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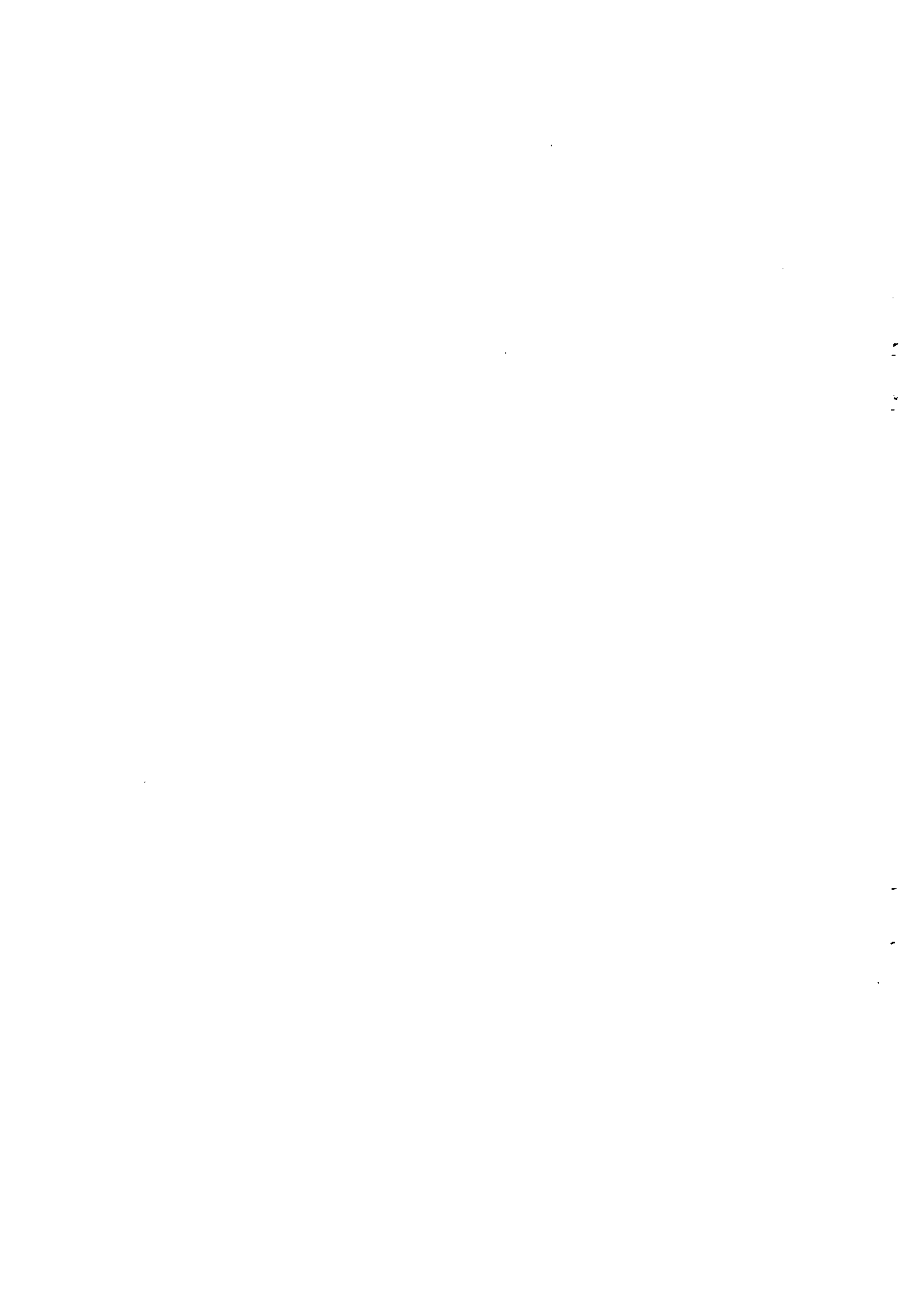

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Distinctive Features of the Japanese Main Bank System in a Comparative Perspective

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Abstract --- This paper views the main bank system as a dual contract in finance and control. It analyses the statutory scheme in Japan that gives rise to the main bank system from a comparative perspective and thus clarifies its distinctive features. It stresses that most of the stylised facts about the main bank system emerges from the statutory aspects of the Japanese banking system that the banks' internal coordination with a borrowing firm is not legally prohibited.

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1. Introduction

It is often argued that the "main bank" system in Japan has contributed to the remarkable growth of the Japanese economy in the post-war period. Traditionally, large firms in Japan have relied heavily on bank loans for their finance and maintained a close relationship with a particular bank, known as the firm's main bank. The main bank is usually defined as a bank that holds the single largest share of loans to a firm among banks.

