature of capital has provoked political concerns among interested actors including the regulators and the regulated.

Regulators and banks interpreted their interests under changing economic and political conditions and interacted with one another in pursuit of their own interests. In particular, political conflicts were over regulatory scope (Which assets and which banks should be regulated?), the definition of regulatory capital (Of which components should capital be made?), and the measurement framework (How should risk be estimated?). The thread of argument about these political questions is running throughout this research.

The creation and development of the Basle minimum capital standards is a dynamic political process in which domestic and international political forces interact to produce outcomes. The next chapter will develop several hypotheses drawing on the logic of two-level games and consider possible alternative hypotheses based upon domestic institutional explanations.

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[1] It should be noted that the European Union (formerly European Community) has been providing a regional framework for banking regulation since the 1950s.
[2] Cooke (1981: 238).
[3] Drucker (1986:781-82). See also *The Economist*, "Get ready for the phoenix", 9 January 1988, and the Bank for International Settlements, "Survey of Foreign Exchange Market Activity", February 1990.
[4] Polanyi (1944: 140) argued the historical evolution of free markets: "far from doing away with the need for control, regulation, and intervention, enormously increased their range". See also Cerny (1993b), Moran (1991) and Vogel (1996).
[5] This section is indebted to Goodhart, *et al.*, (1998) and Santos (2000).
[6] The politico-economic view of markets in this thesis owes a considerable debt to a series of works by Underhill (1991; 1993; 1994; 1997a), among other political economists. The "regulatory capture" approach of economics also challenges the argument that regulators provide "public goods". For the re-distributive nature of the Basle Accord, see Kapstein (1989; 1992; 1994) and Oatley and Nabors (1998).
[7] Halperin and Kanter (1973: 10-12).
[8] See footnote 7.
[9] Cooper (1968).
[10] Kapstein (1989; 1992; 1994), Oatley and Nabors (1998).
[11] Hadjiemmanuil (1996: 55).
[12] See Haufler (2000) for a general argument about private sector international regimes.
[13] See Porter (1991) and Coleman and Porter (1994).
[14] See http://www.group30.org
[15] For the establishment of the IIF, see *Financial Times*, 13 January 1983, "Banks set up world data exchange".
[16] The Group of Thirty (1997: 12).
[17] The Group of Thirty (1997: 27).
[18] For the importance of knowledge in providing international public goods, see Martin (1999).
[19] Jackson, Maude and Peraudin (1998) and Santos (2000) contain wide literature reviews on bank capital requirements.
[20] For various roles that bank capital plays, see Matten (1999).
[21] This attribute of capital excludes from its definition both specific loan provisions for prospective losses on particular accounts which are made on the basis of full cover for bad and doubtful debts and general loan provision for doubtful advances on the ground that they represent a prudent setting aside of earnings against latent loss.
[22] There is rich and extensive literature on the effect of capital adequacy regulation on bank behaviour. See, for example, Di Cagno (1990: 30-37).
[23] The strict regulatory framework involved controls over interests rates and capital movements,

restrictions on portfolio composition and the segmentation of financial institutions (geographically, by maturity of borrowing and lending activities, and by the involvement of securities business, etc.). For comparative studies on the politics of financial liberalisation, see Moran (1991), Vogel (1996), and Underhill ed. (1997).

[24] For the development of the international monetary system, see Helleiner (1994), Eichengreen (1996) and Walter (1993).

[25] For a cross-national comparative survey of capital adequacy rules before the Basle harmonisation, see Dale (1984: chap. 5).

[26] Blunden (1977a).

[27] See Cohen (1986).

[28] Cohen (1986).

[29] Dale (1984: 74-5).

[30] Giddy (1976).

[31] Dale (1984: 73).

[32] Kapstein (1994: 38-39).

[33] James Dean and Ian Giddy, *Averting International Banking Crises*, Monograph Series in Economics and Finance, 1981-1 (New York University, Salomon Brothers Centre) pp. 4-8. Quoted in Dale (1984: 74).

[34] Spero (1980: 110-13) and Giddy (1976).

[35] See Kapstein (1994: 44-8).

[36] Blunden (1977a: 196-98; 1977b: 326)

[37] Cooke (1984), Dale (1984: 173-75), and Porter (1992: 58-61).

[38] Kapstein (1994: 48-56).

[39] Kapstein (1994: 172).

[40] Ōta (1991: 47).

[41] Granirer (1994: 154-55).

[42] Kapstein (1994: 87-92).

[43] Kapstein (1992; 1994) and Oatley and Nabors (1998).

[44] See Chapter 4.

[45] Cooke (1990: 313-14).

[46] *Nihon Keizai Shinbun*, 23 February 1988. The International Conference of Banking Supervisors was founded in 1979, and since then has been held regularly. For its origin, see "International Conference of Banking Supervisors", *Bank of England Quarterly* 19 (1979: 298).

[47] *Financial Times*, "New framework for credit risk in emerging markets", 17 January 2001.

# Chapter 3

## Two-level Game Model and its Alternatives

### 3.1 Introduction

The aim of this chapter is to offer hypotheses on bank regulators' behaviours in the process of international regulatory harmonisation. To this end, the first section outlines a set of policy behaviours and economic outcomes against which to test the hypotheses. The second section presents three sets of hypotheses: a model based upon Putnam's two-level games; a model emphasising the centrality of domestic institutions in defining the probable course of policy; and, systemic-level models assigning greater emphasis to either inter-state power relations or market forces.

The two-level game model sees state negotiators as actors in pursuit of their preferences, and hypothesises several strategies with which negotiators can improve the opportunity to take advantage of the international and domestic interaction. Some might argue that, under the logic of two-level games, a negotiating officer is an agent on behalf of his/her domestic constituents and thus cannot have endogenous

preferences. As Putnam mentions, however, relaxing this assumption of state negotiators as agents sheds light on the motives and strategies of the negotiator to cope with his/her competing priorities.[1] The domestic institution model hypothesises that the informal nature of regulatory network in Japan is a major source of "institutional stickiness" or institutional inertia, which hampers a smooth shift towards rule-based, arm's-length prudential regulation. The image of systemic-level models hypothesising that structural factors determine the course of policy stands in sharp contrast to the image of state negotiators are enmeshed in domestic Japanese bureaucratic and political processes, which the other hypotheses assume.

### 3.2 Indicators of Credible Commitment

How can we know a given country's adherence to the Basle Capital Accord? The Basle Capital Accord is a set of international standards for capital adequacy requirements. For international regulatory standards to be promulgated widely, they must be general enough to accommodate variations in national traditions and economic cultures as well as different national financial system structures. Precisely because of this nature of international standards, the Basle Accord gave national regulators wide discretionary powers to determine the exact way in which it was operationalised within their jurisdiction. This makes it difficult to evaluate a given country's commitment to the Basle Accord. For example, merely meeting the

minimum requirements alone is questionable when accounting standards are inadequate and/or when definitions of impaired loans and required provisions are loose, since there can be considerable slippage between actual and putative capital. Japan has been accused of both.[2]

Just looking at the numerical achievements of Japanese banks, therefore, is not enough to evaluate implementation—a sequence of actions by regulators to carry out the terms of an international agreement. It inherently requires considerable judgement about compliance—the degree to which national regulators, and ultimately private banks themselves, adhere to the spirit of an international regulatory accord. In terms of regulatory prudence, the object of capital adequacy requirements is to make individual banks more resilient to unforeseen losses, thereby increasing the safety and stability of the banking system as a whole. For individual banks to be more resilient, both the quality and the quantity of capital are of importance. For national regulators to strictly comply with prudential regulatory goal of monitoring bank solvency, therefore, they must ensure that related policies support the goal of prudential regulation. In other words, discretionary policies working against this regulatory goal are deemed to move away from meeting the principles for the prudential practices in capital adequacy requirements. Reaching an agreement on international standards and even adopting them as domestic standards—"formal compliance"—should be distinguished from effectively implementing them—"real

compliance".

To analytically examine the indicators of credible commitment to or real compliance with the Basle Accord, capital adequacy requirements are cast as a set of norms:

(1) Capital adequacy is a tool of monitoring bank solvency, and thereby a linchpin of prudential regulation.
(2) Bank regulators should make efforts to make regulatory capital-to-assets ratios more closely attuned to the reality of banks' financial states.
(3) Bank regulators should promptly act to cope with insolvent or undercapitalised banks.

All three norms are related. The monitoring of bank solvency by regulators is the core of prudential regulation. A capital-to-assets ratio is an index of bank's solvency. For monitoring function to be effective, banks' capital ratios must precisely mirror their financial strengths. It is true that, in reality, it is technically challenging to have the balance sheet of a bank exactly reflect its true economic value because not only mark-to-market accounting in general but also market-based estimates of the bank's franchise value or goodwill need to be fully considered. What the second norm requires, however, is to devise the measurement of capital ratios in a less distorted

way, thereby having capital adequacy ratios more accurately reflect a bank's financial status. The monitoring of accurate capital ratios is a necessary condition for bank regulators to swiftly take corrective actions against weakly-capitalised banks. These norms and measures are the baseline against which this study analyses policy choices regarding a given country's commitment to international capital adequacy requirements.

The following help define indicators of credible commitment to the Basle Capital Accord or lack thereof:

(1) *Numerical compliance with required capital adequacy ratios*—banks are at the very least required to meet the capital adequacy ratios. Falling short of this criterion clearly signals non-compliance.

(2) *Statutory capital adequacy rules*—statutory rules are necessary, if not sufficient, for rules-based, arm's-length prudential regulation, which helps reduce the tendency of "regulatory capture" and the scope of regulatory forbearance. A lack of statutory rules weakens credible commitment to the Basle Capital Accord.

(3) *Accounting principles, and loan classification and provisioning rules*—accounting and provisioning rules are crucial for reducing uncertainty about banks' financial states and the quality of capital and assets. Opacity in

these rules is likely to result in a considerable gap between real and putative capital and therefore means a weaker commitment to the Basle Capital Accord.

(4) *Regulators' prompt corrective action*—to the end of prudential regulation, bank regulators are required to swiftly take corrective actions against ailing banks (e.g., closing down of undercapitalised banks or re-capitalising weak banks in exchange for rigid restructuring plans). While a failure to promptly act undermines the credibility of Basle adherence, the institutionalisation of regulators' prompt corrective action will reduce the scope of regulatory forbearance and thereby increase credible commitment.

Rigid adherence to the norms of capital adequacy requirements requires bank regulators to place these above-mentioned policy behaviours ahead of other concerns. Even if these policy behaviours may contribute to the long-term and general gains in terms of promoting financial stability, however, they may unevenly impose short-terms costs on various segments of society. For example, when banks make efforts to increase their capital ratios by shrinking their loans, a so-called credit crunch is likely to hit small- and medium-sized businesses lacking alternative sources of financing through the capital markets.[3] A radical shift towards prudential regulation under a banking crisis may require the unpopular policy of using public

money to bail out ailing banks. Especially when the sloppy management and fraud of the banks concerned are revealed, the use of taxpayers' money is especially unpopular. Politicians may take the blame. To curb such public criticism, the use of public money to recapitalise banks will be offered with strings attached, and inherently invites political interference in bank's management and lending decisions. Therefore, bankers are often reluctant to ask for the infusion of public funds.

In short, there are various forces pulling and pushing in various directions as to compliance with the Basle Accord. In order for countries to comply with the spirit of the Basle Accord, national bank regulators must have enough domestic support to pay for the short-term costs. For countries to effectively defect from the Accord, they must have enough political forces to press for leniency in prudential regulation and to break their commitments.

The next section will provide several hypotheses on political forces affecting the course of banking regulation. The four indicators of numerical compliance, statutory rules, accounting principles, and regulators' prompt action are policy behaviours and economic outcomes against which to test the hypotheses in the empirical part of this thesis.

## 3.3 Hypotheses on Japanese Commitments to the Basle Accord

### *3.3.1 Two-Level Game Hypothesis*

#### 3.3.1.1 Two-level Game in International Banking Regulation

The two-level game framework is one of the most popular and influential conceptual building-blocks in the subject of diplomacy and international cooperation, and international relations in general.[4] Although it has been the subject of modification since its elaboration in the late 1980s, it has remained central to research in the discipline.[5] The basic proposition is that state negotiators are typically playing in two political "games"; that is, they are engaged in domestic and international politics simultaneously. The international and domestic interplay not only constrains policy makers, but also creates new possibilities for creative statecraft. One of the most distinctive features of the two-level-game logic is that "domestic policies can be used to affect the outcomes of international bargaining, and that international moves may be solely aimed at achieving domestic goals".[6] The two-level-game approach assumes that each state negotiator is constrained by his/her domestic win-sets, defined as the set of potential agreements that would be accepted by the most powerful domestic groups. The approach propounds a wide range of bargaining strategies with which state negotiators manipulate the configuration of domestic and foreign win-sets in order to achieve their preferences.[7]

The politics of international financial regulatory co-operation can be understood

in terms of a two-level-game analogy.[8] Bank regulators attending the Basle negotiations are supposed to engage in negotiations with foreign counterparts at the international level, and each of them simultaneously is concerned with the domestic implications of the international negotiations. This perspective helps us to hypothesise regulators' behaviours in the process of international regulatory harmonisation.

Since the late 1950s, when the offshore Eurocurrency market gathered momentum, international finance saw states giving banks an ever-increasing degree of freedom; leading to a concomitant increase in cross-border financial transactions.[9] A deepening of financial interdependence among countries posed substantial political and economic challenges to bank regulators. One of them is that bank regulators are faced with a potential dilemma between the maintenance of a sound domestic banking system and the economic interests (or international competitiveness) of domestic banks under the condition of highly integrated financial markets.[10]

On the one hand, the increase in risk-taking approach of banks accompanying the expansion of their international operations necessitates regulatory means of curbing their imprudent risk-taking. The unique importance of banks in the payment system underpins the maintenance of the sound banking system as a public good.[11] In addition, failure to contain banks' reckless risk-taking would lead unavoidably to an explosion in the costs of maintaining public safety nets for the banking industry,

since the authorities would be forced to bail out a growing number of troubled banks. Thus, the inept handling of a banking disaster by regulators puts political pressure on the regulators themselves. To put it another way, the pursuit of prudential regulatory measures serves the regulators' goals of defending their essential mission and bureaucratic "turf", and maintaining the organisation's autonomy.[12]

On the other hand, bank regulators need to be concerned with the economic interests of private banks. As the "regulatory capture" literature clearly shows, regulated groups with high stakes in the regulation-making process can prevail in struggles with other interests.[13] Since capital adequacy requirements transfer some of the costs of regulatory protection from consumers to banks themselves, banks have incentives to mobilise politicians and to block the introduction of such regulations. According to this line of argument, for bank regulators to minimise politicians' intrusion into the making of regulations, it is necessary to keep the banks satisfied that they are getting a fair deal.[14] In addition, given the growing internationalisation of banking operations, bank regulators have an interest in protecting and promoting the international competitiveness of their national banking industry. It would be undesirable for such regulators to impose unilateral regulatory restrictions that put their domestic banks at a competitive disadvantage against international competitors. The adoption of stricter requirements for banks enjoying lax domestic capital adequacy requirements means not only imposing extra

regulatory costs on the banks, but also eliminating some sources of regulation-induced advantage.

Bank regulators thus confront a dilemma: more regulated financial systems might be safer, but banks placed under stricter domestic regulations would also operate at a competitive disadvantage. A multilateral approach to regulatory harmonisation seems the best means of resolving the policy dilemma with which the increasing necessity of imposing prudential regulation presents national regulators.[15] International regulatory co-ordination could ensure some sort of a competitive "level playing field" for international banks, while curbing domestic opposition and permitting national regulators to pursue prudential regulation.

Furthermore, international banking regulations, which were laid down by the Basle Committee, can be seen as an international regime—a set of "implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations".[16] The Basle Committee has constructed an institutional platform in which its member regulators regularly gather, pool their expertise, and develop international standards for banking regulation. This suggests that developments in regulatory norms and methods at the Basle Committee can be translated into a national level.[17]

The autonomy of national regulators, however, is not self-evident at the domestic level, and therefore transnational proliferation of certain regulatory methods is

subject to domestic politics. There is disagreement over the degree of state autonomy in the literature of Japanese banking regulation. While some argue that Japanese bank regulators enjoy a high degree of autonomy, others argue that they are subject to regulatory capture.[18] As far as the issue of domestic capital adequacy rules in Japan is concerned, it is difficult to say that bank regulators enjoyed a high degree of autonomy. In contrast, the capital adequacy rules were effectively watered down in Japan. As seen below, the logic of two-level game shows several strategies that bank regulators can use to shore up their policy autonomy.

#### 3.3.1.2 Insights from a Two-level-game Framework: Regulators' Strategies

Informed by the two-level-game approach, this section considers various strategies with which the Japanese MoF sorts out the regulatory dilemma between keeping the domestic banking system sound and Japanese banks internationally competitive. The two-level-game approach assumes that each state negotiator at the international negotiating table is constrained by his/her domestic win-sets, defined as the set of potential agreements that would be accepted by the most powerful domestic groups. The two-level-game approach helps us comprehend how domestic policies can be used to affect the outcomes of international bargaining, and how international moves may be utilised to attain domestic objectives. The typology of strategies for simultaneously exploiting both domestic and international politics in a bargaining

situation is examined here.

One strategy drawn from the two-level-game approach is what Putnam labels "reverberation", i.e., international pressures change the domestic power balance or the preferences of domestic groups.[19] This implies that international actions can be employed to change outcomes in the domestic arena. By joining international regimes or linking issues in international negotiations, negotiating officers can use an internationally agreed issue as external leverage to withstand domestic opposition, to legitimise unpopular policy goals, and thereby to shore up their autonomy vis-à-vis domestic interest groups.

The MoF is assumed to have multiple, potentially conflicting objectives (i.e., keeping the domestic banking system sound and domestic banks competitive) and to have partial autonomy. That is to say, although the ministry has its own objectives, its capacities to achieve them are not necessarily ensured. State capacity to achieve policy preferences is not determined independently of societal pressures. Nor is state autonomy automatically derived from the domestic institutional setting. Instead, state autonomy depends upon policymakers' statecraft, using which they strive to achieve policy goals.[20] The extent to which policymakers attain their own preferences is contingent upon their skill in conducting negotiations with societal actors and is determined exogenously.

It can also be interpreted in terms of the issue of regulatory independence.

Regulatory and supervisory independence of the financial sector is seen as a key element in maintaining financial stability, but in reality many national authorities lack such independence.[21] The regulation-making process is likely to be exposed to pressure from both the banking industry and politicians. Joining an international regulatory agreement can be seen as a supplementary policy for resolving a lack of regulatory independence. Thus, one of incentives for joining international agreements is a regulator's perception that resources available domestically are inadequate to sort out a politically controversial issue, and that "reverberation" might provide additional leverage with the regulator.[22]

The two-level interplay also gives regulators strategies to reshape the configuration of the win-set of domestic constituents with the aim of reaching an international agreement and/or increasing their international bargaining position. One of those strategies is what Putnam terms "synergistic issue linkage": by linking a tough policy issue with more popular policy measures, negotiators can enlarge the size of domestic win-sets.[23] A larger domestic win-set gives negotiating officers more leeway to reach a compromise with their foreign counterparts. Another strategy is the manipulation of asymmetric information between negotiating officers and domestic constituents.[24] During international negotiations, regulators may be able to take advantage of their exclusive power to negotiate with their foreign counterparts and the uncertainty of the domestic constituents about the content of the negotiations.

These strategies tell us where to look to understand how the two-level interaction created room for the MoF to manipulate domestic politics in pursuit of its desired international outcomes.

Behind this hypothesis, there is an assumption that bank regulators are the sole, formal interface between domestic and international domains,[25] and simultaneously they are enmeshed in domestic and international institutions. At the domestic level the focus is on relationships between regulators and banks which are most affected by the regulatory change associated with international co-operation. At the international level, only regulators attain formal access to the negotiation table. Private actors and politicians normally do not have direct channels to international negotiations in Basle, and therefore turn to regulators in order to inject their preferences into the negotiation outcomes. Although this highlights the distributive nature of international regulation, an international institutional setting provided by the Basle Committee has also enabled the collective work among its members to play a significant role in diffusing certain regulatory norms. By locating regulators at the link between international and domestic institutions, this assumption allows regulators to play a pivotal role in balancing domestic and international concerns.

The above argument implies that the MoF was playing domestic and international games simultaneously. At the international level, the MoF negotiated with its foreign counterparts with the aim of maintaining the international competitiveness of

Japanese banks. At the domestic level, the ministry used the international negotiations to manipulate domestic politics and to strengthen the domestic capital regulation which private banks had blocked.

*3.3.2 Domestic-level Explanation: A Network State and Institutional Inertia*

An alternative explanation for Japanese participation in the Basle process accords a central role to domestic institutions. While the logic of two-level game approach emphasises regulators' statecraft to pursue their preferences, an institutional approach explores the reason why institutions centred on informal models of interaction may turn out to be particularly "sticky".[26]

3.3.2.1 Japan as a Network State

Looking at the institutionalised relations among state bureaucracy, politicians of the ruling Liberal Democratic Party (LDP), and interest groups, Daniel Okimoto provides a breakthrough in the issue-based classification of Japan's policy-making processes.[27] He sees Japan as a "network state". A network state is defined as "one able to exercise power only in terms of its network of ties with the private sector".[28] On the one hand, various institutional arrangements in the Japanese political economy may give state bureaucracy policy measures with which to intervene in the marketplace. On the other hand, bureaucratic power is institutional-driven; that is, it

emerges from specific institutional structures of LDP-bureaucracy-interest group alignments and the political exchanges that take place among them. This means that the autonomy and power of bureaucracy varies noticeably between and within the different sectors. Thus, autonomy is a matter of degree and the degree varies across bureaucratic jurisdiction.

In order to examine the basis for outstanding variations across sectors in the degree of which Japanese industrial policy is politicised, Okimoto divides policy-making processes into four categories according to modes of state-society relations: "clientelistic linkages", "reciprocal patronage", "generalised support", and "public policy feedback".[29] In each category, the bureaucracy, the LDP and interest groups form a distinct mode of their connections and political exchanges.

Firstly, the type of "clientelistic linkages" covers sectors of solid, traditional support groups for the LDP (agriculture, the medical professionals, small- and medium-scale businesses, and so on), and LDP members continuously intervene in policy-making in pursuit of votes in exchange for favourable legislation, subsidies, generous tax treatment and other promotional policies. Ministries having jurisdiction over these sectors are exposed to LDP's interventions. In such political exchanges, the interrelations among the LDP members, the interest groups and the ministries concerned have been rigidly routinised over decades, and the policy-making process has been highly politicised. Secondly, "reciprocal patronage" type is based on the

recycling of political patronage and has the similar configuration of political exchanges to that of "clientelistic linkages", but the relations among bureaucrats, the LDP politicians and interest groups are less routinised than those of clientelistic linkages. The industries that can mobilise local votes, such as construction, housing, and real estates, fall into this category.

Thirdly, big business and financial firms fall into the category of "generalised support". In contrast to the former two types of political exchanges characterised as LDP's massive intervention, according to Okimoto, this third category is typified by LDP's slight intervention and strong bureaucracy-industry relationships. Political contributions from these sectors to the LDP are enormous, but not tied to specific issues and policies; rather their aims are to secure a general favourable business climate under the rule of the conservative government. Thus, there is rarely an intrusion by the LDP politicians into the policy-making processes regarding these sectors and thereby the bureaucracies having jurisdiction over these sectors (i.e., the Ministry of International Trade and Industry - MITI [currently the Ministry of Economy, Trade and Industry] and the MoF) can enjoy a high degree of autonomy. The bureaucracy-industry relationships are the central linkages for this type of political exchanges.

Finally, "public policy feedback" type revolves around such issues as environmental preservation and social welfare in which "floating voters" or

independent, non-clientelistic voters are interested. Any particular interest groups and bureaucracies that would be involved in this type cannot be specified.

Okimoto concludes "the secret of the power of the Japanese state [i.e., outstanding variations across sectors in the degree of which Japanese industrial policy is politicised] thus embedded in the structure of its relationship to the rest of society".[30] His study has, at least, two implications. One is the shift from a focus on the state's role in the idea of "Japan, Inc.", which regards Japan as a unified front, towards the broader interest in the relationships between the state and society.[31] This shift mirrors the emergence of "new institutionalism" in comparative politics.[32] Although in his study of the Japanese industrial policies in high-technology sectors, Okimoto claims an autonomous role for MITI in implementing industrial policies, he also pays close attention to mutual communication and consent between the MITI and the industry prior to the formation of industrial policies.[33]

The other implication that Okimoto's study generates is the shift from the aggregate-level perspective of policy-making towards the sectoral perspective. This shift took place along with the growing literature on sectoral policy network or sectoral governance.[34] The literature suggests that the aggregate-level perspectives of policy-making patterns cannot be simply applied to examine state-society relationships in a specific issue area.[35] Although it might be possible to characterise the Japanese style of state-society relations as a whole in terms of certain singular

ideas and institutions, this overall characterisation does not preclude considerable variation across sectors. Namely, it is necessary to devise a more relevant framework with which to narrow our focus to more specified policy issues and circumstances.

According to Okimoto, financial issues are categorised as "generalised support", where there is little intervention of the LDP, and for which the relationships between the MoF and private financial firms are the crucial linkage.[36] However, the mode of relationships among bank regulators, LDP politicians and banks is still open to question. As seen below, contrary to Okimoto's classification, banking regulation is likely to be subject to societal interests, and bank regulators enjoy less policy autonomy than usually expected.

3.3.2.2 Informal Network in Banking Regulation: Network State Hypothesis

Developing the perspective of Japan as a network state, Jennifer Amyx argues that in the realm of banking regulation, various actors concerned were embedded in an informal relational network, and policy behaviours began to be constrained by the embedded nature in the 1990s.[37] This leads to a network state hypothesis: dysfunctional domestic institutions hamper Japanese credible commitments to the Basle Accord. The informal relational network functioned very well during the rapid growth period of Japan. Once several favourable conditions that used to underlie the informal networks eroded, the same network generated inertial tendencies and

constrained more than empowered the government in its policy options and decisions. For this study, three pillars of the informal network of the Japanese banking regulation are examined here. They are the Japanese Diet's oversight of bank regulators; the MoF's relational ties with banks; and bank governance structure (main bank system).

Firstly, institutional arrangements for the Japanese Diet's oversight of bank regulators had a principal-agent problem between regulators and politicians. When principals (politicians) and agents (regulators) are not equally well informed, more informed agents are able to take opportunities and not to carry out appropriate practices in dealing with less informed principals. Diet members were not in a perfect position to monitor and assess the behaviour of the MoF due to institutional deficiency of the oversight of regulators, and therefore they employed "fire alarm" rather than "police patrol" oversight of the MoF.[38] Under this sort of oversight, as long as the financial system was perceived as stable, politicians neither closely watched over the regulators nor intervened in the regulatory policy-making process.

Secondly, informal, exclusive connection between the MoF and individual banks were carried out through several channels: daily face-to-face contacts between bank employees called *MoF-tan* (MoF-handlers or liaisons) and Banking Bureau officials of the MoF; the assumption of posts in private banks by retired MoF officials (so-called *amakudari* or "descent from heaven"); and the temporary assignment of

private sector employees to positions within the MoF (so-called *ama-agari* or "ascent to heaven"). These informal liaison channels enabled MoF officials to convey advice to banks as well as to detect problems at the early stage and, if necessary, to arrange an assisted merger between an ailing bank and a stronger one behind closed doors to preclude formal failure. Banks were cooperative in sharing information with the MoF in the expectation that the MoF would come to rescue when they were in trouble, and banks cooperated in arranging the rescue operations because the MoF awarded the licence of extra branch offices to cooperative banks.[39]

Accounting rules were also set through exclusive networks revolving around the MoF. The Business Accounting Council, an advisory panel to the MoF, played a pivotal role in determining accounting rules. The council consisted of academics, journalists and industrialists. MoF officials, however, played key roles in screening potential members, setting agendas, and conducting meetings.[40] There was no independent, private accounting rule-setting organisation in Japan[41]. The MoF had discretionary powers over the accounting rules setting process.

Thirdly, a so-called "main bank" system, which was based on the implicit and informal but long-standing relationships between banks, their client firms, and regulatory authorities, played a crucial role in monitoring loan portfolios.[42] The relationships between the firm and its main bank served five functions: (1) a main bank provided loans and was a major creditor; (2) a main bank committed bond issue

related services; (3) a main bank was a major stockholder; (4) a main bank carried payment settlement accounts; and, (5) a main bank supplied management information and resources and acted as a rescuer of financially depressed firms.[43] These long-standing relationships of that system had served to reduce uncertainty and transaction costs.

The network state hypothesis argues that these informal forms of banking regulation turn out to be a stumbling block to credible commitment to the Basle Accord when they are stressed. As regards the MoF-politician relations, the "fire alarm" oversight of the MoF induces the regulators to exercise forbearance policy in dealing with non-performing loans (NPLs). In moments of crisis, the MoF has incentives to conceal the real picture of NPLs from politicians, since the disclosure of regulatory breakdown is likely to trigger political intervention and reduce policy-making autonomy—one of the MoF's main organisational interests. This is an institutional source of regulatory forbearance and hidden defection.

Once it becomes obvious that financial instability hits those social groups with which LDP politicians establish personal and clientelistic relationships, however, the politicians will intervene in the regulatory policy-making process. For politicians whose prime concern is their re-election, adherence to international regulatory standards or the pursuit of prudential regulation is secondary. Compared with regulatory authorities and banks, therefore, politicians are less worried about the

costs of defection and sometimes prioritise policy objectives rather than the strict implementation of prudential banking regulations. In particular, during an economic downturn, politicians are often willing to sacrifice regulatory prudence in order to pull the economy out of recession. This is in particular the case for capital adequacy requirements, since they are frequently seen as a main source of a credit crunch, and in a country already suffering financial distress, their strict implementation leads to the deterioration of the existing credit crunch. Furthermore, the costs of credit crunches are concentrated on politically sensitive sectors such as small- and medium-sized businesses and the construction industry. These politically powerful borrowers are highly dependent on bank credit, thereby being vulnerable to credit crunches. Thus, the severity of the domestic economic problems politicises the issue of capital adequacy requirements and activates politicians who are less keen to strictly comply with international standards.

The relations between the MoF and banks changed significantly after the ministry's fiasco of the 1981 Banking Act.[44] MoF officials failed to calculate acceptable compromises with the banks. It led the officials to rethink the way of communication with the banks. Hereafter, ministry officials saw relations with *MoF-tan* as a means for obtaining information from private banks. The MoF's capacity to arrange informal rescue operations also gradually eroded in parallel with financial liberalisation. For example, branching authorisations no longer provided

banks with incentives to cooperate with the MoF. As foreign financial institutions tied up Japanese banks' NPLs in derivative transactions, information on the real magnitude of the NPL problem was leaked to the market in the late 1990s. These changes hindered the MoF's capacity to arrange mergers behind closed doors.[45]

The breakdown of the MoF-led rescue operations revealed the problem that the main bank system *per se* did not devise proper corporate governance of banks themselves. Main banks were reluctant to allow their borrowers to default, partly because it would negatively affect their monitoring reputation in the loan markets and partly because it was main banks that had to absorb some of the losses incurred by other creditors. Most banks still continue to extend new loans to debt-burdened companies, often in exchange for only modest restructuring plans. They also restructured nonviable loans by reducing interest rates and extending their maturity. In addition, weak corporate governance of banks puts little pressure on managements to maximise profitability (low profitability meant that they had small amount of retained earnings to deal with NPLs) and to take proactive action to address mounting NPLs, resulting in an unnecessary protraction of the crisis.[46]

It should be noted that the informal nature of banking regulation functioned under historically specific conditions. A set of protective, competition-preventing regulatory measures, consisting of ceilings on interest rates, segmentation of the whole financial system, regulations on newly opening branches, and insulation from

foreign competition underpinned the informal regulatory systems. In addition, generally favourable economic conditions worked on the informal system. In the period of overall growth in the economy, troubled banks were the exception rather than the rule. None of these three conditions held in the 1990s after the collapse of the financial bubble.[47] In short, once these favourable conditions had gone, the once-effective *modus operandi* of informal regulatory networks became dysfunctional and the closely embedded linkage among the actors concerned turned out to be a source for institutional inertia blocking credible commitments to international regulatory standards.[48]

*3.3.3 Systemic-level Explanations*

Systemic-level approaches hypothesise that pressure for participation and compliance arises through various mechanisms at the international level, and explain compliance mechanisms in terms of some international bonus or sanction costs.[49]

3.3.3.1 Redistributive Logic

The structuralist tenet of Kenneth Waltz argues that as anarchy is the ordering principle in the international system, units (states) seek, at a minimum, to survive, and in such a self-help system the survival of states entails responding to relative

power of others.[50] This line of argument stresses the role that power distribution among states plays in determining outcomes, and it assigns less importance to the independent role of international institutions, especially in economic realms.

Although his emphasis on the anarchical nature of the international system and on the importance of inter-state power distribution is highly influential, Waltz' persistence in privileging military security is not necessarily echoed by scholars in the field of international political economy. Challenging the Waltzian conceptualisation of international politics, Keohane and Nye emphasise "asymmetrical interdependence" as a source of power, and suggest the need to specify the context, that is to say, the issue-areas.[51] In each issue-area, asymmetrical interdependence among states generates unique power relations, and therefore military resources are not necessarily useful when employed, for example, in a financial context. Even Robert Gilpin, a structural realist emphasising the inter-state power distribution as the chief explanation for outcomes, argues that economic interdependence creates "economic power which one actor can use against another".[52] In the realm of the politics of international banking regulation, according to this perspective, relative size and importance of a national financial market within the international system determine the international power configuration. Abilities to offer international lender-of-the-last-resort services, to grant market access to financial institutions, or, alternatively, to threaten market closure, underline power

resources of a state which possesses large and dynamic financial markets.

Oatley and Nabors specifically apply this line of argument to the Basle international banking regulation, which is here labelled the "redistributive logic" of the Basle Accord: a powerful state, driven by domestic concerns, disproportionately shapes an international regime to serve its domestic groups' interests at the expense of those of other states.[53] Predictably, the crude application of the systemic-level perspective is prone to pay insufficient attention to domestic factors. Oatley and Nabors solve this problem by incorporating the positive theory of economic regulation in order to explain preference formation in the powerful state. Their approach somehow derives from an influential analysis by Jeffrey Freiden about distributional impacts of international financial flows on domestic social groups.[54] He suggests that the increase in capital mobility does not automatically determine a set of policy options of states, but rather it causes various social groups to form different policy preferences. Oatley and Nabors argue that for American policymakers, the Basle Accord was a political tool for solving competing policy preferences between banks and taxpayers in the U.S.

Oatley and Nabors claim the Japanese financial sector's asymmetry of relative "vulnerability" vis-à-vis the Anglo-American counterparts, or the high "opportunity costs" of losing their markets, endowed the U.S. with financial power (threatening market closure) against Japan.[55] The American regulators, together with the British

whose banks were also confronting the challenge from Japanese banks, exercised the financial power to push Japan into an unfavourable multilateral framework; thereby forcing Japanese banks to raise their capital ratios. This logic parsimoniously illuminates the significant role of the U.S. domestic interests in generating the U.S. initiatives. It argues that the Accord was intentionally designed by the U.S. policymakers to "transfer income from Japanese commercial banks to compensate American commercial banks for the costs of [otherwise unilateral] regulation", and was successfully negotiated "*only* through U.S. policymakers' use of financial market power".[56] They assert that the Japanese were the "primary targets" and were as a whole the losers of the Basle negotiations.[57]

3.3.3.2 Market Pressure Logic

With regard to Japanese banks' rapid increase in their capital ratios in the late 1980s, Beth Simmons points out the influence of "market pressure logic".[58] International banking has one distinctive feature: the great concentration of financial power in one or two countries (i.e., the U.S. and the U.K.) by virtue of their market size, efficiency, and internationalisation of markets, and the sophistication of regulatory structures. For this reason, Simmons argues, there is considerable market pressure on non-Anglo-American banks to follow a regulatory standard adopted in the dominant financial centres. Banks are not competing for international business on price alone,

but rather they are concerned about reputation and do not want to be perceived as inferior institutions. By the same token, national regulators are also afraid of developing a reputation of their banks as poorly regulated, thereby emulating the regulatory structures adopted in the dominant financial centres.

