Contemporary Strategic Aspects of Relationship Banking in Japan

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Abstract

This paper reviews the background and current status of relationship banking in Japan. First, the composition and share of the banking sector in the total financial market are discussed along with the measures taken in the banking sector after the burst of the bubble economy. Second, relationship banking is defined with its merits and demerits. Third, the nature of relationship banking in Japan is argued. Finally, the effects of relationship banking are examined. The evidence from various theoretical and empirical studies has indicated that relationship banking reduces information asymmetry and risk, mitigates liquidity constraints and contributes as rescues in financial distress. However these benefits are often obtained by the firms at the cost of higher rents through higher lending interest rates.

Key words: relationship banking, corporate governance, information asymmetry, liquidity constraints

1. Introduction

Bank-based financial system of corporate financing and governance is regarded as one of the best suited alternatives for Asian economies. This is due to the absence of strong financial market and regulatory bodies to supply funds and support their corporate firms in times of financial distress. Accordingly, the American model of corporate governance, where banks are prohibited by legislation to exercise close monitoring on client firm's decisions, is difficult to replicate in Asian economies. Among Asian economies Japan is the role model for bank-based corporate governance system. The corporate governance which the Japanese banks exercise by establishing a long-term relationship with the corporate firms attracted lot of attentions and become an area of great interest for Asian economies. On this background, this paper reviews the nature and status of such relationship banking in Japan and also its effect on the performance and profitability of the corporate borrowers. The results of this study are expected to reveal suggestions to Asian economies about the pros and cons of relationship banking and the way for replicating this system to their particular banking systems.

