Asia Focus

COUNTRY ANALYSIS UNIT FEDERAL RESERVE BANK OF SAN FRANCISCO AUGUST 2009

# Japan's Cross-Shareholding Legacy: the Financial Impact on Banks

Japanese banks' financial results for the Fiscal Year Ending (FYE) March 2009 marked their worst performance in recent years, with the six major banks reporting a collective loss of nearly JPY1.2 trillion (USD12 billion).[i] Although soaring loan loss charges contributed to the banks' weak performances, losses on equity securities were also a key driver. These losses have drawn renewed attention to the practice of Japanese banks owning stock in the companies to which they lend through so-called "cross-shareholdings," and the market risk resulting from these holdings. Despite reducing cross-shareholdings since the early 1990s, banks still retain significant equity portfolios. This Asia Focus provides a brief background on the development of cross-shareholding and the elements of Japan's regulatory system that permit banks to hold equity securities. The report also examines some of the problems associated with shareholdings that Japanese banks have begun to face since the mid-1990s and considers measures that banks and the government have taken to unwind these shareholdings.

## Cross-Shareholding: Background and Development

*What is cross-shareholding?*

Broadly, cross-shareholding refers to a system of interlocking share ownership between Japanese companies. Most of these cross-shareholding relationships are between banks and their corporate customers. Such relationships are relatively unique; furthermore, many countries restrict banks' holdings of equity securities. In the United States, for example, although banks are permitted to hold investment grade debt securities, with few exceptions they are prohibited from holding stocks as investment securities.[ii] In Japan, however, banks are permitted to hold up to 5% of outstanding shares in any single company, and many banks have used this arrangement as a means to solidify and strengthen ties with long-term clients. In turn, these client companies have purchased shares in the banks from which they borrow, further strengthening ties and creating a network of cross-shareholding.

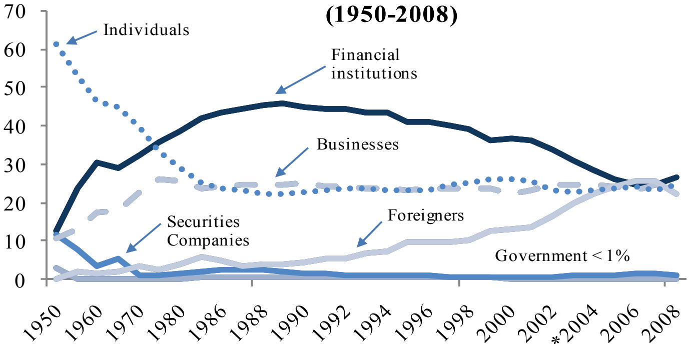
*How and why did it develop?*

Cross-shareholding developed in the years during and immediately following the Allied occupation of Japan from 1945 to 1952. Prior to World War II, large family-controlled industrial conglomerates, the *zaibatsu*, were key features of the Japanese economic landscape. The *zaibatsu* founding families maintained controlling interests in a horizontal network of subsidiary companies through ownership of a holding company; these subsidiaries came to dominate important sectors of Japan's economy including banking, mining, iron and steel, and shipbuilding.

Because Allied authorities blamed the *zaibatsu* for having helped facilitate Japan's war effort, a major thrust of occupational reform was the dissolution of the *zaibatsu* and the unwinding of the family-owned shareholdings. The Anti-Monopoly Law, passed in 1947, outlawed the formation of holding companies, prohibited non-financial firms from owning shares in other companies, and limited financial firms' ownership of other companies to 5% of outstanding shares.[iii] Occupation authorities also expropriated and sold to the general public much of the stock that had been formerly held by *zaibatsu* families and holding companies. As a result of these reforms, the number of individual stockowners more than doubled between 1945 and 1949, and the percentage of outstanding shares held by companies fell from 51.9% to 5.5%.[iv]

Revisions of the Anti-Monopoly Law in 1949 and 1953 removed the restriction on shareholding by non-financial firms, provided that such shareholdings did not restrain competition in a particular sector, and raised the 5% shareholding ceiling for financial firms to 10% (a 1977 revision subsequently reduced this ceiling to 5% but had little effect on the steady increase in bank shareholding through the early 1990s). These revisions enabled a gradual shift in the relative concentration of ownership of listed firms from individuals to financial institutions and businesses. In 1950, individuals owned 61.3% of shares traded on the Tokyo Stock Exchange, compared with 12.6% and 11% for financial institutions and business corporations, respectively. By the peak of the stock

**Chart I: Percent of Unit Shares by Holder (1950-2008)**




market bubble in 1989, however, financial institutions and businesses had increased their respective holdings to 46% and 25%, while individual holdings had fallen to 22.6% of outstanding shares (*see Chart I*).