The main bank system has recently attracted the attentions of the economists who have studied the distinctive features of the Japanese banking system and its contributions to the high economic growth.[1] Especially, they have asked what roles the main bank has played in the Japanese corporate finance, and whether the main bank system has reduced the cost of capital for Japanese firms so that they can enjoy a competitive advantage in the world market.

However, few studies have been done to analyse the statutory framework of the Japanese finance that gives rise to the main bank system or on the distinctive features of the main bank system from a comparative perspective. This lack of research may be due to the implicit nature of the Japanese main bank system. As is often pointed out, no written agreement is exchanged to establish the main bank relation in spite of its long-term

[1] For the recent development of the theory on the main bank system, see Horiuchi and Zui (1992) and Aoki; Patric and Sheard (1993).

nature, and therefore it would be very difficult for ouside observers to specify the precise contents of such an implicit contract. As a result, most literature have adopted the operational definition of the main bank as a bank that holds the largest share of loans to a firm.

Moreover, most literature have emphasised the informational role of the main bank as a delegated screening and monitoring body among banks to effectively minimise the cost of those activities borne by lending banks as a whole. But, screening and monitoring are a core function of a bank (financial intermediary) in general as argued by Diamond (1984): and they are not unique to the Japanese banks. In fact, in the literatute stressing the informational role, one can find only a few references to the distinctive features of the Japanese main bank system.

This paper instead tries to analyse the institutional aspects of the Japanese banking system that give rise to the main bank system from a comparative perspective. Focusing on its long-term and stable nature, it views the main bank system as the banking custom embodying an optimal contract among the parties involved that they take cooperative actions to enhance their profit opportunities for one another. The organisational form and constituents are examined to provide a better picture of the main bank system in the context of the statutory environment of the banking activities in Japan. Then it argues that a Japanese main bank is different from the counterparts in other major countries, a hausbank in Germany and a line or lead bank in the U.S..

A main contribution of this paper is that it identifies the

Japanese main bank system as a dual contract in finance and control: the main bank is committed to stablise the business performance of a borrowing firm through bank finance and control, while it maintains the right to intervene in the borrowing firm's management. That is, to fulfill the firm's demand for bank loans and to keep loan-risk diversion, the main bank organises a de facto loan consortium by implicitly guaranteeing the credit worthiness of the firm to other non-main banks. And the main bank will usually extend rescue measures as an agent of the loan consortium to the firm in case of financial distress, so that other non-main banks would remain in confidence with the loan and maintain their exposures. In this regard, the main bank is closely monitored by other banks participating in the loan consortium. Furthermore, it is also importnat that firms that maintain the main bank relation with this bank concerned monitor whether its rescue activities as the main bank are credible.

And the fact that the main bank can take a lead in rescue activities such as accepting interest and principal concessions emerges from the statutory backgrounds of the Japanese banking system. That is, the banks' internal coordination or collusion with the borrowing firm is not legally prohibited as opposed to those in the U.S., where banks can not institutionally establish internal ties with borrowing firms.

The organisation of the paper is as follows. Section 2 examines the institutional aspects of the Japanese main bank system in terms of an optimal contract among parties involved. Section 3 explores the origin and development of the main bank system in relation to the Japanese economy. Section 4 examines

the distinctive features of the Japanese main bank system from a comparative perspective by comparing the similarities to and differences from the counterparts in Germany and the U.S.. Finally, Section 5 summarises the main conclusions of the paper.

2. Characteritics of the Japanese Main Bank System

(a) Definition of the main bank revisited

Traditionally large firms in Japan have relied heavily on bank loans for financing their investment, and maintained a distinctive banking relationship with a particular bank called the firm's main bank. The main bank is usually defined as a bank that has the single largest share in loans extended to the firm among banks. This definition reflects an outstanding feature of the main bank, and has an operational simplicity in analysing its economic significance. With this definition, the main bank of a firm is easily identified by looking at its financial statements.

However, the loan exposure of the main bank is not large; the loan share of the main bank is limited to at most 20 to 30%. It means that cooperation in finance by other non-main banks is required to fulfill the firm's demand for bank loans. Furthermore, it should be noted that the main bank also has the largest share in the equity holdings, the transactions of deposits, funds transfers, foreign exchanges etc., although statistical data except for equity holdings are not disclosed in the financial statements.