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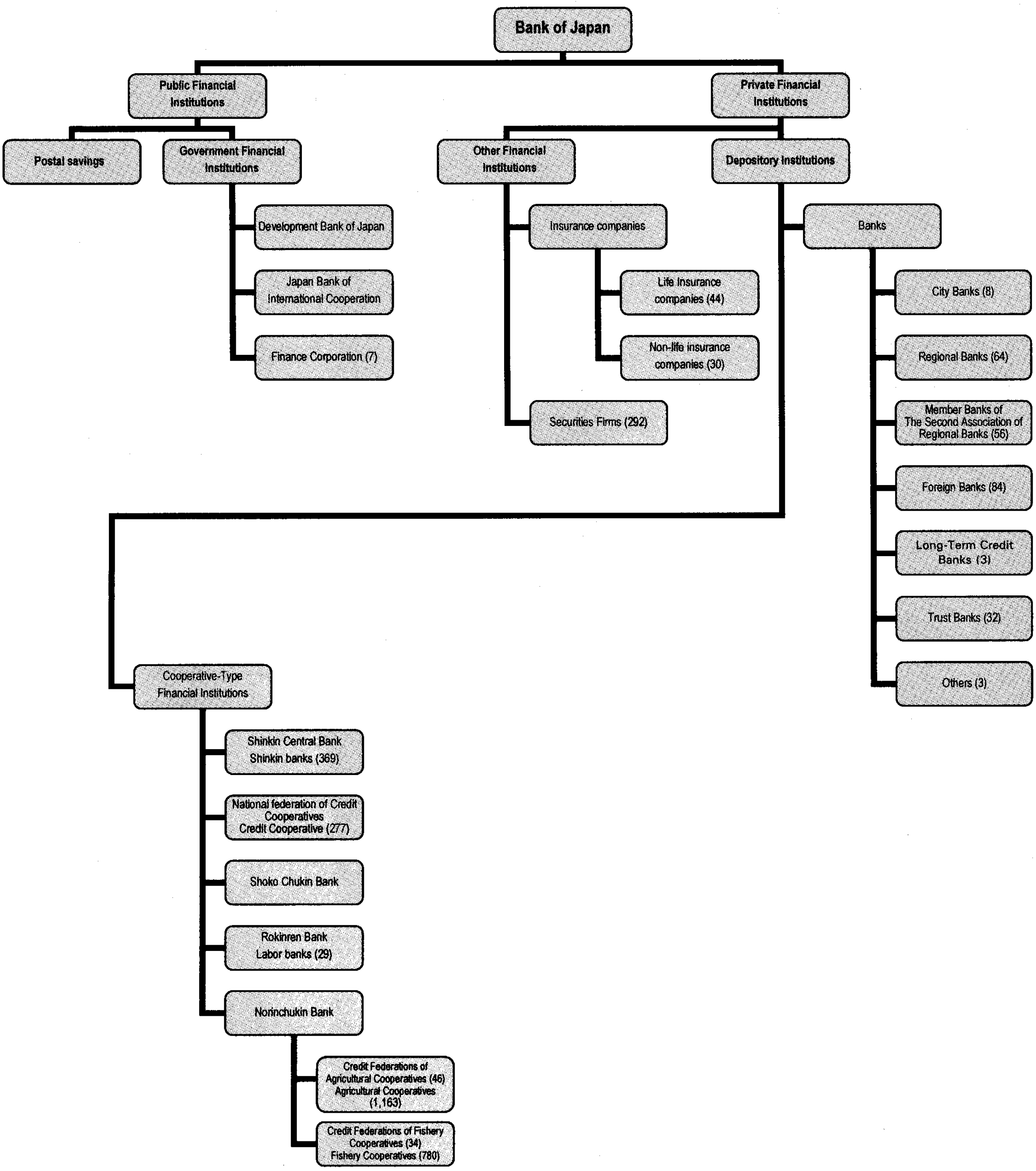
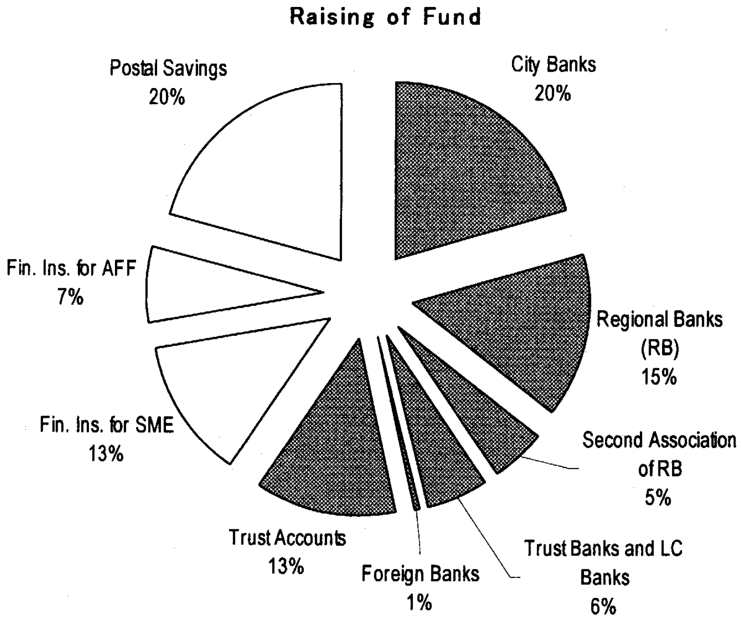


Fig.1 Financial institutions operating in Japan as of 2001

Source: Complied from Bank of Japan, 2005 and Japanese Bankers Association, 2005

2. Recent State of Banking Sector of Japan

Japanese firms depend more on debt than on issuing stocks. Banks play the most dominant role in the financial markets of Japan (see **Fig.1** showing the category and number of financial



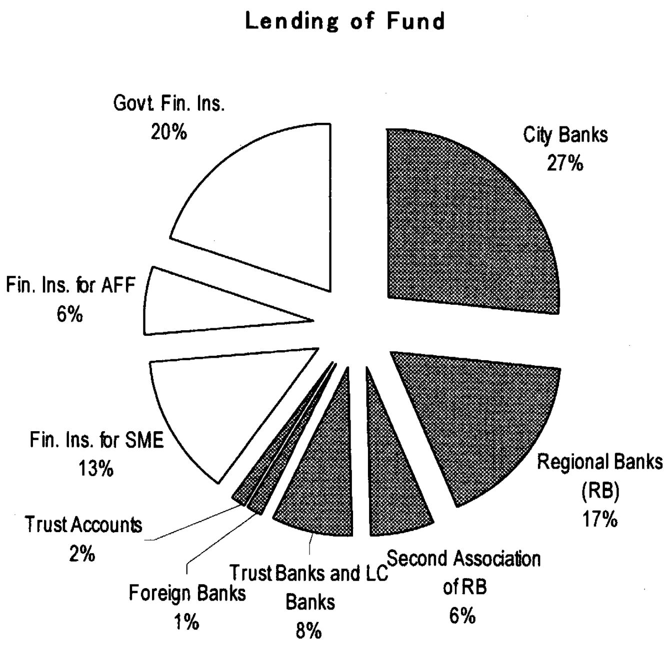


Fig.2 Raising and lending of funds by the financial institutions in Japan at the end of 2000 (The black pieces of the pies represent the share of the banking sector)
Source: Bank of Japan, 2005 and Japanese Bankers Association, 2005