A number of factors contributed to the changing ownership composition of Japanese shareholdings. Companies' heavy reliance on bank finance during the period of high economic growth in the late 1950s and early 1960s led to the formation of new industrial groups, the *keiretsu*, around the six largest city banks.[v] These banks typically provided *keiretsu* member companies with their largest loans and held shares in the companies. Equity ownership in borrowing firms allowed the banks to strengthen relationships within the group and enhanced their ability to monitor lending and exercise corporate governance over borrowers. Group companies also acquired equity stakes in one another, further solidifying inter-group ties.

The government also contributed to the development of cross-shareholding networks. Following the near collapse of several large securities companies in the mid-1960s, two government-backed institutions were established to help stabilize stock prices through the purchase of shares from securities companies and the market. The purchased shares were frozen and later sold back on the market; they were primarily purchased by companies to further strengthen cross-shareholding networks.[vi]

Many firms eventually came to view these cross-shareholding relationships as a means to protect themselves from unfriendly takeovers.[vii] Although the Anti-Monopoly Law limited shareholding by companies and banks in a single firm, intra-group shareholdings could be substantially higher, making it difficult for outside investors to acquire controlling stakes in a company. Because the banks and companies that comprised the cross-shareholding network were considered stable shareholders unlikely to sell their shares, collectively these arrangements tied up significant amounts of outstanding stock.[viii] Such stable shareholders played an important role in allowing companies to take advantage of new equity issues during the 1970s and 1980s without diluting the ratio of cross-held shares.

## Bank Shareholding since the Mid-1990s

Although cross-shareholding benefited both banks and associated companies for decades, this practice began to present challenges for banks in the mid-1990s. The root of these challenges is the linkage that the shareholdings create between a bank's financial health and the performance of the stock market. Like other investors, banks gain from increases in the value of their equity portfolios and suffer losses from decreases. One downside risk is that banks are required to record impairment charges for "permanent and substantial" declines in prices of the shares held in their equity portfolios, which directly reduces profits.[ix] In addition, the market value of a bank's equity portfolio affects its capital levels. Although risk-based capital rules allow internationally active banks to include 45% of unrealized gains on equity securities toward the calculation of Tier 2 capital, these rules also require Japanese banks to deduct from Tier 1 capital any unrealized valuation losses of any amount on equity securities designated as "available-for-sale," which include all cross-shareholdings.[x] Thus, stock market downturns usually hurt a bank's profitability and capitalization, while upturns provide a direct boost.

*Challenges for Banks*

The downside risks of cross-shareholding were most clearly visible in the financial results announced by banks following periods of significant stock market declines. For FYE March 2003, for example, Japan's six largest banks announced a combined net loss of JPY4.6 trillion (USD38.4 billion).[xi] This loss was driven mainly by an increase in loan loss charges and impairments on equity portfolios that accompanied a 30% decline in the Nikkei 225 average between March 2002 and March 2003. More recently, for FYE March 2009 the descendents of the same six banks reported net losses of JPY1.17 trillion (USD12 billion), their worst results since 2003.[xii] Although credit related costs also contributed to these losses, once again the banks suffered large stock impairment charges as global equity markets plummeted during the second half of 2008. Japan's three "megabanks" – Sumitomo Mitsui Financial Group (SMFG), Mizuho Financial Group (Mizuho), and Mitsubishi UFJ Financial Group (MUFG) – posted combined net losses on equity securities of JPY993 billion (USD10 billion) and combined unrealized losses on equity securities of JPY356.5 billion (USD3.6 billion) (*see Table I*).[xiii]