In the banking community, the main bank is routinely refered to as a bank that maintains the greatest share in all the banking transactions with the firm. By employing this as the definition of the main bank, the paper emphasises that the largest share in loan is just one aspect of it. There are other important aspects of the main bank. For example, the main bank advises the firm to allocate its banking transactions in proportion to its loan share among banks. Furthermore, the transaction share of each bank of the consortium is rather stable through time. The economic role and significance of the Japanese main bank system may be better understood by asking why the main bank maintains the largest but not overwhelming share in all the banking transactions and why the allotment of banking transactions based on their loan-share among banks has taken place and has stayed roughly constant over a long period.

These features of the Japanese main bank system, especially the stability of transaction shares suggest that the main bank system can be viewed as a long-term optimal contract for both banks and the borrowing firm that they take cooperative actions to enhance their profit opportunities. The stability of transaction shares implies that neither banks nor the firm have an incentive to change the main bank contract in effect. However, it is difficult to specify the the contract of the main bank relation since its contents are largely implicit.

The main bank contract is implicit in the sense that no written agreement is exchanged to establish the main bank relation. The contract is said to be established when a particular bank, appointed as the firm's main bank, has come to

hold the largest share in all the banking transactions of a firm. It just requires for both the bank and the borrowing firm to establish and maintain internal coordination among them so that each of them enjoys a better position in terms of the transactional volume and profit ranking table than their rivals.

(b) Main bank system as a dual contract in finance and control

As stated above, the Japanese main bank system can be taken as a banking relation which embodies a dual contract in finance and control between the main bank and the borrowing firm. Through this contract, the main bank is committed to stabilise the business performance of the firm by means of finance and corporate control. Most of the stylised facts on the main bank relations, such as the secondment of bank's executives to top management positions of the borrowing firm, should be considered to derive from this contract.

The first element of the main bank contract is related to the bank's function as a financial intermediary. Since large firms in Japan had to rely heavily on bank loans to finance their investment, they have been seeking the bank's commitment to provide them with stable loans. The aim of the contract is to reduce the funds availability risk and to help the firm implement its investment as initially planned. However, it is difficult for a sigle bank to underwrite all the bank loan demanded by the firm because of the loan size and the loan-risk involved.

To fulfill the firm's demand for bank finance and to maintain loan-risk diversion, the main bank appointed by the firm organises the de facto loan consortium by implicitly guaranteeing

the credit worthiness of the borrower to other participating banks. De facto loan consortium means that, in spite of active involvement, no master loan agreement is formally exchanged between the main bank as an agent and a particular borrower. Instead, each bank individually signs a loan contract with the firm by its name.

The main bank may extend a disproportionate measure to the distressed firm as the implementation of this guarantee, that is, to ensure the safety and soundness of the loan extended by the consortium as committed, as will be discussed in detail later. These features of the main bank system are sometimes refered to as the "last resort" function of the main bank, and the firms are considered to enter the main bank contract to enjoy such an advantage of emergency back-up as well as stable bank loan.

On the other hand, the firm commits itself to the main bank that it provides the bank with a better position than the rivals in terms of the deposit and loan market share and the profit competition. To this end, the largest share of the banking transactions goes to the main bank in proportion to the loan-share. Here the settlement account plays an important role. Through this arrangement, the main bank effectively monitors the business performance of the firm from its flow of funds to maintain its reputation as a delegated monitor. Furthermore, it can also receive a seignorage by issuing non-interest-bearing inside money in the form of a demand depoist. In this respect, the firm is paying the implicit guarantee charge to the main bank through the concentration of the banking transactions.

In terms of the theory of the financial intermediation

proposed by Diamond (1984), the finance aspect of the main bank contract can be summarised as follows: the main bank tries to organise a de facto loan cosortium by allowing participating banks to take a free ride on its screening and monitoring activities to fulfill its financial commitment to the firm.[2] And the rescue activities of the main bank can be seen as counter-measures to ensure the credit worthiness of the loan that was initially indicated to other non-main banks.

The second element of the main bank contract is related to the controlling aspect of the firm. In Japan a bank can hold the equity stake of any company up to a certain share of equities issued, presently 5 %, set by the Anti-Monopoly Law.[3] The main bank usually holds the equity of the borrowing firm up to the maximum limit and reserves the right to intervene in the corporate management of the firm when it is in trouble. However, in normal times, it contributes to stabilising the management's control over the firm by reducing risks of mergers and acquisitions as a major but silent holder. Thus, the borrowing firm views as desirable because it can stabilise the management's control. Meanwhile, the bank reserves the right to intervene in the corporate governance of the firm, which could be effectively

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[2] Kato, Packer and Horiuchi (1992) also takes the main bank system as a la loan consortium and argues that no 'free rider' problem arises since the credit risk of the borrower is transfered to and borne by participating banks through the process of the syndication. However, their arguments are different from ours in that they implicitly assume that the main bank organises a formal loan consortium in which it signs with the borrower on behalf of lending banks as a whole.