Table 1 Main measures to stabilize the banking sector after the burst of bubble economy

1. Dealing with bad loans **a) Classification and disclosure of bad loans** To tackle bad loans, the Banking Law instructed banks classify their assets into four categories and disclose: Ⅰ. Loans to borrowers in legal bankruptcy; Ⅱ. Past due loans in arrears by six months or more; Ⅲ. Past due loans in arrears by three months or more; and Ⅳ. Restructured loans. **b) Writing-off of bad loans from balance sheets** The emergency economic package revealed on April 2001, instructed writing off of bad loans from the bank's balance sheet within 2 years for existing bad loans.
2. Limitation on bank shareholdings According to the Japanese Anti-Monopoly Law, banks can hold up to 5 percent of a firm's stock (prior to 1987 up to 10 percent) on their own account. On 2001 the Financial Council report suggested a proposal to restrict the total shareholding by banks exceeding their own capital from 2004.
3. Establishing the banks shareholdings purchase cooperation Bank's Shareholding Purchase Corporation was established on January 30, 2002 to absorb the excess supply of shares due to the implementation of limited shareholding law.
4. Removal of full deposit insurance The full deposit protection provided under the Deposit Insurance Law of 1996 is revised on April 2002. Accordingly, deposit insurance will protect deposits up to 10 million yen plus interest per depositor.

Source: *Stabilizing the financial system*, Japanese Bankers Association, *2005*.

institutions operating in Japan). The share of banks is approximately 60 percent in both raising and lending of funds among all the financial institutions (see **Fig.2**). This indicates the active role of banking sector in financial markets. Even after financial liberalizations and burst of the bubble economy in 1991, this dominance of the banking system is still prevalent. **Table 1** summarizes the various measures taken to reform and stabilize the banking sector throughout the last ten years. The main purpose has surely been to cope with diminishing bad loans (non-performing loans) within the sector. According to Financial Services Agency, the measures could basically be classified into a) summary of the program for further financial reformation, b) program for financial revival, c) new deposit insurance system, amid the deregulation and/or liberalization of banking and financial industries in Japan.

The government has also adopted the action program in March 2003 and new legislation and its implementation in August 2004 for relationship banking and risk management aiming to reform management performance of small- and medium-sized businesses, promote regional economic activities, along with further amendment of financial status of the banks and other financial intermediaries for the small and medium enterprises including the restructuring of Japanese financial industries.[1]

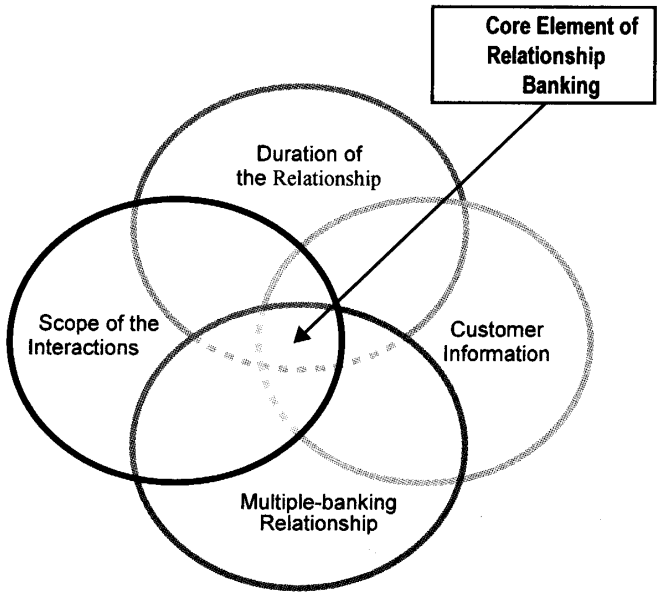


Fig.3 Concept of relationship banking

3. Defining Relationship Banking

The term relationship banking is still vague and not clearly defined in various literatures. Berger (1999) specified the existence of relationship banking where the following three conditions are met:

i . the intermediary gathers information beyond readily available public information;

ii . information gathering takes place over time through multiple interactions with the borrower, often through the provision of multiple financial services;

iii . the information remains confidential.

