Japan: Formalization of Banking Supervision Including a Reversal

3.1 INTRODUCTION

Japan introduced formal banking supervision earlier than most other developed countries. As detailed later, the first modern banking system in Japan was basically a copy of the United States (US) national banking system. The US National Bank Act included provisions for formal banking supervision, and thus the Japanese government also included provisions for a formal banking supervisory system when it created the banking system with the National Bank Decree in 1872. During the Edo period (1603–1868), before the introduction of the modern banking system, *Ryōgae* (financial merchants) provided several financial services including remittance, exchange, and loans. The issuance of remittance bills to reduce the cost of carrying gold/silver coins between Tokyo and Osaka and significant lending to feudal lords (*Daimyō-gashi*) provided most of the business of the financial merchants. However, their activity differed from that of the modern banking sector in that the financial merchants did not operate proper deposit-taking businesses including elements such as term deposits and current deposits.

While the history of Japanese banking supervision is highly relevant for developed countries, few studies have been published in English and

Table 3.1 Japan's population and gross domestic product, 1885–1920 (5-year intervals)

<i>Year</i>	<i>1885</i>	<i>1890</i>	<i>1895</i>	<i>1900</i>	<i>1905</i>	<i>1910</i>	<i>1915</i>	<i>1920</i>
Population ('000s)	38,313	39,902	41,557	43,847	46,620	49,184	52,752	55,473
GDP (million USD)	33,052	40,556	46,933	52,020	54,170	64,599	75,952	94,654
Per capita GDP	863	1,016	1,129	1,186	1,162	1,313	1,440	1,706

Source Population: Bank of Japan (1966); GDP: Maddison Historical Statistics, Maddison Database 2010, <https://www.rug.nl/ggdc/historicaldevelopment/maddison/releases/maddison-database-2010>, accessed on 18 April 2020

limited information is available.¹ The purpose of this chapter is to identify the driver of the formalization of banking supervision in Japan by tracing the formalization process that began with the introduction of the national banking system and that was completed with the enactment of the Banking Act of 1927. Additionally, this chapter focuses on the creation of an independent agency for banking supervision within the Ministry of Finance.

Because the formalization of banking supervision in Japan included a reversal, this chapter also examines the cause of this reversal and how the reversal transformed formal banking supervision after its reintroduction in 1915–1916.

3.2 DEVELOPMENT OF COMMERCIAL BANKS

In Japan, a significant increase in the number of commercial banks, the enhanced position of commercial banking in the national economy by the early twentieth century, and a policy of rapid industrialization facilitated by the Industrial Revolution provided the background for the formalization of banking supervision (see Table 3.1).

As Tamaki (1995: 21–45) noted, a modern banking system was introduced to Japan following the Meiji Restoration in 1868 and quickly

¹See, for example, Allen et al. (1938: 279–300), Ehrlich and Tamagna (1954: 532–545), Hotori (2011), and Hotori and Wendschlag (2019).

developed via multiple paths. Commercial banks, exchange companies, lending companies, savings associations, and regional development companies were the main financial institutions before the banking system was formalized and integrated in the 1890s. The commercial banks were especially important in relation to the emergence of the modern Japanese banking system. The commercial banks (officially known as *ordinary banks*) were derived from two streams—*Kokuritsu Ginkō* and *Shiritsu Ginkō*.² The former was basically modeled on the US national banking system, whereby each bank took deposits, provided loans, and issuing its own banknotes. The number of banks (*Kokuritsu Ginkō*) increased to 150 during the boom of 1877–1879; to maintain the value of their banknotes, the establishment of new banks was no longer permitted after 1879. Furthermore, the creation of the Bank of Japan in 1882 saw the centralization of note-issuing.³ Each *Kokuritsu Ginkō* was transformed into a commercial bank by 1899, and these constituted a significant share of the commercial banking sector. The *Shiritsu Ginkō*, which were mostly the successors to the financial merchants who operated in the Edo period (1603–1868), provided deposit and loan services. The number of banks increased from 1880 onwards, especially during the first industrial boom (1886–1889) and the Sino–Japanese War boom (1894–1896). Under the Bank Decree of 1890, each *Shiritsu Ginkō* was formally categorized as a commercial bank.