[3] Formally speaking, before 1977 Japanese banks are permitted by Anti-Monopoly Law to hold equities of other firms up to 10%, and, with the transition period of 1978-1987, the maximum limit on them is reduced to 5% from 1988.

used to ensure the safety and soundness of bank loans in both normal and crisis situations.

This contolling aspect of the main bank contract is very peculiar in the sense that the management of the firm can take an independent decision on its activities when it performs well, but the main bank may intervene in the managerial decision-making in various ways and to varying degrees when the firm is in trouble. In fact, the replacement of the top managements initiated by the main bank has sometimes occured. As a major equity holder the main bank has the right to control the firm and can exercise this right when it deems necessary. The bank's potential involvement in the corporate governance of the firm disciplines the management to run it well. This function is known as the "second duality theorem" (Aoki(1990)) of the Japanese corporate management.

(c) Main bank as a residual risk bearer

When discussing the economic significance of the main bank system, we should note the higher debt-gearing ratio of Japanese firms in a comparative perspective. It implies that in spite of inherent seniority of bank loans, both banks and equity holders have to bear the bankrupt risk of borrowing firms. In Japan banks have been required to provide the risk capital in the form of bank loans for the firms in place of the equity holders, and thus have been assigned to monitor the loan-receiving firms as a provider of the risk capital in addition to the traditional role of a debt-holder. In other words, banks in Japan have also performed the monitoring activities, which should be

intrinsically conducted in the capital market, and have disciplined the firm more effectively.

Against these backgrounds, as Sheard (1989) pointed out, Japanese banks represented by the main bank maintain the right to intervene in the management of the firm as a residual risk bearer. The role of main bank that it takes disproportionate rescue or reorganisation measures when necessary is strengthened by its peculiar status as a representative residual risk bearer. Furthermore, it should be noted that the regulatory body of the Government has kept protective banking policy to ensure the safety and soundness of their management in order for banks to be able to perform the role of the residual risk bearer.

In spite of residual risk bearing by the main bank, its legal liablity is the same as that of non-main banks. As was pointed out earlier, the main bank organises the de facto loan consortium as an agent, but its legal status is the same as that of other non-main banks irrespective of loan share because the loan agreements with the borrowing firm is concluded individually with each banks. Then, why does the main bank act as if it were a sole residual risk bearer beyond its intrinsic legal liability or why do non-main banks play such a passive role in rescuing the distressed firm despite their legal liablities?

The different attitudes between the main bank and non-main banks towards the distressed firm seem to arise from their different status in the de facto loan consortium. In organising the consortium, the main bank ensures to other non-main banks that the borrowing firm will remain credit-worthy as long as their loan exposures kept. That is, the main bank implicitly

guarantees the full repayment of the loans to other banks and, to make this commitment credible, it acts as a residual risk bearer representing the loan consortium.

The activities of the main bank as a residual risk bearer for the distressed firm are monitored by non-main banks and other finacing firms. They have the right to withdraw from the loan consortium or change the main bank to another bank when they see the rescuing or reorganising activities of the main bank as inadequate. To maintain the loan exposures of other non-main banks, the main bank has to work out the rescue activities by paying some cost of its own, so as to minimise the possiblity of a collapse of the whole loan consortium. Thus, the main bank are required to takes a lead among lending banks and acts more than its legal liability dictates in order to reorganise the financially distressed firm.

3. Main Bank System in a Historical Perspective

(a) The origin and development of the main bank system

Why has the Japanese main bank system come to show such features as represented by the dual contract of finance and control? To answer this question, one should analyse the origin and development of the main bank system together with peculiar economic conditions in the post-war development of the Japanese economy.

The main bank system in Japan may be traced back to the counter-measures that group banks and firms have taken together

to ease firms' financial difficulties and to stabilise their corporate control. A bank-customer relationship known as the main bank system was initially observed in the post-war reconstruction period during 1949-54. As Teranishi (1993) pointed out, the prototype of its financing mechanism can be found in the Government-led bank loan syndicate known as "the designated bank system for millitary industry," which was established by the Government in the war-time to smoothly provide the millitary industry with bank finance. Before an introduction of the system, most of the major banks had been organised so as to finance their group firms, and little syndicate loan outside the group had taken place in Japan.