Boot (2000) also stated relationship banking somewhat in the same direction, as the provision of financial services by a financial intermediary that might invest in obtaining customer-specific information, often proprietary in nature; and evaluate the profitability of the investments through interactions with the same customer over time and/or across products.

The relationship banking esteemed from the Japanese main bank system is often defined as the relationship of the bank having the largest loan share with the firm is not true as largest loan share often changes in times of sudden long term borrowing from long term credit or trust banks (Hirota and Horiuchi, 2001).

Thus from the above discussion the term relationship banking can be defined as a long term relationship between the financial intermediary and the corporate firm developed by repeated interactions transpired from diversified transactions, accumulation of specific information and major loan concentration. This overlapping aspects which give birth to relationship banking are described by **Fig.3.**

4. Merits and Demerits of Relationship Banking

There are various merits and demerits of relationship banking. These are summarized in **Table 2** with reference to the relevant literatures.

Table 2 Merits and demerits of relationship banking

Merits	
Overcoming Asymmetry of Information	Due to relationship banking a borrowing firm might disclose specific information to its bank which would never been disclosed to the financial markets (Bhattacharya and Chiesa, 1995). The firm would be willing to do so as the bank is the financier and need to worry about information leakage to competitors (Boot, 2000).
Flexibility of Contract	Relationship banking provides less rigid nature of relationship compared to capital market funding, as rearrangement of the contract can be done easily and can improve welfare (Boot et al. 1993).
Detailed Covenants	Inclusion of covenants in relationship lending might provide a chance for better control of potential conflicts of interest and reduce agency costs (Boot, 2000). As lending contracts are easy to renegotiate compared to other bond issues or public capital market funding instruments, strict and detailed covenants can be included (Berlin and Mester, 1992).
Accommodation and Monitoring of Collateral	Bank lending contract can include collateral which is proved to be effective in mitigating moral hazard and adverse selection problems in loan contracting (Chan and Thakor, 1987). Monitoring of collateral is possible with closeness and proprietary information obtained from relationship banking.
Lending at Lower Profit	Relationship banking allows the bank to provide loans which are not profitable in the short-term, as it can compensate the former with higher rents from the borrower in the long-term. This is known as intertemporal transfers in loan pricing (Berlin and Mester, 1992; Boot, 2000).
Demerits	
Lower Investment Efficiency	Relationship banking might lower investment efficiency due to soft-budget constraints (Bolton and Scharfstein, 1996). This is due to the flexibility in loan negotiations would provide less incentive in making efficient investment of borrowed funds.
Hold up Problem	In relationship banking the bank might charge higher lending rate as it has information monopoly and the borrower can not turn to other lenders (Nam, 2004).
Avoid Risky Investment	Firms having relationship banking might take too few risky investments as the bank will discourage projects with high risk and high return. (Nam, 2004).

5. Relationship Banking in Japan

In Japan, where the size of the banking sector to GNP is the largest, we can find the most typical and conventional nature of relationship banking. This kind of relationship is also interchangeably referred to as *'main bank' relationship*. According to Aoki, Patrick and Sheard (1994), there are five main aspects of relationship banking in Japan, such as, bank loans; bond issue related services; shareholding; payment settlement account; and supply of management and information resources.

As shown in the **Fig.5**, financing aspect refers to bank loans and bond issue related services, of which bank loan has been traditionally the key one. While settlement accounts, stockholding and supply of management resources are the monitoring and governance aspect of the relationship. In Japan this second dimension of the bank-firm relationship is ensured by the following activities:

5.1 Stockholding of Firms

In Japan a bank maintains a substantial stockholding in the firms to which it acts as a main bank. According to *the Japanese Anti-Monopoly Law,* banks can hold up to 5 percent of a firm's stock (prior to 1987 up to 10 percent) on their own account. But on 2001 the Financial Council report suggested a proposal to restrict the total shareholding by banks exceeding their own capital from 2004 as soon as possible. The main bank usually is in the top five shareholders of the client firm and is normally the top shareholder among banks. This enables the main bank to protect a customer firm from hostile take-over.