The number of commercial banks (*ordinary banks*) peaked at 1,890 in 1901 (Goto 1970: 56–57), and by 1910 there were 1,600 commercial banks operating a total of 3,300 offices, which meant that the average population per office was approximately 15,000 (see Table 3.2). This meant that even the general public could access commercial banking services (deposits and loans) within their community (town or city) from around 1910.⁴ Most importantly, the total deposits of the commercial banks increased more than 14-fold from 1895 to 1910 (Bank of Japan 1966: 198–199) as the Japanese commercial banks were gradually transformed into deposit-taking banks during the 1900s.

²The main founders of *Kokuritsu Ginkō* were feudal lords and *samurai*, while the main founders of *Shiritsu Ginkō* were wealthy merchants and farmers (Tamaki 1995: 36–45).

³See Schiltz (2006) for further details.

⁴By 1920, the population of every city in Japan exceeded 20,000 (Bank of Japan 1966: 14–15).

Table 3.2 Development of ordinary banks, 1895–1910 (5-year intervals)

<i>Year</i>	<i>1895</i>	<i>1900</i>	<i>1905</i>	<i>1910</i>
Number of banks	792	1,802	1,697	1,604
Number of bank offices	1,069	3,176	3,112	3,301
Population per bank office	38,875	13,806	14,981	14,900
Aggregate assets of banks (million yen)	140	715	1,009	1,561

Source Ministry of Finance (1896, 1901, 1906, 1911)

Around the turn of the century, *zaibatsu* banks rose to prominence in the Japanese economy, especially in the commercial banking sector. Five major *zaibatsu* banks (Mitsui, Mitsubishi, Sumitomo, Yasuda, and Daiichi) accounted for 17.2% of all loans and 21.5% of all deposits in 1910 and accounted for more than 25% of both loans and deposits by the 1920s (Goto 1970: 86–93). The main activities of the *zaibatsu* banks varied. While Mitsui Bank and Mitsubishi Bank provided loans to their group companies (e.g., trading, mining, cotton spinning, and shipping companies), Yasuda Bank focused on business activities involving national and state governments such as underwriting public bonds. This strategy eventually enabled Yasuda Bank to expand its market share by amalgamating failed country banks following an informal rescue request from the government (Kato 1970).

Following the Taisho bubble economy period (1915–1919), the banking sector suffered a series of financial crises in 1920, 1922, 1923, 1927, and 1930. Many banks were either bankrupted or purchased by larger banks, and the number of commercial banks decreased from 1,794 in 1922 to 680 in 1931 (Kato 1957: 278–279). The Showa financial crisis of 1927 was particularly serious and led to a run on banks throughout the country, and not only small banks but also several large banks (Jūgo Ginkō, Oumi Ginkō, Fujita Ginkō, and Kajima Ginkō) were forced to suspend their business. Following these crises, the surviving banks were forced to become more conservative in line with the prudential recommendations of the bank supervisors (Ministry of Finance), and thus the Japanese banking system did not experience any further serious financial crises until 1997.

While the banking sector has been a major component of the Japanese financial system since 1872, the stock market (especially the formal

market) remained inactive until the financial “Big Bang” (1996–2001).⁵ Although the Tokyo Stock Exchange was created in 1878, the trading volume was dominated by futures transactions. Shimura (1969: 38–42) noted that the volume of futures transactions was much larger than that of physical-delivery (spot) transactions.⁶ The defectiveness of the formal stock exchange and lack of related institutions such as reliable investment banks meant that many companies (e.g., textile, mining, and trading companies) preferred to do business with commercial banks (particularly when seeking loans). Even railway and electricity companies partially depended on loans from commercial banks to avoid the high cash dividend payments that accompanied increases in capital through the stock market. The aggregate assets of the commercial banks increased tenfold from 1895 to 1910, reaching 1,600 million yen in 1910, while the ratio of aggregate assets to GNP increased from 11 to 54% during the same period (Bank of Japan 1966: 32, 198–199). In the early twentieth century, the interests of the commercial banks became increasingly intertwined with the development of modern industries and with middle-class people’s daily business.

3.3 THE DEVELOPMENT OF COMMERCIAL BANKING REGULATION

Commercial banking regulation was gradually introduced to Japan in the second half of the nineteenth century. With the National Bank Decree of 1872, the organization of the Japanese banking system (*Kokuritsu Ginkō*) was modeled on the US national banking system. Similar to the US guidelines, the National Bank Decree of 1872 set out the terms in relation to the issuance of national bank notes, limited large loans to

⁵In Japan, the informal stock market was presumed to be larger than the formal stock market. However, it remains unclear whether the banking sector or the informal stock market was more important in relation to the Japanese financial system (Bank of Japan 2012).