In the reconstruction period, most of the big millitary firms, formerly affiliated with Zaibatsu, a Japanese corporate conglomerate group, faced serious financial difficulties reflecting the extinct war-time demands for their goods and the abrupt cuts of subsidiaries from the Government. Most of large banks except for their group banks were extremely cautious of extending loans to those firms in the old millitary industry since their financial conditions had markedly deteriorated. At that times, capital increases were also considered as fund-raising measures in addition to bank loans. Nevertheless, they were not feasible because of the collapse of the stock market. The financial dependence of former Zaibatsu firms on their affiliated banks has thus remarkably increased, but their demand for bank finance was too large to be underwritten by a single major bank.

Refering to the bank loan syndicate implemented during the

war, the major banks have tried to organise a de facto loan consortium to fulfill their demand for bank finance, by proclaiming the soundness of the borrower through the reckless loan grantings. The support by major banks for their group-affiliated firms in financial difficulties had an important signalling effect on those banks that had been initially reluctant to give loans. Most of the major banks have ensured other banks in forming the consortium that the borrower is qualified for loans and that its credit worthiness will be maintained as long as they keep their loan exposures. Thus, the prototype of the main bank can be found in these activities of the major banks to support their group affiliated firms in serious financial difficulties.

Moreover, the controlling aspect of the main bank contract can also be found in the group firm's counter-measures against hostile take-overs. Before the end of the war, most of the big companies' stocks had been owned by the Zaibatsu's holding campany and their transactions were almost negligible in the stock market. Then, after the war anybody could buy and sell any amount of a particular company as they wished in the market reflecting the democratising measures such as Zaibatu dissolution conducted by the Allied Occupation Forces.

It is important to note that the hostile take-overs of good and well-known group companies had been tried by corporate raiders in the reconstruction period. But they failed because of strong resistence by the targetted companies. They urged their group banks and firms to take counter-measures to ensure the stability of the equity ownership. Through this process,

mutual holdings of equities by group firms or inter-lockings of share holding became prevalent and the major banks came to hold a larger portion of the equities to stabilise the corporate control by the firm's management.

Then, why could banks play such an important role in the finance and control of the firm in the reconstruction period? One can cite the preferential treatment of banks by the Allied Occupation Forces. In view of their important role in finance for the reconstruction of Japan's economy, they put a top priority on the reconstruction of banks during the firm's reorganisation process. Non-financial firms were required to repay their outstanding bank loans underwritten during the war-time as quickly as possible, and losses of loans, if they had had any, were balanced by the deposits cut-off.

In addition, banks were exempt from the Concentration Avoidance Law and could maintain their sizes as they were. In contrast, other large firms were divided into smaller ones to avoid their excessive control over prices. Under these favourable treatment, Japanese banks completed their reconstruction quickly and became an important player in the following phase of reconstruction and development of Japan's economy.

(b) The role of the main bank system in the high economic growth period

The commitment of the main bank to stabilise the bank finance and control reduced the risk of funds shortage for a particular firm. It also stabilised the control of the firm by

their management. Under these conditions, the major firms that had been released from risks of the loan unavailability and hostile take-over could make their investment according to their initial plan and long-term strategy. In other words, the main bank system contributed to the growth of Japanese economy through both the stabilisation of firms' finance and control.

This bank-customer relationship that had evoled in the reconstruction period was appreciated by other non-group or independent banks and firms, and even spread to non-group firm's banking transactions in the high economic growth period. It has thus become a distinctive feature of the Japanese banking system known as the main bank relations with the development of Japan's economy in the post-war period.

For high economic growth, the main bank system has functioned as an effective fund-channelling mechanism in the Japanese loan market. The loan demand had persistently exceeded the supply in the bank loan market in that period, and especially major banks such as city banks faced huge demands for their loans and could not meet all of them. Since interest rates on both lending and deposits had been regulated by the Government, Japanese banks had to rely on some sort of the quantity adjustments or credit rationings with the huge excessive demands for their loans.

These issues on the quantity adjustments were effectively solved by adopting the main bank system as a method of means for the credit rationing. Those firms who had the main bank relation with a particular bank were given a top priority in the banks' credit allotment, and other non-main banks were required to give

them smaller share of loans. Thus, in the high economic growth period, bank loans were channelled rather smoothly via the main bank system to those firms that relied heavily on bank loans for their investment finance.