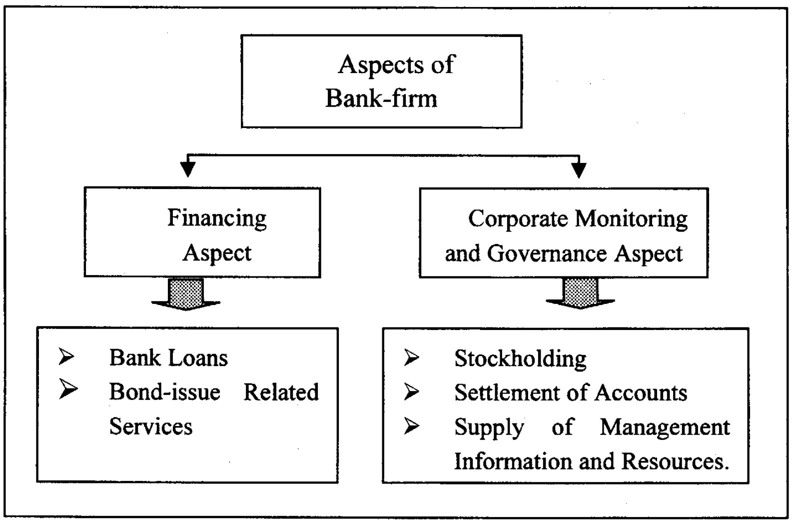


Fig.5 Aspects of bank-firm relationship
Source: Ahmed and Fukaura (2001)

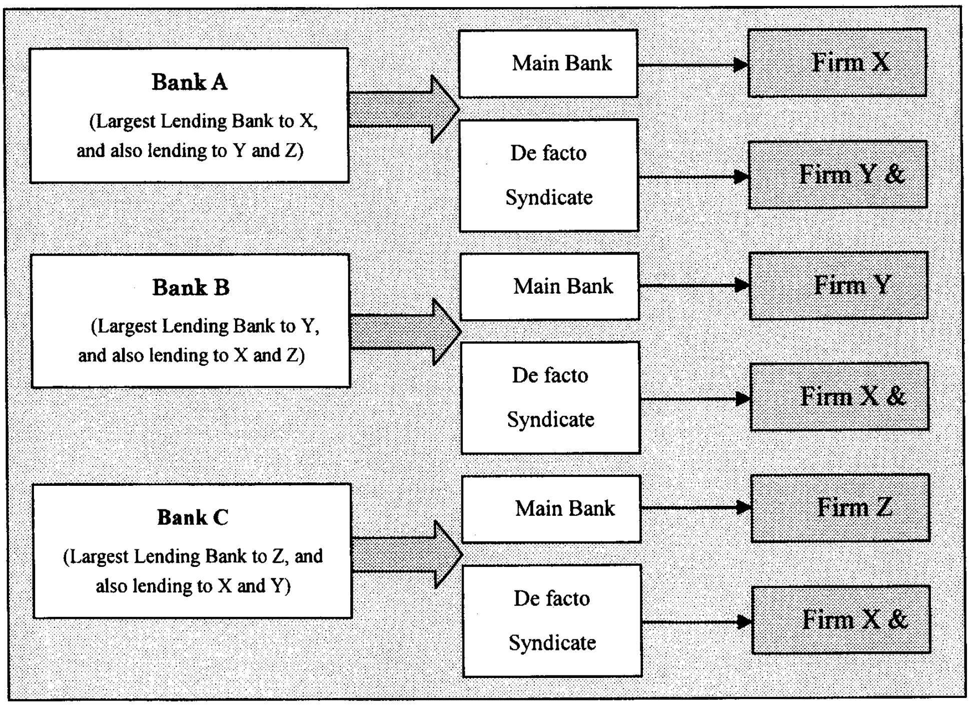


Fig.6 Loan Syndication Procedure under Japanese Banking System
Source: Ahmed and Fukaura (2001)

5.2 Supply of Management Resources

In Japan bank often sends its mangers as directors or auditors on the board of client firms. In 1992, about one quarter (24.4 percent) of the 40,045 directors of listed Japanese firms were from outside the firm (Aoki et al, 1994). Of those about one-fifth (21.7 percent, or just over 5 percent of all directors) were from banks (*Kigyo Keiretsu Soran*, 1992). The shifts of managers from the main bank to its customer firms promote close management relationship and enable the transfer of management know-how. On the other hand banks can also prevent the board of directors of the firm from making an illegal or seriously unjust decision.