⁶In 1920, there were 152,312 futures transactions and 17,464 spot transactions (Shimura 1969: 39). When the Tokyo Stock Exchange resumed operations in 1949, the US General Headquarters of the Allied Forces prohibited futures transactions with the aim of developing the formal stock market.

certain borrowers,⁷ and included specific provisions for bank examinations (Articles 73 and 74). Under the Decree, the national banks were also required to obtain a bank license.

Following the establishment of the Bank of Japan in 1882,⁸ the issuance of banknotes was finally centralized with the establishment of a national currency, although regulatory power was not granted to the Bank of Japan. Following the creation of a central bank, the national banking system was abolished and the existing national banks were incentivized to convert to ordinary banks⁹ that essentially engaged in commercial banking. The most critical incentives to undertake this conversion was the deregulation of large loans to certain borrowers and much looser banking supervision, including the suspension of on-site examinations. During this period of lax bank regulation and supervision (1893–1914), the number of Japanese banks increased threefold, and this expansion was accompanied by a significant increase in problems related to insider lending (the “*Kikan Ginkō*” problem). Kasuya (2000: 8–28) detailed the transition of the Bank Decree from 1890 to 1916 and noted that Japanese bankers were slow to recognize the importance of systemic risk, even after the spectacular failure of the Hyaku-Sanjū Ginkō in 1904.

This historical journey provides an interesting example of the reversal of the institutionalization process. Similarities are apparent between this period in Japan and the antebellum period in the US that featured “free-banking.” The US Free Banking era coincided with the Industrial Revolution in the US, wherein the railway, shipbuilding, and telegraph industries developed rapidly. In the US, the Civil War was the trigger for introducing national banking. In Japan, the period of lax bank regulation and supervision coincided with the Meiji Industrial Revolution. Following this period of social and economic development and the advent of well-educated bankers, the outbreak of the First World War was the trigger for reintroducing prudential regulation and supervision.

The Ministry of Finance issued an official notice on 31 August 1901 stating that the government would no longer grant banking licenses to

⁷A large loan was limited to no more than 10% of the total capital of a national bank (Article 56).

⁸The Belgian central bank inspired the institutional setup of the Bank of Japan (Bank of Japan 1982: 119–120; Schiltz 2006).

⁹Commercial banks, which were established under the Bank Decree of 1893, were defined as “ordinary banks” by the government (Bank of Japan 1966).

newcomers. In addition to this administrative entry barrier, banking regulation was incrementally reintroduced from 1916 to 1927. For commercial banks, special disclosure rules, including a distinction between various types of loans, and the use of balance sheet and profit-and-loss statement templates were prescribed under the Bank Decree of 1916. Together with the Bank of Japan, the Ministry of Finance supported the existence of cartels among the commercial banks in each region in relation to deposit interest rates from December 1918.¹⁰ In 1923, the Ministry of Finance issued an official notice stating that commercial banks were no longer permitted to open a new branch office or agency except in the case of a merger. On 25 December 1924 (and each year thereafter until 1934), the Ministry of Finance issued an official notice recommending a reduction in the stock dividends paid by the commercial banks.

On 28 September 1926, the Financial System Research Committee was established to discuss the reform of bank regulation in Japan.¹¹ The committee was chaired by the Minister of Finance and comprised approximately 40 members including government officers from the Ministry of Finance, Ministry of Commerce, and Ministry of Agriculture, *zaibatsu* bankers, stockbrokers, members of the Diet (Parliament), and financial experts (academics). The top priority among many items on the agenda was the reform of the ordinary (commercial) banking system, and the committee's recommendations presented in November 1926 were mostly embodied in a new bank bill, *Ginkōhō* (the Banking Act), which was passed on 30 March 1927 (Bank of Japan 1956: 1–16). The banking crisis occurred in April 1927, and hence the Banking Act of 1927 was not the “product” of a financial crisis.

Under the Banking Act of 1927, the scope of the commercial banking business was basically limited to “proper” kinds of business—loans, deposits, and exchange services (i.e., there was a separation of the banking and securities businesses). With regard to multiple directorships, every bank director was required to obtain permission from the government

¹⁰Following the financial crisis of 1900, the deposit interest rate cartels began as a gentlemen's agreement among members of the bankers' association during the period of lax regulation and supervision. Following this period, the government “recommended,” that is, effectively forced, all commercial banks to establish deposit interest rate cartels (Okada 1987).