Based upon this observation, Simmons argues that the 1987 U.S.-U.K. bilateral proposals for common capital adequacy requirements promoted the regulatory innovation as a focal point for other countries' regulators to emulate.[59] Specifically, regulatory changes in the dominant financial centre gave the rest of the world not only competitive incentives to catch up with the regulatory change in order to maintain or attract business, but also market pressures for conforming to the regulatory environment of the dominant centre. It implies that Japanese participation in the Basle rules is market-driven, rather than politically or institutionally-driven. Simmons sees the Basle Committee as a facilitative institution pooling and exchanging technical expertise, and her emphasis is on strong market-based incentives that encourage the rest of the world to converge on the U.S.-U.K. regulatory innovation. In short, Japanese banks themselves were aware of the costs, in terms of credit ratings and international business reputation, of adopting lax capital adequacy rules.[60]

## 3.4 Conclusion

This chapter has presented different types of hypotheses: a two-level-game model, a network state model; and two systemic-level modes, redistributive logic and market pressure logic. The two-level-game model emphasises the implications of the international and domestic interaction for regulators' strategies to pursue their preferences. The network state model attributes the informal nature of banking regulation to institutional obstacles for credible commitment to the Basle Accord. The redistibutive logic assigns greater importance to inter-state power relations. The market pressure logic sees financial markets as a sort of participation and compliance mechanisms.

This chapter has also outlined a set of indicators of policy behaviours and economic outcomes against which to test the hypotheses. Evaluation of national commitment to the Basle Accord is particularly difficult due to its general contents leaving a range of discretionary powers to national bank regulators. Four policy behaviours and economic outcomes are deduced from three norms of capital adequacy requirements. These indicators establish a vantage-point from which the test of the above mentioned hypotheses are carried out in the empirical part of this thesis.

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[1] Putnam (1988: 456-57).
[2] Posen (2002).
[3] Ito (2000: 94). See also Ito and Sasaki (1998).
[4] Putnam (1988).

[5] See, for example, Evans, *et al.*, eds. (1993), Iida (1993), Schoppa (1993).
[6] Moravcsik (1993: 17).
[7] Putnam (1988) and Evans, *et al.*, eds. (1993).
[8] Kapstein (1994: 10-12).
[9] See Helleiner (1994).
[10] Hadjiemmanuil (1996).
[11] Goodhart, *et al.* (1998).
[12] See Halperin and Kanter (1973).
[13] See Stigler (1971) and Peltzman (1976) on original ideas of the positive theory of regulation, and see Noll (1989) on its variation.
[14] See Rosenbluth (1989).
[15] Kapstein (1994).
[16] Krasner (1983: 2).
[17] Porter (1993). See also Haas, ed. (1992).
[18] On the former, see Vogel (1996). On the letter, see Rosenbluth (1989).
[19] Putnam (1988: 454-55).
[20] Kato (1994).
[21] See Barth, Caprio and Levine (2002) and Quintyn and Taylor (2002).
[22] Moravcsik (1993).
[23] Putnam (1988: 446-48).
[24] Moravcsik (1993: 27).
[25] Putnam (1988: 256-59).
[26] Amyx (2001).
[27] Okimoto (1989).
[28] Okimoto (1989: 226).
[29] Okimoto (1989: 193-202).
[30] Okimoto (1989: 226).
[31] On the Japan, Inc. model, see Kaplan (1972).
[32] The "new institutionalism" never forms a unified body of thought, though its variants commonly have developed in reaction to the behavioural revolution in social science in the 1960s, and all seek to elucidate the role that institutions play in the determination of political outcomes. The literature includes, to name a few, Katzenstein ed. (1978), Katzenstein(1987), Gourevitch (1986), P. Hall (1986), North (1990), and Steinmo, Thelem and Longstreth, eds. (1992). On the variety of "new institutionalism", see Hall and Taylor (1996).
[33] Okimoto (1989: 50-51, 93-94, 106).
[34] See, for example, Wilks and Wright (1987), Wilks and Wright, eds. (1991), Börzel (1997), Hollingsworth and Boyer, eds. (1997), and Mabuchi (1997a).
[35] There are, however, several seminal works attempting to capture a whole picture of the Japanese politico-economic system. See Hiwatarai (1991), Williams (1994) and Tsunekawa (1996: chap. 4).
[36] Okimoto (1989: 199-201).
[37] Amyx (2000).
[38] Amyx (forthcoming).
[39] See Kitagawa and Kurosawa (1994). Under limited price-based competition, the expansion of branch networks was crucial for banks' competitiveness.
[40] Isoyama (2002: 79-80). See also Horne (1985: 79-85, 95-96), Vogel (1996: 171).
[41] It was not until August 2001 that the Accounting Setting Board of Japan (ASB-J), a private organisation for accounting-setting, was established.
[42] See Aoki and Patrick, eds. (1994).
[43] Main bank relationships can be distinguished from the loose forms of corporate groupings of large firms, so-called financial *keiretsu*. A financial *keiretsu* represents a group of major firms from various industrial, commercial and financial sectors, connected to each other by interlocking shares, a common main bank relationship, and a certain degree of mutual

business transactions. Although the member firms of financial *keiretsu* have an affiliated city bank within the same group as their main bank, those firms that are not affiliated with any *keiretsu* also normally have a main bank relationship with one of the principal commercial banks, such as city banks and the Industrial Bank of Japan.

[44] Amyx (2001: 58).

[45] Amyx (2001: 58, 62).

[46] See Kanaya and Woo (2000: 12-14, 18-22).

[47] See Amyx (2001).

[48] See also Von Wolferen (1989) for the concept of a stateless nation.

[49] See Underdal (1998).

[50] Waltz (1979). On pros and cons of the Waltzian "neo-realist" framework, see Keohane, ed. (1986) and Baldwin, ed. (1993), and Ruggie (1998), and Wendt (1999).

[51] Keohane and Nye (1989).

[52] Gilpin (1987: 23). In his latest book, he takes a state-centric analytical stance, rather than a structural one. See Giplin (2001).

[53] Oatley and Nobors (1998).

[54] Freiden (1991).

[55] On the concept of vulnerability, see Keohane and Nye (1989).

[56] Oatley and Nabors (1998: 36, emphasis added).

[57] Oatley and Nabors (1998: 51).

[58] Simmons (2001).

[59] Simmons (2001: 601-604).

[60] For a similar point, see Kapstein (1994: 126).

# Part II Empirical Studies: Japan and the Basle Capital Accords

# Chapter 4

## A Pre-Basle Accord History of Capital Standards: Japan and the Basle Committee

### 4.1 Introduction

As has been argued in previous chapters, the roles which bank capital plays in prudential regulation and competitiveness politicise the regulation-making process at the domestic and international levels. A given country's commitments to prudential regulation in general and capital adequacy requirements in particular are a highly political matter. This chapter will consider a history of capital adequacy requirements in Japan and the regulatory development at the Basle Committee prior to the 1988 Basle Accord. Only a historically sensitive examination can allow us to recognise the political arena within which relevant actors are positioned.

How did Japanese regulators traditionally formulate and exercise capital adequacy requirements? How did international institutions provided by the Basle Committee

affect Japanese regulators' perceptions of capital adequacy measures? To what extent and how did domestic institutions and private interests matter in the regulation-making and implementation processes? To answer these questions is not only interesting in terms of theoretical concerns over international regulatory harmonisation, but also provides a starting point for examining Japanese commitments to the Basle Accord.

## 4.2 A Brief History of the Politics of Japanese Capital Adequacy Requirements

### *4.2.1 The Structure of Japanese Banking Regulation*

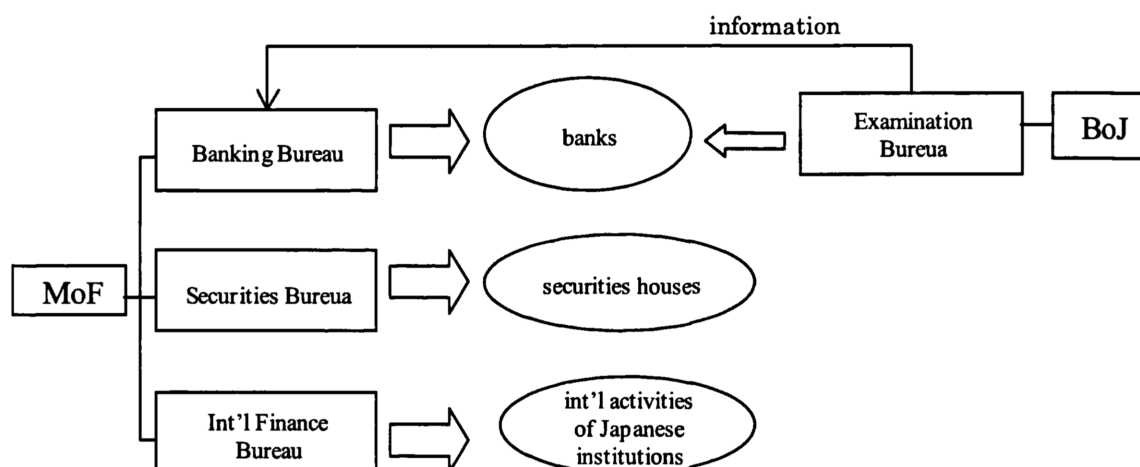
Both the Ministry of Finance (MoF) and the Bank of Japan (BoJ) were bank regulators in Japan until the 1998 establishment of the Financial Supervisory Agency (renamed the Financial Services Agency in 2001).[1] The MoF had wide-reaching powers over the financial and monetary realm, ranging from fiscal and monetary policy, the tax collection, the government budget arrangement, the government bond flotation, to the regulation and supervision of financial institutions. The ministry had seven Bureaux. Among them, the Banking Bureau, the Securities Bureau, and the International Finance Bureau were responsible for financial regulation in private sectors. The Banking Bureau and the Securities Bureau monopolised the supervisory responsibility over the banking sector and the securities sector respectively. The International Finance Bureau oversaw the overseas operations of Japanese financial firms and the

operations of foreign financial firms in Japan. The Banking Bureau was central to the regulation of private banks, or private depository institutions, and thus was a key actor in "policy networks" revolving around the issue of capital ratio rules.[2] While the Securities Bureau and the International Finance Bureau were not directly responsible for capital adequacy requirements for banks, they were involved in the policy network regarding capital rules when related policies touched their jurisdictional boundaries. These bureaux did not have a monolithic view of the issue of international convergence of capital adequacy requirements.

The BoJ, the central bank in Japan, is the secondary bank regulator. It is not legally a government body, but a special corporation outside the framework of the government. However, it had rarely enjoyed full independence of the government since its foundation in 1882, until the 1998 review of the Bank of Japan Law. In particular, the wartime Bank of Japan Law (1942) confirmed the bank's subservience to the government and was designed to commit the BoJ to war fighting rather than the stabilisation of the currency. The Law was not revised during the post-war occupation and remained effective.[3] Despite its subordinate status, the Examination Bureau at the BoJ carried out regular audits on banks, and collected information more than the Banking Bureau possessed. Rather, the Banking Bureau had to depend on the Examination Bureau for gathering detailed information on individual banks. Further,

the BoJ had been a member of the Bank for International Settlements (BIS) since its establishment in 1930, with the exception of suspension years after World War II (1950-70), and after the 1974 establishment of the Basle Committee the BoJ sent its officials to the Committee.[4] Figure 4.1 describes the basic framework of Japanese banking regulation until 1998.

Figure 4.1 Financial Regulation Framework in Japan (until 1998)




It was not until the mid-1980s that the MoF started to send its officials to the Basle Committee at the BIS. Since then, Japanese participants in the Committee became two bodies, the BoJ and the MoF. At first, the International Finance Bureau of the MoF despatched its officials to the Basle Committee. Once it was recognised that the prospected subject of discussion was central to banking regulation, however, the MoF's Banking Bureau took over the membership of the Committee in the winter of

1986.[5] Since the Banking Bureau monopolised authority over banking regulation including capital adequacy requirements, the Banking Bureau effectively became a primary negotiator in international negotiations over capital adequacy requirements and the BoJ took a secondary role. At the domestic level, the Banking Bureau continued to be the representative body of Japanese regulators in policy networks regarding capital adequacy rules.

Private banks are classified into several sub-sectoral groups according to their business in which each type of bank is permitted to engage.[6] The city banks with close ties to large industrial enterprises and with a nation-wide network of deposit-taking branches; the long-term credit banks issuing long-term bank debentures in exchange for lending long-term loans to industry; the trust banks accepting large-denomination trust accounts and pension funds from businesses, issuing long-term debentures, and making long-term loans to industry; and one specialist foreign exchange bank, make up so-called "big finance". In the early 1980s, private banks began to enlarge their international operations. Therefore, when international capital adequacy rules became international agenda, they were at the centre of a policy network revolving around that issue. At the other end of scale are the smaller banks, including a large number of the regional banks, the credit associations, the credit co-operatives and the agricultural co-operatives.[7] In the mid- to late 1980s, backed by the strong yen and booming asset

prices, some of the top regional banks embarked on international business, but the majority of the regional banks and other small institutions operated domestically. They assumed they were insulated from impacts of international convergence of capital adequacy requirements for international banks. When changes in domestic regulations in association with international negotiations affected their interests, however, they got involved in policy networks revolving around the issues of the international capital accord.

There were several organisations that function as what Peter Katzenstein calls "nodes of the policy network" in which the regulatory authorities and the regulated sector continually exchanged their views on financial matters.[8] The private banks tended to collectively work to support their own positions vis-à-vis the MoF. The Federation of Bankers' Associations of Japan (FBAJ) was the umbrella organisation for the banking sector. During the period discussed here, four city banks (Dai-Ichi Kangyo, Fuji, Mitsubishi, and Mitsui), of which head offices were in Tokyo, took the chair in one-year rotation. The chair bank staffed the FBAJ with a dozen of their officials to support the chairman. As seen below, representing the whole bank industry, the FBAJ actively voiced its views on capital adequacy requirements. Besides the FBAJ, each type of banks established its own association with its own distinct interests, such as the City Bank Roundtable, the Federation of Regional Bankers' Associations

and so on. Each association fine-tuned its interests and hammered out a common position vis-à-vis the MoF on matters of banking administration.

It did not necessarily mean, however, that banks always succeeded in forging a cross-sectoral common preference. Especially when issues concerned intruded sub-sectoral vested interests, disputes between the sub-sectors were evident. Indeed, private banks established a common ground with regard to general rules of capital adequacy, but discussion on specific policy means of securitisation of bank assets, which would help banks to increase their capital-to-asset ratios in general but erode monopoly profits of certain types of banks, provoked sub-sectoral disputes within the banking industry. An association of each banking type played a significant part in this kind of sub-sectoral disputes. In short, these self-organised associations were important in the process of forming regulation.

In addition to the self-organised bodies, advisory policy councils in the MoF, such as the Financial System Research Council (FSRC), played a significant role in connecting regulators and private banks. The FSRC was a formal advisory council, consisting of senior businessmen, financial industry representatives and others, with Banking Bureau officials attending as advisors. Its main purpose was to facilitate an exchange of opinions among knowledgeable people.[9] Masaru Mabuchi emphasised a role of the FSRC in providing private banks with opportunities to express their

opinions.[10] He argued that the FSRC served to introduce organised interests into the policymaking process through participation of interest groups, and, at the same time, functioned as an intermediary of MoF's view to private sector. However, MoF officials played key roles in screening potential members, setting agendas, and conducting meetings,[11] and reports and recommendations published by the FSRC are not necessarily compatible with preferences of private banks. Therefore, the FSRC was not a corridor through which specific private interests were straightforwardly injected into policy-making, but rather as an arena in which various interpretations of interests contested with one another.

Intervention by politicians was occasional, but had influence over policy outcomes.[12] In the 1980s, "big finance" was one of the biggest private-sector contributors to political parties, with almost all of the money going to the ruling conservative Liberal Democratic Party (LDP). Such huge contribution from 'big finance' was to ensure the generally favourable environment provided by the LDP's conservative, stable rule, and usually not to call for specific favours. However, when negotiations with the MoF broke down or the MoF ultimately intended to take the initiative in setting new rules unfavourable to banks, banks were likely to turn to Diet's individual influential LDP members for support. Small banks traditionally established close relationships with Diet's members from their districts through political

contributions, because much of their concerns were at the local level. The actual intervention from the LDP and even the potential threat of political intervention affected outcomes of the regulation-making process.[13]

Under this domestic institutional structure, the MoF had multiple objectives, and therefore had to balance various concerns. In addition to regulatory objective of maintaining the stable credit order, the MoF had to consider the economic interests of banks (economic objectives) and increase its own political manoeuvrability in order to pursue desired policy outcomes (domestic political objectives). It means that MoF had a partial state autonomy. The MoF's ability to achieve these objectives thus depends on its statecraft to manipulate politics.

### *4.2.2 Historical Overview of Capital Adequacy Requirements*

In Japan, capital adequacy requirements had a long history, at least on paper. It was not until the early 1980s, however, that Japanese bank regulators started to pay serious attention to bank capital adequacy. This section examines relationships between the regulators and the regulated, which revolved around the issues of capital adequacy requirements, before the U.S. took the initiative in international regulatory harmonisation. Lacking a statutory basis and any sort of enforcement mechanisms, Japanese capital adequacy rules were less than effective at the time.

As in other industrialised countries, the banking industry was highly regulated in Japan. An array of competition-preventing regulations and administrative actions was sometimes referred to as the "protective convoy system".[14] The system consisted of four main institutional pillars: ceilings on interest rates, segmentation of the whole financial system, regulations on new branches, and insulation from foreign competition. Just as in wartime transport ships were gathered when crossing the high seas to enable the fast escort ships to protect the slower ones, the Japanese financial system was characterised as one in which the large, efficient banks kept a slower pace with the small and inefficient banks. Within the framework, all banks, even the most inefficient, were led to grow at the same rate and none was allowed to go bankrupt. While the protective convoy system limited price competition among banks and guaranteed them a steady source of comfortable profits, it was deemed sufficient to keep Japanese banks sound throughout the period of the post-war economic recovery (the 1950s-60s).[15]

The protective convoy system was not created in a political vacuum. In the early 1950s, in the course of the dispute over the post-war reconstruction of the Japanese banking system, the MoF proposed several plans to transfer some of the costs of regulatory protection towards banks themselves through such measures as a margin risk reserve against bank deposits. However, faced with strong resistance from banks,

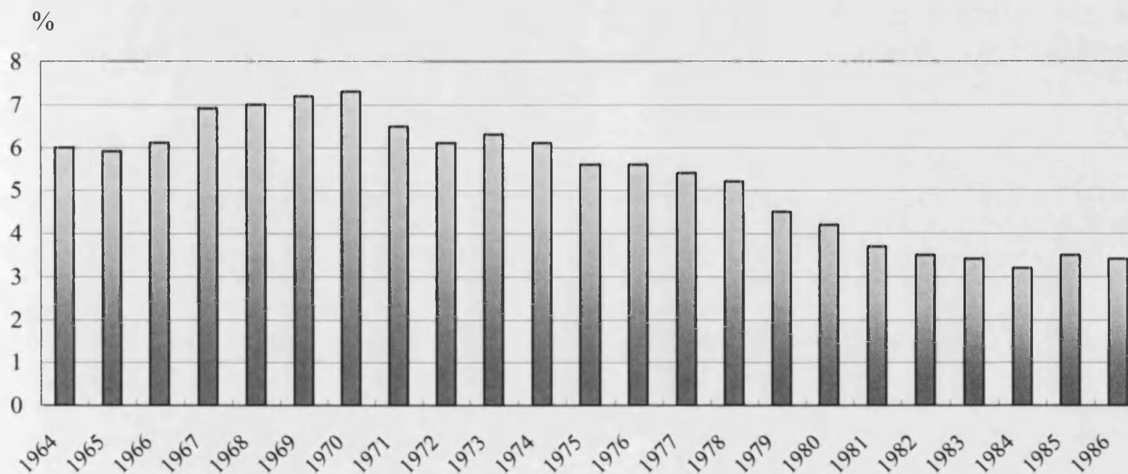
those attempts ended in failure.[16] The power with which banks resisted the MoF's regulatory pressures derived from three institutional structures.

Firstly, private banks enjoyed systematic favouritism by the government during the early post-war period, which enabled them to quickly seize the opportunity of their restoration, while the overall Japanese economy struggled in the immediate aftermath of war destruction.[17] Financial regulatory institutions served to create the bank-centred patterns of corporate finance which entrenched their influence: what Kent Calder had named as the "Bankers' Kingdom".[18] Secondly, a well-organised association of the banking industry also survived the post-war de-concentration of economic power. The FBAJ emerged as a successor of the war-time self-regulation body of the banking industry and helped banks exchange their views to hammer out a common stance vis-à-vis the MoF on matters of banking administration when possible. Thirdly, the banking industry was long one of main sources of political contributions to the ruling conservative party. These special politico-economic positions of banks endowed banks with power. Borrowing words of a Japanese economist, private banks were "the linchpin of the Japanese political economy". [19] When Japanese bank regulators attempted to establish such unfavourable regulations as capital adequacy standards, they found banks hard to deal with.

In the absence of statutory forms of regulation over banks' operating and balance

sheet ratios, the MoF used "administrative guidance", non-legal guidelines issued by the ministry, to regulate banks' balance sheet ratios. Requiring banks to hold a sufficient level of capital in relation to their holding deposit was part of this administrative guidance.[20] In 1954, the MoF issued administrative guidance regarding capital ratios and required banks to hold capital-to-deposit ratios of 10 percent.[21] In the literature on Japanese politics, administrative guidance was sometimes understood as a powerful form of policy leverage that could deliberately enhance bureaucrats' degree and range of control far beyond that suggested by the formal legal parameters.[22] However, as shown in Figure 4.2, such administrative guidance was less than effective. Throughout the 1960s and 1970s, average capital-to-deposit ratios stood approximately at 6 percent, and fell to around 3 percent in the early 1980s. In sum, the 1954 administrative guidance regarding capital adequacy ratios was not effectively enforced.

Figure 4.2 Capital-to-Deposit Ratios of Japanese City Banks (1964-1986)




Notes: Capital consists of equity, loan loss reserve, reserve for retirement, and other reserves.
Deposit consists of deposits, negotiable certificates for deposit, and debenture.
Source: own calculations based on data from various editions of *Analysis of Financial Statements of All Banks*, Federation of Bankers' Associations of Japan.

Notwithstanding low levels of capital, the stability of the banking system was maintained by a continually growing economy and the protective convoy system. In the 1970s, however, the pillars of the competition-preventing regulations, such as interest rate controls, entry restrictions and the segmentation of financial institutions, began to cave in. The financial system adapted a series of new conditions: the slower economic growth, the rapid increase in government bond issuance, a chronic trade surplus, technological innovation, and the burgeoning external expansion of manufacturing industries and banks.[23] Since the mid-1980s, new factors deriving from the Japan-U.S. trade friction also spurred financial liberalisation in Japan.[24] Though the pace of financial liberalisation in Japan was slow, the MoF officials recognised that

further liberalisation would be inevitable sooner or later.[25] They began to assign their greater emphasis to supervision of banks' balance sheet ratios. It was against this background that Japanese regulators began to shift their regulatory emphasis to supervision of banks' capital adequacy ratios—an area where regulation had not been implemented effectively under the 1954 administrative guidance.

As for most of the other members of the Basle Committee, by the late 1970s Japanese regulators embarked on the reinforcement of bank capital adequacy.[26] In March 1979, the Financial System Research Council (FSRC), advisory council of the Banking Bureau of the MoF, published a report advocating a stronger MoF oversight power with sanctions, stricter net-worth ratios and more rigid disclosure rules for banks.[27] The report said that "the net worth of a bank is the basis of confidence in the bank's solvency."[28] Based on the FSRC's report, the MoF proposed a new banking law to the Federation of Bankers' Associations in March 1981.[29] Alongside strict disclosure rules, the proposal included a provision regarding the maintenance of sound management, which required banks to make efforts to improve their capital levels. Since this provision was deemed a new statutory source of the MoF' control over banks' capital levels, the banking industry felt unhappy. Claiming self-responsibility for maintaining own financial soundness, banks lined up against the MoF's proposals and turned to the LDP for support. In the deliberations of the LDP's Policy Affairs

Research Committee, the MoF's initial proposals were considerably revised and the capital adequacy provision was deleted.[30] To secure favourable revisions in the MoF's proposals, banks allegedly paid 500 million yen to individual influential LDP politicians in unreported contributions on top of their usual contributions.[31] The 1981 revision of the Banking Act, in short, failed to get legally binding capital adequacy requirements on the statute book

### 4.3 Early Efforts of the Basle Committee: A Growing Consensus

#### *4.3.1 The Idea of Risk-Weighted Assets: Learning and Ideational Diffusion*

By the late 1970s, almost all members of the Basle Committee had reviewed or redefined their own domestic approaches for monitoring banks' capital adequacy.[32] However, momentum towards international convergence had not yet gathered. There was a range of national diversity in approaches to capital adequacy requirements among the Committee members, reflecting the unique historical development of the national financial system.[33] These differences of approach made it impossible to make meaningful cross-country comparisons of capital adequacy. Moreover, in the 1970s, there was little consensus in the Committee about the value of such comparisons.[34]

It was, nevertheless, the progressive, and prospectively dangerous, erosion of capital levels of international banks that facilitated a consensus among the Committee

members on the general need to address the issue of capital adequacy on an international scale during the late 1970s and the early 1980s.[35] Not only the U.S. but also other countries experienced a general decline in their banks' capital ratios. They had either already taken preventive action to end any further deterioration, or were about to do so.[36] The worry of bank regulators was fuelled by the pace at which banks were expanding their international lending, particularly to developing countries. Against this background, the Committee members began to exchange information with one another on different approaches to capital regulations.[37] In a communiqué issued by the BIS in 1980, the Basle Committee members reaffirmed the cardinal importance attached to the maintenance of sound banking standards, in particular regarding capital adequacy, liquidity and concentration of risks.[38]

One of the biggest fruits of these early efforts was a growing consensus on a risk-weighted capital adequacy requirement as a preferable formula for measuring assets. In the early 1980s, the Basle Committee members were divided into two groups according to the methods of calculating banks' assets. While most of European countries took a risk-weighting approach, the others including Canada, Italy, Japan and the U.S. took a gearing ratio approach. The former weighted assets according to the risk exposure of banks' asset portfolios, and the latter related capital funds to the unweighted total of the balance sheet without sensitiveness to the risk exposure of

individual banks. Risk-weighted capital adequacy requirements were developed and adopted in Continental Europe. Countries in which capital adequacy was traditionally governed by formal prudential ratios, such as Belgium, France, and the Netherlands, introduced risk asset ratios (i.e., the ratio of capital to risk-weighted assets) in the late 1970s.[39] British bank regulators, previously taking informal approaches to banking regulation and paying little attention to bank capital adequacy, also began to establish a statutory basis for banking regulation in response to the secondary banking crisis of 1973-75, and the harmonisation requirements of the 1977 EEC Directive on banking.[40] In 1980, the Bank of England began to use two capital ratios, a gearing ratio and a risk asset ratio, as a basis for assessing capital adequacy.[41] Following the first EEC Banking Co-ordination Directive of 1977, the EEC Advisory Banking Committee defined a number of observation ratios in 1980, and risk asset ratio was one of them. These ratios were introduced for observation purposes, but the Directive apparently sought the possibility that harmonised prudential ratios might be applied in the longer term. In short, European regulators developed the idea of the risk-weighted capital adequacy on which the Basle Committee drew when initiating its own work on capital adequacy requirements in the early 1980s.

Latecomers to the risk weighting approach, such as the U.S. and Japan, began to adopt the approach in the mid-1980s. In the U.S., the notion of risk weighting itself

was not novel. Indeed, it was favoured as early as the immediate post-war period, but it was soon abandoned due to technical problems. Throughout the 1960s and 1970s, American federal regulators had different stances on capital adequacy. It was not until 1981 that the three federal bank regulatory bodies (the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporate) could agree on uniform domestic capital adequacy standards.[42]

With regard to the re-introduction of a risk-weighting approach in the U.S., problems developed in adjusting a common stance among the federal regulators. While the OCC and the Federal Reserve Bank of New York were keen on the re-introduction of the risk-weighting approach, FDIC Chairperson William Seidman insisted on the traditional gearing approach. There were two reasons for his objection. One was that the risk-weighted system would have too much impact on the selection of banks' asset portfolios. The other was that the risk-weighted system previously introduced by the Fed was too complex to be effectively implemented, and the system died out in the course of time.[43] With regard to his first reason, Seidman seemed to be naive about market principles and overestimated the value of a simple, non-risk-weighted system of capital adequacy. Indeed, the collapse of Continental Illinois in May 1984, where the gearing ratio was relatively high at 5.8 percent, demonstrated that straight gearing ratios could be misleading and even perverse.[44]

Concerning technical difficulty, the experience of European countries, especially the U.K., helped American regulators study the risk-weighting system further. Eventually, Seidman changed his mind, and in remarks at a banking conference, he thanked the Bank of England "for providing us with the results of their analysis on off-balance-sheet risk".[45] In January 1986, the Federal Reserve Board proposed a risk-weighting approach to domestic capital adequacy requirements; the OCC and the FDIC were expected to follow with similar proposals.[46] The Fed's concrete proposals mentioned that "...adoption of this proposal would begin to bring capital adequacy policies in the U.S. more closely in line with those of other major industrial countries".[47]

In line with this trend, Japanese banking regulators began to share the idea of risk-weighted assets as a preferable measure of bank capital adequacy. As will be discussed in the next section, following the International Finance Bureau's experimental introduction in the summer of 1985, the 1986 capital guidelines of the Banking Bureau adopted a risk-weighting approach as the method of relating capital to the size of banks' overseas assets. In forming the guidelines, Japanese regulatory officials referred to risk-weighting approaches of other countries, that of the U.K. in particular.[48] Japanese regulatory officials mentioned that although crude classification of risk weights remained problematic, "the risk asset ratio under the risk-weighting

approach was obviously better than the gearing ratio".[49]

One of major reasons why the risk-weighting approach became popular was a change in the international financial markets: the proliferation of off-balance sheet activities by internationally active banks. A range of new categories of off-balance sheet business, particularly various forms of underwriting commitment (note issuance facilities and revolving underwriting facilities—NIFs and RUFs) and interest and exchange rate related "derivatives" (options, swaps, futures, and so on) were introduced. The gearing approach was deemed to provide banks with an incentive to expand off-balance sheet activities, which were not captured by the approach, and to focus on higher risk assets at the expense of low-risk, liquid assets within the balance sheet.[50] Conversely, by relating capital to the varying degrees of risk involved in the spectrum of bank assets and in contingent liabilities off the balance sheet, the risk-weighting approach was expected to contain banks' reckless risk-taking.

Despite the growing consensus on the risk-weighted approach, much remained to be done. Two problems in particular arose. One was cross-national differences in risk weightings. Each national regulator developed risk-weighted capital adequacy requirements different from others', and this resulted in a situation where risk weightings applied to similar categories of assets varied. The other was rapid and continuous innovation of new off-balance sheet instruments. Though the simple

framework of measurement employed in many European countries had included traditional off-balance sheet engagements with either a 50 or 100 percent risk weight, many of the new innovations were not yet captured in the reporting systems and therefore were not incorporated into measures of capital adequacy.

In 1984, the Basle Committee founded a working group to conduct a detailed study of off-balance sheet risks to determine the extent to which off-balance sheet risks were being captured in the members' prevailing supervisory mechanisms, and the degree to which they were subject to capital requirements. In early 1986, the working group released a report listing a series of common definitions for a plethora of off-balance sheet instruments, both new and traditional, and the degree of risk they entailed, though no specific capital requirements for various risk categories were prescribed.[51] The results of this working group contributed to the formation of a consensus regarding risk weights of bank assets. An agreement on the weighting of bank assets according to risk was crucial to the consequent accord on capital adequacy standards, by forming a consensus on the technique of measuring assets. Were it not for such agreement, there could have been no common ground as to how to determine the asset side of capital-asset ratios.[52]

The growing consensus on the risk weighting approach exhibits an approximation to "learning", defined by Ernest Haas as "the process by which consensual knowledge

is used to specify causal relationships in new ways so that the result affects the content of public policy".[53] In response to the expansion of banks' off-balance sheet activities, new regulatory methods of incorporating off-balance sheet items into risk weightings were introduced, tested, and adopted, thereby producing new consensual knowledge. This knowledge was constructed through regular interactions among the member regulators, which were made possible by institutional arrangements of the Basle Committee. Through the learning process, the members of the Basle Committee arrived at a common understanding of what was challenging the existing procedures of capital adequacy requirements, as well as a shared perspective on how to cope with it. Transnational ideational diffusion came with this learning process. Japanese regulators also re-defined their policy objectives along with what they learned at the Basle Committee.

*4.3.2 Problem of Defining Capital: A Prototype of a Tiered-capital Framework*

A diversity in national definitions of capital still raised problems with which the Basle committee had to cope. While there was a consensus on the notion of risk assessment as an evaluation tool, differences of opinion on a definition of the capital elements to be included in the measure were still too great for any acceptable compromise to be quickly reached.[54] There were three main problems concerning the capital side of

capital-asset ratio standards:

(1) how to define and value capital;

(2) how to develop a formula that measures capital's adequacy; and,

(3) the minimum level of capital considered "adequate".[55]

A complicating factor was the differential treatment of reserves across countries. The various types of reserves, which differed in their financial and accounting features as well as their abilities to absorb losses, had traditionally been regarded as regulatory capital in some member countries. First of all, therefore, it was necessary for the Committee members to build a common technical understanding with the aim of working "towards a common view among member countries of the main constituent elements of capital...".[56] The Committee also needed to analyse different kinds of ratios (risk-weighting vs. gearing vs. risk-asset vs. risk-deposit vs. large loan-exposure ratios, and so on) and assess their usefulness.[57]

These issues were not only technical but also inherently political. In general, tougher capital adequacy requirements would result in new costs to the banking industry. Hence, regulators faced opposition from entrenched interests in their respective banking industry. A change in the definition of capital would affect measured capital ratios and thus alter the market's perception of the financial strength of the banks. It implied that a certain change in the capital definition would possibly

impose higher costs on specific groups of banks than others. This distributional concern could trigger political reaction from negatively affected countries. Furthermore, a national definition of capital reflected a unique set of country-specific accounting practices, banking activities, tax systems and regulatory tradition.[58] Thus, a change in the capital definition may cause political disputes within the domestic policy, and individual regulators did not easily abandon their regulatory systems.

Regulators were aware of these technical and political difficulties in finding a generally acceptable basis for reconciling the diverse approaches to capital adequacy existing within the member states, and were reluctant to commit themselves to hasty efforts to converge. The first initiative to accelerating the pace of international harmonisation came from American domestic politics.[59] International regulatory harmonisation was deemed to serve to resolve a policy dilemma that American regulators confronted at home. Faced with the debt crisis in the early 1980s, American regulators sought to tackle this problem through an increase in the resources of the International Monetary Fund (IMF). However, the request to Congress for an IMF quota increase triggered strong demands for tougher regulatory means, reflecting voter unwillingness to bear the costs of reckless bank lending practices. The unilateral introduction of stricter domestic financial regulation, however, generated opposition from American commercial banks because the tighter domestic regulation would

erode their competitiveness vis-à-vis international competitors. In this climate, international harmonisation of capital adequacy requirements appeared the best means of achieving stricter regulation without weakening the banks' international competitiveness.[60] Congress passed the International Lending Supervisory Act (ILSA), which required the regulators to consult with regulators from other countries with regard to international harmonisation of capital adequacy requirements and to make efforts to reach an agreement. This domestic political climate led to the U.S. initiative in advancing international harmonization of capital adequacy rules at the Basle Committee.

In accordance with ILAS, Fed chair Paul Volcker presented Congress' request for more harmonised capital rules to his fellow regulators at a meeting in Basle in May 1984.[61] However, according to one Fed staff member who was present, his remarks were "greeted with a yawn".[62] Peter Cooke, the chair of the Basle Committee, received a personal mandate by other members to develop recommendations for:

(1) assessing the comparability of different measures of capital adequacy; and,

(2) attaining over time comparable and adequate minimum international capital standards.[63]

In contrast to the Volcker presentation, this mandate suggested a more moderate pace at which international harmonisation would take place. As Volcker and the Treasury

Secretary Donald Regan put it, in a May 1984 report to Congress, "the difficulties involved...were recognized as substantial".[64] Throughout the spring and summer of 1984 there was no breakthrough towards a single generally accepted method of measuring capital adequacy.