Nevertheless, it should be noted that the main bank system can restrict the financial activities and the business scope of the borrowing firms. In exchange for the stable bank finance, they are required to contribute to their main bank's gaining a better position than their rivals in the deposit and profit competitions. That is, aside from maintaining the pre-alloted share of all the banking transactions, they are usually encouraged by the main bank not only to make more deposits at the end of each quarter, but also to use its customers network in their production and sale so that the main bank's transaction volume will be increased.

(c) The main bank system in a changing financial environment

These restrictions imposed by the main bank relationship have been regarded by the borrowing firms as the cost for enjoying the stability in finance and control. And in the high economic growth period, they passively accepted this cost as necessary to maintain a good relationship with banks. However, with the decline of the fund shortage risk due to financial deregulations in Japan, the borrowing firms have come to see it as an unnecessary cost because it restricts the scope of freedom or discretion in their financial activities. In fact, large Japanese firms are now much more dependent on the capital market than the bank loan market for their investment finance. This

phenomenon is sometimes called "a drift away from banks" and it is a result of a rational behaviour of Japanese firms that recognise its high cost in an environment of financial deregulation.

As stated above, some problems that the main bank system generated to the borrowing firms are now unfolding. Japanese banks are required to cope with these challenges, and in that pcocess, the main bank system might be changed to a new bank-customer relationship. The inceased dependence on the capital market in big firms' fund-raising activities means that equity holders perform their intrinsic role as a provider of the risk capital, and as a result the bank's involvement with the corporate control of the borrowing firms might be reduced.

A key factor that determines the main bank relation in the new environment might be the banks' attitude toward the firms as equity holders. In the case where they remain as a silent majority in voting, the banks can maintain the right of intervention in the management as well, although the degree of involvement might be reduced. On the contrary, although its possibility seems to be low, if the banks ask them to seek for value-maximising behaviour in a strict way, things would be dramatically changed and their involvement with the control of the borrowing firm would be surely reduced. Nevertheless, as far as the present statutory scheme and bank supervision policy remain unchanged, the main bank system will still perform an important role in channelling the funds through the bank loan market and stabilising the corporate control in the capital market.

4. Statutory Framework in Japan and the Main Bank System

This section examines the distinctive features of the main bank system in Japan from a comparative perspective by comparing the statutory scheme or institutional customs for concluding the dual contract. Then, it discusses some similarities to and differences from the counterparts in Germany and the U.S..[4] The main question here is whether the statutory framework of each country permits collusion or internal coordination in the field of finance and control by banks and the borrowing firm to enhance their profit opportunities for one another.

More specifically, the distinctive features of the Japanese main bank system will be clarified by examining the following questions: (i) whether the bank is permitted to hold the equities issued by its customer firm so that it can have the right to intervene in the management as an owner of the firm; (ii) whether the bank's intervention in the firm's management is permitted or not; and (iii) whether the bank's rescue activities extended to the distressed firm are practically possible or not?

(a) Are banks close to firms?

Firstly the statutory restrictions on the bank's equity holding are compared, because they condition the possibility of the bank's collusion with the borrowing firm. In Japan banks are permitted to hold equities for their investment purposes, provided that a bank's share holding does not exceed 5% of the

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[4] For the discussion on the bank-customer relationship, see Franks and Mayer (1990), Grundfest (1990), Jacobs (1991) and Roe (1990).

total equities issued. The main bank generally holds the equity of the customer firm up to this maximum amount and maintains the right to intervene in the firm's corporare control as a major equity holder. It may even send its senior executives to take the top management positions of the firm.

The main bank is also entitled to access the firm's insider information through its daily contact and from the firm's top managements seconded by the bank. This information can be used to monitor the business performance and financial conditions of the firm, so that the main bank can maintain its reputation as a delegated monitor. Thus there is no statutory wall in Japan that prohibits the firm from coordinating with banks and this provides a legal background under which firms can form a close relationship with banks.

In Germany the equity holding by banks is also permitted; but it is different from that in Japan in that the maximum limit to the holding is not actually imposed. German banks seem to have involved themselves in the management of the customer firm much more than Japanese banks, and this feature is sometimes refered to as "control of firms by banks". German banks' control over the firm's management is further strengthened by the custom of the equity deposit at the bank. Most institutional and individual investors leave their shares on deposit at the bank, granting the bank the power of attorney to vote, and through this custom major German banks can control a majority of the equities in most of the public companies.

Against the background that major banks in Germany hold a huge share of voting rights of major public companies, sometimes

more than 50%, a bank's senior executive is appointed to the member of a supervisory board, a supreme decision-making body in German companies, in most cases as a chairman of the board. Through the supervisory board, major German banks can influence the corporate management of big firms such as the removal and appointment of directors, while acquiring insider informatin on their business performance and financial conditions far more precisely and promptly. To sum up, major German banks are more closely associated with firms than Japanese banks, and effectively monitor and influence the firm's management.