¹¹The committee, which was created by the government, discussed fundamental revisions of the Bank Decree of 1916 and significant enhancement of the banking supervisory system (Bank of Japan 1956).

(Article 13). Notably, the minimum capital requirement was increased from half a million yen to one million yen (Article 3), and the commercial banks were forced to comply with this regulation. Furthermore, the commercial banks were now obliged to submit their financial statements to the Minister of Finance for inspection. If an error was found, the government issued an official guidance to correct the error. Legal sanctions, including fines and imprisonment, were applicable in relation to breaches including accounting fraud and window dressing.

A bank consolidation policy was also implemented under the Banking Act of 1927, and the Ministry of Finance dispatched its officers (bank examiners) to commercial banks to provide “constructive advice” together with officers of the Bank of Japan as well as officers of the financial division of the local government in the area where negotiations regarding bank mergers were taking place. There were more than 600 amalgamations between 1927 and 1932.¹²

The formalization of the regulatory system for commercial banks in Japan was completed in 1927 (see Table 3.3).¹³ Entry barriers, branch opening restrictions, regulation of the services provided through the banking business, and special disclosure rules remained the main banking regulatory measures until the next major revision of the Banking Act in 1981.¹⁴

3.4 FORMALIZATION OF THE BANKING SUPERVISORY SYSTEM

The formalization of banking supervision in Japan began in the second half of the nineteenth century (see Table 3.4). The Ministry of Finance had been responsible for licensing banks under the national or ordinary banking system since 1872. The first official on-site examination of the First National Bank of Tokyo was conducted in 1875. However, neither a specific organization nor a specialized post for banking supervision was created within the Ministry of Finance until 1915. Officers

¹²Okazaki and Sawada (2007) empirically identified a positive effect of the bank consolidation policy in the form of increased deposits from the public, while the banks’ return on assets deteriorated in several cases following amalgamation.

¹³See Hotori (2006: 46–87) for further details.

¹⁴Financial deregulation in Japan mainly occurred in the 1980s and 1990s (Hotori 2016b).

Table 3.3 List of major bank regulations (up to December 1927)

<i>Type of bank regulation</i>	<i>Content of regulation</i>	<i>Year introduced</i>
Bank entry regulations	New entry was not allowed under the bank licensing system operated by the Ministry of Finance	1901
Special disclosure rules	Special balance sheet and profit-and-loss statement templates were prescribed	1916
Arrangements for deposit interest rate cartels	The Ministry of Finance “recommended,” that is, effectively ordered, ordinary banks to organize deposit interest rate cartels	1918
Bank branch regulations	Opening of new branches was rigidly regulated by the Ministry of Finance	1923
Limitations on stock dividends	The Ministry of Finance recommended that ordinary banks reduce their stock dividends	1924
Restrictions on multiple directorships	Every bank director was required to obtain permission to serve as a director of another company	1927

Source See the text

from the Ministry of Finance engaged in multiple tasks such as taxation-related activities, and hence were not properly trained to act as examiners or supervisors.¹⁵ These multiple roles in relation to fiscal and monetary policy strengthened the Ministry of Finance’s influence over the banking sector and eventually led to abuses of power and corrupt behavior by officers (especially in the 1990s).¹⁶ The commercial banks were not charged any examination fee because the costs of banking supervision such as travel expenses for on-site examinations were covered by tax revenue, unlike the situation in the US and Sweden.

In August 1915, a specialized bank inspection position was established, and in April 1916, the Banking Bureau was recreated within the

¹⁵There is no archival evidence explaining why the Japanese government did not create the independent supervisory authority similar to the OCC in the US.

¹⁶Notably, most of the former bank examiners were not corrupt (Hotori 2016a).