Anticipating the losses for FYE March 2009, the Bank of Japan's (BOJ) 2009 Financial System Report identified the market risk associated with stockholdings and the reduction of this risk for the overall banking sector over the long term as an ongoing and "very important" managerial challenge for Japanese banks. The BOJ noted further that nearly two-thirds of major banks recorded declines in Tier I capital as a result of unrealized losses on securities during the first half of FYE March 2009, and

| Table I: Mega Banks' Unrealized and Net Gains/Losses on Equity Holdings | | | | | | | |
|---|---|---|---|---|---|---|---|
| | FYE 03/09 | FYE 03/08 | FYE 03/07 | FYE 03/06 | FYE 03/05 | FYE 03/04 | FYE 03/03 |
| **Unrealized Gains/Losses on Equity Securities (JPY billions) – After Tax Impact on Tier 1 Capital** | | | | | | | |
| **MUFG** | -179.8 | 1,378.0 | 3,221.3 | 2,980.8 | 1,348.3 | 1,143.9 | -609.2 |
| **SMFG** | 7.0 | 936.2 | 1,972.6 | 1,702.7 | 705.0 | 669.8 | -165.4 |
| **Mizuho** | -183.7 | 253.3 | 2,693.8 | 2,462.4 | 1,109.6 | 884.6 | -190.6 |
| ***TOTAL*** | *-356.5* | *2,567.5* | *7,887.7* | *7,145.9* | *3,162.9* | *2,698.3* | *-965.2* |
| **Net Gains/Losses on Equity Securities (JPY billions) – Direct Impact on Net Income** | | | | | | | |
| **MUFG** | -408.8 | -24.9 | 127.1 | 60.9 | -186.5 | 237.7 | -997.4 |
| **SMFG** | -183.7 | -7.0 | 44.7 | 47.1 | -101.9 | 101.5 | -621.5 |
| **Mizuho** | -400.2 | 253.3 | -109.6 | 231.5 | 210.4 | 190.8 | -925.0 |
| ***TOTAL*** | *-992.7* | *221.4* | *62.2* | *339.5* | *-78.0* | *530.0* | *-2,543.9* |
| **Annual Percent Change in the Nikkei 225 Average (end-March)** | | | | | | | |
| **Annual Change in Nikkei 225 Average (end-March)** | -35.2% | -27.5% | 1.3% | 46.2% | -0.4% | 47.0% | -27.7% |

*Source: Bank financial statements and TSE.*

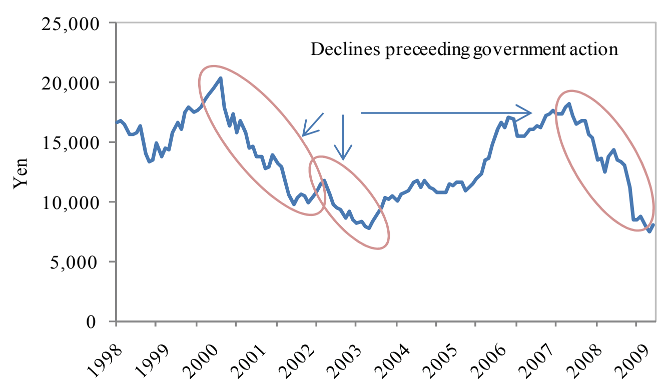
that approximately 20% of these banks experienced Tier I declines of 10% or greater.[xiv]

*Responding to the Challenges*

Liquidating shareholdings through sales is the most direct way for Japanese banks to minimize the risk posed by exposure to equity markets, and banks have used this approach to reduce net equity investments since the mid-1990s. But liquidation through sales can be somewhat problematic for a number of reasons. For example, banks may in some cases be reluctant to unwind shareholdings in firms with which they have long-term business ties because doing so could damage these relationships. Yet even in cases where banks are willing to sell shares, the Japanese government fears that the sudden sale of large amounts of bank-held stocks could depress share values and adversely impact equity markets and the economy as a whole.

Accordingly, the Japanese government has taken a number of actions in recent years to help banks reduce shareholdings while minimizing the impact of such reductions on financial markets. Each of these actions has followed sudden and substantial market downturns that have occurred during the past decade and contributed to weak financial results among Japanese banks. Between March 2000 and March 2001 the Nikkei fell from 20,000 to 13,000, losing 36% of its total value (*see Chart II*). In response, the government implemented a law in November 2001 that required banks to reduce their stock holdings to 100% of their Tier I capital by 2004 (this date was later extended to 2006).[xv] To prevent sales of shares by banks from placing additional downward pressure on already declining stock prices, the law also created the Banks' Shareholding Purchase Corporation (BSPC) in January 2002 and enabled it to conduct voluntary and direct purchases of shares from banks.[xvi]