Instead of a leap forward into a formulation of a single measure, there was a slow development to a generally accepted one. During 1983, a "general framework" for measuring capital was adopted in order to observe the capital positions of international banks.[65] The framework was designed not to replace individual national standards, but rather to compare and analyse banks' capital positions by means of the different approaches used in the Committee's member countries. Reflecting the diversity of definitions of capital among the members, several alternative definitions of capital, such as narrow and wide definitions (i.e., to what extent should less "pure" capital be counted?), were included in this general framework. The study based on the general framework was conducted with two aims in mind. Firstly, the usefulness of international comparisons of bank capital should be ensured. Secondly, whereas the members recognised that this particular effort could not automatically lead to any narrowing of national capital adequacy standards, they did not lose sight of this long-term goal.[66]

The above efforts served to develop a "tiered approach", as opposed to a single

measure, which was expected to overcome rather deep-rooted different opinions on the appropriate elements to be included in the capital base for any common measure. This framework aimed to establish common ground into which different countries' systems could be fitted. As Table 4.1 exhibits, within this framework, admitted elements of capital were to be categorised roughly in descending order of quality, and different readings of capital adequacy could be derived according to narrower or wider definitions of the capital base. The most restrictive definition consisted of only Tier 1, and the most liberal was Tiers 1-5 inclusive. Cooke mentions that the "idea was that this framework would allow all countries to slot into the system and produce illustrative figures which could be read alongside those for other countries".[67]

Table 4.1 Elements of Capital in the Original Tiered Framework (1983)

| Tier | Elements of capital | Countries which did not recognise these elements as being within capital in their accounting or supervisory systems |
|---|---|---|
| 1 | Issued and fully-paid ordinary shares<br>Non-redeemable preference shares<br>Share premium<br>Retained profit and general reserves | None |
| 2 | plus Undisclosed reserves | Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Sweden, United Sates |
| 3 | plus Asset revaluation reserves | Canada, Germany, Sweden, Switzerland, United States |
| 4 | plus General provisions | Germany |
| 5 | plus Subordinated debt (up to a maximum of 50% of items 1 to 4) | Germany, Italy, Japan |

Note: Subsequent to the development of the original tiered framework, a new tier of "hybrid capital instruments" was introduced between 4 and 5 to accommodate the new capital instruments which were developed in the market during 1984 and after.

Source: Cooke (1990: 318).

By the end of 1986, the Basle Committee had succeeded in the formulation of a series of common definitions for a plethora of off-balance sheet instruments and the degree of risk they entailed, and a complex definition of capital on which all countries roughly agreed. When the Fourth International Conference of Banking Supervisors was held in the Amsterdam in October 1986, H. J. Müller, Chairperson of the Basle Committee and Executive Director of the Netherlands central bank, presented the results of the Committee's developing consensus on the issue of capital adequacy. Emphasising the cardinal importance of capital adequacy, a reference in the press communiqué issued at the end of the conference noted "there was broad measure of

agreement on what should constitute the composition of capital...[and] that the risk ratio approach was the preferred approach".[68]

## 4.4 Developments in Japanese Capital Adequacy Requirements in the mid-1980s

### *4.4.1 The Incompetent 1986 Administrative Guidance*

Japanese regulators tried to update the Japanese capital adequacy regulation in parallel with the development of the Basle efforts. Despite the fiasco of the 1981 revision of the Banking Act, the MoF's intention to strengthen capital standards never disappeared. In June 1985, the FSRC came out with another report which particularly pointed out the cardinal importance of a more effective method of regulating bank capital adequacy. Tetsuro Nishizaki, a journalist and one of the FSRC members, said that the 1985 report was a turning point for capital adequacy regulation in Japan.[69] Of particular note is that the diffusion of regulatory norms through the interaction at the Basle Committee stimulated the development of capital adequacy rules in Japan. As seen above, at that time, alongside American and Canadian counterparts, Japanese regulators still adopted a non-risk-weighting, or gearing, approach to measuring bank assets. However, a pitfall of the gearing approach became apparent later. Through the learning process in Basle, Japanese regulators started to share the idea of the risk-weighting approach as the best measure of capital adequacy. Initially, the

International Finance Bureau of the MoF which represented on the Committee at the time, began to prepare for its introduction in the summer of 1985.[70] This was deemed to bring Japanese regulation more closely in line with those of other Basle Committee members.

Based upon the 1985 FSRC report, the Banking Bureau of the MoF issued new administrative guidance on banks' capital ratios, revising the ratio from 10 percent to a more realistic figure, in May 1986. This revision was, in fact, conciliatory. The guidelines consisted of main rules and sub-rules. The main rules required all banks to hold 4 percent of non-risk-weighted assets as the capital base (narrowly defined). In addition to the main rules, banks with overseas branches were also subject to the sub-rules: (1) the capital-to-asset ratio, including 70 percent of unrealised capital gains in part of capital, should be over 6 percent; and (2) risk-weighted overseas assets should be less than 3.5 times the amount of capital.

It was not a straightforward process defining regulatory capital. The definition of capital, or more exactly, the degree to which unrealised capital gains on banks' securities holdings should be counted as a source of capital, sparked controversy between regulators and banks. Banks traditionally possessed a sizeable amount of long-standing holdings of marketable securities of other firms, and realised these capital gains to repay loan losses when necessary.[71] Though the view of unrealised

capital gains as an effective means to cover loan losses prevailed, regulators were aware of the side effect that the inclusion of a large amount of unrealised capital gains in the capital base might have.[72] The more banks' capital bases became dependent on unrealised capital gains, the more unstable banking operations would be due to their reliance on unpredictable market prices of securities. Given this concern, regulators wanted to reduce the portion of unrealised gains in capital instruments, but banks agitated for a broader definition of capital. Finally, as a compromise, while the main rules of the 1986 guidelines excluded unrealised gains as capital, the sub-rules explicitly counted 70 percent of unrealised gains as a form of capital. This 70 percent cushion was expected to absorb price fluctuations to some extent, and was large enough to be accepted by banks.

The new guidelines were a victory for banks, on balance. The guidelines were numerically more lax than the MoF initially intended, and did not come with any means of strengthening the MoF's capacity to enforce bank compliance. The private banks responded positively to the downward revision of capital definition, but not with great interest in living up to the lower standard of capital-to-asset ratios. Thanks to the inclusion of unrealised capital gains, all the major banks easily met the sub-rules of the 1986 guidelines. However, the banks neither complied with the stricter main rules nor made serious efforts to improve their capital ratios. Rather, 8 city banks out of 13

*decreased* their main-rule-based capital-to-asset ratios during the year of 1987 (see Table 4.2).[73] Notwithstanding, those failing to improve their capital ratios in line with the 1986 guidelines continued to do business without being subject to regulatory scrutiny and sanctions, because the MoF did not have authority to punish them. Japanese banks still aggressively engaged in thin-margin international loan markets without due capitalisation.

Table 4.2 Capital Adequacy Ratios of City Banks based on the 1986 Administrative Guidance

unit: %

| | March 1987 | | September 1987 | |
|---|---|---|---|---|
| | The main rules | The sub-rules | The main rules | The sub-rules |
| Dai-ichi Kangyo | 2.87 | 9.66 | 2.98 | 9.99 |
| Sumitomo | 3.1 | 9.1 | 3.0 | 9.1 |
| Fuji | 3.31 | 9.70 | 3.0 | 9.91 |
| Mitsubishi | 3.2 | 11.3 | 3.2 | 11.0 |
| Sanwa | 3.02 | 9.36 | 3.1 | 9.7 |
| Tokai | 2.92 | 9.7 | 2.65 | 9.91 |
| Mitsui | 2.97 | 10.94 | 2.71 | 10.79 |
| Taiyo-Kobe | 2.77 | 9.0 | 2.6 | 9.2 |
| Kyowa | 2.81 | 10.61 | 3.15 | 11.85 |
| Daiwa | 3.59 | 10.82 | 3.46 | 11.92 |
| Saitama | 3.09 | 8.84 | 2.95 | 8.78 |
| Hokkaido Takushoku | 2.59 | 8.73 | 2.75 | 9.37 |
| Bank of Tokyo | 3.53 | 9.19 | 3.26 | 9.22 |

Notes: The main rules of the 1986 administrative guidance required banks to hold more than 4% of capital-to-asset ratios (unrealised capital gains were excluded from capital). In addition to the main rules, banks with overseas brunches were subject to the sub-rules that required them to hold more than 6% of capital ratios to risk-weighted assets (70% of unrealised capital gains were counted as capital).

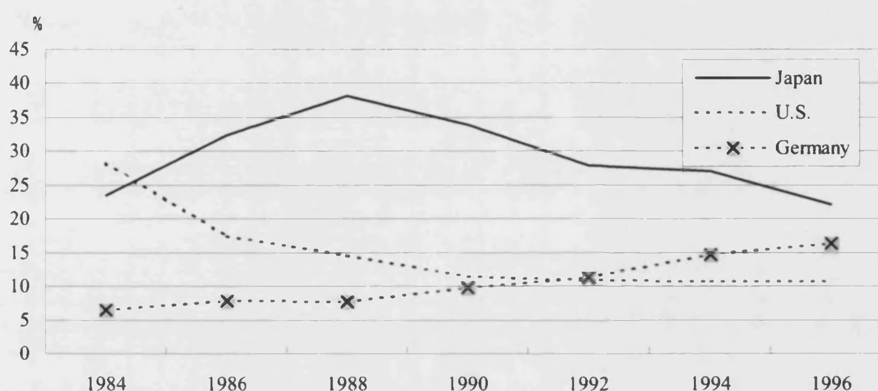
Source: *Kin-y□Bijinesu [Financial Business]*, January 1988, p.7.

*4.4.2 The International Expansion of Japanese Banks*

Throughout the 1980s, Japanese banks expanded their international operations and by the late 1980s they emerged as a dominant force in global finance. The market share of Japanese banks in terms of foreign assets stood at only 5 percent in 1980, but increased to 23 percent in 1984 and 38 percent in 1988 (see Figure 4.3). In contrast, the market

share of American banks decreased since 1984, and their share shrunk to one third of the Japanese in 1988. This section considers implications of competitive pressures from Japanese banks for the Basle process of international convergence of capital adequacy requirements.

Figure 4.3 Positions of International Bank Assets
by Nationality of Ownership




Sources: various issues of *Annual Report* (Bank for Internaitonal Settlements)

The increase in Japanese banks' presence was remarkable especially in the U.K. and the U.S. (see Table 4.3). Market share of Japanese banks in the City of London stood at 8 percent level in the 1970s.[74] However, when American banks with high exposure to Latin American countries scaled back their lending rather significantly in the course of the debt crisis, Japanese banks enlarged their market share by intensively purchasing FRNs (Floating Rate Notes), the most notable subcategory of the Eurobond market, in London.[75] The liberalisation of Euroyen regulations (Euroyen

loans, Euroyen CDs, and Euroyen bonds), after the 1984 Yen-Dollar Committee's Agreement, gave Japanese banks a renewed incentive to deal in these financial instruments and accelerated the expansion of Japanese banks' foreign assets.[76] Furthermore, Japanese banks raised U.S. dollar funds in inter-bank markets in London in order to make the "impact loan" (foreign-currency loans to Japanese manufactures). This activity also increased foreign assets.

Table 4.3 Market Share of Japanese Banks in Major Countries

(in terms of financial assets)

unit: %

| | The early 1980s | | The late 1980s | |
|---|---|---|---|---|
| | The share of total foreign banks | The share of Japanese banks | The share of total foreign banks | The share of Japanese banks |
| The U.S. | 13.5 | 5.5 | 25.0 | 14.0 |
| The U.K. | 60.4 | 16.9 | 61.2 | 24.0 |
| Germany | 2.0 | n.a. | 4.2 | 1.0 |

Notes: The comparison of the U.S. markets is between December 1980 and December 1989; the U.K., July 1982 and July 1988; and Germany, December 1971 and October 1986.
Source: Kurosawa (1993: 252).

Among European countries, Japanese banks succeeded in establishing a beachhead in the U.K. to get access to local markets. In Germany, close relationships between major banks and industry, based upon the universal banking system, was an obstacle to Japanese challenge. In contrast, the success of Japanese banks in building

up local client bases in the U.K. was impressive. Especially, Japanese banks concentrated on selected target industry sectors, such as government services, water supplies, building societies, and energy companies. In the first three of these U.K. industries, the market share of Japanese lending was over 30 percent respectively in 1987.[77]

American banks also encountered Japanese competitive challenge in not only international but also domestic markets. In the Euromarket, the rapid increase of Japanese banks' share was accompanied with the decline of American banks' share. Yet, even at the domestic level, the Japanese challenge was formidable. One notable case was a regional niche in California.[78] There were more than a thousand subsidiaries of Japanese industrial firms in California, and many Japanese banks opened their subsidiaries and branches to follow their clients. Some of the banks even acquired local banks there in a rather aggressive fashion: Mitsubishi Bank bought the Bank of California in 1984, Sanwa Bank Lloyds Bank of California in 1986 and Bank of Tokyo Union Bank of California in 1988. In the aggregate, Japanese banks owned 424 branches and had a market share of 25 percent in California as of the late 1980s, according to the Federal Reserve Bank of San Francisco.[79]

Japanese banks expanded their wholesale operations in the money centres in New York and Chicago. Being armed with low interest rates, they took the low-spread/

high-volume strategy in loan syndication, and engaged in leverage-buy-out. By the end of 1987, Japanese banks' total share of the U.S. commercial and industrial loan market rose to 13 percent, making them the biggest foreign banking group in that market, up from less than 1 percent a decade earlier.[80] Some also became very active in guaranteeing municipal and state debts, where they had an edge over many of their American rivals because of their better credit quality. Moreover, Japanese banks' activity in M&A of foreign financial firms was impressive. Following Daiwa Bank's acquisition of CBO (a commercial bank) in 1980, Dai-ichi Kangyo Bank bought a 60 percent stake in CIT (a finance company subsidiary of Manufacture Hanover), Fuji Bank bought Walter E. Heller in 1984 and Industrial Bank of Japan (IBJ) acquired J. Henry Schroder Bank & Trust of New York at the beginning of 1986. Furthermore, IBJ and Sanwa Bank bought primary dealers in US treasury bonds (IBJ: Aubrey G. Lanston in 1986; Sanwa: Prophy Gestal Knigh & Co. in 1988), and Sumitomo Bank bought a 12.5 percent stake in Goldman Sachs in 1986 (although a decision by the US supervisory authorities forced Sumitomo to remain a passive investor for the time being), and Mitsubishi Bank acquired control of the Bank of California New York Trust in January 1987.[81]

Such various factors as the strength of the domestic Japanese economy, its mounting current account surplus, on-going liberalisation of its financial system,

burgeoning international operations of Japanese manufactures, low domestic interest rates (1986-89), the strong yen after 1985, and rising domestic stock and property markets contributed to the Japanese financial expansion outside Japan.[82] Among these factors, low capitalisation of Japanese banks drew attention of both regulators and their foreign competitors. Despite the MoF's several attempts to introduce effective capital adequacy requirements, Japanese banks continued to engage in thin-margin international loan markets and enlarge their foreign currency assets, especially in the American and British markets, without due capitalisation. This behaviour of Japanese banks provoked anxiety among Japanese regulators about the banks' ambitious international business (see the next chapter). Simultaneously, from foreign bankers' viewpoint, Japanese banks' razor-thin capital operations meant that their competitiveness in international markets was leveraged by liberal domestic capital requirements. It contributed to the Japan-bashing mood among American and British bankers.

Japanese banks typically seemed to operate with lower level of capital than U.S. or European banks for a variety of reasons, and it was argued that the low capital ratios gave Japanese banks an unfair competitive advantage.[83] Whether Japanese banks do indeed use return on equity as their main pricing determinant is a moot point. In theory, however, capital divergences cause "unfair advantages" for banks with lower capital

ratios: they can accept lower returns when quoting for business to achieve a given return on equity. According to this account, a main reason that Japanese banks increased their market share in international and overseas markets so dramatically was not that they offered a superior product or superior service. Rather, it was because they were able to quote prices, which other banks under tougher capital regulations were not able to meet. As early as 1982, in a survey of the Group of Thirty, U.S. bankers pointed to the existing capital adequacy standards as a factor that contributed to their competitive disadvantage vis-à-vis Japanese banks.[84]

The concern for competitiveness by American banks influenced domestic disputes over the resolution for the debt crisis and the reform of banking regulation in the early 1980s. In response to pressure by the banking industry and statements by American regulatory authorities during the 1983 hearings of ISLA, Congress became considerably sensitised to the competitive inequalities that might arise from cross-national divergent banking regulations in a highly integrated global banking market. Representatives from the banking industry expressed their grievances that any unilateral imposition of higher capital ratios would prove to be a major nuisance for American banks to compete in international and domestic markets. They warned that any new unilateral regulations could give rise to the decrease in domestic and international lending, as well as a loss in relative competitiveness of American

commercial banks with regard both to foreign banks and to non-bank financial institutions. Paul Volcker, the then U.S. Federal Reserve Board Chairperson, also mentioned:

> There are intense competitive pressures in these markets, and this is an area where it is important, to the degree possible, to have a common international approach...I would also note that—not as any kind of excuse, but as a fact—banks undoubtedly have felt under very heavy pressure internationally, and carrying more capital is a cost. From the viewpoint of an individual institution, if it feels its competitors, particularly in this business which is literally worldwide, have competitive advantage, this is not an atmosphere in which it is easy to get capital increases...It is an area that has international as well as domestic dimensions.[85]

As seen in the previous sections, Japanese banks politically succeeded in blocking Japanese regulators' attempts to introduce tougher capital adequacy requirements into the Japanese regulatory system in the early half of the 1980s. They, as a result, enjoyed the domestic regulatory institution that effectively allowed them to engage in low-margin, asset-intensive operations to corporate sector and governments outside Japan. Given the very rapid expansion of Japanese financial institutions in the 1980s, this behaviour of Japanese banks gave rise to political reaction from foreign competitors, and sparked off the "levelling a playing field" argument. Together with the slow progress in Basle and the U.S. domestic pressure exerted upon American regulators, the Japanese banks' challenge eventually led to the 1987 U.S.-U.K.

bilateral agreement on capital rule harmonisation. As seen in the next chapter, this bilateral agreement was a political breakthrough that accelerated the pace of the Basle process, and Japanese regulators used the international harmonisation process to push ahead with the statutory base for domestic capital adequacy requirements.

### 4.5 Conclusion

The Japanese regulatory system did not meet any of the indicators of credible commitment to capital adequacy requirements during the period considered here (from the 1950s to the mid-1980s). Japan failed to meet the two primary indicators, let alone the other two; it lacked a statutory basis of capital adequacy requirements and banks significantly came short of meeting the required capital ratios. There was an absence of prudential regulation. This contrasts with what the two-level game model hypothesises (that is, the international and domestic interaction gives regulators room for improving regulatory manoeuvrability.)

Competitive pressures from low-capitalised Japanese banks in the 1980s and their stimulating influence on the Basle process have been well documented.[86] Yet what is scant in the existing literature is that Japanese regulators tried to improve domestic capital adequacy requirements, but Japanese banks successfully fended off such attempts. It has three implications. One is that Japanese regulators and banks had

different views of capital adequacy. Unlike the "Japan, Inc." perspective of the international expansion of Japanese banks, regulators did not intentionally support such rapid expansion based upon aggressive thin-margin, asset-incentive strategies. Rather, lax capital regulation in Japan was a product of the domestic politics where private banks prevailed in regulation-making. Given the trend towards financial liberalisation, the MoF had the regulatory objective of establishing effective domestic capital requirements in order to countervail the greater degree of freedom enjoyed by banks. In other words, Japanese regulators did not see existing regulation as an ideal. Moreover, the way in which Japanese banks expanded their international operations became an anxiety to them.

The second, related to the first, is that it was necessary for Japanese regulators to shift the domestic power balance in order to introduce effective capital adequacy requirements. Institutional structures of the Japanese state were major obstacles to the regulatory goal. Power configurations under the domestic institutional structure of the time did not give the MoF autonomy vis-à-vis private banks in the field of capital adequacy requirements. The resistance of powerful private banks had been an impediment to the legislation and implementation of strict capital requirements. For regulators, the issues of bank capital adequacy were politically tough deals.

The third was the role that the learning process at the Basle Committee played in

affecting preference formation of Japanese regulators, albeit with significant limits on its domestic implementation. Through interaction with their foreign counterparts in the Basle banking regulatory regime, Japanese regulators imported significant regulatory norms and means such as the risk-weighted approach to capital-to-asset ratios. A common recognition of problems and shared knowledge about risk-weighted capital ratios have been evolving out of interactive contact between member regulators in Basle. It should be also emphasised that Japanese regulators were not the only ones learning through the Basle process, but the Americans, too. Exclusive attention to American domestic politics and concerns for competitiveness tends to blur the picture of the Basle process.

In short, by the mid-1980s Japanese bank regulators began attempting to move Japanese capital standards more closely in line with those of many other Basle Committee members. However, Japanese bank regulators confronted the stubborn resistance of private banks, and Japanese capital standards remained insufficient and lacked any compliance mechanism. This lax capital regulation constructed a domestic platform from which low-capitalised Japanese banks aggressively expanded their market share in international finance, and this behaviour evoked outcries by their foreign competitors against Japanese banks' low capitalisation. However, this situation was not a product of closely tied relationships between regulatory policies and private

initiatives, but rather a result of a political victory of Japanese banks over regulators. The following chapter will examine how Japanese regulators attempted to cope with politically powerful banks after the U.S.-U.K. joint initiatives accelerated international negotiations.

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[1] The MoF's roles of licensing, inspection, supervision and resolution of problem cases with regard to financial firms (i.e., banks, securities houses and insurance companies) were transferred to the newly established Financial Supervision Agency in 1998. This supervisory body is independent of the MoF, being part of the Prime Minister's Office. This will be discussed in the Chapters 6 and 7.

[2] Wilks and Wrights (1987: 299) defines a policy network as "a linking process, the outcome of those exchanges, within a policy community or between a number of policy communities", consisting of actors who commonly share a concern over a specific policy issue. Börzel (1997) offers a concise survey of variations on the use of "policy network" in Comparative Politics and International Relations.

[3] In June1997, a Bill amending the Bank of Japan Law of 1942, giving the Bank greater independence, was approved in the Diet. The Bill became in operation on 1 April 1998.

[4] Shiota (1998: 162). For the origin of the Bank for International Settlements, see Simmons (1993).

[5] Interview with Kōsuke Nakahira, director of the Banking Bureau at the Japanese Ministry of Finance (1985-87). Also see Shiota (1999: 196-97).

[6] The 1992 revision of the Banking Act, which allowed city banks to acquire trust banks on certain conditions, paved the way for dissegmentation within the banking industry. See Nihon Keizai Shinbun Sha, ed. (2000b: 37).

[7] Local governments were responsible for supervising credit associations and credit co-operatives, and the Ministry of Agriculture, Forestry and Fisheries has supervisory authority over agricultural co-operatives.

[8] Katzenstein (1987: 35).

[9] Another policy council is the Financial Problems Research Group. However, it makes up of academics and journalists and not representatives of interest groups. See Horne (1985: 79-85, 95-96).

[10] Mabuchi (1997: 161).

[11] Horne (1985: 79-85, 95-96) and Vogel (1996: 171).

[12] Rosenbluth (1989: 26-31, 34-38). In the late 1990s politicians became more influential in shaping and carrying out regulatory policies. See Chapter 7.

[13] Rosenbluth (1989).

[14] Kitagawa and Kurosawa (1994: 88), Williams (1994), and Ito (1995: 201-202).

[15] Under the protective convoy system, however, competition for deposit taking among banks was intensive. Since the MoF carried out branching policy based on the deposit volume of each bank in order to maintain the status quo of market share and the policy effectively determined the scale of the bank's operation, there was severe competition for deposits among banks. The prime principle of bank's behaviour was maximising deposits (Teranishi 1993: 87; Teranishi 1994: 34-35). When they went abroad, Japanese banks still aggressively pursued market share in overseas markets.

[16] Rosenbluth (1989: 117-18).

[17] For example, private banks were not subject to *zaibatsu* dissolution of 1945 and received favourable treatment in the early post-war evaluation of corporate assets for tax purposes.

[18] Calder (1993).

[19] Miyazaki (1967).

[20] Aizawa and Sera (1988).
[21] Horiuchi (1998: 47).
[22] For example, Johnson (1982: 265-74).
[23] For example, the MoF redrew the lines dividing the banking and securities businesses and deregulated the secondary market for bonds, thereby embarking on de-segmentation in the financial system in 1977. These deregulatory measures were essential for the smooth absorption of a large volume of government bonds. For domestic factors for financial liberalisation, see Hamada and Horiuchi (1987); Shinkai (1988); Rosenbluth (1989); and M. Hall (1998).
[24] See Rosenbluth (1989: chap. 3).
[25] Interview with Kōsuke Nakahira, director of the Banking Bureau at the MoF (1985-87), Tokyo, September 1999.
[26] Cooke (1990: 310-35).
[27] *Nihon Keizai Shinbun*, 20 March 1979. Net worth means net assets (= total liabilities – total assets) and thus an alternative term for equity capital. Net-worth ratios are used in a banking context as a measure of capital backing for deposits.
[28] *Tokyo Business Today*, October 1992, p. 34.
[29] *Kin-yū Zaisei Jijyō*, 9 March 1981, pp. 14-15.
[30] *Kin-yū Zaisei Jijyō*, 20 April 1981, p. 6.
[31] This seems a conservative estimate, *Kin-yū Zaisei Jijyō*, 20 April 1981, pp. 10-11.
[32] Cooke (1990: 134).
[33] For the cross-national diversity in capital standards as of the early 1980s, see Dale (1984).
[34] Cooke (1990: 314).
[35] Cooke (1990: 314).
[36] *American Banker*, 28 November 1980, 24 December and 28 December 1981; *The Banker*, June 1983.
[37] Pierre Jaans in *International Conference of Bank Supervisors*, 5 and 6 July 1979; *Institutional Investor*, January 1985.
[38] Cooke (1984).
[39] Dale (1984: 100, 105,118-19).
[40] Dale (1984: 127-28) and, Norton (1991).
[41] *The Bank of England Quarterly Bulletin*, September 1980.
[42] On the domestic politics of capital standards in the U.S., see Reinicke (1995: chap. 7).
[43] Remarks by William Seidman, quoted in Shiota (1999: 177).
[44] Kapstein (1994: 108-9).
[45] In the summer of 1985, the three federal regulators began working together to develop a risk-weighted capital adequacy standards for U.S. banks. See Bardos (1987-88: 28).
[46] Reinicke (1995: 150-51). Shortly after, the Canadian followed suit.
[47] 51 Fed. Reg. 3976 cont. (31 January 1986); see also Statement by Paul Volcker, *Risk-Based Capital Requirements for Banks and Bank Holding Companies*.
[48] Interviews with a former MoF official and BoJ officials.
[49] Interviews with a former MoF official and BoJ officials.
[50] Di Cagno (1990: 30-37).
[51] Basle Committee (1986); *Financial Times*, 11 March and 17 March 1986.
[52] Underhill (1991: 218).
[53] E. Haas (1990: 23). Strictly speaking, what happened at the Committee at that time is not true "learning" in the Haas' sense, because he refers his term "learning" to the "situations in which an organization [or institution] is induced to question the basic beliefs underlying the selection of ends" (E. Haas 1990: 36) and the Basle Committee did not question its ultimate, normative end, the maintenance of a stable international banking system. See also Porter (1993: 80) for "learning" at the Basle Committee.
[54] Cooke (1990).
[55] Reinicke (1995: 162).
[56] Quoted in Cooke (1990).
[57] Cooke (1990).
[58] Bardos (1987-8: 28-29), Kapstein (1994), and Reinicke (1995: 162).
[59] Reinicke 1995 (chaps. 7 and 8).

[60] Kapstein 1994 (92-5, 106-114) and Oatley and Nabors 1998 (42-46).
[61] For ILSA, Kapstein (1994: 92-95, 106-9) and Reinicke (1995: 148-53, 162-63).
[62] Quoted in Kapstein (1994: 108).
[63] Cooke (1990: 315-16).
[64] Paul Volcker and Donald Regan, "Improving International Bank Capital Standards", 30 May 1984, mimeograph, quoted in Kapstein (1994: 108).
[65] Cooke (1990: 318).
[66] Reinicke (1995: 163).
[67] Cooke (1990: 318).
[68] Press communiqué, *4th International Conference of Banking Supervisory*; *Financial Times*, 22 October 1986.
[69] Quoted in Shiota (1999: 188-89).
[70] Interview with a Bank of Japan Official, March 2000. For the regulatory shift in the U.S. and its implications for the Basle process, see Porter (1992: 182, n.11) and Reinicke (1995: 150-51, 166-67).
[71] The Anti-trust Law of 1947 prohibited industrial companies from owning shares of other companies, but allowed banks to hold up to 5 percent of shares of a single company. Once the Law became operational, banks from three pre-war *zaibatsu* (family-owned conglomerates) bought one another's shares, which earlier had been sold in the market as part of the *zaibatsu* dissolution program.
[72] Interview with Nakahira.
[73] 11 major Japanese banks out of 23 (including the 13 city banks, 3 long-term credit banks and 7 trust banks) decreased their ratios of capital to assets in the same period. *Kin-yū Bijinesu*, January 1988, 7.
[74] The Japanese Ministry of Finance for the first time allowed Japanese banks to lend money to foreign governments and co-operations in 1972.
[75] FRNs were a type of so-called hybrid bonds, combining characteristics of a long-term international bond with a medium-term syndicated bank loan. As the Eurodollar syndicated loan market grew, for banks without a natural source of U.S. dollar (i.e., non-U.S. banks), FRNs provided them access to the U.S. dollar funds needed to back these loans. FRN's percentage share (% of total Eurobond market) was: 10.9 in 1970; 3, 1975; 22.1, 1980; 40.9, 1985; and 7, 1987. See Fisher (1988: 172).
[76] On the Yen-Dollar Committee, see Frankel (1984) and Rosenbluth (1989). For the impacts of the Yen-Dollar Agreement on the Japanese financial liberalisation, see Miyazaki (1992: 109-15).
[77] Hawawini and Schill (1994: 243-47).
[78] Bank of Tokyo and Sumitomo Bank began their operations to serve Japanese immigrants in California before the Second World War.
[79] Handelsblatt (1989) "Siegeszug in Kalifornien", 22 August. Quoted in Düser (1990: 96).
[80] French, Martin, "High Noon could Draw a Blank", *Euromoney*, December 1987, pp. 109-15.
[81] Düser (1990: 96-97) and Kurosawa (1993: 253-56).
[82] Full explanation for the international growth of Japanese banks is a challenge and far beyond the scope of this thesis. See, for example, Düser (1990) and Goodhart and Sutija ed. (1990).
[83] Monro-Davies, Robin. "Capital Ratios Are Only One Step", *The Banker*, May 1987, pp. 55-59. French banks, most of which were government-owned banks at the time, also had lower capital-to-asset ratios than other European banks.
[84] Group of Thirty (1982).
[85] *International Financial Markets and Related Problems*, quoted in Reinicke (1995: 163).
[86] Kapstein (1989; 1991; 1994), Underhill (1991), Reiniche (1995), Otaley and Nabors (1998), and Shiota (1999).

# Chapter 5

## Negotiating the 1988 Basle Accord:

## International Negotiations and Domestic Politics

### 5.1 Introduction

This chapter will consider the negotiation process leading up to the 1988 Basle Capital Accord. The international negotiations over regulatory harmonisation and domestic politics about capital adequacy provide the two-level-game model with its enticing example. The preceding chapter has argued that the model encounters problems when applied to the pre-Basle Accord development in capital adequacy requirements. It can be argued, however, that the pre-Basle Accord period did not have international forces substantial enough to generate the domestic and international interaction. By closely examining Japanese regulators' preference formation, perception of market trends, international and domestic bargaining positions through a filter of the two-level game model, this chapter tries to analyse

the degree to which the model can explain Japan's commitments to the Basle Accord.

Most commentators rightly point out the importance of the U.S. initiatives in advancing international harmonisation of capital adequacy standards as well as the U.S. concerns on competitiveness behind such initiatives. Some writers like Oatley and Nabors go further, arguing that the Accord represents a redistributive international co-operation designed by American policy-makers to transfer income from Japanese banks to compensate American banks for the costs of regulation.[1] Many Japanese writers also frequently refer to the 1988 Basle Accord as an explicit turning-point in the rise and fall of Japanese financial power.[2] The existing literature on the 1988 Basle Accord, however, is inadequate in terms of providing a comprehensive survey covering Japanese actors' preferences and achievements.

The argument made here is a modified version of Kapstein's account of the Basle Accord, viewed through the eyes of a country that negotiated its way into an international regulatory agreement that had been launched by the U.S. and the U.K.[3] Kapstein explains how a regulatory dilemma between keeping domestic banks competitive and the financial system stable led to the Basle Accord. This chapter considers how Japanese regulatory officials dealt with the similar dilemma by participating in international negotiations. This argument presents a counterexample to a "redistributive logic" of the Basle Accord: American policymakers, together with

the British, whose banks were confronting the growing Japanese challenge, exercised financial power to push Japan into an unfavourable multilateral framework; thereby forcing Japanese banks to raise their capital ratios.[4] The approach presented here also differs from a bank-centred analysis emphasising market pressure as a driving force for emulating the U.S.-U.K.initiative on regulatory standards.[5] Moreover, the chapter not only provides additional evidence for, but also refines and revises the notion of Japan being a "reactive state".[6] Even in an issue-area of banking regulation, where the bureaucracy has been often deemed to enjoy a high degree of autonomy, the MoF was exposed to societal interests and had incentives to use external pressure, or *gaiatu*, to attain its domestic goals.

Despite these merits, the two-level-game model is less successful in accounting for the question of Japanese commitments to the Basle Accord. Specifically, it pays insufficient attention to domestic Japanese bureaucratic and political processes, where institutional inertia hampered a shift towards prudential regulation along with the Basle Accord. Implementation issues will be examined in chapter 7.

## 5.2 The Formation of an International Agenda and Japanese Preferences

### *5.2.1 The U.S.-U.K. Bilateral Agreement*

As seen in the precious chapter, American regulators began to embark on domestic banking regulation reform by the mid-1980s, especially in the wake of the debt crisis. Their effort to introduce a risk-weighted capital adequacy measure was an effort to manage to obtain their banks' consent. Their regulatory concerns were over both the changes in banking activities (the rapidly growth in off-balance sheet exposure, in particular) and recognition of the growing divergence between U.S. capital standards and the risk-weighted capital adequacy measures introduced by other major industrial countries. The three U.S. federal regulators issued their proposal for public comment in January 1986. As expected, American commercial banks protested this unilateral measure, which was deemed to put them at a competitive disadvantage vis-à-vis their foreign rivals as well as American non-bank financial institutions. Meeting with stiff resistance, the regulators believed that their domestic efforts would have to be accompanied by similar international measures in order to be politically feasible.

Considering the institutional framework provided by the Basle Committee and the accumulation of its earlier work on this area, the Basle Committee was naturally seen as a vehicle for international harmonisation. However, the earlier work by the

Committee failed to make substantial progress, and American regulators got frustrated by other members' reluctance to commit themselves to international harmonisation. As Kapstein points out, at this point, American regulators had three alternatives: it could continue to negotiate with foreign regulators within the Basle framework; it could adopt new domestic standards; or it could seek a piecemeal extension of the proposed standard to countries that had already taken a similar measure.[7] Initially, the U.S. regulators decided to pursue common standards outside the Basle framework, and found the Bank of England (BoE) to be an ally.

For the BoE, the joint approach was attractive for at least three reasons. Firstly, 1986 was the year of the so-called Big Bang in the U.K., and the BoE began to embark on a radical reform of the British financial structure. The BoE was interested in developing a common framework to cope with the growing array of off-balance sheet transactions.[8] Secondly, the joint approach with the U.S. was regarded as a powerful means of countering the emerging standard in the EC, to which the BoE had objected.[9] Finally, as in the U.S., the City of London was under pressure from Japanese banks with low capitalisation.[10] In the autumn of 1986, negotiations began between Brian Quinn of the BoE and William Taylor of the Federal Reserve, the two officials in charge of the banking supervision divisions in their respective organisations.