Table 3.4 Timeline of the formalization of banking supervision in Japan

<i>Year</i>	<i>Contents</i>
1872	Enactment of the National Bank Decree and creation of the modern banking system in Japan
1875	First official on-site bank examination by the Ministry of Finance
1893	Implementation of the Bank Decree and introduction of the formal ordinary (commercial) banking system
1893–1914	Lax bank regulation and supervision (e.g., no regular on-site examinations)
1915	Creation of a specialized bank inspection role and recommencement of regular official on-site bank examinations
1916	Creation of the Banking Bureau, enactment of the revised Bank Decree of 1916, and introduction of legal power of enforcement for bank examiners
1927	Enactment of the Banking Act of 1927, which strengthened the enforcement power, increased staff and budget for banking supervision, and increased the frequency of examinations (every 2 years), and creation of the Bank Inspection Section as part of the Banking Bureau

Source See the text

Table 3.5 Burden on Ministry of Finance Bank examiners (1915–1940, 5-year intervals)

<i>Year</i>	<i>1915</i>	<i>1920</i>	<i>1925</i>	<i>1930</i>	<i>1935</i>	<i>1940</i>
Number of examiners	6	6	22	72	63	59
Number of ordinary banks	1,442	1,326	1,537	782	466	286
Number of ordinary banks per examiner	240.3	221.0	69.9	10.9	7.4	4.8

Source Number of examiners: Hotori (2006: 99, 186); Number of ordinary banks: Ministry of Finance (1916, 1921, 1926, 1931, 1936, 1941)

Ministry of Finance, including the bank inspection position (Hotori 2006: 48, 54). Initially, there were only two examiners and four assistants, but these numbers gradually increased to eight and 22, respectively, by 1922 (Hotori 2011: 34). Accordingly, the number of ordinary banks per examiner decreased from 221 in 1920 to 70 in 1925 (see Table 3.5). However, the burden on the bank examiners remained heavy as the number of banks per examiner was almost the same as that of the US OCC examiners about twenty years before (in the 1900s). The number of banks per OCC examiner was 64 in 1907 (see Chapter 2 for further details).

Following discussions among the Financial System Research Committee in 1926,¹⁷ the Bank Inspection Section was created as part of the Banking Bureau in May 1927. Subsequently, the numbers of examiners and assistants increased to 18 and 54, respectively (see Table 3.5), which allowed the frequency of on-site examinations to increase to at least once every 2 years (see Table 3.6). Newly recruited officers were expected to have spent part of their career in a private company after having been educated at a commercial college (Hotori 2006: 94), and in 1927 these newly recruited officers received numerous lectures on subjects including banking and bookkeeping at the Ministry of Finance. Additionally, in 1928 the Bank Examination Division was created within the Bank of Japan, with the main aim of supporting the on-site examination activities of the Ministry of Finance.

Following a series of financial crises in the 1920s, most Japanese bankers came to understand the high cost of systemic risk, and thus *zaibatsu* bankers did not oppose the implementation of the new Banking Act of 1927, which contained much stricter regulations including a restriction on multiple directorships (Hotori 2006: 76–77). *Zaibatsu* banks were already well-capitalized and pursuing a relatively conservative strategy by 1927; therefore, the regulations introduced under the new Banking Act were initially aimed at smaller banks. The examiners were appointed from among high-ranking officers in the Ministry of Finance until 1942, when on-site examinations were suspended because of the Second World War.¹⁸

3.5 THE PURPOSE AND PRACTICE OF BANKING SUPERVISION

The Meiji Restoration in 1868 paved the way for the Japanese people's first experience with modern banking. Strange as it might seem to contemporary readers, the main purpose of a bank examination was the “education” of bankers,¹⁹ that is, training the bankers in relation to

¹⁷See Bank of Japan (1956: 375–397) for further details.

¹⁸Hotori (2016a) elaborated the profiles of bank examiners from 1927 to 1998.

¹⁹Who educated the supervisors? A Scottish banker, Alexander Shand, was hired by the government to teach and demonstrate the process of bank examination. The textbook “On banking” (1877), which was edited by Shand, was translated into Japanese, and knowledge regarding prudential practice was shared among officers of the Ministry of Finance. In

Table 3.6 Frequency of on-site bank examinations by the Ministry of Finance in Japan (1915–1934)

<i>Year</i>	1915	1916	1917	1918	1919	1920	1921	1922	1923	1924
Number of exams	38	80	69	44	36	5	70	118	65	105
Number of banks	2,099	2,091	2,062	2,039	2,001	1,987	2,001	1,945	1,840	1,765
Frequency (years)	55.2	26.1	29.9	46.3	55.6	397.4	28.6	16.5	28.3	16.8
<i>Year</i>	1925	1926	1927	1928	1929	1930	1931	1932	1933	1934
Number of exams	93	53	20	421	461	96	205	154	204	135
Number of banks	1,670	1,544	1,396	1,131	976	872	771	625	601	563
Frequency (years)	18.0	29.1	69.8	2.7	2.1	9.1	3.8	4.1	2.9	4.2