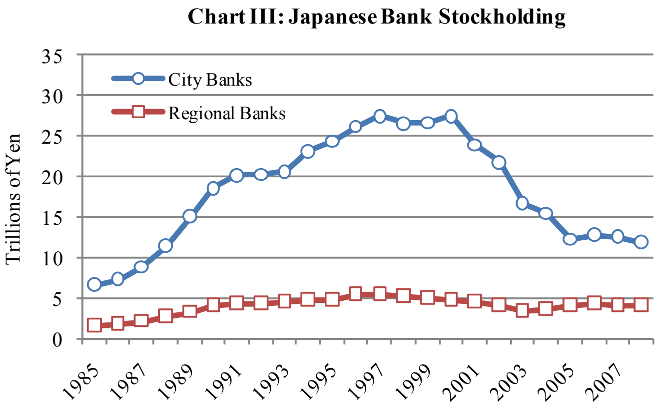
**Chart II: Nikkei 225 Average (end of Month)**




*Source: Bank of Japan*

Following another significant stock price decline that began in May 2002, the BOJ announced a complementary program in September 2002 aimed at helping banks reduce equity holdings. Under this stock purchasing plan, the BOJ agreed to buy up to JPY2 trillion (USD16.3 billion) in stocks from banks whose equity holdings exceeded their Tier I capital through end-September 2003 and hold the purchased stocks through end-September 2007. The BOJ later increased its purchase ceiling to JPY3 trillion (USD 24.5 billion) and extended the purchase program through end-September 2004.

Between 2002 and 2006, the BSPC and BOJ purchased a combined total of JPY3.8 trillion (USD 31 billion) in stocks from banks. Banks also conducted sales independent of the government to reduce their stockholdings below their Tier 1 capital levels in line with the government's 2006 deadline.[xvii] During roughly this same period, the value of shareholding by the six city and 64 regional banks fell by 34%, from JPY25.9 trillion to JPY 17.1 trillion (USD211.3 billion to USD139.5 billion, *see*



*Source: Bank of Japan*

*Chart III*).[xviii] This reduction in shareholding helped address the market risk exposure associated with banks' remaining stockholdings, and a sustained recovery in the Japanese stock market from mid-2003 to late-2007 appears to have lessened pressure on banks to make continued reductions during that period. Accordingly, in October 2007 the BOJ began scheduled sales of the stocks it had acquired from banks under the share purchase program. The BOJ suspended the sales only a year later, however, after the Nikkei average fell by 45% through October 2008. As stock prices continued to decline into 2009 and the end of banks' fiscal year approached, in February 2009 the BOJ announced a resumption of its stock purchase plan for banks whose stockholdings exceed 50% of Tier I capital. Then in March 2009, the BSPC announced that it would restart purchases of bank-held stocks through October 2009. As of late July 2009, the BOJ had purchased some JPY30 billion (USD308.4 million) in stocks from banks under the plan and the BSPC had purchased nearly JPY137 billion (USD 1.14 billion), further reducing banks' market risk.[xix] However, it remains to be seen what effect the 30% plus rebound in the Nikkei average since both measures' announcement will have on banks' desire to participate in either share purchase program going forward.

## Conclusion

Measures implemented by Japanese banks and the government have been successful in reducing the overall level of bank shareholdings and the market risk associated with those holdings. The BOJ's resumption of its stock purchase program early this year signals the government's willingness to continue to support bank efforts to liquidate shareholdings. Moreover, Japan's Financial Services Agency (FSA) has publicly encouraged banks to take advantage of the BSPC program and will reportedly begin to require Japanese banks to disclose the value of and reasons for any cross-shareholdings.[xx] But it remains unclear whether the recent rebound in Japanese stock prices will lessen the immediacy of government efforts to reduce banks' shareholdings further. Past patterns suggest that further reductions will likely be gradual in the absence of new regulatory restrictions or another sharp decline in equity markets. It is therefore likely—as the BOJ has stated—that cross-shareholdings and the accompanying market risk will remain significant challenges for Japanese banks going forward.