In spite of conceptual similarity between their risk-weighting asset systems, problems remained over the appropriate definition of capital, since each country brought its own definition to the negotiations.[11] Efforts to overcome problems resulted in a creative solution to it. As the Basle Committee previously forged the "tiered framework" in order to cope with cross-national differences in the definition of capital, the two countries set up their "two-tiered" definition of total capital in order to deal with the same problem. "Unlimited capital", consisting of traditional forms of capital immediately available to cover losses, would be counted as the measure of regulatory capital on an unlimited basis. "Limited capital", consisting of other types of capital instruments, would be restricted to the amount of base capital held by banks. Capital instruments under dispute (i.e., those that were not universally regarded as capital) were included in limited capital. For example, such controversial capital instruments as certain types of convertible bonds, which the Americans saw as part of capital but the British not, and some types of perpetual preferred stocks, which the British regarded as part of capital but the Americans not, were included in limited capital.[12]

In January 1987, the U.S.-U.K. Agreement was announced. One American regulatory official said that "in light of the importance of New York and London as international banking centres, agreement on a single risk-based capital framework to

be applied in both the U.S and the U.K. would indeed represent a major step forward in international convergence".[13] Thus, the two countries appealed to other countries to join the programme. This was consistent with competitiveness concerns of bankers. Ira Stepanian, president of the Bank of Boston, expressed his dissatisfaction with the bilateral agreement: "serious concerns with the...proposal as it related to competitive equity, not only between US banks and those overseas, but also between US banks and non-bank financial institutions...[A] major segment of worldwide banking had been left out—including Japan, which now had seven of the top ten banks in the world".[14]

One of chief concerns was how to bring Japan, of which banks occupied more than one third of international lending in the mid-1980s, into a multilateral convergence scheme for bank capital adequacy.[15] Prior to the announcement of the U.S.-U.K. Agreement, both countries began to make contact with Japanese regulators. In November 1986, Gerald Corrigan, president of the Federal Reserve Bank of New York, asked Toyoo Gyoten, vice minister for international finance of the MoF, to dispatch his officials to New York in order to discuss the possibility of international regulatory co-ordination, in particular capital adequacy requirements. Three MoF officials from the Banking Bureau, the Securities Bureau and the International Finance Bureau met with Corrigan at the N.Y. Fed in early December. At the dinner

meeting, Corrigan, though he did not clarify concrete contents, revealed that the U.S. Fed and the BoE had been negotiating over the convergence of capital adequacy measures and standards and would announce a bilateral agreement soon. He also sounded the Japanese regulatory authorities out on their participation in the convergence process.[16] During the course of international negotiations on capital standards in Basle, MoF officials had indicated both publicly and privately their commitment to increased co-operation among regulatory authorities of other countries. At this stage, however, the MoF officials did not explicitly decide their attitude to this matter because of lack of sufficient information. They brought the issue to Japan and started to discuss it within the Banking Bureau and consult with the banking industry about it.

*5.2.2 Preferences of Japanese Actors*

Japanese private bankers, who were caught up in the euphoria of the "bubble economy", vocally complained about the U.S.-U.K. proposal. Japanese bankers felt their capital holdings were sufficient to cover loan losses and that criticism of their low capital levels in the U.S. was "politically motivated and triggered by a Japan-bashing mood".[17] They thought that the ulterior objective of the joint proposal was to put a brake on the rapid growth of Japanese banks, by eliminating the funding-cost

advantage of Japanese banks. Among these criticisms, Mitsui Bank, whose president occupied the chair of the Federation of Bankers' Associations of Japan (FBAJ), sent an official public comment to the Japanese MoF as well as the U.S. and British authorities.[18] The points of the public comment were: (1) banks were allowed to hold securities, and their unrealised gains were large and had been functioning well as buffers for loan losses; (2) bank loans were, in principle, secured by mortgage or property; and (3) the soundness of banks' assets was continuously supervised by Japanese regulators. If we consider that Japanese banks were not complying with domestic capital rules, these claims seemed less than convincing. However, in the late 1980s the flourishing Japanese banks had strong confidence in their business style and did not want to lose part of their regulatory advantage vis-à-vis their international competitors.[19]

Japanese banks could not reject the U.S.-U.K. proposal however. Though they were unhappy with the U.S.-U.K. proposal, the importance of the U.K. and U.S. financial markets left to them no choice but to negotiate over more favourable conditions.[20] Japanese banks perceived the U.S.-U.K. proposal as a real threat of market closure: exclusion from the New York and London markets meant that it would spell disaster to Japanese banks in their international operations. This fear caused the banks to take the situation seriously. The Japanese banking industry

fiercely demanded that unrealised capital gains on marketable securities be counted in the definition of capital, whereas they were excluded from the U.S.-U.K proposed capital instruments. While their transnational lobbying ended with little success, they put pressure on Japanese regulators to achieve this objective. Inputting this demand into the harmonisation process was thought by Japanese bankers to be a way of winning favourable conditions that would lower the compliance costs of Japanese banks to the upcoming stricter capital adequacy rules.

From the Japanese MoF's point of view, international regulatory co-ordination in itself was not necessarily unacceptable. MoF officials perceived the need for some form of international co-ordination of capital adequacy rules. As other Basle Committee members recognised, one of MoF's motivations was the increasing difficulty of attaining the soundness and stability of the national banking system in a highly integrated and competitive international banking market. Disparities in national regulations as regards both the way in which capital adequacy was measured and the amount of capital which banks were required to hold could have several harmful consequences for national banking supervision, and could result in an increasing difficulty for individual national supervisors and individual banks to maintain, let alone raise, prudential standards.[21] With these concerns, the MoF and the BoJ had previously co-operated in the Committee's early work on attaining

internationally comparable capital standards and initial data collection on international banks' capital positions in the early and mid-1980s.[22]

Another set of anxieties over Japanese banks' international operations also turned the MoF's attention to international regulatory co-ordination. Despite the MoF's domestic attempts to raise bank capital ratios, Japanese banks operated with relatively low levels of capital, so that the worries in the MoF grew that the banks' foreign assets were not backed strongly enough by an adequate net worth. Furthermore, the MoF officials were worried about Japanese banks' ability to manage risk as the government had largely absorbed credit risk under the "policy-of-not-letting-any-bank-go-bankrupt".[23] Government-guaranteed control of credit risk (through various forms of implicit subsides arising from competition-preventing regulations) discouraged Japanese banks for developing, or catching up with, state-of-the-art risk management. Perceived underdevelopment of Japanese banks' risk management skills, together with their thin margin operations in the international loan market, provoked the MoF officials' anxiety that the surge of such Japanese banks' presence in the international loan market would cause some problems in the international banking system.[24]

Therefore, the MoF had different objectives at the international and domestic levels, respectively. On the one hand, the MoF insisted as a condition of Japanese

participation that unrealised capital gains be counted as capital. The MoF had to take distributive issues into account. For Japanese banks, the inclusion of unrealised capital gains on banks' securities holdings was regarded as crucial to preserving their positions in the international banking market. On the other hand, the MoF saw the strengthening of domestic capital adequacy rules and compliance mechanisms as its domestic objectives. Although the MoF had to consider the competitiveness bias of the international capital rule harmonisation scheme which would negatively affect Japanese banks, it continued to have a normative desire that domestic capital rules should be upgraded further to catch up with the on-going financial liberalisation. The former led the MoF to negotiate with foreign counterparts for the inclusion of unrealised capital gains in the capital definition. The latter gave the MoF an incentive to use the Basle negotiation to realise its desired outcomes regarding tough domestic issues such as capital adequacy rules.

## 5.3 Negotiations: International and Domestic Interactions

### *5.3.1 International Bargaining: Power and Innovation of an Acceptable Framework*

The diversity in interests regarding distributive issues meant that interactions among the Basle members took on an atmosphere of bargaining and negotiation. Stimulated by the U.S.-U.K. proposal, a multilateral meeting at the Basle Committee took significant steps towards regulatory harmonisation. In April 1987, the Committee members decided to move swiftly towards the establishment of internationally harmonised capital standards based on the U.S.-U.K. proposal.

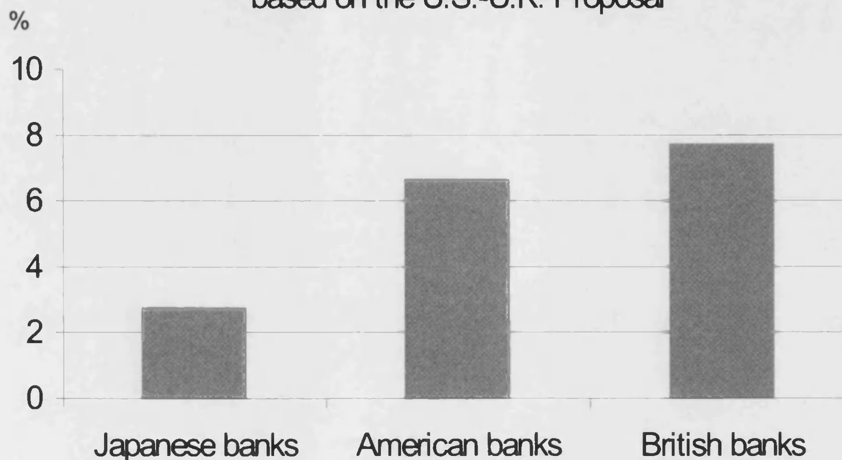
At that meeting, Japanese representatives objected to use the U.S.-U.K. proposal as a basis for further discussion. They insisted that banks' unrealised capital gains had long played adequate roles in repaying banks' non-performing assets in Japan and that it was unrealistic to exclude them from the capital base. Most of the other participants, however, objected to this Japanese request. The delegates from the U.S. and the U.K. claimed stock prices were so volatile that unrealised capital gains could not be included in capital. German regulators also clarified its stance against any effort to widen the definition of capital.[25] The MoF was isolated, but withheld its full commitment to the international harmonisation process unless the role of unrealised capital gains as capital was taken into account.

As Japan was one of the biggest financial powers, how to bring Japan into a multilateral convergence scheme for bank capital was the biggest challenge for the U.S. In early June 1987, a high-level delegation led by William Taylor of the Fed met in Japan with Japanese regulators to discuss Japanese participation. The definition of capital, in particular the treatment of unrealised capital gains on marketable securities, was a crucial stumbling block. While the Japanese delegation continued to be adamant that unrealised capital gains be included in the capital base, the U.S. side did not recognize such gains as relevant.

The strength of Japanese banks in the international markets enabled the MoF to prevail at the negotiation table. The MoF presented the capital-to-asset ratios of major American, British, and Japanese banks that were broadly calculated in line with the formula of the original U.S.-U.K. proposal.[26] While the estimated ratios of the Japanese banks were extremely low, those of the British banks were extremely high. The American banks stood between the two (see Figure 5.1). This estimated result was at odds with credit ratings provided by private agencies. For example, Moody's Investors Services, an American credit agency, rated all the major Japanese banks at higher than Aa2, and nine of them obtained the highest rate, Aaa. In contrast, many of top U.S. banks had been downgraded to less than single A or triple B, due to their bad loans to the U.S. oil and agricultural sectors and to debt-ridden developing

countries (see Table 5.1). The Japanese side drew attention to the potential pitfalls of a regulatory scheme whose outcomes would be incompatible with a market perspective. The U.S. delegation came to a better understanding of the Japanese authorities' point, and effectively dropped its wholesale opposition.[27] The U.S. had to make a compromise with Japan, which had seven of the top ten banks in the world at the time in terms of asset size. At the end of the bilateral meeting, the U.S. delegation implied part of unrealised capital gains on marketable securities would be counted as capital.[28] The Japanese participants informed the US delegation that they would be committed to taking part in the international effort to establish common capital adequacy rules.[29] For the MoF, the inclusion of unrealised capital gains was the first step towards its full participation in the convergence process.

Figure 5.1 International Comparisons of Capital-to-asset Ratios based on the U.S.-U.K. Proposal




Notes: The figure of Japanese banks is the average of 13 city banks (March 1986). That of the American is the average of top 10 banks (December 1985). The British are the average o major 4 clearing banks (December 1985).

Source: Dai-Ichi Kangyo Bank, quoted in *Nihon Keizai Shinbun*, 17 August 1987.

Table 5.1 Long-term Debt Ratings of Selected International Banks (June 1987)

| | Japanese banks | American banks | British banks |
|---|---|---|---|
| Aaa | IBJ, LTCB, DKB, Mitsubishi, Sumitomo, Fuji, Sanwa, Mitsubishi Trust, Sumitomo Trust | J.P. Morgan | NatWest, Barclays |
| Aa1 | Bank of Tokyo, Mitsui Trust | | |
| Aa2 | Tokai Bank, | | |
| Aa3 | | Bankers Trust | |
| A1 | | Citicorp | |
| A2 | | Chase Manhattan, Chemical Banking, First Chicago | |
| A3 | | Manufacturers Hanover | |
| Baa1 | | | |
| Baa2 | | | |
| Baa3 | | Continental Bank | |
| Ba1 | | BankAmerica | |

Notes: IBJ, LTCB and DKB stand for Industrial Bank of Japan, Long-term Credit Bank of Japan, and Dai-Ichi Kangyo Bank, respectively. Lloyds Bank, the other major U.K. clearing bank, did not seek rating because it did not issue bonds on the U.S. markets.

Source: Moody's Investors Service

Following this progress, at the Basle Committee meeting in Brussels in June 1987, Japanese regulators officially indicated, for the first time, that they could, in principle, accept the new harmonisation proposal.[30] The meeting also reached an important agreement on an acceptable framework of capital, namely the two-tier capital structure. As on the asset side, a prototype of the framework of measuring capital had already been created. In making efforts to compare cross-national bank capital in the early 1980s, the Committee had adopted a "tiered capital" framework to allow countries to slot into various definitions of capital and to produce illustrative figures which could be read alongside those for other countries.[31] Based upon this idea, the U.S.-U.K. bilateral proposal took a "two-tier capital" framework and the 1987 Brussels framework also divided capital into two tiers. The first tier of capital, or core capital, consisted exclusively of equity stock and retained earnings. The second tier of capital, or supplementary capital, included other less pure forms of capital. Unrealised capital gains on securities, therefore, were expected to be included in supplementary capital.

Besides the inclusion of unrealised capital gains on banks' securities holdings in capital, in the course of the international negotiations, Japanese regulators recognised other two policy issues with which they had to deal: mutual holdings of banks' capital instruments and the categorisation of risk-weights.[32] The first issue was

related to a problem as to which assets should be deducted from both the capital base and total risk-adjusted assets. Investments in other banks' capital instruments were totally deduced from capital in several countries (for instance, France and the U.K.) in order to prevent banks from artificially increasing capital bases by mutually holding equities. Yet, such holdings prevailed in other countries. In Japan, mutual shareholdings were not negligible at the time. Dai-ich Kangyo Bank (DKB), for example, owned 3.4 percent of Long-Term Credit Bank of Japan, which in turn held 2.7 percent of DKB. Six of Nippon Credit Bank's largest shareholders were city banks.[33] Furthermore, *keiretsu* relations (industrial grouping), such as Sumitomo and Mitsubishi, had strong links among city and trust banks in terms of mutual shareholdings. American banks also held equity positions in other banks in anticipation of the relaxation of inter-state banking laws.[34] Since this sort of holdings was widely accepted in certain countries, especially in the two largest financial powers, the Basle Committee did not propose to require an across-the-board deduction, and allowed discretion to each national regulatory authority to determine whether deduction of banks' cross-shareholdings from the capital base would be applied or not.

Of particular note with regard to the re-categorisation of risk weights was the treatment of collateral. Although the U.S-U.K. bilateral agreement proposed to

charge both secured and unsecured corporate loans with a 100 percent risk-weight, Japanese regulators insisted that with regard to credit risk, there should be a difference in risk-weightings according to whether loans were secured or not. A role of collateral in Japan, where bank loans were a main funding source for corporate finance, was different from that in the U.S., where indirect corporate finance was dominant. American commercial banks made loans on the short-term basis, and did not usually require collateral. When Japanese banks lent money to their corporate clients, however, they always required collateral from borrowers, even from blue-chip companies. Japanese regulators argued that collateral was important in reducing potential loan losses and therefore a risk-weight for secured loans should be lower than that for unsecured loans. In the final Basle framework, the collateral concept related to the risk-weight measurements was in part introduced. This re-categorisation of risk-weights for secured and unsecured commercial loans was in line with Japanese regulators' request.[35]

*5.3.2 MoF's Domestic Manipulation: Domestic and International Interactions*

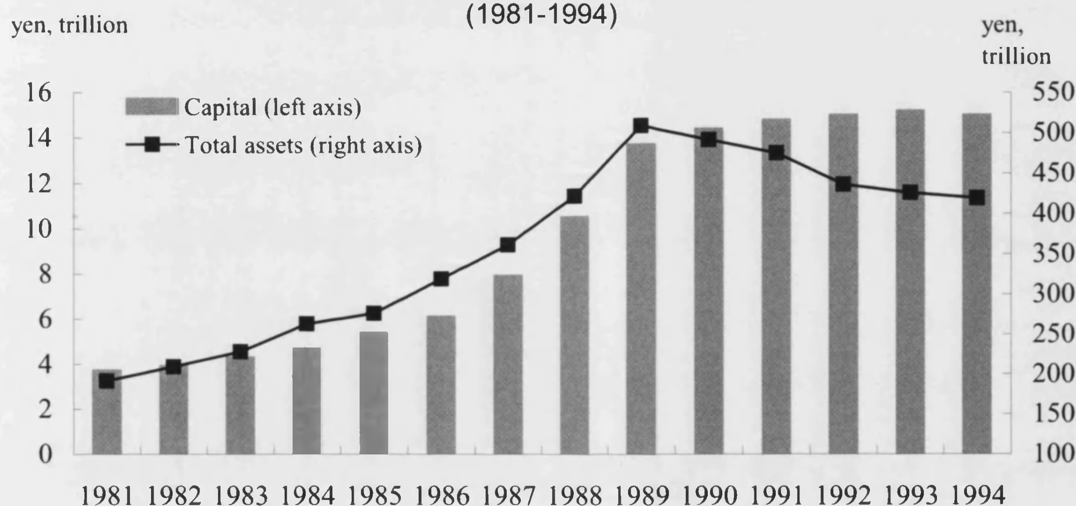
While engaging in international negotiations with foreign counterparts, the MoF pursued domestic strategies to require Japanese private banks to raise their capital-to-asset ratios and to reinforce domestic capital adequacy rules. These policies were

motivated by both international and domestic considerations. Internationally, the MoF intended to evade the critique of its lax regulation of Japanese banks and to improve its bargaining position in the international negotiations. One MoF official said that banks' capitalisation would favour Japanese negotiators in the Basle negotiations.[36]

Domestically, these policies were seen as means to strengthen the soundness of the domestic banking system. Taking advantage of their superior access to information regarding the Basle negotiations vis-à-vis the private banks, the MoF attempted to induce the banks to raise their capital levels. As the banks did not have direct access to the negotiation table, they had to depend on regulators for information about the content of the on-going international negotiations. The MoF took advantage of this information imbalance and selectively leaked information in order to induce banks to raise their capital. Through unofficial contact with private bankers, the MoF officials continued to warn them that the outcomes of the international negotiations might end up with very severe terms,[37] and encouraged their re-capitalization.[38] Private bankers themselves also recognized the significance of the U.S.-U.K. proposal, and started massive re-capitalization as early as in April 1987. Thanks to booming stock markets, they were able to carry out low cost equity finance, amounting to 10 trillion yen for three years (1987-89). However, as Table

5.2 exhibits, total assets also increased in parallel with the pace of re-capitalisation in the same period. Thus, Japanese banks' asset-incentive lending operations effectively remained same until 1989.

Figure 5.2 Capitalisation by City Banks (1981-1994)




Notes: Capital consists of common stock, legal reserves and earned surplus.
Total assets are the whole (non-risk weighted) sum of cash, loans, bill boughts, securities holdings, and foreign exchanges.
Sources: various issues of *Financial Statements of All Banks* (Federation of Bankers' Associations of Japan)

While attempting to encourage the banks to improve their capital-to-asset ratios, the MoF also planned to adopt the stricter domestic capital rules. The ministry announced the expanded domestic application of the risk-weighting approach in August 1987.[39] The 1986 guideline applied the risk-weighting measures only to banks' overseas assets. The MoF's new plan, however, was an across-the-board

application, by wiping out the line between overseas and domestic assets. Moreover, in September 1987, the MoF announced that the maximum permitted ratio of foreign assets to foreign net worth would be reduced from 3.5 to 2.5 in order to call a halt to "unhealthy and highly risky practices of Japanese banks".[40] These plans were intended to be complementary to the 1986 guidelines on bank capital adequacy until new Basle rules were agreed. Yet the plans did not come into force, because the Basle Committee reached an agreement more quickly than the MoF had expected and the plans gave the way to the new Basle rules.[41] These actions can be interpreted in terms of both the MoF's international and domestic strategies. At the international level, the MoF could improve its bargaining position by signalling to other Basle Committee members that it was making efforts at reinforcing domestic regulation. At the domestic level, the MoF used international negotiations to reinforce the domestic regulation of banks' balance sheet ratios.

Meanwhile, Japanese banks became somewhat conciliatory. In order to widen the win-set of Japanese banks, the MoF Banking Bureau took several measures both to reduce assets and to raise capital.[42] Compared with the U.S. and European banks, Japanese banks' securitisation of assets—parcelling loans into small lots and selling them to institutional investors, thereby removing assets from banks' balance sheets—was underdeveloped. Accordingly, promoting securitisation became the first policy

choice. However, once the issue of securitisation moved into concrete discussions, it turned out to be a tug of war over vested interests. Neither long-term credit banks nor trust banks wanted city banks to make inroads into their business field. For example, housing loans, which accounted for 10 percent of city banks' assets, were the most obvious target for securitisation. However, long-term credit banks opposed to the plan since such securitised assets would compete with the bank debentures that long-term credit banks alone were allowed to issue.[43] Measures to increase banks' capital, such as domestic convertible bonds, also aroused controversy within the banking industry. The political gridlock left no alternative but to issue subordinated debts, which sparked off fewer disputes but were a costly means of re-capitalization.[44] In short, the attempts to expand banks' win-set by linking stricter capital rules with reliable securitisation and re-capitalization means—synergistic issue linkages—were not particularly effective.

Similarly, measures to increase banks' capital, such as banks' issuance of domestic convertible bonds, preferred stocks and subordinated debts, also aroused controversy within the banking industry and resistance from the securities community.[45] The failure to aggregate preferences led to a political gridlock among complex vested interests. The political gridlock left no alternative but to issue subordinated debts, which sparked off fewer disputes but were a costly re-

capitalisation means.[46] In short, the intra-industry divisions among banks on the securitisation and re-capitalisation issues were so deep that banks were not able to swiftly reach compromises among them. This cleavage rendered the MoF's "synergistic issue linkage" policy less than effective.

The banks' concession rather came from their optimistic views of market trends. As the rapid rise in stock prices expanded the volume of unrealised capital gains on their securities holdings, they optimistically anticipated that their ability to meet stricter capital standards would strengthen. In August 1987, the FBAJ announced that their banks were no longer insisting on counting 70 percent of unrealised capital gains as capital: "We can't accept zero, but we are flexible".[47] This meant that the MoF no longer needed to insist on the figure of 70 percent in the international negotiations. The change in private banks' attitude gave Japanese regulatory officials more leeway to reach a compromise with their foreign counterparts.

## 5.4 Multilateral Agreement and the Limits of its Domestic Implementation

### *5.4.1 Japan's International Achievements and Unpredicted Domestic Consequences*

The regulatory authorities from three countries, Japan, the U.S., and the U.K., met on 13 September 1987 in London. At the trilateral negotiation, several major issues

were addressed. Among them, the degree to which unrealised capital gains on securities could be counted as supplementary capital was a main theme. The regulators from the three countries agreed that Japanese banks could count 45 percent of their unrealised capital gains as Tier II capital.[48] When realising capital gains, Japanese banks were taxed at 50 to 60 percent. This fact of life was reflected in the figure finally agreed at 45 percent of unrealised capital gains that would be allowed to count as part of capital.[49] The figure of 45 percent was much less than the initial Japanese request for a 70 percent inclusion, but Japanese banks were broadly satisfied with this outcome. They felt that in view of the booming stock market, the inclusion of 45 percent of unrealised capital gains in capital would be sufficient to allow them to boost their capital fairly easily.

In July 1988, the Basle Committee reached an agreement of *International Convergence of Capital Measurement and Capital Standards*, which became known as the Basle Capital Accord. In substance, it differed little from the agreement reached by the trilateral meeting in September 1987. The minimum ratio of 8 percent eventually appeared at the final stage. The figure of 8 percent was not derived from any economically rational grounds. According to Peter Cooke, then Committee chair, the minimum ratio was set "by the seat of the pants".[50] The figure was roughly equivalent to the capital ratios held by the relatively well-capitalized banks at the

time. The Japanese delegation did not object to the provisional figure, as they had expected the minimum ratio to be in the range of 7 to 9 percent.[51]

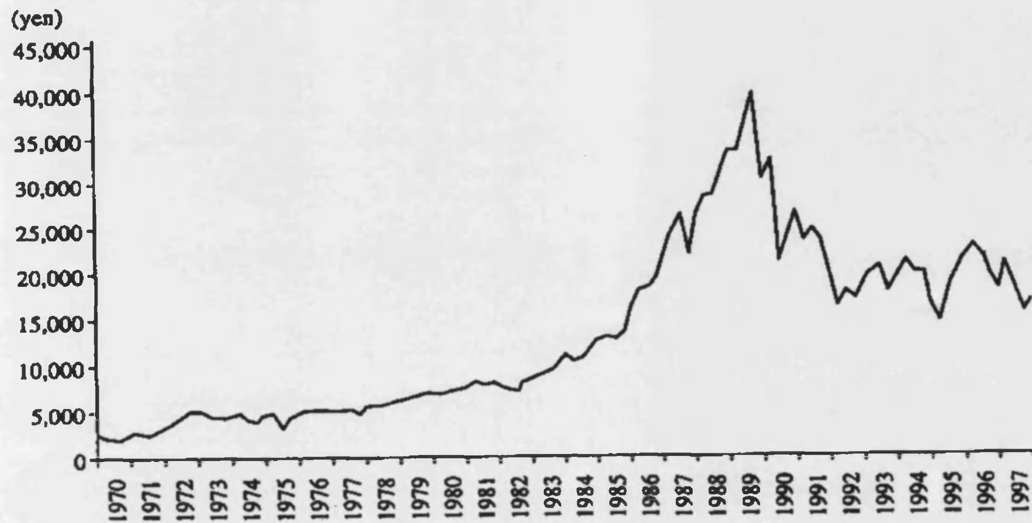
Flourishing Japanese financial markets in the late 1980s generated optimistic expectation of the future market trends among Japanese bankers. At the time, the Tokyo stock market index almost reached 39,000 and a leading securities house and its research body expected the Nikkei index would reach 80,000 by the mid-1990s.[52] In such a situation, the booming stock prices contributed to the increase in Tier I capital through equity finance, and the inclusion of 45 percent of unrealised capital gains in Tier II was thought to enable Japanese banks to clear the Basle minimum standards with ease. Indeed, one officer of Dai-ichi Kangyo Bank said that once the bank boosted its capital ratio up well above 8 percent it would use this as a marketing tool, much as it had already used its status as a holder of the largest asset size in the world and its top rating of triple A.[53] Some foreign observers also argued that by inducing Japanese banks to relate their capital to their assets' risk profiles, the Basle Accord enhanced Japanese banks' international competitiveness further.[54]

Alas, as we now know all too well, things did not go according to those rosy expectations. Ironically, in the aftermath of the 1990 collapse of the financial bubble, the MoF's negotiation achievement of getting unrealised capital gains incorporated into regulatory capital ironically revealed the fragility of Japanese banks' capital

bases and even worsened that fragility. For much of the early half of the 1990s, the Nikkei 225 index was languishing at around the 19,000 mark, less than half of the historic peak of just under 40,000 recorded at the end of 1989 (see Figure 5.2). Japanese banks' heavy dependence on the unrealised gains on their securities holdings for clearing the minimum standards caused difficulties for them. Their unrealised capital gains evaporated, and their capital bases quickly shrank. Salomon Brothers estimated the effect which different levels of the Nikkei index had on each bank's capital base (see Table 5.3). Although the table provides a very rough guide as the banks can operate different policies with their stock portfolios, they largely illustrate the extent to which the capital levels of the banks were subject to swings in the Nikkei index.

Figure 5.3 Nikkei Stock Average (TSE 225 issues):

1970-1998 (quarterly)




Source: M. Hall (1998) Chart 2.9, p. 56.

Table 5.2 What the Nikkei means for City Banks' Basle capital

unit: %

| Nikkei level / city banks | 18,500 | 19,500 | 20,500 | 21,500 | 22,500 | 23,500 | 24,500 |
|---|---|---|---|---|---|---|---|
| Dai-Ichi Kangyo | 7.21 | 7.41 | 7.61 | 7.80 | 8.00 | 8.20 | 8.40 |
| Mitsui Taiyo Kobe (Sakura) | 7.01 | 7.30 | 7.35 | 7.35 | 7.35 | 7.35 | 7.35 |
| Sumitomo | 7.61 | 7.70 | 7.96 | 8.14 | 8.31 | 8.48 | 8.66 |
| Fuji | 7.51 | 7.70 | 7.90 | 8.09 | 8.28 | 8.48 | 8.67 |
| Mitsubishi | 7.39 | 7.59 | 7.80 | 8.01 | 8.21 | 8.42 | 8.63 |
| Sanwa | 6.99 | 7.19 | 7.39 | 7.59 | 7.79 | 7.99 | 8.18 |
| Tokai | 7.50 | 7.73 | 7.96 | 8.05 | 8.05 | 8.05 | 8.05 |
| Daiwa | 7.42 | 7.71 | 8.00 | 8.29 | 8.58 | 8.87 | 8.93 |
| HokkaidoTakushoku | 8.25 | 8.46 | 8.67 | 8.74 | 8.74 | 8.74 | 8.74 |
| Bank of Tokyo | 6.85 | 7.01 | 7.17 | 7.33 | 7.49 | 7.65 | 7.81 |
| Kyowa Saitama (Asahi) | 7.56 | 7.79 | 8.01 | 8.24 | 8.47 | 8.69 | 8.92 |
| Average | 7.40 | 7.61 | 7.80 | 7.97 | 8.12 | 8.26 | 8.39 |

Source: Salomon Brothers, Japanese Stock Research, 9 July 1991(quoted in *The Banker*, January 1992. 44)

*5.4.2 Domestic Legislation: Establishing a Statutory Basis for Capital Rules*

A six-month period for public comment followed the publication of the Basle Committee's December 1987 proposal. The member regulatory authorities published the results and took comments from interested parties. During the period for public comment, on 22 December 1987, Ken-ichi Kamiya, chairperson of the FBAJ, announced that the FBAJ would set up a special section on capital adequacy problems mainly to harmonise interests regarding capital adequacy rules among its banks and inject the interests into the MoF's domestic implementation of the Basle Accord.[55] Taking the 8 percent minimum ratio and the inclusion of 45 percent of unrealised capital gains as given, the special section dealt with remaining issues such as the type of banks to which the Basle Accord and national discretion would apply. With regards national discretion, one of their chief issues of concern was the treatment of cross-shareholdings by banks.

On 7 April 1988, after taking comments from the Japanese banking industry, the MoF published a proposal of how to apply the Basle Accord to Japanese banks. The proposal stated that mutual shareholdings by banks would be deducted from the capital base only when deliberately arranged solely to boost capital levels.[56] The term of "deliberately" was interpreted in the kindest possible way. In other words, it was,

in principle, possible for Japanese banks to count their mutual equity holdings among banks as the capital base.[57]

After the sharp decline of asset prices in 1990, growing difficulties for Japanese banks in meeting the minimum standards triggered outcries against the Basle Accord in Japan. However, Japanese regulators resisted political pressures from the banking sectors calling for revision of the Accord. Yoshimasa Nishimura, the then director of the MoF Fiscal and Monetary Research Institute, argued that any lenient domestic implementation or postponement of the Accord would only result in an international crisis of confidence in the Japanese financial system.[58] In May 1992, in testimony before the Upper House finance committee, Masaki Tsuchida, then Director General of the MoF Banking Bureau, rejected bankers' claims for a lowering of the regulatory standards at the next Basle Committee meeting.[59]

The culmination of Japanese regulators' commitment to the Basle Accord was the 1992 revision of the Banking Law: for the first time ever, the regulators succeeded in legislating for the statutory form of capital adequacy requirements. This process of legislation can be understood in terms of "reverberation" of an international agreement. In early 1991 the MoF drafted proposals of a financial system reform that allowed cross-entry of banks and securities houses into each business, but a series of major financial scandals followed in the summer of 1991.[60]

This called into question the existing method of banking regulation based upon non-legal administrative guidance and opaque relationships between the regulators and the regulated. This regulatory style was deemed to impede "proper competition" in the market, thereby preventing banks from exercising due self-responsibility. The Financial System Research Council urged the early enforcement of financial systemic reform, which would promote "proper competition" in the Japanese financial system, and at once the introduction of transparency regulatory rules, which would shore up the stability and confidence in the financial system.[61] As part of the transparent rules, the statutory form of capital adequacy requirements drew attention.

The fact that other Basle Council member countries were also legislating for capital adequacy rules in line with the Basle Accord legitimised the MoF's effort to give Japanese capital rules a legal basis. In addition, two domestic factors prevented private banks from openly opposing the legislation. One was growing anti-bank sentiment from the public in the wake of a series of financial scandals. The other was that, since the statutory form of capital rules was tied up with the approval of cross-entry into banks and securities business—something that the banks had desired for decades—the banks did not fend off the proposals as they had done previously. In this climate, the MoF was able to incorporate a provision of capital adequacy requirements in the revised Banking Law of 1992.[62]

Perception of the market trend by regulators also encouraged them to take a regulatory hard line. Despite the rapid fall of stock prices, the Japanese government still held an optimistic view of the economy at the time. Until the autumn of 1991 government forecasts predicted a steady upturn, and even as late as the spring of 1992, Japanese regulators did not see the drop in stock prices as critical and structural, as banks were reporting increased operating profits.[63] These views helped the regulators to prioritise the regulatory objective over the banks' claims for leniency. Yoshimasa Nishimura of the MoF said that comparison with the pre-war banking sector showed that the thin capital of Japanese banks from the 1960s to the 1980s was an "anomaly".[64] For him, the Basle Accord was a positive measure that would bring Japanese banks back onto the right track. Evidently, as Granirer observes, Japanese regulators did not see their behaviour as a "sell-out" of Japanese banks.[65] The international agreement on capital adequacy requirements helped Japanese regulators achieve their objective of that period, which was to establish statutory capital adequacy requirements.

It should be noted, however, that the introduction of statutory capital adequacy requirements alone was neither an adequate condition for the change of bank behaviour nor the strict implementation of capital adequacy rules in Japan. In other words, the above-mentioned development in the Japanese capital rule just met two of

the four indicators of credible commitment to international capital adequacy standards outlined in Chapter 3. The MoF established the statutory form of capital rules, and Japanese banks began to meet the required capital ratios. However, more crucial indices (accounting principles and regulators' prompt corrective action) were left untouched. Rather, without these policy indicators, the statutory capital rules and private banks' numerical compliance do not ensure the credible commitments of Japan to the Basle Accord.

In fact, it is difficult to say that Japanese regulators became tough regulators after the 1992 legislation. In the wake of the collapse of the financial bubble, the MoF continued to take a "forbearance policy", allowing banks to hold non-performing loans without radical remedies in the hope that the economy would recover soon. In addition, when some of major Japanese banks began to fail to meet the Basle standards, the regulators changed accounting rules for banks' stockholdings appraisals, which were designed to increase the apparent level of capital ratios, without any efforts to improve the quality of capital components. This suggests the *de facto* defection from the strict implementation of the international regulatory standards. The development of regulatory norms and methods at the Basle Committee and the statutory and legal changes in Japanese banking regulation did

not automatically bring about the credible implementation of capital adequacy rules. The issue of implementation will be addressed in detail in Chapter 7.

### 5.4 Conclusion

Employing the two-level-game approach, this chapter contributes to the understanding of a process in which Japanese regulators specified their preferences towards the Basle negotiations, and a way in which they behaved in pursuit of different policy goals, domestically and internationally. At the international level, the MoF pursued the prime goal of having new international capital rules that include unrealised capital gains on banks' securities holdings in the definition of capital, because the inclusion of these unrealised gains was deemed to help Japanese banks to maintain their international competitiveness. The distributive effect of international capital adequacy regulations inclined Japanese banks to put pressure on the MoF, and the MoF itself did not want to see Japanese banks lose their international competitiveness. Thanks to Japanese banks' strong market positions and the Basle innovation of the two-tier capital structure, the MoF succeeded in injecting their demands into the negotiation outcomes. Japanese banks were allowed to include 45 percent of unrealised capital gains on their securities holdings as part of regulatory capital.

A bullish market sentiment in the late 1980s predisposed Japanese banks to hold an idea that the inclusion of unrealised capital gains in capital would be a quick and easy way to boost their capital bases. They were satisfied with the negotiation outcome in the expectation that it would make the compliance costs for the banks low. Japanese regulators, who steeped in the idea of unrealised capital gains as capital were also receptive to the banks' claims at the time. For the regulators, the Basle Accord was satisfactory too, because it was deemed to help Japanese banks maintain their international competitiveness and simultaneously to force them to raise their capital-to-asset ratios. Contrary to Oatley and Nabors' argument, at the time of 1988, both Japanese regulators and banks assessed the outcomes of the Basle negotiations as successful.[66]

Retrospectively, however, the MoF's policy goal based upon the belief in ever-rising stock prices was misguided. The inclusion of unrealised capital gains on holding securities under the Basle framework left the capital levels of Japanese banks sensitive to stock market fluctuations. Their capital composition heavily relying on unrealised capital gains eventually caused massive negative effects on the capital levels of Japanese banks especially after the 1990 collapse of Japanese stock markets. In hindsight, had the MoF attempted to tackle this problem of Japanese banks' large

exposure to market risk from their equity portfolios at a time when the banks were in a position of strength, their capital structures would not have become so fragile.