Notes Frequency refers to the expected interval between on-site examinations of a particular bank. The number of banks includes both savings and ordinary banks
Source Hotori (2011: 34)

practices such as double-entry bookkeeping, risk management, and distinguishing between deposits and capital. Thus, the banking supervisor was initially engaged in providing organizational learning for the commercial banks rather than banking supervision. Daiichi Bank (1957: 214–235) documented the earliest bank examiner's report of their examination of the First National Bank of Tokyo in 1875.²⁰ The on-site examination was directed by Alexander Shand, who was the Secretary for the Ministry of Finance at the time.²¹ Many of the points made in his examination report concerned the proper and prudent management of the bank's affairs. As could be expected, Japanese banks experienced numerous problems in relation to their banking business and operations in the early stages, and examiners primarily endeavored to detail the problems of each bank as clearly as possible, and provide instructions on how to address these problems. The priority for on-site bank examinations was the inspection of ledgers and the provision of instructions on correct bookkeeping practice, which was a crucial part of the British principles of prudence as taught by Shand and his staff. For example, bank examiners visited the 26th National Bank of Osaka and found evidence of fraudulent accounting in relation to the capital account involving the inclusion of some large deposits from ex-feudal lords.²² The bank was required to correct the ledger based on "advice" (which was nearly a threat) from the chief bank examiner and was also recommended to dismiss the director in charge.

If necessary, the Ministry of Finance appointed an officer to the board of a problem bank. For example, Shuzo Toyama, a former bank examiner of the Ministry of Finance, was appointed as the president of the 32nd

1882, the Ministry of Finance created the College of Banking and Commerce, where prudence was taught. See Hotori et al. (2018: 115) for further details.

²⁰Alexander Shand, Report on the First National Bank of Tokyo, 5 February 1875, *Documents on Bank Examination of the First National Bank of Tokyo*, Ministry of Finance, Okuma Shigenobu Collection, A1126-1, Waseda University Library: Tokyo.

²¹Although the model for the national banking system was that of the US, Shand was a Scottish banker who had never worked for a US bank. Later, he became a director of Parr's Bank in the UK (Tsuchiya 1966).

²²Nagaaki Tsutsumi and Shuzo Toyama, Examiners' Letter regarding the 26th National Bank of Osaka, 24 October 1878, *Documents on Bank Examination of the Three Banks (The 16th National Bank of Gifu, The 32nd National Bank of Osaka, and the 26th National Bank of Osaka)*, Ministry of Finance, Okuma Shigenobu Collection, A1167, Waseda University Library: Tokyo.

National Bank of Osaka under an informal order from the Minister of Finance in January 1879 to supervise the reconstruction of the bank.

The examination trip in the early period was quite tough, since there was no nationwide railway network until the 1890s. Harada Sekizen-kai (1938) documented a diary of one examination trip schedule from April to May 1875 directed by Jiro Harada (Table 3.7). This material indicated that on-site examination was carried out during two or three days per national bank, and the main focusing points were inspection of ledgers, instruction on bookkeeping, and check of large loans and/or insider lending. If an error or a fault was identified through the examination, bank examiners instructed the bank how to correct. Examiners spent more time in headquarters than in branches, and on branch visit examiners often found the old fashion Japanese ledgers—single bookkeeping with secrecy (*Dai Fuku-chō*). These bank examinations were to be unannounced, yet bankers could predict an approximate visit date, once they had arrived at their first destination.

Following the aforementioned period of lax or no on- and off-site examinations in the late nineteenth century and early twentieth century, the financial crises of 1900 and 1907 led more bankers to understand the importance of systemic risk. Shibuya (1975) documented a series of special bank investigation reports of the Ministry of Finance that covered failed or badly performing banks. These reports illustrated the seriousness of the financial crises that occurred during the period 1907–1914. It was subsequently reported (Anonymous 1914: 6–8) that a number of bankers had called for the resumption of the on-site examination system. The period of lax supervision led to some hard-earned lessons for Japanese bankers in relation to identifying systemic risk in the financial markets, and the gradual maturing process that occurred around the turn of the century brought about a positive transformation in the supervisor's role in relation to the banking system. In addition to the financial crisis of 1914, the outbreak of the First World War prompted a return to the banking supervisory system by the Ministry of Finance (Hotori 2006: 48).