It is sometimes pointed out that a German bank as 'hausbank' has similar functions to those of the main bank in Japan. But, despite many similarities, they are different in the following two respects: Firstly, a bank loan is generally extended by the sigle hausbank in Germany, sometimes jointly with a few other banks, whereas in Japan a de facto consortium is organised by the main bank to fulfill the huge loan demand. Secondly, all the banking transactions in Germany are mostly dominated by the hausbank, in contrary to those based on the loan-share allotment system in Japan.

In contrast, in the U.S., the equity holding by commercial banks is strictly prohibited. Furthermore, banks are also restricted to use the voting rights for their internal purposes, which are assigned to them as the custody of mutual and trust funds in the course of operating their trust business. Thus, US banks cannot be involved in the management of the firm nor take coordinated actions with the borrowing firm through the equity holding. A bank holding company, or a parent company of a

commercial bank, is entitled to hold equities issued by non-financial companies, but this route of involvement is also closed by US statutory system known as the doctorine of 'equitable subordination', which will be discussed later.

In the U.S., a commercial bank's involvement in the management of the firm as the equity holder is virtually forbidden, but it should be recognised that the banks can influence the borrowing firms through their loan commitment. In fact, Mintz and Schwartz (1985) has cited various examples to show substantial banks' control over firms. The involvement by banks through their loan commitment is one aspect of ordinary banking functions, as Stiglitz (1985) has called "banks' control of firms as a debt holder," and Japanese and German banks can also influence firms through this channel. Nevertheless, they can more directly control the firm's management as an equity holder.

In the U.S., a bank that maintains a relationship banking with a particular firm is sometimes called 'line bank' or 'lead bank.' Mainly because of their close and stable relationship, it is sometimes argued that the line bank may have similar functions to those of the main bank in Japan. However, the banks' collusion with borrowing firms through equity holdings is strictly prohibited in the U.S.. In addition, their transaction relationship is rather different in that it dominates all the banking transactions of the firms.

Furthermore, senior executive officers of US commercial banks are sometimes appointed as the outside directors of big non-financial firms. By taking advantage of this position, they can

control the firm and gain access to the firm's insider information. But their use of the power and information that are acquired through the outside director of the firm for the interest of their bank is totally prohibited. Moreover, the banks' access and use of the firms' insider information is strictly controlled by the insider transaction regulations, and the banks' monitoring activities over the business performance and financial conditions of the borrowing firms do not seem to be conducted as much as in Japan and Germany. As a result, the banks are forced to ensure the safety and soundness of the loan by restricting financial activities of the firms through the imposition of detailed covenants. In any case, in the U.S., banks are legally more separated from firms, and the banks' coordination with the firms is not permitted as opposed to Japan and Germany.

(b) Can banks intervene in the management of distressed firms?

Secondly, the banks' involvement in the corporate management of the borrowing firms or the feasibility of the banks' rescue activities to the troubled firms will be explored in a comparative perspective. Generally speaking, it depends heavily on the statutory treatment of bad loans in their home country. The question is when bank loans to a troubled firm are identified as "bad" or "deteriorated", and when and how the banks are required to make provisions against these bad loans? The answers differ from country to country, reflecting the differences in the statutory framework for loan loss provisions.

In Japan, detailed criteria for bank loan losses are

prescribed by tax regulations, which state that banks can make provisions against or write off bad loans if and only if the borrowing firm goes bankrupt either legally or virtually. Thus, even though the firm actually falls into insolvency, it is regarded as solvent as long as the banks continue to supply liquidity sufficiently in the form of extending rescue loans and the consession of principal and interest repayment so that its debts are serviced. The bank loans extended to such a liquid but de facto insolvent firms are not recoginised as bad in Japanese tax regulations, and banks are thus not required to make provisions against these loans when they decide to give their financial assistance.

In other words, bank loans are regarded as safe by the Japanese tax regulations even in the case of the actual deterioration, as far as banks give financial assistance to those distressed firms in the hope of their better performance in the future. As a result, banks have to bear no burden of making provisions while they continue to provide sufficient liquidity, and this makes a statutory rationale for Japanese banks to intervene in and extend financial assistance to troubled firms. Moreover, should the distressed firm go bankrupt despite the financial assistance by banks, the repayment order or the seniority of bank loans among the firm's total debts would not be affected. That is, in Japan the banks' rescue activities to the distressed firms are beneficial to the banks themselves. A statutory framework behind this helps to endorse a financial assistance led by the main bank.