Whereas the MoF miscalculated the source of Japanese banks' assumed strength, the ministry pursued the domestic goal of establishing effective capital rules in order to countervail the greater degree of freedom enjoyed by banks. This corresponds with what Putnam calls reverberation or the synergy strategy: international actions are used to reinforce state negotiators' policy autonomy vis-à-vis societal interests. Inadequate domestic institutions and policy tools motivated the MoF to use external pressure to manipulate the domestic politics of capital adequacy requirements. The MoF's efforts culminated in the 1992 legislation for capital adequacy requirements. In the absence of an effective enforcement mechanism, however, the 1992 legislation left the regulators with a scope of forbearance in handling banking problems in the 1990s. In this sense, it was not effective in terms of prudential regulation. Yet the interplay between international and domestic politics enabled the MoF to achieve its objective of establishing the statutory basis for capital rules, which the ministry had wanted since the early 1980s but had effectively failed to do so under political pressure at the domestic level.

As regards regulators' strategies to manipulate domestic politics, the politics of the securitisation of bank assets showed that the success of synergistic issue linkage

was largely contingent upon the domestic interest configuration of concern. Although bank assets' securitisation was deemed to help banks to raise their capital-to-asset ratios in general, it caused intra-industry divisions among the types of banks—city banks, long-term credit banks, and trust banks—on the issue of what sorts of assets should be securitised and on what conditions. Specifically, long-term credit banks and trust banks opposed the securitisation plans that would threaten their privilege. This cleavage hindered the MoF's efforts at linking the generally favourable policy packages with tough capital adequacy requirements. The complex vested interests in the domestic politics proved to be political gridlock that culminated in a very limited result of securitisation. Consequently, it also negatively affected the Japanese banks' struggle for meeting the Basle standards.

The findings of this chapter have implications for the two standard, systemic-level explanations: the redistributive logic and the market pressure logic. The chapter has revealed that the interplay between international and domestic politics enabled the MoF to achieve its objective of establishing the statutory basis for capital rules. It means that the MoF's domestic regulatory goal was similar to the American regulators' goal of re-capitalizing U.S. banks. At least as regards the domestic goal of regulators, therefore, the Basle Accord is more closely attuned to what Putnam and Bayne call a "mutual reinforcement" type of international policy coordination,

which enables each participant to obtain external pressure for one's domestic policy, than Oately and Nabors' characterization of it as "redistributive cooperation".[67]

The other explanation for the Japanese banks' rapid increase in their capital ratios focuses on market pressures.[68] Yet this bank-cantered explanation and the explanation made above are not necessarily incompatible with each other, but rather complementary. While the market pressure logic focuses on the banks' perspective, the approach presented here has put the MoF in the context of domestic politics and taken account of its motivation. Like the redistributive logic, the bank-centered explanation is likely to lead to an image that Japanese regulators were forced to accept the Basle Accord, and blurs the Japanese domestic politics that motivated the regulators to pursue their domestic goal of strengthening capital requirements.

Moreover, the case of the 1988 Basle Accord not only provides further evidence for, but also revises the argument of Japan as a "reactive state"—the Japanese political system incorporates a mechanism in which actors use foreign political pressure, or *gaiatsu*, to shape or pursue domestic policy agenda. Kent Calder argued that Japan's reactive state behaviour had been typical in policy issue-areas where the decision-making authority was fragmented and/or where domestic interest groups established clientelistic relationships with the ruling party politicians.[69] This chapter has added to the reactive state argument that even in a policy area of banking

regulation, where the bureaucracy is often deemed to enjoy a high degree of autonomy, regulators were exposed to societal interests.[70] The autonomy of Japanese regulators was not institutionally given in the realm of capital adequacy requirements, but rather was a product of their statecraft in overcoming institutional impediments. The interaction between domestic and international politics gave the regulators a political tool to create autonomy and improve their manoeuvrability over financial regulation.

Explanatory power of the two-level-game model, however, should not be overestimated. It is true that the two-level-game model holds as long as the negotiation process is concerned. However, the logic of two-level game model, which privileges neither international factors nor domestic politics, leaves important questions unanswered. What did happen once the debate of capital adequacy becomes enmeshed in domestic Japanese bureaucratic and political processes at the post-negotiation implementation stage? Chapter 7 will discuss the question and significantly qualify the validity of the two-level game mode for accounting for compliance.

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[1] Oatley and Nabors (1998).
[2] Kikkawa (1998), Nishimura (1999) and Shiota (1999).
[3] Kapstein (1994).
[4] Oatley and Nabors (1998).
[5] Simmons (2001).

[6] Calder (1988).
[7] Kapstein (1994: 113).
[8] Bardos (1987-88: 27) and Granirer (1994: 184-85).
[9] Kapstein (1994: 113).
[10] Oatley and Nabors (1998).
[11] Bardos (1987-88: 27).
[12] Granirer (1994: 186-87).
[13] Bardos (1987-88: 27).
[14] Bank of Boston, "Comments to the Federal Reserve Board", 11 May 1987, mimeograph, cited by Kapstein (1994: 114).
[15] Another concern was how to harmonise the bilateral agreement with activities of the EC Banking Advisory Committee, which had sought regulatory convergence along with the 1992 programme of European integration. See Granirer (1994: 195-200).
[16] Interview with Kōsuke Nakahira, director of the Banking Bureau at the Japanese Ministry of Finance (1985-87), Tokyo, 8 September 1999.
[17] *Wall Street Journal*, 6 August 1987.
[18] The public comment appeared on *Kin-yū Zaisei Jijyō*, 18 May 1987, 7. For Japanese banks' transnational lobbying efforts, see *Financial Times*, 4 March 1987; 13 May 1987.
[19] It should be noted that low capital ratios were not the only source of regulation-induced cost advantage for Japanese banks, which also benefited from such the competition-preventing regulations as market entry restriction, and deposit-rate regulation. Hadjiemmanuil (1996: 62 n.251).
[20] Oatley and Nabors (1998: 51).
[21] Interview with ex-MoF officials, September and December 1999.
[22] Interview with a BoJ official, March 2000.
[23] On risk-taking by the government, see Ueda (1994: 96-7). Ironically, foreign credit agencies admitted the government-backed financial system as a source of Japanese banks' credit. As seen below, despite their low capital levels, most of Japanese banks therefore enjoyed high credit ratings in the late 1980s.
[24] Interview with an ex-MoF official, September 1999.
[25] *Nihon Keizai Shinbun*, 5 May 1987.
[26] Interview with Nakahira.
[27] Interview with Nakahira.
[28] *Nihon Keizai Shinbun*, 22 June 1987.
[29] Vernon, Spar, and Tobin (1991: 149).
[30] *Nihon Keizai Shinbun*, 22 June 1987.
[31] Cooke (1990).
[32] Interviews with Nakahira and former MoF officials, September and December 1999.
[33] Figures are from *Euromoney*, July 1988, p.40.
[34] Bardos (1987-88: 30).
[35] Interview with Nakahira.
[36] *Nihon Keizai Shinbun*, 17 August 1987.
[37] Interview with Nakahira.
[38] *Nihon Keizai Shinbun*, 17 August 1987.
[39] *Nihon Keizai Shinbun*, 15 May 1987.
[40] *Financial Times*, 22 September 1987.
[41] Japanese regulators initially expected that the issue of regulatory convergence would be settled in one or two years. *Nihon Keizai Shinbun*, 22 March 1987.
[42] See Namiki (1991).
[43] *Nihon Keizai Shinbun*, 17 August 1987.
[44] Under the Basle rules, subordinated debts with a maturity of longer than five years were counted as Tier II capital up to 50 per cent of Tier I capital when they were non-perpetual, and up to 100 per cent when perpetual. Though subordinated debts played a critical role in

offsetting sharp decline in unrealised capital gains on banks' securities holdings, Japanese banks began to rely on such debt instruments for capital compositions too much.
[45] Domestic convertible bonds would also compete with long-term credit banks' bank debentures, their main source of fund raising. The politics of measures of helping banks' improvement in capital-to-asset ratios will be discussed later.
[46] The role that subordinated debt played in offsetting sharp decline in unrealised capital gains on banks' securities holdings will be discussed later. See also Horiuchi and Shimizu (1998).
[47] Wagster (1996: 1338).
[48] *Nihon Keizai Shinbun,* 13 September 1987.
[49] Interview with an ex-MoF official, December 1999.
[50] *Institutional Investor*, August 1994.
[51] *Nihon Keizai Shinbun*, 22 March 1987.
[52] Nomura Securities and Nomura Research Institute. 1989. Mega-trend of the Tokyo Equity Market. Paper presented at Tokyo Equity Forum '89, November, Tokyo. Quoted in Taniguchi (1993: 1).
[53] Interview quoted by *Euromoney*, July 1988, p.47.
[54] For example, see Wagsyl, Stefan. Survey of Japanese Financial Markets (4): New Rules Accelerate Change—Commercial Banks. *Financial Times*, 13 March 1989.
[55] *Nihon Keizai Shinbun*, 23 December 1987; *Kin-yū Zaisei Jijyō*, 18 January 1988.
[56] *Nihon Keizai Shinbun*, 8 April 1988.
[57] This "double gearing" rule was modified in 1998. See Chapter 7.
[58] *Shūkan Tōyō Keizai*, 5 September 1992, 92-97.
[59] *Reuters Money Report*, 26 May 1992.
[60] For the politics of the early 1990s financial reform, see Vogel (1996: 180-89). The scandals of 1991 included securities houses' huge compensation to their top corporate clients and allegedly to *yakuza*, and major banks' fictitious deposit certificates, which many firms engaging in reckless speculation used as collateral to additionally borrow numerous money from the banks. For an overview of a series of financial scandals in the 1990s, see Nihon Keizai Shinbun Sha (2000b).
[61] *Kin-yū Zaisei Jijyō*, 3 February 1992, 16-35.
[62] However, the banking crises of 1995 and 1997 demonstrated the MoF was not yet ready for being a "tough" regulator. See Chapter 7.
[63] *Remarks of Masaki Tsuchida, then Director General of the MoF Banking Bureau, see Kin-yū Zaisei Jijyō*, 4 May 1992, 16-17.
[64] *Shūkan Tōyō Keizai*, 5 September 1992, 93.
[65] Granirer (1994: 283).
[66] See Oatley and Nabors (1998).
[67] Putnam and Bayne (1987: 261-62).
[68] Simmons (2001).
[69] Calder (1988).
[70] Vogel (1996).

# Chapter 6

# Negotiating the 1996 Amendment: A New International Power Configuration and Domestic Financial Turmoil

## 6.1 Introduction

The 1996 Amendment to incorporate market risk represented a sea-change in the development of the Basle capital standards in terms of regulatory norms and methods. In addition to credit risk, the 1996 Amendment applied capital charges to the risk of losses in on- and off-balance-sheet positions arising from movements in market prices (so-called market risk). Besides the new scope of capital requirements, the Amendment included several important changes to the way in which banks measured their market risks. The biggest of these was that the Basle Committee, for the first time, allowed banks to use their own internal risk models for estimating capital requirements for market risks that they were taking. "Using internal models is a profound innovation

in the methods and philosophy of regulation", said Tommaso Padoa-Schioppa, the then Committee Chairman.[1]

A main concern of this chapter is to elucidate how Japanese bank regulators were engaged in the issues of the 1996 Amendment, internationally and domestically, through a lens of the two-level-game framework. Section 6.2 investigates Japanese regulators' preferences and bargaining positions in the international negations on the 1996 Amendment. It addresses questions as to how domestic conditions affected Japanese regulators' preference formation and where the regulators fitted in a newly emerged political configuration of international banking regulation. Section 6.3 considers domestic impact of the 1996 Amendment. Questions considered in that section are such as the following. What was the driving force behind the mid-1990s banking regulation reform in Japan? And, to what extent does the two-level-game model can prevail in explaining Japanese regulators' behaviour and the domestic regulatory change as a whole?

## 6.2 Japanese Regulators in International Negotiations

### *6.2.1 American and European Preferences towards Market Risk Regulations*

Liberalisation of financial markets, financial innovation, and sharpened competition squeezed margins on traditional banking business since the early 1980s. On the other hand, the growth of derivatives markets made it easier and cheaper for banks to move

into trading. This switch in focus has transformed the character of the risks faced by banks. A new concern has been added to old concerns like liquidity risk (the risk that the cash available to a bank could be exceeded by customers' calls on it) and credit risk; that of market risk. The Basle Committee recognised the need for action in this area.

The Basle Committee, first of all, had to address the question of the scope and coverage of market risk regulations: What categories of financial assets should be covered by the market risk regulations? Although the 1988 Basle Capital Accord stated that issues related to interest rate risk and market risk would be addressed later, the scope and coverage of the capital charges for market risk remained open to question. With regard to this issue, regulators' domestic considerations played significant roles in defining the scope of market risk regulations. As in the case of the 1988 Basle Accord, member regulators' preferences and behaviour largely reflected domestic concerns. That is to say, regulators tried to make a new regulatory framework consistent with their own domestic considerations.

It was American regulators that were keen to get on with capital requirements for market risk from the outset. They proposed to apply new Basle rules to a wide range of market risks. There were domestic considerations behind this U.S. initiative. At the end of the 1980s, the American economy confronted a "financially induced recession"

that was caused by so-called "three Ls": LDC (non-performance loans to Least Developed Countries), LBO (leverage-buy-out), and LAND (loans to real estate).[2] A steep increase in the number of bank failures gave rise to a sharp increase in expenses of the Federal Deposit Insurance Corporation (FDIC). With the aim of minimising the loss to the FDIC, the U.S. Congress passed the FDIC Improvement Act (FDICIA) in December 1991. The Act introduced a so-called "prompt collective action scheme", which linked the graduated intensity of regulatory intervention to the degree of banks' capitalisation. The FDICIA required American regulators to look at a broad range of financial risk exposures (including institutions' interest rate risk, market risk, and loan concentration) in the capital assessment process of the prompt collective action scheme, and set the deadline of June 1993 for implementation. The U.S. Federal Reserve Board (Fed), often expressing its staunch opposition to any relaxation of regulatory capital requirements,[3] published its own proposal for a new domestic regulatory scheme covering a broad range of non-credit risks.[4]

The above domestic factors determined American regulators' preferences with regard to the scope of new Basle capital requirements. The regulators insisted that the capital charges of the new Basle rules should cover the whole loans and investments in securities that banks carried on their books.[5] Thus, the eagerness of the American regulators to add the wide range of non-credit risks to the Basle framework reflected

their intention to make the Basle framework consistent with their domestic efforts.

In contrast, the European members of the Basle Committee had a strong political motivation to narrow the scope of market risk regulations. In the European financial markets, European banks had already made a considerable effort and expenditure on reporting systems to comply with the European Union's Capital Adequacy Directive (CAD)—new capital requirements for banks and securities houses adopted as part of the Single Financial Market programme.[6] The CAD divided the activities of a financial institution into two books: a banking book and a trading book. The capital charges for market risk under the CAD rules were employed to cover only a trading book consisting of short-term transferable securities. For EU members, if new and different capital requirements were agreed at the Basle Committee, they would have to require their banks to prepare another new set of reporting systems. Therefore, European members had a strong incentive to limit the scope of the new Basle rules to the CAD trading book.

*6.2.2 Japanese Preferences towards Market Risk Negotiations*

Like the European members of the Basle Committee, Japanese regulatory authorities wanted to limit the application of market risk regulations to short-term trading portfolios. Their preference also came from their concerns over their domestic banking system. When market risk undertaken by banks became an urgent issue at the Basle

Committee, the financial environment of Japan was serious enough for Japanese regulators to ponder potential effects of new regulatory capital requirements on their troubled private banks. The regulators wanted to somehow mitigate negative impacts of the new requirements for market risk on Japanese banks' performance.[7] At the same time, there were accumulating complaints from the Japanese banking industry about the minimum capital standards of the Basle Committee throughout the 1990s. After the 1990 collapse of the financial bubble, Japanese banks went to great lengths to meet the requirements of the Basle standards.

In fact, in the mid-1990, rumoured proposals for tighter Basle capital adequacy standards reached Tokyo.[8] The rumour was that, in order to take into account foreign exchange risk and exposure to investments in securities, the Basle Committee was planning to introduce new standards to add banks' holdings of foreign exchange, stocks and bonds to their total asset figure.[9] As seen above, reflecting their own domestic concerns, American regulators proposed the broad scope of market risk regulations covering banks' securities holdings for investment purposes. Japanese bankers expressed considerable dismay over the U.S. proposal because they possessed a large quantity of stocks and bonds that amounted to 14 percent of their assets on average.[10] Given the huge stock and bond holdings, such an expansion of the definition of bank assets would compel the Japanese banks to raise capital and add

more burdens on Japanese banks.

Strained domestic financial conditions made Japanese regulators circumspect about additional burdens that new market risk regulations might impose on Japanese banks. The regulators feared the strong political reaction from banks and politicians that additional capital requirements would inevitably provoke.[11] The scope of the application of market risk regulations became a major concern to the regulators. Considering Japanese banks' huge holdings of stocks and bonds, they favoured the application of market risk regulations on a restricted basis. The domestic situation, thus, made the Japanese delegation to the Basle negotiations to prefer the restrictive application of capital requirements for market risk, which seemed to impose fewer additional burdens on the banks than the broad application would.[12]

At the Basle Committee, the already-established EU CAD constructed a "focal point", a base on which others' ideas could converge.[13] In exchanging views with other members, American regulators started to recognise the technical difficulty of their broad application proposals and were inclined to agree on the restricted coverage of capital requirements for market risks.[14] With regard to the technical feasibility of the broad coverage of market risk, there was no concrete idea on how to quantify various market risk factors that an array of loans and investments in securities generated.[15] The limited scope of market risk was a product of a compromise made between American

regulators who urged the early introduction of market regulation, on the one hand, and Japanese and European regulators who preferred to narrow the scope, on the other hand. The Basle Committee finally decided to apply market risk regulations to the trading risk of marketable securities and commodities positions and the exchange rate risks of foreign exchange positions.[16] The Basle definition was in effect consistent, albeit in less detail, with the definition of the trading book in the EU CAD.[17]

The above outcome enabled Japanese regulators to stress their "achievement" of narrowing down the regulatory scope. Namely, the outcome gave Japanese regulators chances of convincing Japanese banks and other interested parties to accept the newly agreed intentional capital standards, by emphasising that they made great efforts to limit the scope only to trading portfolios and foreign exchange positions.[18] The MoF also stressed that the newly proposed regulation did not intend to impose additional regulatory requirements, but it rather aimed at establishing a more accurate regulatory system to capture and control risks.[19] Indeed, the Japanese banking circle received the 1993 proposal with relief. Thanks to the narrow scope of the application, it was expected that top city banks would need to increase their capital bases by 0.1 to 0.2 percent, and long-term credit banks and trust banks would be to raise their capital bases by 0.2 percent.[20]

*6.2.3 A New Political Configuration: The Issue of Internal Models*

The second issue of market risk regulations, which the Basle Committee had to cope with, was the method of measurement frameworks. The method issue included questions of how to measure the market risks undertaken and how to set regulatory capital requirements against the market risks. The Basle Committee initially came out in favour of a so-called building-block approach, which the EU CAD had already adopted. The building-block approach differentiated requirements for "specific market risk" (the risk of loss caused by an adverse price movement of a security due principally to factors related to an individual issuer of the security) from those for "general market risk" (the risk of loss arising from adverse changes in market prices) and summed up the two elements of the risk profiles. The first fruit of this regulator-led initiative was the 1993 consultation paper.

The 1993 proposal, however, encountered serious reactions from leading banks possessing advanced risk management systems. The building-block approach imposed the simple rules laid down by regulators on all banks to determine their regulatory capital. Namely, the same basic formula for determining minimum regulatory capital was applied to all banks, regardless of differences in their risk management skills and capabilities, their actual portfolios, or their attitudes towards risk taking. This crude "buckets" method provoked a series of objections from banks with cutting-edge risk management techniques. For example, the Institute of International Finance, a

Washington, D.C.-based lobby group and research organisation for international banks, published a counter-report challenging the 1993 proposal. The paper said that the proposed methods "fail[ed] to create sufficient regulatory incentives for banks to operate more sophisticated risk measurement systems than those necessary to meet the regulatory minimum".[21]

In response to harsh comments from the banking industry, the Basle Committee published the 1995 proposal. The new proposal permitted banks to have a choice between the use of their own internal models to calculate market risks and the use of the standardised measurement framework originally set out in the 1993 proposal. Banks, whose internal risk management systems were judged adequate, were allowed to use their own models to estimate how much capital they should hold against market risks. The 1995 proposal became a prototype for the Market Risk Regulation, which was formally announced in April 1996.

The process leading up to the 1996 Amendment had at least two outstanding features. One is increased technical complexity. The assessment of market risk was a complex task because the value of securities and foreign exchange rates were highly volatile. Accordingly, capital adequacy requirements for market risk became esoteric. The other is that the rapid development of private banking operations which has outpaced the ability of regulators to grasp this has induced private organisations, such

as the Group of Thirty (G-30) and the IIF, to commit them to lobby the Basle Committee in pursuit of self-governance for the banking industry. These two features are related, since knowledge is not only something technical and instrumental, but also something associated with power and thereby affects the nature of interaction between regulators and private banks.

The increasingly esoteric nature of banking regulation significantly increased the ability of leading international banks to achieve their desired objectives using the power derived from knowledge about sophisticated risk management. The power phenomena were both relational and structural.[22] The banks engaged in direct political lobbying activities. Relevant knowledge about risk management enabled the leading banks that possessed it to directly challenge the regulator-led 1993 proposal, and to suggest other alternatives.

The powerful banks also had covert influence over the regulators' causal belief concerning capital adequacy requirements for market risk. When JP Morgan chairman Dennis Weatherstone, who was also the then head of the G-30, made its VAR (value-at-risk)-based internal model—RiskMetrics—available to the world free of charge in October 1994, the bank gave VAR a decisive boost.[23] VAR is an estimate of the potential losses that banks face in their day-to-day operations.[24] Given the increasing sensitivity of the industry to various types of risks, it was in JP Morgan's

interest to ensure that its customers were managing their risks properly.[25] Soon after, Bankers Trust, another leader in the field, unveiled its RARCO (risk-adjusted return on capital) 2020 system, hoping to rebuild its reputation, which had been damaged by a legal dispute with a former client over derivatives deals, with the launch of a model which took risk management a giant step forward.[26]

The releases of private banks' internal models had a significant impact on the regulatory evolution towards the use of banks' internal models. First, VAR became the *de facto* standard of risk management systems that other banks followed, as the concept of VAR was widely seen as a convenient device to measure their risks. Second, the unveiling of VAR-type internal models gave regulators an indication of where they could go with regard to risk management, and provided them with guidance as to how to achieve their preferred objectives to ensure the soundness of the financial system.[27] As for the method of measuring risk, a clear consensus emerged that some form of VAR was a convenient means of estimating market risk in financial circles, including the regulators and the regulated.[28] This consensus formation can be regarded as a power phenomenon generating legitimacy for the worldview of leading banks and affecting regulators' perspective in conformity with such a worldview. In sum, the public releases of cutting-edge internal models by a few leading banks made some regulators see banks' internal models as a possible regulatory measure and be more

receptive to the idea of delegating part of the regulatory functions to private banks.

Through the overt and covert exercise of power by private banks, a conservative belief in simple, big numbers of capital-to-asset ratios dwindled among regulators. The Basle Committee decided to allow private banks to use their own internal models for regulatory purposes. The leading international banks with sophisticated portfolio adjustment and reliable internal risk management had much to gain from this decision, as the regulatory use of internal models effectively reduced the regulatory burden on them. This represented a political victory for the leading banks.[29]

The market-oriented form of capital adequacy requirements, however, put great strains on banks lacking relevant knowledge, at least in the short run. Banks which did not have sufficient risk management systems would remain stuck with the crude "buckets" system laid down in the 1993 Basle proposal, and found themselves at a competitive disadvantage vis-à-vis those using their internal models for regulatory purposes. Likewise, those that wanted to engage in lucrative trading business but lacked adequate internal risk management systems had to establish such expensive systems. What is obvious is that knowledge in the field of risk management crucially mattered. While banks with relevant knowledge obtained powerful influence in the process of forming international regulation, those lacking such knowledge were effectively shoved out of the regulation-making process. The international banking

community did not have a set of coherent preferences with regard to the regulatory facilitation of internal models and within it there was a differential in terms of relevant expertise. The differential gave rise to the asymmetric distribution of power among international banks. Adjustment costs associated with the 1996 regulatory changes fell on those that lacked relevant knowledge.

Within the Basle Committee, the spread of the idea of the regulatory use of banks' internal models was promoted by regulators who recognised the potential usefulness of internal models as regulatory measures they would like to see brought into capital rules. The regulators armed with expertise took the initiative in shifting supervision towards the monitoring of banks' own safeguards and internal managerial risk-control mechanisms, and in introducing banks' internal models for regulatory purposes. Moreover, the failure of Barings, a British merchant banking group, brought the importance of banks' internal risk management systems into sharp focus.[30] The incident revealed limitations of externally imposed regulations, and discredited the validity of the existing system. It was under these circumstances that the idea of the regulatory use of banks' internal models came to prevail within the Basle Committee.

The final content of the 1996 Market Risk Regulation did not appear as private interests prescribed. The decision by the Basle Committee to adopt the regulatory facilitation of banks' internal models was not through a simple, automatic process. The

regulators who promoted the idea of the regulatory use of banks' internal model held pronounced views on institutionalising internal models and established strict criteria for the use of internal models for regulatory purposes. They did not leave everything to market participants, and their intentions had a great bearing on the outcomes.[31] Thus, the consequent outcomes were not dictated by private interests, but rather influenced by a belief system that regulators held independently of inputs from private banks. Regulators did not abolish the belief system that gave priority to a public concern: the maintenance of the soundness and safety of the financial system. The introduction of banks' internal models for regulatory purposes was seen as neither the abandonment of the idea of capital adequacy requirements nor a simple victory of markets over regulators.

It should be noted that the new 1996 rules were possible as long as they did not contradict the interests of the most powerful state in the domain of global finance, the U.S. Some U.S. banks were taking the lead in innovative risk management as well as prevailing in important private sector organisations such as the G-30 and the IIF. The U.S. regulators also had relevant knowledge. Thus, both the U.S. regulators and bankers had powerful influence over the knowledge-demanding process of making international banking regulations, and benefited most from the new rules. The U.S. remained at the centre of the knowledge-based power configuration in the politics of

international banking regulation.

As the importance of knowledge as power increased in the politics of international financial regulation, the locus of power became elastic. This locus cannot be captured by a simple "state versus market" perspective. Generally, private banks with sophisticated risk management skills took the lead, but regulators were still able to counterbalance such technical lags with new regulatory norms and methods that aimed at reinforcing internal managerial risk-control mechanisms in line with the goal of prudential regulation. In the realm of international banking regulation, asymmetrical power relations emerged between knowledgeable actors and less knowledgeable ones, rather than between regulators and private banks. This means that while political opportunities were potentially open to both private banks and regulators with relevant knowledge, those lacking such knowledge were effectively sidelined. The newly emerged political foundation of international banking regulation stands on a knowledge-based power configuration.

### *6.2.4 Japanese Role in Knowledge-based Networks*

The newly emerged political foundation of international banking regulation stands on a knowledge-based power configuration. Where and how did Japanese actors fit in this knowledge-demanding process of regulation making? Did Japanese banks, which were still major players in terms of asset size, play any practical role in such a process?

What roles did Japanese regulators play between the esoteric subject of the international negotiations on capital requirements and the growing scepticism about domestic regulatory system?

Through the network of knowledgeable experts, individual Japanese officials with mathematical and statistical expertise were able to take part in the process of forming the regulatory framework based on banks' internal risk models. Japanese regulators were somewhat receptive to the introduction of banks' internal models in general, and junior Japanese officials in particular with relevant expertise were keen to commit themselves to this new idea.[32] However, the American, British and German officials, and to some extent the French, played leading roles in determining concrete contents and substantive meanings of the internal-model-based regulation.[33] Japanese regulators provided various statistical data that were useful for laying out criteria for the regulatory use of internal risk models, but their contribution to the specific criteria and rule-making process was limited. Knowledge and experience crucially mattered. What put Japanese regulators on the fringes of the regulation-establishing process was relative lack of knowledge and experience of risk management systems and market risk regulations.

Unlike the U.S. and U.K. authorities, Japanese regulators focused narrowly on credit risk and did not pay close attention to other risks including market risk when

implementing the capital adequacy requirements based on the 1988 Basle Accord. The U.S. and U.K. authorities were eager to take the management factor and various risk exposures into account in the assessment process and to set requirements on an individual bank-by-bank basis. It is true that Japanese regulators also began to urge banks to develop comprehensive risk control functions to cover credit risk, market risk, and country risk and so on.[34] Yet, in practice, Japanese authorities required from banks no more than the minimum agreed at the Basle Committee. This was mainly because the scale of Japanese banks' involvement in trading activities was small. The scope of the capital adequacy requirements, as implemented after March 1993 in Japan, was limited to credit risk, and Japanese regulators did not yet develop supervisory and monitoring systems to capture market risk. Therefore, Japanese bank regulators lacked enough knowledge and experience in this realm.

Japanese banks also could not propose substantive alternative plans to the Basle proposal. Japanese banks' organisational structures and strategic choice of expanding their international market share by massive, low-margin corporate lending hindered their financial innovation and prevented them from creating an internationally competitive edge in risk management.[35] In fact, Japanese banks were outstripped by leading American and European banks in the competitiveness of providing sophisticated products and services. As a Japanese banker observed in the late 1980s,

the financial innovations were introduced first in the U.S. and spread first to London and then Tokyo.[36] This observation still holds. The mounting bad debts of Japanese banks also put them in a difficult position in derivatives activities because their credit ratings were downgraded. International Swaps Dealers' Association (ISDA) for example, allows swaps participants to cancel their swaps contract when their counterparty's credit rating is downgraded below A.

With regard to derivatives activities, Japanese banks' participation was heavily biased towards "plain vanilla" international interest and currency swaps, of which margins were low.[37] Even in these fields of derivatives, Japanese banks with inadequate risk management techniques found themselves at a disadvantage against American rivals. A financial daily, for instance, reported that in March 1994, when Yen interest rate swaps market kept on moving in one direction, Japanese banks were forced to temporarily suspend their market-making, while such leading American banks as JP Morgan continued their business. Even in the one-direction market situation, JP Morgan could transfer risk to those who were willing to take the risk, helped by risk management techniques and whole-scale banking connections with various types of multinational corporations.[38] Japanese banks built up their international presence primarily through traditionally defined banking, i.e., asset-intensive, balance-sheet lending operations, rather than market-related trading

and off-balance-sheet activities,[39] and lagged far behind the adoption of sophisticated internal risk management systems.[40]

Such state of Japanese banks' internal risk management systems had profound implications when private banks with sophisticated risk management increased their influence in the Basle process. It was the American and European banks possessing adequate knowledge and experience in trading activities that exercised influence over the process of the 1996 Amendment. Japanese banks were not included in this political enterprise; in fact, Japanese banks neither had expertise concerned nor influence in such important private organisations as the G-30 and the IIF.[41] On the contrary, in its public comments on the 1995 Basle proposal, the Federation of Bankers Associations of Japan (FBAJ), an umbrella industrial association of Japanese banks, demanded that conditions for the use of internal models should be applied more flexibly because the proposed conditions were too strict for them.[42] Furthermore, the 1996 Amendment imposed extra costs on some Japanese banks wishing to deal in lucrative trading activities, by pressurising the Japanese banks to improve their internal systems in order to compete with American and European rivals under the new regulation.[43] Thus, in the new power configuration in the 1996 Basle process, Japanese banks had little influence and their preferences were not represented.

Although Japanese contributions were marginal in the rule-making process in

Basle, their participation in the knowledge-based network within the Basle Committee gave the MoF a domestic political tool. This issue will be taken up in the next section.

## 6.3 Domestic Regulatory Reform: International and Domestic Interactions

### *6.3.1 Politics of Banking Disasters: Domestic Conditions for Transnational Ideational Diffusion*

Domestic financial turmoil in the 1990s had the MoF meet the most severe criticism that the ministry had ever gone through. The MoF had to launch a political campaign to mitigate the harsh criticism and to preserve its organisation. In doing so, it was necessary for the ministry to show a new direction of banking regulation. Although the 1998 establishment of the Financial Supervisory Agency as an independent agency meant that the MoF's efforts ended with failure, it is worthwhile to recognise the ideational diffusion of the Basle market risk regulation to Japan.[44] As John Odell points out, the potential influence of ideas may be most evident in the wake of an economic crisis.[45] This section considers how a widespread crisis created domestic conditions for the transnational diffusion of new regulatory ideas, and its limitations.

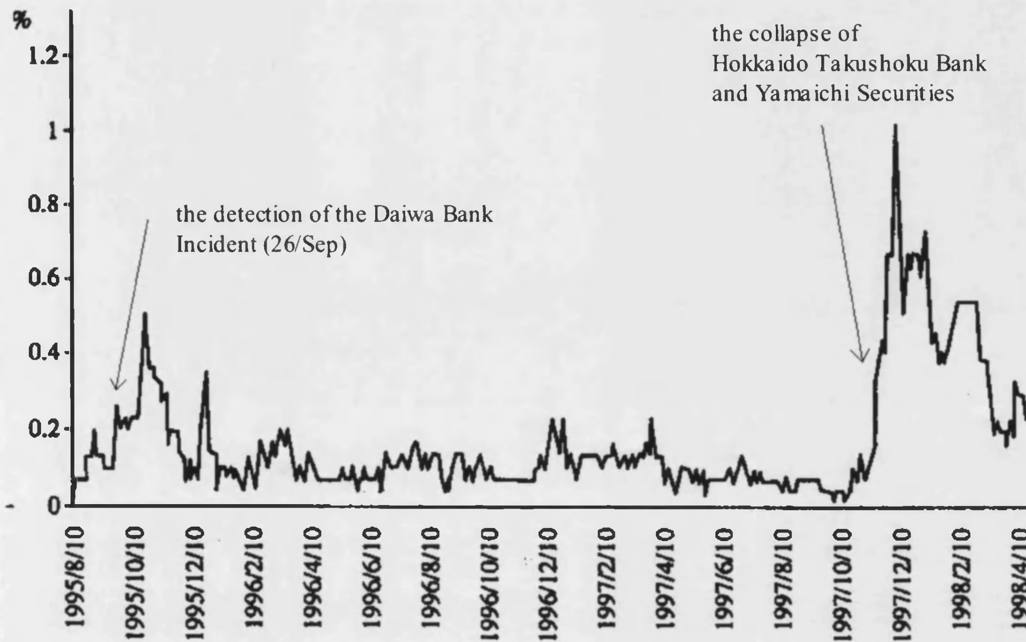
In the first half of the 1990s, the MoF's attempts to cope with problems in the Japanese financial system were piecemeal, rather than offering a radical solution. Typically, the MoF called on healthier banks to bail out insolvent financial institutions, merging them or shoring them up with loan packages based upon arrangements

directed by the MoF. In this manner, all depositors were fully protected, a contagion effect was contained, and no costs were imposed on taxpayers. However, when the MoF proposed the liquidation plan of two troubled credit co-operatives (Tokyo Kyowa Credit Co-operative and Anzen Credit Co-operative) in 1994, this policy line backfired. The MoF asked private banks to create a new bank to which the on-going business of the liquidated two credit co-operatives would be transferred. The MoF's intention was to assure financial stability by guaranteeing all deposits of the failed financial institutions. The MoF officials feared that pay-off (i.e., deposits would be ensured up to a maximum of ¥10 million) might jolt other banks' depositors and spark deposit runs. Once the sloppy management and fraud of the two institutions was revealed, however, a public outcry against the MoF's liquidation plan emerged. The MoF's plan was accused of being "a rescue plan for the sloppy credit co-operatives made behind closed doors" for the sake of the rich with large deposits.[46] To make matters worse, in the course of inspecting the two institutions, unprecedented scandals in which MoF officials were involved came to light. These consecutive financial scandals caused the bank-bashing mood and amplified the criticism and distrust of the MoF.

The MoF's ability to handle domestic financial unrest also began to be noticed with suspicion by international financial markets. Since the summer of 1995, the

so-called "Japan premium", an addition to the interest rate in international money markets, loomed (see Figure 6.1). When Japanese banks raised funds from interbank markets, extra interest charges, ranging from 0.2 to 0.5 percent, were imposed on LIBOR (London Interbank Offer Rate). The collapse of Cosmo Credit Co-operative in July 1995 triggered the emergence of the Japan premium.[47] The following collapse of two financial firms, as well as Moody's Investor Service's announcement that credit ratings of Japanese banks would be downgraded in August, continued to extend the Japan premium.[48] The Japan premium reached its first peak when the over $1.1 billion losses of Daiwa Bank in the New York markets were divulged on 26th September 1995. At that time, a 0.5 percent premium was imposed even on top city banks and no less than 1.0 percent was imposed on several trust banks.[49] A lack of distinction in the management functions between front and back offices of the market division at Daiwa Bank enabled one trader to cause such huge losses in unauthorised transactions. This fact revealed the inadequacy of the bank's internal control functions and also raised widespread concerns about risk management practices at Japanese banks.