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[i] The exchange rate used is ¥98.56 = US$1 (prevailing rate as of 03/31/09).
[ii] Under federal law, national banks may not deal in stocks for their own account, unless explicitly permitted by the Comptroller of the Currency (12USC24). State chartered banks also follow similar rules. Permitted stock holdings include stock in the Federal Reserve Bank, small business investment companies, the Federal National Mortgage Corporation, and the Government National Mortgage Association, among others. Banks may also temporarily hold equity securities if obtained through foreclosure on collateral, in good faith by way of compromise of a doubtful claim, or to avoid a loss in connection with a debt previously contracted, provided that they are not held for a speculative purpose. Banks must divest of such securities within five years of the transfer of ownership to the bank. (12CFR1.7)
[iii] A 1997 revision to the Anti-Monopoly Law removed the prohibition on the formation of holding companies.
[iv] Toshiaki Tachibanaki and Ryotaro Nagakubo, "*Kabushiki Mochiai to Kigyo Doki*" in the Ministry of Finance's *Monthly Finance Review*, November 1997.
[v] These six banks were Mitsui (later renamed Sakura) Bank, Mitsubishi Bank, Sumitomo Bank, Fuji Bank, Sanwa Bank, and Dai-Ichi Kangyo Bank. Sakura Bank and Sumitomo Bank merged in 2001 to form the Sumitomo Mitsui Banking Corporation. Mitsubishi Bank and Sanwa Bank each merged with other banks, which in turn combined in 2005 to form Mitsubishi UFJ Financial Group. Fuji Bank and Dai-Ichi Kangyo Bank merged in 2002 to form Mizuho Bank.
[vi] Masahiko Aoki, "The Japanese Firm in Transition" in *The Political Economy of Japan, Vol. 1: The Domestic Transformation*, ed. Kozo Yamamura and Yasukichi Yasuba (Stanford: Stanford University Press, 1987).
[vii] This motivation was particularly strong following the liberalization of Japan's investment regime required by its accession to the Organization of Economic Cooperation and Development in 1964.
[viii] For example, between 1980 and 2002, average cross-shareholding within the six main keiretsu groups ranged from 10% to 25% or more. Data are from Edward J. Lincoln, *Arthritic Japan* (Washington, DC: Brookings Institution Press, 2001).
[ix] The criteria for determining whether a decline in share prices is "substantial" are subject to bank management's discretion. Whether a decline is "permanent" is based on whether a recovery in the stock prices is expected by bank management within one year. Banks must disclose the criteria used in both cases.
[x] 60% of net unrealized losses are deducted from Tier 1 capital after the inclusion of deferred tax assets. However, due to abnormal behavior in the capital markets, the Japanese Financial Services Agency offered some temporary relief until March 2012 by allowing domestic banks to exclude net unrealized losses from Tier 1 capital calculations. For internationally active banks, only unrealized losses or gains on risk-free bonds are excluded; however, such banks may count 45% of unrealized gains toward the calculation of their Tier II capital.
[xi] These banks include the predecessors of the current six largest banks: Mitsubishi UFJ Financial Group (MUFG), Mizuho Holdings, Sumitomo Mitsui Financial Group (SMFG), Resona, Sumitomo Trust, and Chuo Mitsui Trust. The exchange rate used is ¥119.85 = US$1 (prevailing rate as of 03/31/03).
[xii] Data are from Fitch and bank financial statements.
[xiii] Net equity losses reflect the sum of losses and gains on sales as well as write-downs (impairments) on equity securities. As of March 31, 2009, stockholdings as a percentage of Tier I capital for the three megabanks were 45.6% for SMFG, 51.6% for MUFG and 74.1% for Mizuho. SMFG Financial Results for FY2008.
[xiv] Bank of Japan. *Financial System Report* (March 2009).
[xv] The Bank Shareholding Restriction Law (*Ginkoto no kabushikito no hoyuno seigento ni kansuru horitsu*).
[xvi] Although the BSPC was established by the November 2001 "Shareholdings Restriction Law" and the government is involved in its management, membership includes private banks.
[xvii] According to estimates by Fitch, major Japanese banks reduced their equity portfolios from around 150% of Tier I capital in 2000 to around 50% of Tier I capital as of end-March 2008. The exchange rate used in the preceding two paragraphs is ¥122.6 = US$1 (prevailing rate as of 09/30/02).
[xviii] Bank of Japan, Financial Institutions Account data.
[xix] The exchange rate used is ¥98.56 = US$1 (prevailing rate as of 03/31/09).
[xx] According to a report in the *Nihon Keizai Shimbun*.


Contacts: Walter Yao (walter.yao@sf.frb.org) and Nkechi Carroll (nkechi.carroll@sf.frb.org)
Written by: R. Ashle Baxter