In Germany, firms' internal coordination with banks is also

statutorily permitted in the same way as in Japan. German banks can make provisions against bad loans principally at their own discretions, since the loan loss criteria in Germany are not precisely stated in the Commercial Law, which permits banks some discretion. Thus, no restrictions are statutorily imposed on the financial assistance to a troubled firm in Germany, and most of the auguments about the Japanese case can be applied to German's without major revisions.

It is frequently pointed out that four major banks as the hausbank take measures to financially back up the reorganisation of a troubled firm. In this respect some academics argue that the hausbank in Germany has similar functions to those of the main bank in Japan. But their ways and means of giving financial assintance are markedly different from those in Japan, reflecting the German's traditional view that the bankruptcy risk of a firm should be borne by the equity holders themselves. That is, the hausbank's financial assistances to a distressed firm are usually given through the acquisition of equity-related instruments. They are mainly consisted with underwritings of new equities, granting of subordinated loans and the swap transactions between loans and equities, all of which are regarded as the risk capital provided by the equity holder and subordinated to other claims when the distressed firm goes bankrupt.

The US statutory framework on the firms' collusion with banks is completely different from that in Japan and Germany. The reorganisation of a troubled firm led by banks is virtually impossible in the U.S. because of the legal doctorine called 'equitable subordination'. This doctorine prescribes that all

the claims held by those banks involved in making of the reorganisation plan are regarded as those of insiders and their repayment order is subordinated to other claims in spite of the contractual seniority as secured credits, if the reorganisation of a particular firm fails. In the case that the banks take measures to endorse the rescue or reorganisation of the troubled firm at their own discretion, they run the risk of subordination of the loan repayment on the doctorine of equitable subordination or of being sued by other creditors who claim that the banks have been given a preferential treatment to their debts vis-a-vis other debts. The equity holding by a bank holding company could be cited as an evidence for the banks' intervention. Thus, the bank holding company is forced not to invest in the equities of non-financial firms to which affiliated banks give loans.

Furthermore, the loan loss criteria in the U.S. are strictly enforced such that when the repayment of principal and interest on loans including the rescue loans fall into arreas for some specified period, the loans are recognised as bad and the banks are required to make provisions against these loans. These statutory treatments of bad loans in the U.S., in addition to the equitable subordination, limit the banks' timely and effective financial assistance to the distressed firms. The banks have no other choices than imposing detailed covenants to ensure that the financial deterioration of the borrowing firm can be limited in a permissible range.

5. Conclusion

This paper has examined distinctive features of the main bank system in Japan. From the viewpoint of a dual contract between the main bank and the borrowing firm in finance and control, it has analysed the institutional aspects of the Japanese main bank system in a comparative perspective and has identified some distinctive characteristics. The main conclusions of this paper may be summarised as follows.

Firstly, the main bank system in Japan can be viewed as a dual contract in finance and control. To meet the huge demand of customer firms, the main bank organise a de facto loan consortium by allowing other participating banks to take a free ride on its monitoring activities. And the rescue activities of the main bank extended to distressed firms can be regarded as measures to ensure the credit worthiness of the loan, which has ben initially commited to other banks. Furthermore, the main bank usually holds the equity of a borrowing firm up to the maximum limit and tries to stabilise the management's control over the firm as a major but silent equity holder.

Secondly, the statutory scheme in Japan is designed to permit a collusion between banks and firms that reflects the dual contract nature of the main bank relationship. That is, Japanese banks are allowed to hold the equity of borrowing firms, and also encouraged to give financial assistance to troubled firms by the regulatory policy of the Government.

Thirdly, the Japanese main bank system is different from the hausbank in Germany and the line bank in the U.S. in that it is

a de facto loan consortium, and all the banking transactions are alloted to the participating banks on their loan-share basis whereas the hausbank and the line bank generally dominate all the transactions. In Germany, the hausbank is also permitted to extend rescue measures to the distressed firms, but the instruments of financial assistance are markedly different from those of Japan; capital increases, subordinated loans are actively adopted with the belief that the bankruptcy risk should be borne by the equity holder. In the U.S., bank-led reorganisation activities are difficult to implement. Because of the doctorine of equitable subordination, should the firm fail, their loans would have to be subordinated in repayment.

Finally, in a rapidly changing financial environment, the main bank system itself might develop a new bank-customer relationship. Yet, as far as the present statutory scheme and the bank supervision policy remain unchanged, the main bank system would continue to perform an important role in channelling the funds through the bank-loan market and stabilising the corporate control in the capital market.

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