Figure 6.1 Japan Premium: 1996-1998 (daily)




Note: The Japan premium is an extra expense that Japanese banks must pay for raising funds in overseas financial markets. The Japan premium in this figure is calculated as follows: Japan premium = interest rate quoted by Bank of Tokyo Mitsubishi – interest rate quoted by Barclays Bank in the Eurodollar market (London).
Source: Hall (1998: 186). Balloons are added.

Furthermore, the MoF's misconduct cast serious international doubts on the Japanese methods of banking regulation. Daiwa Bank had initially attempted to cover up its huge losses in the New York markets and to cope with the problem under the guidance of the Japanese MoF, and had not reported the losses to the American authorities. It demonstrated that the MoF was not a "tough" supervisor because of its overriding concern with the short-term stability of the financial system. Its failures to take tough and timely action to deal with Daiwa Bank's transgressions and to report to

the U.S. authorities damaged the reputation of the MoF. Testifying before the Senate banking committee, Alan Greenspan, chairman of the U.S. Fed, said that it was "regrettable" that the Japanese authorities had not alerted the U.S. authorities to the problem earlier.[50] This practice of the MoF conspired to undermine the credibility, both at home and abroad, of Japanese banking regulation and the MoF as a supervisory body. Market participants became increasingly uneasy at the way in which the reported figures for bad debts were being calculated, thereby giving rise to the Japan premium in international capital markets.

A final blow to the MoF came from a *jusen* (the housing-loan companies) problem that exercised politicians, bankers, agricultural co-operative lobbyists and bureaucrats in the early and mid-1990s.[51] As *jusen* had lent vast sums for speculative property development in the days of the bubble economy, the consequent collapse of asset prices left the *jusen* suffering huge amounts of non-performing loans that in turn caused them to default on their borrowings from financial institutions. It was estimated that, out of a total loan book of 10.7 trillion yen, 6.27 trillion yen would be proved irrecoverable, with other losses of 0.14 trillion yen anticipated.[52]

Two factors made the *jusen* problem particularly complex.[53] One was that a number of Japanese banks made loans to the *jusen*. The *jusen,* which were originally started up by big banks (founding banks) borrowed from a number of other banks

(creditor banks). However, the big banks refused to pay to rescue the *jusen*. Even relatively healthy banks had some bad debts so that they were loath to share an extra burden. The other factor was that financial institutions linked to agricultural co-operatives, which had already fallen into financial difficulties but which had still been politically powerful, were also lending huge amount of money to the *jusen*. Agricultural financial institutions asserted that the banks concerned should take full responsibility and refused any sharing of costs. These agricultural financial institutions were organising large voting constituencies for LDP politicians in rural areas, and therefore the politicians could not ignore their interests. Furthermore, the Ministry of Agriculture, Forestry and Fisheries (MAFF) supported them. In sum, the political dispute over the resolution plan revolved around the issue of sharing costs among the founding banks, the creditor banks and the agricultural financial institutions.[54]

Despite strong public opposition, the Murayama Coalition Cabinet decided in December 1995 to spend 685 billion yen of taxpayers' money to compensate the creditors of the *jusen*.[55] This liquidation plan was politically inspired by the horse trading between the MoF and the MAFF.[56] Initially, the three-party coalition government established the Finance-Securities Project Team in order to deal with the *jusen* problem, but complex vested interests prevented the politicians-led initiative

from reaching any effective conclusion.[57] In addition, the MoF could not take the initiative. The MoF thought that the *jusen* should be capitalised immediately in order to maintain confidence in the Japanese financial system.[58] As seen above, international concerns over the Japanese financial system had already triggered the "Japan premium". Yet, its flip-side was the loss of MoF's prestige. The MoF failed to fill the gulf between the banks and agricultural co-operatives. In particular, the latter's political muscle ensured that their contribution was kept to a minimum, and hence the total contribution from the banks and agricultural financial firms did not fully make up the liquidation plan. In the end, the shortage was met by the government, using public funds. The government feared a public outcry against the use of taxpayers' money, but could not find any alternative. The coalition government tried to blur responsibility for this problem by announcing the liquidation plan under the joint signatories, ensuring that the criminal liability of *jusen* managers and debtors should be duly investigated, criticising bank managers, and forcing the Administrative Vice-Minister for Finance to resign.[59] More importantly, as seen below, politicians began to insist on the MoF break-up in order to avoid being blamed for their decision to use public money to resolve the crisis.[60]

The use of public funds for resolving the *jusen* problem culminated in an avalanche of the MoF criticism. The MoF's failures to prevent and subsequently cope

adequately with the deterioration of balance sheets of the *jusen* and other banks called the MoF's credibility and legitimacy into serious doubt. What the MoF officials were worried most about was growing argument for the dissolution of the MoF. The combination of the failure to respond to the financial turmoil with bad macroeconomic management put the organisation and function of the MoF itself under criticism. In particular, the sheer extent of its powers, ranging from budgetary considerations, taxation, financial supervision, monetary policy to the management of state-owned assets (including privatisations), became a symbol of the structural problems of the Japanese economy. Such concentration of powers was seen as the ultimate cause of the MoF's organisational malfunction and of scandal-hotbed relationships with the financial industry. The widespread crisis created a condition under which the prevailing regulatory ideas would be discredited.

### *6.3.2 Domestic Reform of Banking Regulation: Transnational Ideas as a Domestic Political Tool*

The ideas most likely to spread politically are the ones which are deemed to offer a relevant resolution to the current problem and those whose advocates launch the most successful publicity campaign.[61] In this respect, a set of new regulatory norms and methods, which emerged in the course of the discussion of market risk regulations at the Basle Committee, was an obvious candidate for political selection. Their emphasis

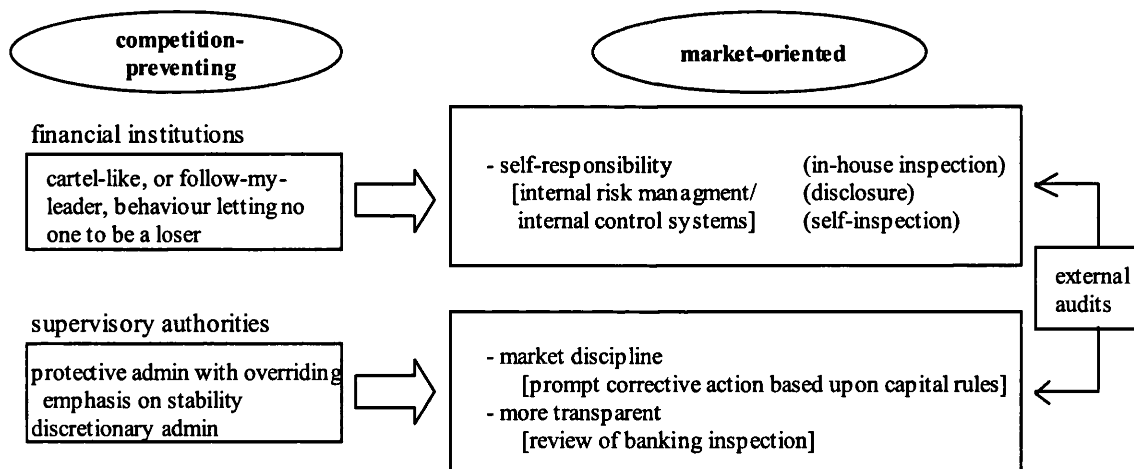
on internal risk management, internal control systems, and, above all, the self-responsibility of market participants was regarded as an alternative to the "protective convoy system" that characterised post-war Japanese banking regulation. Although the infusion of the new regulatory system running contrary to the existing ones was not easy, the harsh criticism of the existing system and the MoF itself drove the MoF to tackle this task. Thus, the MoF was politically motivated to advocate new ideas in order to protect its organisational interests.

On 26 December 1995, the same day on which the use of public money to resolve the *jusen* problem was announced, the MoF's Banking Bureau published a reform plan for banking regulation and administration, which was radical enough to take even BoJ officials by surprise.[62] The announcement was partly a tactic by the MoF to head off the mounting criticism of the *jusen* problem and to divert the focus of the criticism away from the dissolution of the MoF.[63] The MoF turned its emphasis away from the conventional "protective convoy" regulatory system towards an arm's length regulatory system emphasising the banks' internal control functions, risk management systems and strict disclosure.

The MoF's reform plan, named "Financial Regulation and Supervision as It Ought to Be, and its Concrete Measures", was seen as a starting-point for comprehensive reforms in Japanese banking regulation and administration.[64] In the statement, the

MoF acknowledged the inadequacy of the traditional "protective convoy" style of banking administration, and admitted that it had placed too much trust in financial institutions (which led to insufficient checks on management and internal control functions) and that banking supervision had not been transparent enough. The MoF proposed many changes based upon two principles: first, that the management of financial firms should exercise more *self-responsibility*; and second, that supervision should be more *transparent* and based on *market discipline* (see Figure 6.2).

Figure 6.2 MoF's Plan for New Banking Regulation
(December 1995)




As for the improvement of internal control functions, financial firms were advised to reinforce their in-house inspections, encouraged to carry out external audits of their overseas branches, asked to enhance their internal audit and compliance functions

(especially, in respect of overseas operations) and urged to improve their risk management systems for market-related operations. The MoF's guidelines on in-house inspections covered quality of assets, internal controls including compliance with laws and regulations, risk management for market-related business including derivatives, and computer systems. The guidelines on market risk control covered the following: basic policies on risk control; organisational control arrangements promoting sound risk management (including the checking of functions and the independence of risk management sections); and procedures for controlling risks (including the measurement of risks, reporting to the Executive Board, and the assignment of risk limits or stop-loss limits). In addition, the MoF promised that it would closely monitor institutions' in-house inspections, and also demanded that those financial institutions carrying out market-related business on a global basis should adopt the most advanced risk management systems available.

The content of the MoF's reform plan largely followed new regulatory norms and methods that the Basle Committee had developed in response to critical public comments on its 1993 proposal for market risk regulations. This new consensual knowledge about how to regulate and supervise highly complex financial transactions was directed towards a greater reliance on market-enforced discipline. Along with this line of the argument, the MoF emphasised the importance of private banks' internal

risk management and internal control systems, and argued for arm's-length, rule-based regulatory practices. Generally speaking, a painful experience running contrary to prevailing policy made those ideas dubious among policy-makers, turning them towards alternatives, and thereby led to corresponding policy changes.[65] In addition to this general condition, as mentioned at the outset of this section, a sense of crisis from the MoF's consecutive failures to handle regulatory issues motivated the MoF officials to adopt the Basle-originated regulatory norms and methods in order to protect their organisation. The domestic and international interaction made it possible for the MoF to use what they learned from Basle as a domestic political tool to mitigate against the mounting criticism.

Each of the Basle Committee members was expected to put the market risk regulation into force by the end of 1997. In December 1997, the MoF revised its notification regarding capital adequacy requirements, based on Article 14 of the Banking Act, in order to introduce the 1996 Amendment into Japan.[66] The revised notification stipulated new rules for capital requirements for market risk, including qualitative and quantitative criteria for the use of banks' internal models and measurement methods based upon the standardised building-block approach, in conformity with the 1996 Amendment. The MoF also clarified conditions under which banks could be exempted from the new rules. A bank, of which the sum of their trading

book's assets and liabilities is less than 100 billion yen and the ratio of the sum to total assets is less than 10 percent, does not need to add market risk to capital adequacy requirements. Arguably, due to the small impact that the 1996 Amendment had on Japanese banks' capital levels, and partly because Japanese banks were so preoccupied with settling the *jusen* problem, the introduction of the 1996 Market Risk Regulation did not draw much attention in Japan.

The new rules posed three challenges, however, to Japanese banks: first, the banks needed to perceive market risk on the current market value basis. Second, they had to capture the risk on the quantitative basis using, for example, VAR. Third, they had to build up organisations for effective managerial risk-control mechanisms.[67] Japanese banks had to tackle these three tasks in order to compete with international rivals in the lucrative field of trading activities. Once the 1996 Amendment was recognised as an international regulatory arrangement, it started imposing its discipline on banks through the market. In addition to a minimum level of capital, the market required the sophistication of banks' internal risk management systems, among other things. In order to obtain higher credit ratings, a minimum level of capital is required, but any excess over this minimum does not guarantee an automatic upgrade to the next rating level.[68] Building proper internal risk management systems has become an integral condition for such upgrade. Most city banks have developed internal managerial

risk-control systems which were able to meet the Basle/MoF required criteria, and have been publishing detailed information on internal risk management in their annual reports.

*6.3.3 MoF Losing Ground: Towards a Politician-led Reform*

The domestic introduction of Basle-originated, market-oriented regulatory norms and methods was seen as the MoF's attempt to manoeuvre itself away from the danger of dissolution. However, the MoF's political efforts to protect its organisation failed afterwards in political and economic upheaval.

After the sudden resignation of Prime Minister Murayama who was exhausted by the *jusen* problem, the three-party coalition formed the Hashimoto Cabinet in January 1996. To wipe out the unpleasant image that the *jusen* problem had caused, the new cabinet launched a series of new policy lines: a sound budget policy; the administration reform programme; and the "Big Bang" programme.[69] These policies culminated in a backlash against the MoF. The allegedly premature return from a stimulus fiscal policy to a sound budget policy threw the still-weak economy into a deflationary spiral and triggered the second financial crisis in 1997. This time, big financial firms such as Hokkaido Takushoku Bank and Yamaichi Securities collapsed.[70] In both cases, a combination of downgrading of the institutions' credit ratings and a sharp fall in their stock prices, followed by a drying up of the availability

of overnight or other short-term credit, forced the institutions to go out of business.[71] These incidents revealed that market forces had begun to work and again highlighted the clumsiness of the MoF in this new situation. In particular, the fact that the MoF turned a blind eye to Yamaichi's losses concealed by *tobashi*—the practice of shuffling losses between different accounts—embarrassed the ministry again.[72]

In the course of the administrative reform, the determination of the MoF not to relinquish any of its powers made the ministry a symbol of stubborn resistance to change. Furthermore, the avowed "Big Bang" goal to create "fair, free and global" financial markets required a complete departure from the traditional Japanese means of financial regulation. However, the bungling performance of the MoF conveyed the impression that the 1995 regulatory reform plan was just on paper. What was worse, the Tokyo prosecutors arrested two MoF officials on suspicion of accepting bribes from banks. It transpired that several major banks had been offering lavish entertainment—including wining and dining, golf, and trips to sex bars—to the MoF officials who were supposed to be regulating them. The financial minister and several senior MoF officials resigned, but it was no longer possible for the ministry to regain public support.

More importantly, the necessity of using public money to resolve the 1998 banking crisis changed politicians' attitude towards the MoF. As Nobuhiro Hiwatari argued, the

unpopular policy of using taxpayers' money to cope with bank failure led politicians to take blame avoidance behaviour.[73] That is, politicians do not always seek to claim credit, but they also try to avoid blame. When politicians have to make unpopular decisions that are necessary for, say, the stabilisation of a financial system but impose costs on the electorate in the short-term, they try to avoid being blamed for the decision. In particular, given the increased public criticism against the MoF, in the course of the 1996 general election, the dissolution of the MoF became an attractive election pledge.[74] The use of public money to resolve bank failure is a typical example of this blame avoidance, and the much-criticised MoF was a good target on which politicians placed the blame.

Under these circumstances, the MoF was dissolved and its regulatory functions were transferred to a newly established financial watchdog, the Financial Supervisory Agency (FSA), in June 1998.[75] In 2001, the agency was renamed the Financial Services Agency. The FSA is independent of the MoF, being part of the Prime Minister's Office. Thus, the MoF's attempts to protect its organisation failed. In the new regulatory environment, relationships between the regulators and the regulated were designed to be much more transparent and be conducted at arm's length. The extent to which this new regulatory institution affected the implementation of capital adequacy rules in a practical sense will be considered in Chapter 7.

### 6.4 Conclusion

This chapter has considered how Japanese regulators were engaged in the international negotiations of the 1996 Amendment and how the interaction between the international development of new regulation and domestic unrest affected Japanese regulators' behaviour. The two-level-game framework, which places regulators at the interface between the domestic political context and the international institutional context, makes the behaviour of regulators more intelligible in terms of material interest concerns and ideational diffusion.

Domestic considerations heavily affected Japanese regulators' preferences with regard to the international negotiations of the 1996 Amendment. Their concerns over domestic banking troubles formed their preference for the narrow application of market risk regulations. The narrow application was deemed to minimise additional regulatory burdens on Japanese banks because their huge securities holdings for investment purposes were exempted from market risk regulations. Thanks to European preferences for the narrow application and the technical difficulty of the broad application of market risk regulations, the Basle Committee eventually adopted the narrow application of market risk regulations (circumscribing the regulatory scope within short-term trading activities) and Japanese regulators' preferences were advanced in this respect.

The other side of the coin is, however, that Japanese regulators did not sufficiently

address the problem of Japanese banks' large exposure to market risk from their equity portfolios, especially the cross-shareholdings of their corporate clients, since the collapse of the financial bubble. Such hesitation crippled Japanese effective commitments to the Basle Accord. Opacity in Japanese banks' exposure to market risk resulted in a considerable gap between real and putative capital. As seen in Chapter 3, a failure to reduce uncertainty on banks' financial states leads to weak compliance with the Basle Accord. This problem will be discussed in the next chapter in detail further.

With regard to the issue of the regulatory usage of banks' internal models, one of the most significant elements in the recent development of international banking regulation, Japanese regulators' influence was of little significance. This chapter has revealed that Japanese regulators' lack of sufficient experience of capital requirements for market risk hampered their influence over the issue of banks' internal models, and Japanese banks also lay quite a way behind in the realm of risk management. This backwardness eroded their power in the politics of international banking regulations. Control over relevant knowledge has become an important source of power in the politics of international financial regulations. This emergent power configuration negatively affected Japanese public and private influence in the Basle regulatory-making process.

Meanwhile, the interactions between domestic politics and the role of the Basle

Committee in facilitating ideational diffusion also shed light on Japanese regulators' domestic behaviour. It was a domestic crisis in the regulatory realm that set conditions under which the Basle-originated regulatory norms and methods were diffused into the national level. The introduction of the new regulatory norms was politically inspired by the much-criticised MoF in order to mitigate the criticism. Consecutive failures to deal with troubled banks and a series of corruption scandals eroded the MoF's influence in domestic politics and the MoF faced mounting pressure to dissolve its organisation. It was necessary for the MoF to show a new direction for banking regulation and to demonstrate its own ability to reform Japanese banking regulation. The domestic political dynamics of the time needed the new regulatory norms and the Basle process provided them. That is, the MoF used the new regulatory norms to mitigate the growing criticism. Though the MoF's political efforts eventually failed under pressure from politicians who wanted to put the blame for the use of public money to resolve the banking crisis on the MoF, a new, more transparent regulatory regime was established.

Overall, the two-level game framework gives us a better understanding of how the domestic and international interplay affects the preference formation and bargaining position of Japanese bank regulators in the mid-1990s. The two-level game framework also shows a process through which the two-level interaction triggered a shift of the

Japanese regulatory system towards more transparent one, albeit with significant limits. However, the issue of implementation and compliance is closely related to domestic institutions in which domestic capital adequacy requirements are embedded. A question of the extent to which the new regulatory system observed in this chapter served the actual implementation of capital adequacy requirements remains unsolved. The two-level game framework in itself does not shed light on this question.

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[1] Quoted in *The Economist*, "Do-it-yourself regulation", 15 April 1995.
[2] *Business Week*, 24 December 1990.
[3] See, for example, *Financial Times*, 13 February 1991 and *Nikkei Weekly*, 2 May 1996, p. 6.
[4] Bacon, Kenneth H. "Fed Offers Capital Standards for Banks That Incorporate Wider Range of Risks," *Wall Street Journal*, 1 April 1993.
[5] Oda (1993: 16).
[6] Directive 93/6/EEC, reproduced in *Official Journal of the European Communities*, no. 141(1), 11 June 1993. The next section will consider the CAD in terms of the level playing field argument.
[7] Confidential interview with a Financial Supervisory Agency of Japan official, Tokyo, 2000.
[8] Robin (1990).
[9] The 1991 minor amendment to Basle Capital Accord incorporated foreign exchange holdings in part of overall bank asset, but not holdings of stocks and bonds.
[10] Himino (1993).
[11] Confidential interview with a Financial Supervisory Agency of Japan official, Tokyo, 2000.
[12] Confidential interviews with officials of the Financial Supervisory Agency of Japan and Bank of Japan, Tokyo, March and April 2000. See also a comment of a Japanese Ministry of Finance official in *Kin-yū Zaisei Jijyō* (31 May 1993: 28).
[13] See Garrett and Weingast (1993) for the concept of a focal point.
[14] Confidential interview with a former Bank of England official, London, December 1999, and interviews with Bank of Japan officials, Tokyo, March 2000.
[15] Confidential interviews with Bank of Japan officials, Tokyo, March 2000.
[16] The Basle definition is as follows: bank's proprietary positions in financial instruments [including derivative products and off-balance-sheet instruments] which are internationally held for short-term resale and/or which are taken on by the bank with the intention of benefiting in the short-term from actual and/or expected differences between their buying and selling prices, or from other price or interest-rate variations, and positions in financial instruments arising from matched principal brokering and market making, or positions taken in order to hedge other elements of the trading book (Basle Committee, 1996a: 1).
[17] Basle Committee (1996a: 1).
[18] Interview with Takashi Hatagawa (former Bank of Japan official), Tokyo, April 2000.
[19] *Kin-yū Zaisei Jijyō*, 31 May 1993, pp. 20-21.
[20] *Kin-yū Zaisei Jijyō*, 31 May 1993, p. 21.
[21] IIF (1993).
[22] Structural power is defined as the power to shape and determine the structure in which individual actors have to operate—especially in the security, finance and knowledge structures.

See Strange (1994: chap.2).
[23] Hartmann (1996: 38).
[24] On the details of the concept of VAR, see, for example, Warburg Dillon Read and Goldman, Sachs & Co. (1999).
[25] Talmor (1996).
[26] *Financial Times*, "Shock-absorbing models / Risk management Banks with risk management systems are developing versions for commercial market", 16 November 1995.
[27] Interviews with Bank of Japan officials, Tokyo, March 2000.
[28] Walmsley and Scott-Quinn (1996).
[29] See Underhill, ed. (1997) and Strange (1998).
[30] Goodhart, *et al.* (1998: 39).
[31] This contrasts with the argument made by Strange (1998).
[32] Confidential interview with a Bank of Japan official, March 2000, Tokyo.
[33] Confidential interview with a former Bank of England official, London, December 1999.
[34] *Kin-yū Zaisei Jijyō*, 7 December 1987, pp. 20-5.
[35] Organisational features of Japanese banks include the seniority wage system, short-term personnel reshuffles, lack of mobility in the labour market of the Japanese banking industry, consensus-based decision-making, and business operations divided on a location basis (as opposed to division on a function or product basis). See Togashi (1996: 152-54).
[36] Enkyo (1989).
[37] *Euromoney*, Japan Edition, Summer 1994, p. 17.
[38] *Nikkei Kin-yū Shinbun*, 9 June 1994.
[39] Hawawini and Schill (1994: 252-54).
[40] Interviews with Japanese bank officials, London and Tokyo, December 1999.
[41] Interviews with Japanese bank officials.
[42] *Kin-yū Zaisei Jijyō,* 4 September 1995, p. 8.
[43] Hatagawa and Imai (1996).
[44] The Financial Supervisory Agency was renamed the Financial Services Agency in 2001.
[45] Odell (1988).
[46] Nihon Keizai Shinbun Sha, ed. (2000b: 107).
[47] Cosmo Credit Co-operative's business was suspended in the wake of a deposit run sparked by fears over use of aggressive interest-rate bidding for funds and the scale of bad loans.
[48] The two financial institutions were Kizu Credit Co-operative and Hyogo Bank, a regional bank. The former collapsed because of crippling non-performing loans (¥1190 billion), which amounted to 60% of its total loans. The latter collapsed due to its huge size of bad loans (¥800 billion).
[49] Suda (1996: 150-51).
[50] Waters, Richard "Fed chief admits US failed to act on Daiwa warning signs", *Financial Times*, 28 November 1995.
[51] For the *jusen* problem, see Goodhart, et al. (1998: 124-26), M. Hall (1998: 167-71), Nishimura (1999: ch.3) and Nihon Keizai Shinbun Sha, ed. (2000b: ch.2).
[52] M. Hall (1998: 167-68).
[53] Nishimura (1999: 142).
[54] Nihon Keizai Shinbun Sha, ed. (2000b: 41-49, 61-82).
[55] After the coalition cabinet led by Morihiro Hosokawa ousted the LDP from power in August 1993, the LDP resorted to the extreme tactic of accepting Socialist leader Tomiichi Murayama as Prime Minister in order to get back to power in May 1994. A three-party coalition consisted of the LDP, the Social Democratic Party, and the Sakigake Party.
[56] Nihon Keizai Shinbun Sha, ed. (2000b: 63-71).
[57] Nishimura (1999: 144) and Nihon Keizai Shinbun Sha, ed. (2000b: 62, 70).
[58] Nishimura (1999: 142-43).
[59] Nihon Keizai Shinbun Sha, ed. (2000b: 70-71).
[60] Hiwatari (2000).
[61] See Odell (1988: 298).
[62] Confidential interview with a Bank of Japan official, Tokyo, March 2000.
[63] *Nihon Keizai Shinbun*, 27 December 1995.
[64] See M. Hall (1998) and Hosoda (1998). The plan was reprinted in *Kin-yū Zaisei Jijyō*, 15

January 1996, pp. 22-25. The MoF's statement on measures to improve banking administration appeared in *Kin-yū Zaisei Jijyō*, 15 January 1996, pp. 64-67, and *Nihon Keizai Shinbun*, 27 December 1995.

[65] See Odell (1988: 298).

[66] *Kokusai Kin-yū*, no. 999, 1 February 1998, pp. 46-49, and *Kokusai Kin-yū*, no. 1001, 1 March 1998, pp. 28-33.

[67] Interview with Hatagawa. See also, *Kin-yū Zaisei Jijyō*, 31 May 1993, p. 3.

[68] Matten (2000: 35-37) shows no direct correlation between capital levels and credit ratings.

[69] For more details on the Japanese Big Bang programme, see M. Hall (1998: chap.4).

[70] Hokkaido Takushoku Bank was a city bank, and Yamaichi Securities was one of the so-called "Big Four" securities houses in Japan. In 1998, shortly after the establishment of the new FSA, two long-term credit banks, the Long-Term Credit Bank of Japan and the Nippon Credit Bank, went out of business.

[71] Fujiwara (1998).

[72] The extent to which Japanese regulators knew of Yamaichi's *tobashi* practices is still uncertain. Nihon Keizai Shinbun Sha, ed. (2000b: 182-85) said that the regulators grasped part of them and failed to detect the rest of them. Yet, the regulators did not take any action to improve the situation.

[73] Hiwatari (2000). On the notion of blame avoidance, see Weaver (1986).

[74] Mabuchi (1997: 188-91, 204-211).

[75] The new Bank of Japan Law (April 1998) also gave BoJ more independence from the MoF in terms of monetary policy-making. The sudden emergence of the issue of BoJ independence in terms of monetary policy, which was not directly relevant to banking regulation, in the midst of banking regulatory reform was also seen partly as an abortive effort by the MoF to head off more radical reform. See Cargill, *et al.* (1997: 140-41).

# Chapter 7

# Implementation of the Basle Capital Adequacy Requirements: Domestic Politics and International Regulatory Standards

## 7.1 Introduction

This chapter looks at the Japanese implementation of the Basle Capital Accord between 1992 and 2001. Although the proposed changes to the Basle Accord have been made to come into effect in 2006, it has been a keystone of a global regime for financial regulatory standards. The Basle Accord has now been adopted by over 100 countries, and *the Core Principles for Effective Banking Supervision*, a reference for the "best practices" in banking regulation published by the Basle Committee, endorses the Accord as one of the main tools of prudential banking regulation.[1] For international regulatory standards to be promulgated widely, however, they must be general enough to accommodate variations in national traditions and economic

cultures. Precisely because of this nature of international standards, the Basle Accord gave national regulators wide discretionary powers to determine the exact way in which it was operationalised within their jurisdiction. In addition, merely meeting the minimum requirements alone may be questionable when accounting standards are inadequate and when definitions of impaired loans and required provisions are loose, since there can be considerable slippage between actual and putative capital. Japan has been accused of both.[2]

Just looking at numerical compliance is, therefore, not enough to evaluate effective implementation. It inherently requires a considerable element of judgement about real compliance—the degree to which national regulators adhere to international regulatory standards for the purpose of prudential regulation.[3] A wide range of national discretionary powers allows the implementation issue to be open to the influence of domestic factors. The conflict among domestic interests and the arrangement of domestic institutions affect the course of the implementation of international regulatory standards, and can be the domestic source of inadequate implementation or defection. That is, as regards implementation the actual international "negotiations" may be of limited importance.

This chapter aims to capture the political sources of a particular form of the discretionary implementation of the Basle capital adequacy standards in Japan, where

the domestic financial system went through crises and changes throughout the 1990s.[4] The two-level-game approach hypothesises that developments in international standards towards prudential regulation give bank regulators external leverage to cope with domestic status quo interests and to deliver on what they agree with foreign counterparts. However, this chapter points out the importance, first, of domestic institutional capacity to deliver, and, second, of the relationship between state and society in the policy-making process. At the domestic level, such factors as institutional frameworks and political interests may press for leniency in implementation. This chapter answers two related questions. Firstly, how did these various forces, both international and domestic, operate and interact during the implementation stage in Japan? Secondly, how was the locus of implementation determined?

The chapter is organised as follows: Section 7.2 examines the issues involved in the implementation of international regulatory standards and identifies various international and domestic forces pulling in various directions. Section 7.3 presents three cases of the banking policies taken in Japan, which affected the degree of the compliance with the Basle Accord. They include the non-performing loan problem (NPLs), the 1998 changes in regulatory and accounting rules, and the 2001 introduction of market-value accounting rules. Section 7.4 evaluates the network state

hypothesis that dysfunctional domestic institutions hamper Japanese credible commitments to the Basle Accord, and discusses two domestic-level alternative explanations.

## *7.2 The Key Issues of Implementation*

### *7.2.1 Indicators of Credible Commitment*

Maximilian Hall argues that the real impact of the Basle Accord is identified within the individual national context, since national regulators possess discretionary powers to affect the quality of regulatory capital and the sensitivity of risk assets.[5] Thus, even when adopting international standards as domestic ones, domestic factors still have a great influence on the mode of implementation. In this sense, accounting principles also have a significant effect on the regulatory regime (in particular, the measurement of capital adequacy), although the Basle Accord itself contains nothing about accounting definitions.[6] Inadequate accounting standards are likely to cloud the picture of the banks' capital compositions and thereby obscure the accuracy of capital adequacy ratios. Thus, when accounting rules are insufficient, numerical compliance is unlikely to ensure real compliance, but rather may imply "hidden defection". It should be noted that capital adequacy ratios in Thailand, South Korea and Indonesia were often more than 8 percent before the 1997 crisis.[7]

Chapter 3 outlined the four indicators of credible commitment to the Basle Capital Accord or lack thereof. They were as follows: (1) numerical compliance with required capital adequacy ratios; (2) statutory capital adequacy rules; (3) accounting principles, and loan classification and provisioning rules; and (4) regulators' prompt corrective action. Previous chapters showed that the first and second indicators were fulfilled.

Apparently, as Figure 1.1 (p. 17) showed, major Japanese banks managed to meet the eight percent minimum capital requirements in the 1990s. One city bank (Hokkaido Takushoku Bank) and two long-term credit banks (Long-term Credit Bank of Japan and Japan Credit Bank) failed to clear the minimum requirements just before they went bankrupt in 1997 and 1998.[8] In the wake of the Daiwa Bank incident of 1995,[9] the bank withdrew from overseas business and adopted domestic rules for capital adequacy, rather than the Basle rules. The domestic rules require banks without overseas operations to adhere to a four percent capital adequacy ratio, and under the rules unrealised capital gains on banks' securities holdings cannot be counted as capital. Of seven trust banks, four also took strategies to stop taking part in international operations and to adopt the domestic rules by March 2000, although their ratios of capital adequacy were well above eight percent. This is all evidence that the capital rules had "bite" in Japan, and the rest of the major banks continued to meet the Basle minimum capital adequacy ratios.

During the course of the Basle negotiations, Japanese regulators succeeded in established the statutory basis for domestic capital adequacy rules, which they had wanted since the early 1980s but had effectively failed to do so under political pressure at the domestic level. It should be noted, however, that neither the introduction of statutory capital adequacy requirements nor the numerical compliance alone was an adequate condition for the strict implementation of capital adequacy rules in Japan. The MoF established the statutory form of capital rules, and Japanese banks began to meet the required capital ratios. However, more crucial indices (accounting principles and regulators' prompt corrective action) were left untouched. Rather, without these policy indicators, the statutory capital rules and private banks' numerical compliance do not ensure the credible commitments of Japan to the Basle Accord.

The degree of compliance with the Basle Accord is subject to domestic politics and the domestic institutional frameworks in which capital adequacy requirements are embedded. Capital adequacy rules will be ineffectual if such institutional frameworks are inadequate. For national regulators to strictly comply with the Basle Accord, therefore, they must ensure that policies related to capital adequacy requirements support the goal of prudential regulation, thereby making individual banks more resilient. In other words, discretionary policies working against this regulatory goal are deemed to move away from meeting the principles for the best practices in capital

adequacy requirements. Reaching an agreement on international standards and even adopting them as domestic standards (formal compliance) should be distinguished from effectively implementing them (real compliance). If the locus of the implementation of international regulatory standards is under the influence of domestic political economy, what sorts of domestic forces operate at that stage, and how do international forces interact with domestic ones? These questions are addressed in the next section.

*7.2.2 A Two-level Game Analogy at the Implementation Stage*

A two-level game framework was initially designed to examine the international negotiation process in which state negotiators negotiate with their foreign counterparts to reach an agreement at the international level, and simultaneously engage in domestic politics to get the international agreement ratified at the domestic level.[10] This logic of two-level game approach can be applied at the implementation stage, locating regulators as the link between international and domestic pressures. The international and domestic pressures at the implementation stage are examined here.

*7.2.2.1 International Pressures for Compliance*

The international relations literature gives us some insight into the question of why

states adhere to international agreements without a formal enforcement mechanism. Regime theories demonstrate that international institutions create a framework in which the temptation to defect can be significantly reduced among players who expect to meet again.[11] International regimes institutionalise reciprocity and the iterated games among players, and make an international agreement have political weight, because reneging would have high political and reputation costs. The epistemic community literature stresses the role of institutional settings in disseminating regulatory norms and methods.[12] An epistemic community in the realm of banking regulation—a knowledge-based network of regulators sharing common policy goals and expertise—can be the medium of diffusion of specific knowledge, such as the best practices in banking regulation, and such knowledge can prevail in national regulatory systems. From this viewpoint, institutional frameworks facilitate the learning process among regulators as they forge a common ground with regard to what causes the particular problems concerned and how to address them. These approaches presume that the institution-induced processes can generate "peer group" pressures in the learning process among the Basle Committee members, and that it anchors national regulations to international regulatory standards.

The cross-border contagion effects of banking crises may induce countries with international financial centres to exercise official or political pressure on those

countries with lax domestic regulation.[13] In international finance, there is a possibility that a banking crisis in one country will threaten to destabilise the international banking system, and international financial centres are likely to be the most vulnerable to such externalities. These externalities drive the policy-makers of those countries with major international financial centres (i.e., the US and the U.K.) to focus their attention on the domestic policies of other countries. This underpins international standard-setting in areas such as banking regulation, auditing and accounting, and corporate governance. Major financial powers put official or political pressure, bilaterally or multilaterally, on other countries with lax domestic regulation to adhere to international "best" practices, which they set. International standards, therefore, are a political tool of major financial powers to reduce their costs of coping with the contagion effects of a crisis.

The pressure from international financial markets may also be at work once a regulatory framework for capital adequacy ratios is established as an international standard. International banks themselves are aware of the costs, in terms of credit ratings and international business reputation, of the low level of capital adequacy ratios. Therefore, they boost their capital bases and/or shed assets in order to meet the Basle capital adequacy standards. Regulatory changes in the dominant financial centres not only give the rest of the world competitive incentives to adopt the

regulatory changes in order to maintain or attract business, but also lead to market pressures to conform to the regulatory environment of the dominant centre.[14] This process favours states with major international financial centres. This line of argument suggests that the market-driven pressure and the politically-driven pressure are connected.