5.3 Loan Syndication

Another unique nature of bank-firm relationship in Japan is the *reciprocal delegated monitoring* in the form of loan syndication. For example banks A, B, and C lends to firms X, Y and Z. Then A will serve as main bank to X, B as the main bank to Y, and C to Z (see **Fig.6**). The main bank is expected to play the leading role in case of corporate distress and organizes financial rescue, restructuring and bear a disproportionate share of the costs of financial assistance in terms of interest exemptions or deferrals, loan rescheduling, loan losses and new fund supply relative to the syndicate as a whole (Aoki et al, 1994). In Japan all these above corporate monitoring and governance have been made possible by the main bank because it is the stockholder, got management representatives and is also major settler of payment accounts for borrowing firms.

6. Effect of Relationship Banking in Japan

Now let us examine the effect of relationship banking practices in Japan by gathering examples from various theoretical and empirical literatures.

6.1 Availability of Credit

The first question regarding the impact of relationship banking is whether it made it easy for the firms in accessing to credit. Many studies concluded that Japanese firms with relationship bank enjoy easier access to credit and did not fall into liquidity constraints (Fukuda and Hirota, 1996). Also there are studies drawing opposite conclusions too. For example, Hayashi (2000) finds no evidence that relationship banking esteemed from main banking did not help the firm in meeting liquidity crisis.

6.2 Rescuing in Financial Distress

It is widely argued that, relationship banking is very much effective in rescuing firms in times of financial distress. Based on the information obtained as result of relationship banking, banks tend to respond quickly to the distress by mitigating liquidity shortfalls, debt restructuring and operational restructuring of borrower firms (Nam, 2004). Japanese firms with strong main bank relationship seem to have better been protected than those without such relationship (Hoshi, Kashyap, and Scharfstein, 1990; Okazaki and Horiuchi, 1992).

6.3 Reduction of Risk

Relationship banking can contribute in reducing risk of corporate borrowers by assisting the firms in times of financial distress and reducing corporate financial fluctuations. Considerable amount of loans supplied to a firm send positive signal to the market participants concerning the quality of the borrower, its profitability and its riskiness (Uchida, 1997). Firms with bank borrowing pay lower interest rate premium in times of financial distress as observed through 1964 to 1993 (Kawai, Hashimoto and Izumida, 1996).

6.4 Performance of Borrowing Firms

Relationship banking is believed to solve the problem information asymmetry, liquidity constraints and agency problem. But this does not mean that this improves the performance of the corporate firms. According to Hosono (1997), the lending interest rate spread was significantly negatively affected by the main bank loan ratio in total debt during the 1982 to 1995 period for the exchange-listed Japanese firms. However Japanese main banks extracted higher rents through higher than average lending rates before financial market liberalization in the 1980s (Weinstein and Yafeh, 1998).

7. Conclusion

We have conducted a comprehensive literature survey-based study for grasping the nature and effect of relationship banking prevailing in Japan. The findings of the study might be summarized and concluded as follows:

(1) Relationship banking is formed between a bank and a corporate firm by meeting three conditions: repeated interactions through various transactions, accumulation of specific information and major loan concentration.

(2) Relationship banking can be seen in the Japanese banking system through holding of shares, supply of management resources and loan monitoring by syndication.

(3) The positive effects of relationship are the reduction of information asymmetry, easier access to credit, allowing the borrowing firm to mitigate liquidity constraints, reduction of risk and rescuing in financial distress. However there are literatures having contradictory results as to the impact of relationship banking on the performance of the firms. Results of some of the studies blamed banks for taking higher rents through higher lending interest rates.

In this place we can conclude that relationship banking has many positive and also some negative impact on the Japanese economy. In a country where capital markets and supporting regulatory systems are not well developed, relationship based banking system might be considered as one of the alternatives for promoting industrial growth by entrusting corporate governance in the hands of banks. But enough care should be provided in replicating the system, so that it turns banks do not exploit the corporate firms in the name of corporate governance.

Note

1) As for the regional banking in Japan see Uchida (1995, 2004) for instance.

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