In sum, there are at least three sources of systemic-level pressure for the implementation of international regulatory standards, which in turn regulators can use as external leverage to withstand domestic opposition, to legitimise unpopular policy goals, and thereby to shore up their autonomy vis-à-vis domestic interest groups. Firstly, in line with regime theories and the epistemic community approach, the Basle Committee generates institutional pressures. The institutionalisation of regulators' meetings increases the incentives for compliance with international regulatory standards through two different mechanisms: reciprocity and the learning process. Secondly, given the powerful contagion effects of banking crises, major financial powers encourage those countries with weak banking regulation to adopt international regulatory best practices through official or political pressure. Thirdly, by rewarding some actions and punishing others, highly integrated financial markets put increased pressure for compliance on the part of both regulators and banks themselves. By assuming some compliance benefits and defection costs, in short, this line of argument

hypothesises external pressures for compliance.

*7.2.2.2 Domestic Politics of Compliance*

At the domestic level, regulators have to interact with other social groups, such as banks and politicians, in the policy-making process, and these groups do not necessarily share the same policy goal. This potential tension between regulators and other social groups raises the question of whether the defection from international regulatory standards at the implementation stage is "voluntary" or "involuntary", using Robert Putnum's terminology.[15] While voluntary defection means that a state as a unitary actor fails to implement an international agreement, involuntary defection means domestic groups override or subvert an agreement apparently supported by a regulator.[16] In addition to the notion of "hidden defection" previously outlined, this distinction also has implications for the domestic source of defection.

The argument presented here suggests that a combination of inadequate domestic institutions for solving NPLs and the relationship between state and society was a source of defection. Lack of institutional capacity to deal with NPLs might not be seen as explicit and deliberate defection from international capital adequacy standards but in effect it hindered the effective implementation—hidden defection. Moreover, institutional arrangements for the Japanese Diet's oversight of bank regulators induced

the regulators to exercise forbearance policy in dealing with NPLs (leaving loan classification rules and provisioning rules lenient, in particular). This delayed response deteriorated the situation and contributed to the outset of credit crunches for small- and medium-sized businesses with which ruling LDP politicians established personal and clientelistic relationships. In such circumstances, the politicians got involved in policy-making and pressed for leniency in order to take credit for representing such politically powerful private interests. This led to further involuntary defection.

A principal-agent problem between regulators and politicians under the Japanese institutional arrangements for regulatory decision-making is a theoretical underpinning of that argument. When principals (politicians) and agents (regulators) are not equally well informed, more informed agents are able to take opportunities and not to implement appropriate practices in dealing with less informed principals. Diet members are not in a perfect position to monitor and assess the behaviour of the MoF due to institutional deficiency of the oversight of regulators, and therefore they employ "fire alarm" rather than "police patrol" oversight of the MoF.[17] As long as the financial system is perceived as stable, politicians neither closely watch over the regulators nor participate in the regulatory policy-making process, but rather they focus their political resources on more politically sensitive niches of the economy such as agriculture, small- and medium-sized businesses and construction sector. In other words, the MoF

has incentives to conceal the real picture of NPLs from politicians, since the disclosure of regulatory breakdown is likely to trigger political intervention and reduce its policy-making autonomy—one of the MoF's main organisational interests. The MoF officials continued to hope that the problem would go away by itself. This is an institutional source of regulatory forbearance.

Once it becomes obvious that financial instability hits the LDP's base of support, however, LDP politicians will take part in the regulatory policy-making process. For politicians whose prime concern is to be re-elected, the pursuit of prudential regulation is secondary. This contrasts with the argument of Rosenbluth and Thies: the new 1994 electoral system provided a potential basis for prudential banking regulation.[18] Unlike the old electoral system of multimember districts, the new system was based upon a combination of single-seat constituencies and large-district proportional representation, and therefore politicians no longer need to divide up party platforms and to depend narrowly on specific interests.[19] They claim that politicians began to adopt a "new sensitivity to majority concerns" and became ready to allocate costs to the banking industry to achieve policy goals that broadly appealed to voters, rather than taking credit for representing the interests of banks.[20] However, politicians' involvements do not often pull in the direction of prudential regulation.[21]

Compared with regulatory authorities and banks, politicians are less worried about

the costs of defection and sometimes prioritise policy objectives other than the strict implementation of prudential banking regulations. In particular, during an economic downturn, politicians are often willing to sacrifice regulatory prudence in order to pull the economy out of recession. This is in particular the case for capital adequacy requirements, since they are frequently seen as a main source of a credit crunch, and in a country already suffering financial distress, their strict implementation leads to the deterioration of the existing credit crunch.[22] Furthermore, the costs of credit crunches are concentrated in politically sensitive sectors such as small- and medium-sized businesses and construction. Unlike big businesses with access to international financial markets, these politically powerful borrowers are highly dependent on bank credit, thereby being vulnerable to credit crunches. Thus, the severity of the domestic banking crisis politicises the issue of capital adequacy requirements and activates politicians who are less keen to strictly comply with international standards.

In short, domestic factors can determine the *modus operandi* of implementation and the degree of compliance. The following section empirically examines how domestic factors overrode international pressure for the implementation of prudential regulations and actually put for leniency.

### *7.3 Examples of Implementation Policies*

The three cases examined in this section—the non-performing loans (NPLs), the 1998 regulatory and accounting changes, and the 2001 introduction of market-value accounting rules—show how domestic and international factors affected the implementation policies in Japan. Such cases are also related to the indicators of credible commitments outlined above. The problem of the NPLs presents the case that a lack of adequate domestic institutions coping with that problem led to hidden defection. The case of the 1998 regulatory changes demonstrates how a banking crisis mobilised politicians and led to further involuntary defection from the Basle Accord in the face of international pressures for strict compliance. The 2001 policy change indicates the new direction towards the transparent implementation of capital adequacy rules in Japan under international pressures, but domestic institutional factors still rendered the Japanese implementation weak. These cases highlight the importance of domestic factors in affecting the course of implementation policies and the degree of compliance.

#### *7.3.1 Forbearance Policy in the Non-performing Loans*

While the clean-up of NPLs is not explicitly about the implementation of capital adequacy requirements, it is crucial. The inadequate write-off of NPLs and lax loan

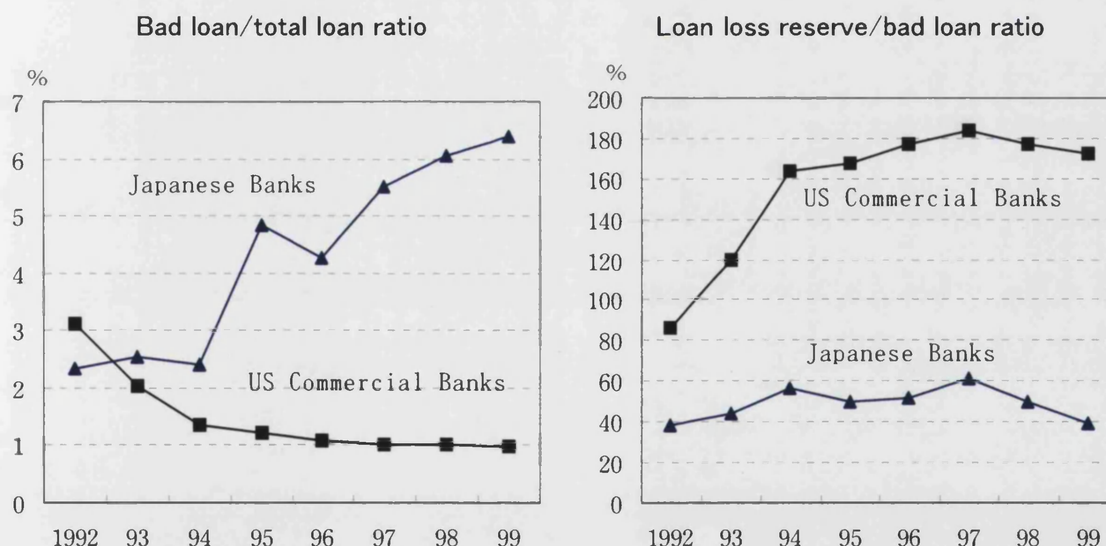
classification and provisioning rules make capital adequacy requirements ineffectual, since less NPLs are provisioned for (i.e., the provisioning requirements are not adequately deducted from capital base calculations). As widely recognised, the mountains of NPLs have been a central cause of the sluggish Japanese economy after the collapse of the financial bubble. However, the pace of dealing with NPLs was painfully slow, despite market pressures via the downgrading of Japanese banks' credit rating and official pressures from the U.S. and the International Monetary Fund.[23]

In the issue of NPLs, regulatory forbearance was taken in the form of weak loan classification standards, which allowed banks to resist classifying as non-performing their dubious or even underwater credits, as well as in the form of lenient reserving rules, which allowed banks not to put up enough loan-loss reserves against NPLs.

The definition of bad loans outstanding, which had been initially very lax, improved gradually and its total figures amounted to 32.1 trillion yen, 6.2 percent of total loans, in September 2000. However, most economists thought Japanese banks still understated the real situation. The more broadly defined bad loan figures, the so-called total "classified loans" of banks (not disclosed on an individual basis), were published by the Financial Services Agency, and amounted to 65.5 trillion yen. Banks were required to classify their loan portfolio into four categories (normal, sub-standard, doubtful and estimated loss loans), taking account of the default risk of borrowers and

the quality of collaterals. Based on this classification, banks estimated their loan-loss reserves and the amount of write-offs. As the classified loans are more broadly defined than disclosed NPLs, the amount of classified loans is much bigger than the disclosed NPLs. However, compared with those of the U.S. banks, the total loan loss reserves of Japanese banks have been quite low.[24]

**Figure 7.1 Comparison of Bad Loan Situations in Japan and the United States**




Note: 1) Japan: fiscal year, US: calendar year

2) Figures after FY 1997 do not include data of Hokkaido Takushoku Bank, Tokyo City Bank, Kyoto Kyoei Bank, Naniwa Bank, Fukutoku Bank, and Midori Bank.

3) Japanese bad loan ratio = Risk control loans/total loans

US bad loan ratio = (loans with arrears for more than 90 days + loans that do not count accrued interest rates as asset + restructured loans)/total loans.

Source: Fukao (2002), Chart 2. Japan Center for Economic Research, *Monetary Policy Under Deflation*, March 2001 (in Japanese).

Given these huge NPLs, uncovered losses and the lenient reserve policy, market analysts commonly came to a conclusion that Japanese banks were still under-capitalised and in aggregate the entire banking industry was potentially insolvent.[25] If NPLs were fully provisioned, critics argued, a number of Japanese banks would fall below the minimum 8 percent of the Basle Capital Accord.[26] Thus, the slow progress in dealing with NPLs not only hampered the implementation of capital adequacy requirements in a practical sense, but also made the level of banks' capital adequacy wholly misleading, if the estimates of NPLs are to be believed.

There were institutional causes of the government's delayed response to the NPL problem. The institutional characteristics of the "fire alarm" oversight of the MoF by Diet members allowed the MoF officials to (and gave them incentives to) hide negative information on the banking sector from politicians. Since the revelation of regulatory breakdown would invite political intervention and reduce the MoF's policy-making autonomy, the MoF was reluctant to disclose the real state of NPLs and to take prompt action to deal with the problem. Indeed, by the mid-1990s, as admitted by Yoshimasa Nishimura, director-general of the Banking Bureau at the MoF between 1994 and 1996, the regulators' approach to NPLs was based upon the expectation that a resumption of economic growth would permit banks and borrowers to recover their financial soundness, and regulators thought lenient loan classification would reduce

the pressure on banks to withdraw credit lines from troubled firms, which would allow such firms to buy time until the economy recovered.[27] The MoF did not adequately inform Diet members of the true state of the banking problem until the banking crisis began to surface. In an economy suffering from negative growth and price deflation, however, forbearance policy made the NPL problem worse and eventually led to political intervention in 1997/8 (see below).

Regulatory forbearance also reflected another lack of institutional frameworks enabling regulators to swiftly use public money. An alternative to forbearance policy is to close down insolvent financial institutions. Viable institutions, however, may require re-capitalisation via the injection of public funds, as in Indonesia, South Korea and Thailand. As the provision of public money in resolving banking failures was unpopular, like in the case of the U.S. through the late 1980s to the early 1990s, the effective institutional frameworks of using public money were slow to be established in Japan. As seen in the next section, this issue became politicised and led to politicians' intervention in the regulatory policy-making.

*7.3.2 Politicians' Intervention: the 1998 Regulatory and Accounting Rule Changes*

Failure to take quick and adequate action to deal with NPLs turned out to have a high price. In November 1997, the failure of major financial firms sharply increased

financial instability, and many banks effectively failed to meet the Basle capital standards. The fact that many lenient policies were carried out intensively in the midst of the 1997-98 banking crisis suggests that such policies were deliberately used to pump up the capital bases of banks. What promoted these changes and to what extent did these policies affect banks' capital ratios?

The banking turmoil of 1997-98 generated a strong downward pressure on already weak stock prices. The consequences of moribund stock prices were twofold—it made it difficult for banks to meet the Basle Accord, and caused a credit crunch. Under the Basle rules, Japanese banks were allowed to count 45 percent of unrealised capital gains on their securities holdings as part of regulatory capital. However, a drop of market value below the book value caused unrealised capital losses, and these losses necessarily eroded Tier I capital even if they could under-provision for NPLs under the lax loan classification and provisioning standards. At the end of fiscal year 1997 (March 1998), major Japanese banks, for the first time in the post-war era, saw latent losses in their stock portfolios. Unrealised losses arose on the stock portfolios of five major banks: Daiwa Bank (67.5 billion yen), Long-Term Credit Bank of Japan or LTCB (21.9 billion yen), Nippon Credit Bank (21.3 billion yen), Yasuda Trust Bank (61.7 billion yen) and Chuo Trust Bank (5 billion yen).[28] These banks were faced with the serious erosion of their capital bases and found it difficult to meet the Basle

minimum capital requirements.

Given that such capital composition was vulnerable to stock price movements, when stock prices declined sharply, the Japanese banks conforming to the Basle standards tightened their credit lines. As new stock issuance was almost impossible during times of market unrest, and the necessity to clean up NPLs prevented Japanese banks from accumulating profits that could become their own capital, they were obliged to shrink their lending volume to achieve the minimum capital requirements. Such stock-market induced credit crunches occurred in 1992, 1995 and 1997.[29]

Growing concern about credit crunches made politicians take the initiative in tackling the financial matters and paved the way for a capital injection into the biggest banks.[30] International political pressure from the U.S. on Japanese banking issues and from the G-7 urging public money infusions also pushed politicians into making a decision to adopt the unpopular policy.[31] By September 1997, the Asian financial crisis had spread well beyond the region and increased the macroeconomic costs of major countries. In the midst of the Long-Term Capital Management problem, the Clinton administration demanded that the Japanese government prepare a sufficient amount of public funds to fix the banking problem and inject these public funds as soon as possible. The same request was echoed at the G-7 meeting of finance ministers in October. Behind these demands there was a fear that the collapse of the Japanese

banking system would accelerate the meltdown of Wall Street and the global economy. These international pressures endorsed the use of public money and made it easier for the Japanese government to do so.

Under the initiative taken by LDP politicians, however, the discussion on the use of public money considered domestic political concerns. The reasons for the injection of public money shifted away from the protection of depositors and the resolution of insolvent banks, and towards the capital build-up of weak banks and a stimulatory effect on the economy.[32] After all, LDP politicians' main concerns were about the economic recovery in general, and about ensuring that small- and medium-sized firms got new credit lines in particular. In response to the LDP's comprehensive policy package, in December 1997, the MoF announced policy measures to deal with the credit crunch, featuring the use of public money, and a change in accounting rules governing the valuation of banks' securities holdings.[33] The public money infusions took place twice, in March 1998 and March 1999, of which the aggregate amount reached around 9.3 trillion yen.

The new accounting rules were particularly designed to strengthen the capital positions of Japanese banks, if only merely for the books. At the end of March 1998, banks were allowed to use either the traditional "lower of cost or market method", or the so-called "acquisition cost method" in evaluating their stock holdings. By allowing

banks to use only the book value (acquisition cost), the new 1998 accounting rules prevented unrealised losses from reducing Tier I capital. Taking advantage of these changes in accounting methods, 16 of the 19 top banks switched from the lower-of-cost-or-market method to the acquisition cost method in evaluating their stock holdings.

The new accounting rules were inconsistent with internationally accepted regulatory principles in two ways. Firstly, by deliberately blurring the gap between actual and putative capital, the 1998 accounting rules made the objectivity of capital adequacy ratios ineffectual, and thereby prevented market participants from obtaining accurate information on Japanese banks' financial health. The case of LTCB suggests the dubious criteria for calculating capital ratios: the bank's capital adequacy ratio was among the highest for major Japanese banks under the 1998 rules, but in reality the bank incurred huge unrealised capital losses on their shareholdings. If such losses were properly considered, the banks failed to achieve the minimum capital requirements. LTCB indeed failed in October 1998. Secondly, the use of acquisition cost in accounting banks' shareholdings obviously went against the growing international trend towards market-value accounting, which will be discussed in the next section.

In addition to this policy change, a series of measures to help banks clear the 8

percent minimum capital requirements was launched in March 1998.[34] The biggest of these was a LDP member's (Ichizo □hara) bill that allowed banks to count 45 percent of unrealised valuation gains on real estate holdings as Tier II capital. The value of these gains for the largest 19 banks amounted to 1.2 trillion yen.[35] Prime Minister Ryutaro Hashimoto, who was worried that his sound budget policy might throw the still-weak economy into a deflationary spiral and lead to a financial crisis, strongly supported the bill.[36] Risk-weights were also revised. The weights applied to loans to securities houses and to loans insured by credit guarantee associates were reduced from 100 percent to 20 percent and to 10 percent respectively. The aim of these changes in risk-weightings was not only to ease banks' capital requirements and to attenuate the risk of a credit crunch, but also to improve incentives for new financial intermediation mechanisms for small- and medium-sized businesses—a bulwark of the LDP.[37]

It should be emphasised that LDP did not simply push the interests of banks. Rather, the intense political pressure to make new loans to small- and medium-sized businesses prevented banks from raising interest margins and partly contributed to the low profitability of the banking sector. Moreover, the Japanese Bankers Association did not publicly seek any type of capital injection to clean up NPLs or to boost capital ratios, since acceptance of such public assistance would signal the banks' weak

financial statements and would invite political interference in bank management and lending decisions.[38] In October 1998, the LDP also stopped accepting political contributions from top banks that had received public money to reduce non-performing loans.[39] The LDP-led regulatory policies aimed to revitalise the economy, not to serve the narrow interests of banks.

The 1998 changes in accounting and regulatory rules had a significant impact on the apparent capital level of banks. As Table 7.1 shows, without this sort of government support, 4 out of 9 city banks would have failed to meet the minimum capital requirements. Until September 2001, banks continued to list the positions of their securities holdings at book value, no matter whether they had gone up or down.

**Table 7.1 Capital Ratios under New Accounting Standards and Old Accounting Standards for the Major 19 Banks***

| | Total Capital Ratios | | | Tier I Capital Ratios | | |
|---|---|---|---|---|---|---|
| | Mar-97 | Mar-98 (old rules) | Mar-98 (new rules) | Mar-97 | Mar-98 (old rules) | Mar-98 (new rules) |
| City Banks | | | | | | |
| Tokyo-Mitsubishi Bank** | 9.28 | 8.20 | 8.54 | 4.97 | 4.27 | 4.27 |
| Dai-Ichi Kangyo | 8.76 | 7.51 | 9.09 | 4.38 | 3.76 | 4.63 |
| Sakura | 8.93 | 7.62 | 9.13 | 4.46 | 3.81 | 4.56 |
| Sumitomo | 8.75 | 8.33 | 9.23 | 4.50 | 4.17 | 4.76 |
| Fuji | 9.23 | 7.29 | 9.41 | 4.80 | 3.65 | 4.79 |
| Sanwa | 9.11 | 8.31 | 9.61 | 4.55 | 4.15 | 4.80 |
| Tokai | 9.09 | 8.82 | 10.26 | 4.55 | 4.41 | 5.41 |
| Asahi | 8.71 | 7.44 | 9.39 | 4.44 | 3.72 | 4.69 |
| Daiwa | 9.09 | n.a. | 10.30 | 4.73 | 3.56 | 5.35 |
| Hokkaido Takushoku | 9.34 | 6.20*** | n.a. | n.a. | n.a. | n.a. |
| Long-term Credit Banks | | | | | | |
| IBJ** | 9.04 | 9.31 | 9.74 | 4.83 | 4.79 | 4.95 |
| LTCB | 9.22 | n.a. | 10.32 | 4.61 | 3.82 | 5.16 |
| NCB | 2.99 | n.a. | n.a. | 1.50 | n.a. | n.a. |
| Trust Banks | | | | | | |
| Mitsubishi Trust** | 9.68 | n.a. | 10.35 | 5.15 | 5.99 | 5.99 |
| Sumitomo Trust | 8.97 | n.a. | 9.90 | 5.45 | 4.22 | 5.27 |
| Mitsui Trust | 9.56 | 8.66 | 10.41 | 5.35 | 4.33 | 6.02 |
| Yasuda Trust | 9.87 | n.a. | 13.56 | 5.73 | 3.97 | 7.14 |
| Toyo Trust | 10.02 | 9.29 | 10.68 | 5.79 | 4.64 | 5.78 |
| Chuo Trust | 9.11 | n.a. | 12.73 | 4.93 | 5.03 | 7.95 |
| Nippon Trust | 11.24 | n.a. | 9.26 | 10.29 | 8.21 | 9.26 |

Source: Fitch IBCA, based upon published financial statements as of May 22, 1998

Notes: * Under the old rule, securities holdings were accounted at the lowest of purchase (book) and market prices for the effect of computing Tier 1 capital (i.e., unrealised losses would reduce Tier 1 capital), and up to 45 percent of unrealised gains could be counted as Tier 2 capital. Under the new standard, banks can choose to use only book values (i.e., unrealised loss does not reduce Tier 2 capital and unrealised gains cannot be included in Tier 2 capital).

** These three banks did not adopt the new accounting methods for unrealised equity securities holdings.

*** This is the figure of September 1997. Hokkaido Takushoku Bank went bankrupt in November 1997.

Credit rating agencies remained unimpressed by this sort of financial juggling to help banks achieve the minimum capital standards. Standard & Poor's, for example, said: "It's very negative that many banks have chosen to adopt the book-value

evaluation to revalue their stock portfolios. That kind of behaviour will further amplify the market distrust toward these banks".[40] Credit rate agencies understood that Japanese banks' capital adequacy ratios would have been much lower if strict criteria had been used, like valuing stock holdings at market value instead of purchase price. However, the Japan premium, which was deemed to reflect both domestic structural problems and banks' liquidity problem in international capital markets,[41] vanished in April 1999. Some economists attributed the cause of the premium's disappearance to re-capitalisation and the rigorous provisioning for NPLs.[42] A Japanese regulatory official also reached a similar conclusion, saying that the market response resulted from a "sense of relief" from government measures to stabilise the financial system.[43] However, considering the nature of the 1998 policy package, this line of account is not convincing. Although it is still not clear why the Japan premium disappeared,[44] market pressures worked against Japan's lax policy changes, as Japanese banks continued to be downgraded by credit rating agencies. However, the pressures from international financial markets did not sufficiently restrict the politicians' ability to formulate the lenient regulatory policies designed to stimulate the national economy by easing capital adequacy requirements.

It should also be pointed out that in parallel with a series of lenient polices in 1998, regulators took some tough measures. In June 1998, regulators revised the definition

of "double gearing", and deducted cross-shareholdings between banks, which had been counted as Tier I capital in Japan, from regulatory capital.[45] Such revision brought Japanese rules closer to the more stringent rules of Germany, the U.K. and the U.S. In addition, Japanese regulators expanded the scope of subsidiaries and affiliates subject to consolidated corporate reporting.[46] The expanded definition resulted in downward pressure on the banks' capital-to-assets ratios because they had to include debt-ridden related companies, to which banks had transferred their NPLs, in their consolidated reports. These policies reflected the general attitude of the Basle Committee towards the double gearing and the development of international accounting standards (see the next section). In this sense, these strict policies showed the commitment of Japanese regulators to internationally accepted regulatory practices. However, compared with the upward effects of the politician-led lenient policies on banks' capital ratios, the downward effects of these tough policies were marginal.

In sum, the case of the 1997-98 banking crisis shows that domestic political intervention aiming to revitalise the economy led to the involuntary defection from internationally accepted regulatory practices. Contrary to Rosenbluth and Thies,[47] politicians favoured weak prudential regulatory rules in the circumstances of 1997-98.

### *7.3.3 Toward Strict Implementation?: The Introduction of Market Value Accounting Rules, the Unwinding of Banks' Shareholdings and Prompt Corrective Action*

The 1998 lenient policies were emergency measures to help banks pump up their capital bases and to mitigate the credit crunch, but they made little effort to seriously tackle the problem of the banks' large exposure to market risk from their equity portfolios, especially the cross-shareholdings of their corporate clients. This type of market risk was not covered by the 1996 Basle Amendment, which narrowed the regulatory scope to trading risk that arose from banks' short-term trading activities.[48] The so-called investment securities held by Japanese banks on a cross-shareholding basis were not for short-term trading, but rather for building long-term relationships with their corporate clients. The major banks' large equity holdings, whose market value was roughly two and a half times as large as the banks' own equity, implied a significant exposure of capital to market risk.[49] Figure 7.2 shows the effect which different levels of the TOPIX had on each bank's capital base, which was estimated by BNP Paribas.

**Table 7.2 Stock Prices and Latent Gains/Losses of Major Four Banks**

**(estimates based upon the data at the end of March 2001)**

30 March 2001 = TOPIX1277.27 (consolidation base, unit: million yen)

| | Latent gains/losses | | | | | |
|---|---|---|---|---|---|---|
| | 31-Mar-01 | TOPIX 1,000 | TOPIX 1,100 | TOPIX 1,200 | TOPIX 1,300 | TOPIX 1,400 |
| Mizuho Holdings | -307,719 | -1,959,733 | -1,363,919 | -768,105 | -172,290 | 423,524 |
| Mitsubishi Tokyo FG | 0 | -708,429 | -128,006 | 452,417 | 1,032,840 | 1,613,263 |
| UFJ | 301,822 | -1,090,571 | -588,392 | -86,212 | 415,967 | 918,147 |
| Sumitomo Mitsui | -517,725 | -1,820,802 | -1,350,881 | -880,868 | -410,902 | 59,065 |

Source: BNP Paribas, quoted by *Economisuto*, 18 September 2001, p. 20.
Note: The value of banks' holding stocks were assumed to move similar to that of TOPIX.

In 2001, measures to remove the fundamental cause of this problem were finally taken. At the end of September, Japanese banks were required to value their securities holdings at market price, and to own up to the losses in their cross-shareholdings. Behind the adoption of market value accounting, there was a combination of international efforts to harmonise accounting standards and domestic concerns of the financial market reform. The International Accounting Standards Committee (IASC), a private sector organisation founded in 1973 and restructured as the International Accounting Standards Board (IASB) in 2001, has made efforts to establish international accounting standards (IAS) and to have them accepted as uniform standards usable in respective national capital markets.[50] In August 1997, IASC

proposed the first draft on accounting principles for financial instruments (IAS 39) and urged the broad use of market values in accounting for financial instruments. The preference for market value accounting principles reflected the intention to make companies' financial statements more transparent, by requiring companies to have unrealised profits or losses on their financial instrument holdings properly reflected on financial statements. The ISA 39, which was approved by board members in December 1997, completed a core set of international accounting standards in March 1998.

IAS 39 significantly increased the use of market values in accounting for financial instruments, compared to most countries' national standards. The Basle Committee was still considering the issue of the extent to which market value accounting should be applied to banks' financial statements, but largely expressed support for IAS and for efforts to harmonise accounting internationally.[51] The IASC's efforts to develop ISA were supported by other international bodies, such as G-7 Finance Ministers and the IMF, as measures to "strengthen the international financial architecture", though U.S. authorities have not demonstrated any willingness to accept IAS. The European Commission was also a strong supporter of the IASC with the intention of using IAS as a common set of accounting rules within the single market, and presented legislation to require the use of IASC Standards for all listed companies no later than

2005.

The development of IAS stimulated an argument as to how to introduce IAS into Japan, although little progress had been made by the mid-1990s.[52] In October 1996, the Business Accounting Council, an advisory panel to the MoF, began to discuss the issue of the introduction of market value accounting standards as part of the Tokyo Big Bang plan. Given the huge potential appraisal losses on their shareholdings, however, Japanese banks were worried about the broad adoption of market-price valuation. When the IASC published the draft IAS 39 in 1997, the Japanese Bankers Association openly demanded that the scope of fair value accounting for financial instruments should be limited to those financial instruments whose markets were fully developed and in which managers traded with the intention of pursuing short-term capital gains.[53] However, this opinion was in a minority, and an international consensus over the broader application of market value accounting principles for financial instruments was already formed.[54] In the autumn of 1997, the MoF began preparing to introduce the mark-to-market accounting in parallel with the advance of the Tokyo Big Bang plan.[55] However, it should be noted that this did not mean that Japanese authorities conformed to a whole set of IAS.[56] In particular, as regards loan classification and provisioning and loan impairment, the Japanese practices were not converged with the relevant IAS (i.e., IAS 36). This suggests that the authorities were selective in

adopting IAS. The IAS perceived as being unfavourable for them were opted out, or at least postponed.

When the market valuation of banks' securities holdings was introduced into Japan, the biggest problem was moribund stock prices. Market-value accounting rules no longer allowed banks to hide away their appraisal losses on their shareholdings. New accounting rules placed pressure on Japanese banks to sell off their shareholdings, which in turn put further downward pressure on stock markets. At the time of January 2001, for the ruling LDP, the recovery of stock prices became a lifeline for the Mori administration, which had little public support.[57] The LDP launched a series of policy plans to rejuvenate the stock markets, including the public money requisition of stock, the removal of a ban on treasury stock, and securities tax reforms. With regard to the composition of bank capital bases, the proposal for establishing either a public or private facility that would purchase banks' shareholdings was of particular importance.[58] By purchasing the stocks sold off by banks and re-selling them to the public, the stock-buying facility was expected to prevent the banks' rapid cross-shareholding sell-offs from putting downward pressure on the stock markets. The LDP also proposed a plan that banks' shareholdings would be either totally banned or forcibly limited to a certain level.

Though the banking industry expressed disapproval of such an idea, because they

did not want to have their hands tied,[59] the LDP no longer protected the narrow interests of the banking industry. In November 2001, the Bank Equity Holdings Limitation Act passed through the Diet. Bank equity holdings will be limited to 100 percent of capital (narrowly defined as either shareholder equity or Tier I capital) from September 2004 onward. Under the legislation, the Bank Shareholding Acquisition Corporation (BSAC) was also established by the 10 billion yen contribution of private banks and the two trillion-yen government guarantees in order to facilitate the scaling down of cross-shareholdings.[60] Since banks held investment shares worth an estimated 130-150 percent of bank capital, a target exposure of 100 percent of capital implies that banks would have to sell 10-15 trillion yen in shares.[61]

The introduction of mark-to-market accounting for a wider range of bank assets also had some implication for the credible implementation of Prompt Corrective Action (PCA), which began to apply for Japanese international banks in 1998. PCA was a policy instrument borrowed from the U.S., which stipulated pre-determined regulatory interventions as a gradual ladder of responses to the degree of banks' capitalisation (see Table 7.3).[62] The major aim of PCA was to reduce the scope for forbearance by replacing regulatory discretion with rules designed to stimulate regulatory intervention as soon as a bank's capital position deteriorated. To do so, it clarified rules for regulators' interventions, improved the transparency in banking

regulations, and indicated a departure from the traditional approach of forbearance adopted by regulators. This in principle meant that capital adequacy requirements were equipped with a formal enforcement mechanism and became a pillar of *ex ante* prudential regulation in Japan.

**Table 7.3 Japanese Version of Prompt Corrective Action**

| | Capital adequacy ratio trigger | | Action to be taken |
|---|---|---|---|
| | Basle standards | Adjusted national standards | |
| 1 | Less than 8% | Less than 4% | To order the formulation and implementation of management improvement plan |
| 2 | Less than 4% | Less than 2% | To order such measures or implement such restrictions as:<br>- formulation of a plan to increase capital;<br>- restraint on the increase of total assets or reduction of total assets;<br>- prohibition on entering new business field;<br>- curtailment of current business operations;<br>- prohibition on opening new offices and curtailment of offices currently opened;<br>- curtailment of business activities of subsidiaries and overseas affiliated companies, and prohibition on establishing such entities;<br>- restraint or prohibition on paying dividends;<br>- restraint on paying bonuses to directors and other senior officers;<br>- restraint or prohibition on taking deposits at high interests rates. |
| 3 | Less than 0% | Less than 0% | To order the suspension of some or all of the business activities |

Sources: M. Hall (1998: 154), and Japanese FSA (www.sfa.go.jp)

The Japanese PCA framework, however, was less demanding than PCA applied in the U.S. and as compared, for example, to revised standards in South Korea (since

1998). For example, in Japan, banks' operations are only suspended when capital falls below zero (or there are strong indications that this will shortly happen), while in the US and South Korea, regulators can suspend the banks when their capital ratios fall below 2 percent. In addition, while American banks with over 10 percent of capital adequacy ratios are subject to no intervention, in Japan the minimum ratios are over 8 percent. More importantly, the Japanese version of PCA did not take into account the exposure of banks' capital bases to market risk.[63] This limited the effectiveness of PCA because without transparent measures of capital and assets at market values, it was difficult for regulators to monitor the moral hazard incentives of banks. The 1998 changes in accounting rules also diluted the scope for the PCA framework to respond to the erosion of the banks' true capital position. This flaw in PCA was mitigated by the wider implementation of mark-to-market accounting only in September 2001.

It is difficult to say, however, that the Japanese PCA combined with market-value accounting standards would provide a basis for the effective implementation of capital adequacy rules, given the laxity of the thresholds. Equally important, as seen in the previous section, the lenient loan classification and provisioning standards have effectively undermined the validity of Japanese banks' capital adequacy ratios.

### 7.4 Evaluation and Alternatives

The opacity of non-performing loans held by Japanese banks prevented market participants and regulators from grasping the actual capital base of the banks, thereby hampering the effective implementation of capital adequacy rules, since the due write-off of NPLs would significantly reduce the size of bank capital. In this sense, the delayed response to the NPL problem weakened the degree of the Japanese compliance with the Basle Accord and in effect caused hidden defection ever since the Basle Accord came into effect in April 1993 in Japan. The numerical compliance, the statutory capital rules, and the establishment of the prompt action scheme did not mean that Japanese regulatory policies were geared up to deliver on the credible implementation of the Basle Accord.

As of writing, there are as yet few signs that NPLs will be cleaned up substantially in the near future. Despite the recent institutional shift towards rule-based, prudential regulation, including the 1998 introduction of PCA and the 2001 introduction of mark-to-market accounting for banks' securities holdings, the NPL problem continues to distort the true picture of the capital adequacy ratios of Japanese banks. At the heart of the weak degree of the Japanese compliance was inadequate institutional capacity to deal with NPLs.

The institutional structure of the Diet's oversight of the MoF—"firm alarm"

oversight—gave the MoF leeway as well as incentives to conceal the adequate information on NPLs. In addition, in fear of political intervention into management and loan decisions, banks wanted to deal with the problem on their own and did not actively turn to ruling LDP members. Until the major financial institution failures of November 1997 and the onset of a serious credit crunch for small- and medium-sized businesses, LDP politicians also hoped that the problem would go away by itself and adopted a passive stance towards the problem. These institutional and political conditions formed impediments to the settlement of the NPL problem, i.e. a source of hidden defection from international regulatory standards.

During the 1997-98 domestic financial crisis, the intervention of politicians into banking politics led to the further, involuntary defection from internationally accepted regulatory standards. Under severe financial distress, LDP politicians were unwilling to take costly steps towards the strict implementation of capital adequacy requirements for fear of causing further deterioration in the existing credit crunch, which hit their political constituencies—small- and medium-sized businesses and construction sector. On the contrary, they pressed for leniency in implementation to spur banks into lending more money to these borrowers. Among others, the 1998 accounting rules that allowed banks to use book value for accounting their shareholdings were designed to increase the apparent level of capital-to-assets ratios and to give them some breathing

space. Thanks to this sort of accounting trick, many banks were able to clear the Basle standards. This change not only widened the gap between Japanese banks' actual and putative capital, but also went against the international trend toward market value accounting principles.

The weak degree of the Japanese compliance with the Basle Accord suggests the limitation of the two-level game hypothesis. The network state hypothesis, which argues that various actors concerned were embedded in an informal regulatory network in Japan and policy behaviour began to be constrained by the embedment in the 1990s, provides a better explanation for the issue of implementation.[64] The informal forms of banking regulation turn out to be a stumbling block to credible commitment to the Basle Accord when they were stressed. As regards the MoF-politician relations, the "fire alarm" oversight by politicians induced the regulators to exercise forbearance policy in dealing with NPLs. In moments of crisis, the MoF had incentives to conceal the real picture of NPLs from politicians, since the disclosure of regulatory breakdown was expected to trigger political intervention and reduce policy-making autonomy—one of the MoF's main organisational interests. This was an institutional source of regulatory forbearance and hidden defection.

There are two domestic-level alternative hypotheses for domestic sources of defection, which need further examination. One is a regulatory capture hypothesis:

regulated groups with high stakes in the regulation-making process are so powerful that they can influence politicians and regulators to serve primarily the interests of those subject to the regulation.[65] This regulatory capture represents a process through which well-organised groups can use their political resources to capture benefits for themselves at the expense of more dispersed groups. This hypothesis apparently corresponds with the weak compliance with international prudential regulations, from which banks can benefit.

The Japanese banking industry, however, did not actively turn to LDP politicians for lax rules throughout the 1990s.[66] It may be possible to argue that even without explicit lobbying by banks, the interests of banks are inherently the major concern of government in all market-oriented societies.[67] Politician-led lax policies, however, had mixed results for banks. While the lax regulatory and accounting rules helped banks to meet the minimum capital adequacy ratios, political pressure on banks to make new loans to small- and medium-sized enterprises, which was accompanied by the generous policies, began to bite. Any public assistance was not offered without any strings attached. In fear of political intervention in banking management and lending decisions, banks did not actively mobilise politicians. For LDP politicians, the strict implementation of capital adequacy requirements could only aggravate the existing credit crunch for small- and medium-sized enterprises and was therefore best avoided.

LDP politicians did not push for the narrow interests of banks, but rather for those of more politically powerful groups such as small- and medium-sized business and construction companies.

A second alternative hypothesis is bureaucracy dominance: the interests and preferences of the MoF officials cannot be reduced to those of other societal groups, and serve as the primary explanatory variable.[68] The regulatory forbearance in dealing with the NPL problem seems to correspond with the MoF preferences to avoid political intervention in the initial years after the collapse of the bubble.

The ability of regulators to achieve their policy goals, however, is not always automatically given. Rather, it is a product of statecraft with which policymakers strive to attain their goals.[69] The way in which regulators interact with social groups reflects institutional settings as well as the pattern of the domestic power relations among them. When the dysfunction of the old banking regulatory regime left no alternative but to use public money to stabilise the banking system, for example, the unpopular policy of using public money resulted in politicians attempting to avoid being blamed by insisting on a popular issue like the break-up of the much-criticised MoF.[70] These political circumstances left regulators on the sidelines. Instead, politicians began to increase their influence on the regulation-making process by passing important laws to cope with the banking problem.[71]

### 7.5 Conclusion

Based on the developments of international financial regulatory standards in the last few decades, it is important to understand how and to what extent they are disseminated and actually implemented. This chapter contributes to this debate by providing possible answers to the Japanese case of the Basle Capital Accord. Although important international pressures were identified, neither a unilateral effect from international forces nor a linear domestic pattern following the international developments was found. Rather, it was found that the locus through which Japanese regulators implemented the Basle capital adequacy rules was firmly placed in the domestic political and institutional context. It might be possible to argue that the long-term, overall pattern of Japanese regulatory policy trends towards the rule-based regulatory method supports the two-level game hypothesis that international developments can is used as external leverage to influence the course of domestic regulatory developments. However, a close look at the degree to which domestic policies were designed to pursue prudential regulation showed that international pressures were blocked by domestic factors during the 1990s.

The weak degree of real compliance with and the defection from international regulatory standards suggest the limitation of the two-level game hypothesis. Inadequate domestic institutional capacity to deal with NPLs posed serious

impediments to the effective implementation of capital adequacy requirements. Furthermore, it was not until 2001 that regulators tackled the problem that the capital base of Japanese banks was exposed to market risk. Rather, Japanese regulators tried to get around the problem by allowing the banks to use lenient accounting standards. The network state hypothesis provides a better explanation for the weak degree of the Japanese compliance than the two-level game hypothesis does.

In the case of Japan, thus, domestic factors largely determined the pattern of implementation and the extent of compliance. Achieving an international agreement and formally adopting its rules as national standards is one thing; the real compliance with the international regulatory standards is another. In order to examine the latter, it is necessary to probe not only the statutory rules of capital adequacy, but also various related policies and institutional frameworks in which capital adequacy rules are embedded at the domestic level.

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[1] The Basle Committee (1997; 1999).
[2] See, for example, *The Economist*, 25 January 2001 and 20 April 2002. See also Posen (2002).
[3] On the problems of international regulatory standards, see Eichengreen (1999: chap. 3).
[4] Underdal (1998) provides a good summary of the literature on compliance.
[5] Hall (1993b: chap. 8).
[6] Basle Committee (2000) presents a comprehensive view on international accounting standards from a banking supervisory perspective.
[7] See Rojas-Suarez (2001).
[8] After temporary nationalisation, the two long-terms banks were sold to investment companies.
[9] The bank's U.S. operations were suspended by U.S. authorities when the bank (and the Ministry of Finance of Japan) failed to promptly report its huge losses in the New York markets to the authorities.
[10] Putnam (1988).

[11] When referring to regime theories here, I have neo-liberal institutionalism in mind. See Axelrod and Keohane (1985) and Keohane (1984; 1989).
[12] E. Haas (1990) and P. Haas ed. (1992).
[13] See Walter (2001: 42).
[14] Simmons (2001: 595-98, 601-5).
[15] Putnam (1988).
[16] Involuntary defection is only apt if regulators really did negotiate the agreement in good faith. As seen in Chapters 4 and 5, the MoF made abortive attempts to introduce effective domestic capital adequacy requirements since the early 1980s and used the Basle negotiation as external leverage to manipulate the domestic regulatory politics. The MoF was also satisfied with the result of the 1988 negotiation at that time.
[17] Amyx (forthcoming). For more on the "police patrol" versus "fire alarm" concept, see McCubbins and Schwartz (1998).
[18] Rosenbluth and Thies (1999). On the detail of the 1994 electoral reform in Japan, see also Rosenbluth (1996).
[19] See Cowhey (1993).
[20] Rosenbluth and Thies (1999:12).
[21] Drawing on a database on bank regulation in 107 countries, for example, Barth, Caprio and Levine (2001) show that banking regulatory policies tend to serve powerful political constituencies, rather than correct market failures.
[22] Santos (2000) presents a wide literature review on capital adequacy requirements and credit crunches.
[23] The U.S. complaints about Japanese regulatory methods arose after the 1995 Daiwa Bank incident. The International Monetary Fund (1995) first criticised Japanese regulators for their delayed responses to NPLs.
[24] Fukao (2002).
[25] *Financial Times*, 6 December 2001.
[26] Ueda (2000: 62-3).
[27] Nishimura (1999: 119).
[28] *Jiji Press*, 31 March 1998.
[29] Ito (2000: 94). See also Ito and Sasaki (1998).
[30] Nishimura (1999: 186-89), *Kin-yū Zaisei Jijyō*, 5 January 1998, pp. 10-12.
[31] Sakakibara (2000).
[32] *Kin-yū Zaisei Jijyō*, 5 January 1998, pp. 10-12, *Shūkan Tōyō Keizai*, 13 December 1997, pp. 6-7.
[33] *Kin-yū Zaisei Jijyō*, 12 January 1998, pp. 20-21.
[34] For the detail of the new rules, see *Kin-yū Zaisei Jijyō*, 27 April 1998, pp. 51-53.
[35] Levy (1999: 122).
[36] *Asahi Shinbun*, 12 January 1998.
[37] *Kin-yū Zaisei Jijyō*, 5 January 1998, pp. 10-12, Levy (1999: 123).
[38] See Nihon Keizai Shinbun Sha ed. (2000a).
[39] *The Japan Times*, 10 October 1998.
[40] *The Nikkei Weekly*, 6 April 1998.
[41] For econometric research on the Japan premium, see Ito and Harada (2000).
[42] See, for example, Ito (2000: 99).
[43] An interview quoted in *The Japan Times*, 10 March 1999.
[44] There is an unconfirmed rumour that Japanese banks began to raise funds in interbank markets on security, instead of paying a premium over LIBOR. I thank Akiyoshi Horiuchi for informing me of this.
[45] *Kin-yū Zaisei Jijyō*, 22 June 1998, p. 7.
[46] *Jiji Press*, 30 October 1998.
[47] Rosenbluth and Thies (1999).
[48] The Basle Committee (1996).

[49] IMF (1999).
[50] Since the first IAS on disclosure of accounting policies in 1975, the IASC/IASB has so far issued 41 IASs. See the IASC/IASB's homepage, www.iasc.org.uk
[51] Basle Committee (2000).
[52] *Kin-yū Zaisei Jijyō*, 3 August 1993, pp. 16- 32, and Yamada (1996).
[53] *Nihon Keizai Shinbun*, 7 August 1997.
[54] *The Japan Times*, 29 October 1998.
[55] *Asahi Shinbun*, 14 June 1997, 28 July 1997, and 17 January 1998.
[56] The new Japan Accounting Standards Board, established in 2001, may change things.
[57] *Nihon Keizai Shinbun*, 16 January 2001.
[58] On the LDP proposals, see *Nihon Keizai Shinbun*, 27 March 2001 and 30 March 2001.
[59] *Nihon Keizai Shinbun*, 24 March 2001.
[60] *Asahi Shinbun*, 22 November 2001. Despite these efforts to mitigate the downward effect of banks' cross-shareholding sell-offs on stock markets, mark-to-market accounting for cross-shareholdings produced selling pressure on stock prices. At the G-7 Financial Ministers meeting of February 2002, the Japanese minister announced that the BSAC would start to operate by the middle of February. *Asahi Shinbun*, 8 February 2002.
[61] IMF (2001).
[62] For a definition of American PCA, see the previous chapter.
[63] In the U.S., banks are not allowed to hold shares in their corporate clients.
[64] See Amyx (2000).
[65] Rosenbluth (1989) develops a regulatory capture model to explain Japan's financial regulatory change.
[66] Nihon Keizai Shinbun sha (2000a).
[67] For the privileged position of business, see Lindbom (1977: ch.13).
[68] A typical example of the bureaucracy-centred model in the Japanese regulatory politics is Vogel (1996).
[69] See Kato (1994).
[70] Hiwatari (2000). On political blame management, see Weaver (1986). See also Mabuchi (1997b) for a different interpretation.
[71] Nishimura (1999: 187) and Horiuchi (2000: 238).

# Chapter 8

## Conclusions

The Basle Accord was seen as a successful example of creating a global governance mechanism for international banking with special focus on capital adequacy requirements.[1] In the mid-1980s, concerns over the surge of Japanese banks with low capital adequacy ratios were part of Anglo-American motivations for initiating international banking regulation. Japanese banks made great efforts to meet the Accord since it came into force in Japan but they were often accused of juggling their capital adequacy ratios. In addition, the Accord was also seen as a main cause for credit crunches in the Japanese economy in the late 1990s. These facts explain the importance of correctly understanding how the preferences and bargaining positions of Japanese actors evolved, to what extent the Basle Accord was effectively

implemented in Japan, and which factors affected the Japanese implementation. I explored these questions by testing the two-level-game framework and alternative domestic- and systemic-level approaches, as well as providing detailed case studies.

The two-level-game framework is one of the most important conceptual approaches in the discipline of international political economy. The framework offers hypotheses about impacts of two-way domestic-international interactions on state negotiators' preference formation, bargaining positions and compliance. By examining the extent to which the hypotheses can explain the preference formation and bargaining positions of Japanese regulators and compliance with the Basle Accord, I pointed out prospects and limitations of the two-level-game model. To articulate such potential and limitations, I considered alternative explanations including domestic- and systemic-level ones.

I argued that three norms support a given country's credible commitment to international capital adequacy standards. First, capital adequacy rules must be a linchpin of prudential regulation, by monitoring banks' solvency; second, regulatory capital adequacy ratios must accurately reflect the reality of banks' financial strength; and third, regulators should take swift corrective action against banks with low capital adequacy standards. These norms help us define a set of policy behaviours and economic outcomes against which hypotheses on the behaviour of bank regulators in

the process of international regulatory harmonisation can be tested. Four indicators for credible compliance are as follows: 1) numerical compliance; 2) the legislation for statutory capital rules; 3) less discretionary rules for accounting, loan classification, and provisioning; and 4) prompt corrective action by regulators.

On the one hand, a close look at Japanese regulators' preference formation and behaviour through a filter of domestic and international interaction allows us to better understand and explain their behaviour at the negotiation process. The thesis presented a counterexample to mainstream systemic-level explanations about the forces leading to the Japanese Ministry of Finance's (MoF's) negotiating position. On the other hand, the thesis had shed light on the importance of the implementation phase as regards international regulatory frameworks, and pointed out limits to the logic of two-level game approach concerning implementation and compliance issues. The negotiation literature so far paid little attention to the details of implementation and compliance.[2] The hypotheses derived from the logic of two-level game approach, however, did not sufficiently explain ineffectual Japanese compliance with the Basle Accord. Both domestic institutional "capacity" and the "willingness" of regulators are important in determining the degree of compliance.

## 8.1 The Argument and Major Findings

A two-level-game model hypothesises, at least, two strategies that bank regulators

can employ to attain their policy preferences under international and domestic interactions. Both hypotheses are assessed here. First, the domestic-international interaction creates an opportunity for regulators to reinforce their autonomy vis-à-vis societal interests in the course of international negotiations—Hypothesis 1. According to this hypothesis, regulators can use internationally agreed norms as a way to legitimise domestically tough issues, such as capital adequacy requirements, and to enhance their ability to implement such norms domestically. Second, the domestic-international interaction gives regulators strategies to reshape the configuration of the win-set of domestic constituents with the aim of reaching an international agreement and/or increasing their international bargaining position—Hypothesis 2.

The common feature in the two cases of the negotiations regarding international capital adequacy regulation (i.e., the 1988 Basle Accord and the 1996 Amendment) was that the MoF tactically used the internationally agreed norms to legitimise its domestic policies and to shore up its position in the domestic politics (Hypothesis 1). Hence, a perspective based upon this hypothesis in principle helps us understand and explain the regulators' behaviour at the negotiation stage. The international and domestic interplay helped Japanese regulators legislate the statutory capital rules, which private banks had previously succeeded in fending off at the domestic level.

However, as Chapter 7 has shown, where implementation issues were concerned, domestic factors crucially mattered. Inadequate domestic institutions for coping with banks' non-performing loans, as well as willingness to help banks to overcome hurdles for meeting the Basle Accord, effectively made Japanese commitments to the Basle Accord problematic even after the Diet got capital adequacy requirements on the statutory book in 1992. In addition, the banking crisis of the late 1990s politicised the issue of capital adequacy requirements and the mobilisation of politicians put severe constraints on Japanese compliance with the Basle Accord. The ultimate success of implementation and compliance is dependent on domestic economic and political conditions. Thus, while Hypothesis 1 has some merits of explaining the negotiation stage, its validity is qualified, especially at the implementation stage.

At the outset, Japanese regulators thought that the 1987 U.S.-U.K. proposal for international convergence of capital adequacy requirements was too hastily proposed and too ambitious. However, once negotiations started, Japanese regulators attempted to reinforce domestic regulation in order to improve their international bargaining power, and at once saw the international negotiations as an opportunity to manipulate the power balance in the domestic policy network revolving around the issue of capital adequacy requirements. Since the early 1980s, in response to financial liberalisation, Japanese regulators had tried to establish effective capital adequacy requirements at

the domestic level, but the private banks' political muscle blocked the establishment of an effective compliance mechanism. As a result, Japanese banks continued to operate with low capitalisation and without any sanction by Japanese regulators. For Japanese regulators, this was a concern.

In this domestic context of banking politics, it was the international negotiations that gave the Japanese regulators an opportunity to pursue their desired policy objectives at home. The regulators used the international agenda to obtain domestic leverage in the establishment of statutory capital rules.[3] The international agreement on minimum capital requirements legitimised the attempts of the MoF, which ultimately succeeded in legislating for capital adequacy requirements in 1992 in the face of complaints from the banking industry.

In the negotiation process of the 1988 Basle Accord, inadequate domestic institutions and policy tools motivated the MoF to use external pressure to prevail in the domestic battle over capital adequacy requirements. In other words, the Japanese regulators' autonomy was not institutionally given in the realm of capital adequacy requirements but was rather a product of the regulators' statecraft in overcoming institutional impediments. This contrasts with the bureaucracy-centred argument as well as a popular image of the strong state of Japan vis-à-vis societal actors in comparative politics.[4] The interaction between domestic and international politics

gave the regulators a political tool to enhance autonomy. Thus, state autonomy is not static, but rather contingent. Nor is it simply a product of domestic political and institutional constraints.

By elucidating where Japanese regulators stood on the international and domestic negotiations regarding the Basle process of harmonising capital rules, the thesis refuted Oatley and Nabors' claim that the Basle Accord was only achieved through the motivation of competitiveness-conscious U.S. policy-makers to force foreign counterparts, in particular the Japanese whose banks allegedly enjoyed lax-regulation-induced competitive advantage, to join the international regulatory harmonisation process in the interests of American commercial banks.[5] Without doubt, the American initiative played a significant part, but Japanese regulators had domestic reasons for joining the Basle process. Under conditions of inadequate domestic institutions to effectively carry out banking regulations and of a domestic crisis generating political incentives to adopt internationally agreed issues, regulators had a reason to turn to international co-operation in order to resolve domestic issues. In contrast to a neo-realist and neo-liberal institutionalist assumption that states as unitary actors have incentives to defect from international co-operation in the absence of a formal compliance mechanism, weak domestic compliance power may push state actors to engage in international co-operation.[6]

It should also be noted that the behaviour of the regulators in the manner of "bounded rationality", which presumes the cognitive limitations of the decision maker—limitations of both knowledge and computational capacity — explains the Japanese regulators' legislation effort.[7] Under the shadow of the past (the continuous rise in stock prices throughout the post-war era in general and the flourishing stock markets in the late 1980s in particular), Japanese regulators failed to grasp properly the nature of looming problems in the financial sector in the early 1990s. In 1992, despite the rapid fall of stock prices, Japanese regulators did not recognise the drop in stock prices as critical and structural. This optimistic perception of the stock market trend gave the backdrop to the regulators' policy preference in the late 1980s and the early 1990s. What Japanese regulators pursued in the Basle international negotiations—the inclusion of unrealised capital gains in banks' securities holdings—reflected their belief in the enduring rise in domestic stock markets. Ironically enough, in the aftermath of the 1992 collapse of the financial bubble, the MoF's achievement of getting unrealised capital gains incorporated into regulatory capital revealed the fragility of Japanese banks' capital bases and even worsened that fragility.

As for the mid-1990s, a sense of crisis motivated the MoF to use internationally emerging regulatory norms and methods to regain its eroded leverage over politicians. Widespread distress in the domestic financial system and the MoF's failure to handle it

called into serious question the validity of the existing domestic regulatory system and the organisational ability of the MoF as a regulator. The banking industry, troubled by a series of scandals, reduced its political influence, and politicians and the public called for a drastic reform of banking regulation and even a dismantling of the entire ministry. Demonstrating the capability for self-reform was necessary for the MoF in order to mitigate such growing criticism. The Basle-originated regulatory norms and methods emphasising internal control mechanisms, greater reliance on the market, and more transparent *modus operandi* were obviously appealing points in this domestic context. The market-oriented regulatory norms and methods emerged in the Basle negotiations leading up to the 1996 Amendment, and provided Japanese regulators with the main thrust of their domestic regulatory reform needed politically. The domestic politics of banking crisis set the conditions under which the new regulatory ideas entered the domestic regulation-making process and replaced the old ones. The domestic regulatory reform based upon the Basle-originated norms and methods was partly a tactic by the MoF to head off the dissolution of the ministry.

By the mid-1990s, however, given the dysfunction of the existing regulatory regime, Liberal Democratic Party (LDP) politicians had no choice but to make an unpopular decision to use public money to resolve the crisis. They simultaneously launched a campaign for the dissolution of the much-criticised MoF in order to avoid

being blamed.[8] The involvement of politicians had a two-fold consequence. Firstly, one of LDP politicians' main concerns was to mitigate a credit crunch, thereby helping their bulwark constituents such as small- and medium-sized businesses and construction companies. This political involvement resulted in a series of lenient regulatory and accounting policies in 1998, thereby substantially weakening Japanese commitments to the Basle Accord. Secondly, the MoF was finally broken up, and its powers to investigate and supervise financial institutions were transferred to a newly established, independent regulatory agency in 1998. In this sense, political efforts by the MoF to protect their organisation ended in failure. Under the newly established regulatory agency, the Financial Services Agency, capital adequacy requirements were equipped with a formal enforcement mechanism—prompt corrective action. The composition of banks' capital bases became more transparent thanks to the 2001 introduction of market-value accounting principles, which was accelerated by international developments in common accounting standards. Despite these institutional changes, lax loan classification and provisioning rules continued to challenge the validity of the Japanese compliance with the Basle rules in a practical sense.

Kent Calder argues that Japan is a "reactive state".[9] Namely, the Japanese political system incorporates a mechanism in which actors use foreign political pressure, or

*gaiatsu*, to shape and pursue national policy agendas. According to him, Japan's reactive state behaviour was typical in policy issue-areas where the decision-making authority was fragmented and/or where domestic interest groups established clientele relationships with the ruling party politicians. Issues of telecommunications, which created a new policy agenda crossing several bureaucratic boundaries, represented the former, and the issue of the liberalisation of agricultural trade was typical of the latter. In these politically controversial issue-areas at the domestic level, proactive initiatives directed towards change, for example trade liberalisation, have been seldom, and the impetus to change has necessarily come from outside. The case of the 1988 Basle Accord provides further evidence for this process. It strengthens but also revises the characterisation of Japan as a "reactive state".

What this thesis has added to the reactive state argument is that even in a policy area of banking regulation, where bureaucracy was previously deemed to enjoy a high degree of autonomy, regulators were exposed to societal interests at both the negotiation and implementation stages. Accordingly, Daniel Okimoto's typology of Japan's policy-making processes needs reconsideration. [10] According to his classification, banking politics falls into the category of "generalised support", in which the intervention of the LDP is less likely and regulatory authorities enjoy a high degree of autonomy. With regard to prudential regulation during the 1980s and the

1990s, however, this view is not persuasive: societal interests extensively penetrated the process of formation and implementation of capital adequacy requirements.

The thesis has also contributed to the understanding of another aspect of Japan's reactive behaviour by putting Japanese regulators in the context of international institutions, where they can absorb new ideas. In the case of the 1988 Basle Accord, institutional settings at the Basle Committee provided Japanese regulators with an opportunity of learning new regulatory norms and methods, which were deemed relevant to domestic application. The synchronous proliferation of risk-weighted approaches to capital adequacy requirements and the formation of a tiered capital framework designed to accommodate variety in the national definition of capital in the early half of the 1980s are typical examples of the learning process—"the process by which consensual knowledge is used to specify causal relationships in new ways so that the result affects the content of public policy"[11]—at the Basle Committee. The MoF's experimental introduction with the risk-weighted capital adequacy requirements in 1986 was indicative of the impact of this learning process on the Japanese regulatory system. The case of the mid-1990s presents another example that the MoF tactically used the Basle-originated regulatory ideas to pursue its domestic political goal—the protection of its bureaucratic organisation—though it failed to achieve the goal in the end. The revised reactive state argument combines external

pressure with the knowledge diffusion through the institutional setting of the Basle Committee.

It is worth noting, however, that although international institutions served to facilitate the diffusion of trans-national ideas, the locus of such ideational proliferation was strongly affected by domestic politico-economic conditions. On the one hand, the strong economic conditions of the 1980s were the backdrop to the regulators' abortive attempts to devise a scheme to adopt prudential regulation, and the thriving banking industry successfully mobilised politicians to block such attempts. The developments in international norms on capital adequacy requirements gave the MoF leverage in breaking through this political stalemate. On the other hand, by the mid-1990s, domestic financial instability had discredited the pre-existing domestic regulatory ideas, and at the same time given rise to the political necessity of adopting a new one. However, the severity of the 1998 banking crisis drove LDP politicians to take a series of lenient regulatory policies in order to pull the economy out of recession, thereby leading to deviation from the spirit of the Basle Accord. Their main concern was not to represent the narrow interests of the banking industry, but rather to serve the interests of their other bulwark constituencies—small- and medium-seized businesses and construction sector that began to be severely damaged by the credit crunch at the time. For LDP politicians, the strict implementation of capital adequacy requirements only

could aggravate the existing credit crunch and was therefore best avoided. These domestic factors were implicated in the development of capital adequacy requirements.

What the thesis has found regarding the Japanese compliance issues contrasts with the Rosenbluth and Thies argument that the 1994 new single-seat-district electoral rules formed a condition that politicians would support prudential regulation that would transfer some costs of protection away from consumers to banks themselves.[12] Their argument may apply more to policy-making in non-crisis situations. However, when the banking crisis hit their important political supporters, LDP politicians were ready to avoid prudential regulation and to take credit for representing the interests of such specific groups. After all, the medium voter/taxpayer was not unambiguously better off due to post-1994 electoral system changes.

In sum, Hypothesis 1 has the merit of examining the negotiation process, but it is considerably weak at the implementation stage. On the one hand, the argument based upon Hypothesis 1 gives us new findings. It allows us to consider how Japanese regulatory officials dealt with a dilemma between the maintenance of a sound domestic banking system and the international competitiveness of domestic banks by participating in international negotiations. This approach presents a counterexample to analyses that emphasise the "redistributive logic" of the Basle Accord. It also provides

additional evidence for the notion of Japan being a "reactive state", while also refining and revising that concept. On the other hand, the implementation phase challenges Hypothesis 1. Hypothesis 1 does not substantially fit in with the fact of weak Japanese compliance with the Basle Accord. Even after regulators succeeded in getting capital adequacy requirements on the statutory book and establishing a prompt corrective action scheme, lenient and discretionary rules for accounting, loan classification, and provisioning weakened Japanese compliance with the Basle Accord. Politicians' involvement in the regulation-making process gave rise to the leniency and discretion. Approaches based upon domestic institutional capacity and the political willingness, such as the network state hypothesis, present more persuasive explanation than the logic of two-level games.[13]

Hypothesis 2 prescribes that regulators can reshape the configuration of the win-set of domestic interest groups by linking internationally negotiated issues with more popular policy measures. The aim of this strategy is either to improve negotiators' bargaining positions against their foreign counterparts by obtaining domestic consent or to make a breakthrough in dead-end negotiations by winning domestic acceptance. Regarding Japanese involvement in the Basle negotiations, Hypothesis 2 also needs to be reserved for at least two reasons. One is that domestic distributional problems made it difficult for regulators to adopt this strategy. The other

is emerging power configurations in the politics of international banking regulation, which crippled Japanese power in the Basle process in general.

First, the politics of the Japanese banking sector on the securitisation of bank assets indicated that the success of "synergistic issue linkage" was largely contingent upon interest configuration in the policy network of concern. Although securitisation of bank assets would help banks to raise their ratios of capital to assets in general, it caused intra-industry divisions among the types of banks—city banks, long-term credit banks, and trust banks—over the issue of what types of assets should be securitised and on what conditions. Regarding this issue, the traditional compartmentalisation of banking business generated entrenched vested interests. A securitisation plan threatening particular vested interests encountered strong opposition from the group of banks whose privileges were under threat. Specifically, long-term credit banks and trust banks opposed the securitisation plans that would threaten their privileges. This cleavage among banks hindered the MoF's efforts at linking the generally favourable policy packages with tough capital adequacy requirements. The complex vested interests in the policy network turned out to be a very limited result of securitisation.

Second, the statecraft capacity of Japanese regulators to link domestic and international domains in order to improve their bargaining positions was constrained

by newly-emerging power balance at the international level. The esoteric nature of banking regulation crippled influence of both the Japanese regulators and the banks in the Basle process in the 1990s. The issue of the use of banks' internal models for the purpose of capital adequacy regulation was negotiated in a new power configuration in which those regulators and banks with expertise increased their influence. Given the underdeveloped nature of the Japanese regulatory system for monitoring and examining banks' trading activities, Japanese regulators had little capability to affect the course of argument at the Basle Committee, let alone to set a substantial alternative in their favour.

The finding that professional knowledge has become an important attribute of power in international banking regulation-making implies that individual international banks were not equally positioned in a newly emerged power configuration. Japanese banks were still dominant actors in international finance in terms of asset size in the mid-1990s, but they never affected the course of trading risk regulation. What separated Japanese banks from those who exercised power was whether or not they possessed relevant knowledge. Viewing international banks as some unified whole may lead us to overlook differences within it and therefore to misunderstand the politics of international financial regulation. In other words, with regard to the power of international banks, this emphasises the banks' involvement in the political process,

not capital mobility *per se*. The asymmetry of possession and access to a certain set of knowledge differentiated the standing of international banks, their preferences and degrees of power.

When banks with sophisticated risk management increased their influence in the Basle process, it was the American and European banks possessing adequate knowledge and experience in trading activities that exercised influence over the process of the 1996 Amendment. Japanese banks were not included in this political enterprise; in fact, Japanese banks had neither the expertise concerned nor influence in such important private organisations as the Group of 30 and the Institute of International Finance.[14] Rather, the 1996 Amendment imposed extra costs on some Japanese banks wishing to deal in lucrative trading activities. The Amendment pressurised the Japanese banks into improving their internal systems in order to compete with their American and European rivals under the new regulation.[15] Thus, Japanese banks had little influence and their preferences were not represented.

The new power configuration in establishing the international financial regulatory regime substantially revises Hypothesis 2. Hypothesis 2 suggests that regulators can mobilise domestic politics in order to achieve their international policy goals. Behind this hypothesis, there is an assumption that bank regulators are the sole, formal interface between domestic and international domains. However, given the growing

arcane nature of banking regulation, private banks with expertise increased their presence in the Basle regulation-making process and bank regulators lost their privilege as the interface between domestic and international domains. The importance of regulators' skill to manipulate domestic politics is not completely refuted. However, private banks with possession of sophisticated risk management expertise increased trans-national influence over the banking regulation-making process. This suggests the presence of "three-level games", where the third-level game of autonomous trans-national processes is added to traditional two levels (i.e., domestic and international games).[16]

### 8.2 Implications for International Regulatory Standards

The cases and evidence presented here help to demonstrate the importance of domestic factors in mediating the impact of international regulatory developments. Negotiating process and researching an agreement on international regulatory standards are important in that such regulations construct institutional arrangement of markets that confer asymmetric advantages upon some and costs upon others.[17] While considering both international and domestic political factors, the logic of two-level games explains forces leading to regulators' negotiation positions, and shows that those banks with risk management expertise increased their political influence over the direction of international banking regulation. With regard to implementation issues, however,

more persuasive explanations come from a domestic approach.

It is true that the Basle process and the Basle capital regulation itself became more complex and esoteric, thereby facilitating autonomous trans-national processes where private banks with risk management expertise increased their power considerably. Domestic factors, however, largely determined the *modus operandi* of implementation and the degree of compliance. Since international regulatory standards gave domestic actors leeway to operationalise the Basle Accord in their jurisdiction, real compliance must be distinguished from a formal one. Inadequate domestic institutions, including rules for coping with banks' non-performing loans and accounting rules, hindered the effective implementation of capital adequacy rules, thereby reducing the degree of real compliance. This frames the implementation problem as one of domestic institutional "capacity".

There was also a "willingness" factor. Regulators had intent to help banks to overcome hurdles for meeting international regulatory standards. In times of economic hardship, moreover, politicians' intervention was likely to put prudential regulation on secondary and press for leniency, having every intention of pulling the economy out of recession. These institutional and intentional factors underlined the possibility that the Basle rules could be sabotaged by vested interests at the implementation phase. In countries already suffering from financial distress, domestic actors put strong pressure

for leniency in the implementation of the Basle Accord in order to mitigate the existing credit crunch. This sort of political intervention can be a main domestic source of hidden defection from international regulatory standards.

The importance of domestic factors leads one to look at institutional meanings that strongly influence policy behaviours. The Japanese case of regulatory change in the 1990s shed doubt on mainstream economists' argument for regulatory conversion along the Anglo-American practices of banking regulation. The conceptual framework of two-level games under which the preferences of state negotiators (i.e., bank regulators) and private banks are deduced from their positions in international financial markets needs to stand on the contextual lexicon of domestic political culture. Theorisation of two-level games without paying adequate attention to domestic institutions is prone to be criticised for its "sweeping aspirations of universalism" [18] into whose self-proclaimed universal framework Japan is squeezed. Big mess and little substantial change in Japanese capital adequacy regulation in the 1990s indicated that Japan did not fit into a simple argument of globalising financial market.

Japanese compliance with the Basle Accord can be seen as a series of defensive attempts to adapt to the evolving Anglo-American market norms and practices of global finance. A question of how momentum for real compliance with international regulatory standards gathers depends upon domestic environments—political

institutions, economic situations, and preferences of major domestic groups. Domestic political institutions disabled Japanese regulators from taking timely corrective actions against troubled banks and contributed to regulatory forbearance. Under sluggish economic situations, rigid implementation of capital adequacy rules became politically difficult. Indeed, some politicians of the ruling LDP saw the Basle Accord as one of the fundamental causes of the credit crunch in the late 1990s, which hurt their bulwark constituencies (i.e., small- and medium-sized enterprises). These domestic factors hindered Japanese capital adequacy rules from gearing with arm's length, prudential regulatory norms. There was a great fuss, but few substantial changes. This weak compliance, as argued above, challenges some of the ruling hypotheses made in the International Political Economy theory about international regulatory harmonisation, including the hypothesis of the two-level interaction as external leverage for regulators, and that of market forces as the driving force behind emulation of the regulatory standards.[19]

The importance of domestic factors in implementing international banking regulatory standards can also be interpreted in terms of the issue of regulatory independence. Regulatory and supervisory independence of the financial sector is seen as a key element in maintaining financial stability, but in reality many national authorities lack such independence.[20] The regulation-making process is likely to be

exposed to pressure from both the banking industry and politicians. As the two-level-game approach has shown here, joining an international regulatory agreement can be seen as a supplementary policy for resolving a lack of regulatory independence. However, neither agreeing on international regulatory standards nor adopting them as national standards alone ensures a country's credible commitments to the international regulatory regime. Related domestic rules, such as accounting principles, also need gearing towards the purposes of the regime. The more domestic factors are involved, the more difficult it is to prioritise and pursue the goal of prudential regulation. This means not only it is inherently difficult to achieve the effectiveness of international regulatory standards, but also it is important to explore the domestic circumstances under which regulatory change is promoted or hindered. The locus of policy behaviour is determined in a social context and a range of its possibility is not set by the MoF (or the Financial Services Agency after 1998) itself. The MoF (or FSA) has some institutional advantages in policy-making process, but it has no means as a prerogative.

These findings have some broader implications for research on international regulatory regimes. Since the global financial turmoil of the late 1990s, the debate on reforming the international financial architecture has been raised and various initiatives have been taken in promoting particular regulatory norms and methods as

the best practices.[21] However, the existence of international regulatory standards itself does not necessarily endorse their meaningful dissemination. It is necessary to probe the domestic political economy in order to examine not only the formation process of international financial regulatory regimes, but also effective implementation and real compliance. As the Japanese case shows, there are huge domestic obstacles before international financial regulatory regimes effectively bite into domestic prudential regulations.

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[1] For example, Kapstein (1992) and Reinicke (1998).
[2] For example, see Odell (2000).
[3] For a similar point, see Kapstein (1992: 282-83).
[4] On the former see, for example, Johnson (1982) and Vogel (1996). On the latter, Katzenstein (1978a) gives an example.
[5] Oatley and Nabors (1998).
[6] See Waltz (1979), Keohane (1984) and Keohane ed. (1986).
[7] On bounded rationality, see Simons (1997) and Odel (2002).
[8] Hiwatari (2000).
[9] Calder (1988).
[10] Okimoto (1989).
[11] E. Haas (1990: 23).
[12] Rosenbluth and Thies (1999).
[13] See Amyx (forthcoming).
[14] Interviews with Japanese bank officials, London, December 1999.
[15] Hatagawa and Imai (1996).
[16] See Risse-Kappen, ed. (1995) and Cerny (2002).
[17] See Underhill (1991; 1993; 1994; 1997a).
[18] Williams (1996: 171).
[19] On the latter, see Simmons (2001).
[20] For normative views on regulatory independence, see Barth, Caprio and Levine (2002) and Quintyn and Taylor (2002).
[21] Eichengreen (1999) summarises the debate over the new international financial architecture.

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