At this point, the nature of the supervision changed from the education of bankers to proper prudential supervision. In 1915, the Ministry of Finance recommenced on-site examinations, and the Banking Bureau was created in 1916. Strict sanctions were also introduced in an effort to force bankers to comply with the examiners' orders. These sanctions were reinforced by the enactment of the Banking Act of 1927, which included provisions for the forcible replacement of bank directors and possible

Table 3.7 Bank examination trip of Harada's group (April–May 1878)

<i>Date</i>	<i>Name of examined banks</i>	<i>Contents of examination</i>
1 April	The 13th National Bank of Osaka	<i>Inspection:</i> cash, loan, time deposit, and current deposit
2 April		<i>Inspection:</i> dairy ledger and general ledger
4 April	The 32nd National Bank of Osaka	<i>Instruction:</i> correct bookkeeping
5 April		<i>Inspection:</i> cash, time deposit, and current deposit
6 April		<i>Inspection:</i> loan and collateral, warehouse
		<i>Inspection:</i> ledgers
15 April	The 1st National Bank of Tokyo (Osaka branch)	<i>Instruction:</i> correct bookkeeping
16 April		<i>Inspection:</i> cash, loan and collateral, time deposit
		<i>Inspection:</i> current deposit, accommodation bill, and commercial bill
17 April	The 17th National Bank of Fukuoka (Osaka branch)	<i>Inspection:</i> old fashion Japanese ledgers (<i>Dai Fuku-chō</i>)
18 April	The 3rd National Bank of Tokyo (Osaka branch)	<i>Vigilance:</i> large loan (10,000 yen)
		<i>Inspection:</i> cash, loan, time deposit
		<i>Probe:</i> main business of the bank manager
19 April	The 34th National Bank of Osaka	<i>Probe:</i> main business of the bank president and director
		<i>Instruction:</i> correct bookkeeping
20 April	The 32nd National Bank of Osaka (Sakai branch)	<i>Inspection:</i> old fashion Japanese ledgers (<i>Dai Fuku-chō</i>)
22 April	The 5th National Bank of Tokyo (Osaka branch)	<i>Inspection:</i> cash, time deposit, current deposit, ledgers
25 April	The 1st National Bank of Tokyo (Kobe branch)	<i>Inspection:</i> cash, national bond, loan, time deposit, and current deposit
		<i>Probe:</i> contents of special loans at the open port of Kobe
4 May	The 26th National Bank of Osaka	<i>Inspection:</i> ledgers
7 May		<i>Interview:</i> with the general manager and chief clerk of the bank
12 May	The 25th National Bank of Obama (Fukui)	<i>Inspection:</i> cash, loan, time deposit, and current deposit
		<i>Vigilance:</i> large loan (22,000 yen)

(continued)

Table 3.7 (continued)

<i>Date</i>	<i>Name of examined banks</i>	<i>Contents of examination</i>
15 May	The 21st National Bank of Nagahama (Shiga)	<i>Vigilance:</i> substance of collateral and loan-to-value ratio <i>Inspection:</i> cash, loan, ledgers
		<i>Vigilance:</i> unsecured large loan (17,000 yen) and insider lending

Notes In addition to bank examination, Harada visited four rice market companies in Dojima (8–13 April), Hyogo (26–27 April), Shichijo (2 May), and Oumi (10 May) for inspection of ledgers, clearing margin, etc.
Source Jiro Harada, The Diary of Bank Examination Trip to Kyoto, Osaka, Hyogo and Shiga, contained in Harada Sekizen-kai (1938: 499–544)

imprisonment for a period of up to one year. An important suggestion, that a summary of the bank examination report should be made available to the public each year to discourage banks from engaging in excessive risk-taking, was also discussed in the Financial System Research Committee on 19 November 1926. However, the suggestion, which was designed to promote banks’ self-disciplinary behavior, was not pursued because of the perceived risk of the public mistakenly assuming that the Ministry of Finance guaranteed the soundness of banks that had been examined (Bank of Japan 1956: 380–384). This meant that the bank examination system in Japan differed from the private auditing system typically adopted in Continental Europe, such as in Switzerland. Instead, commencing in 1935, the commercial banks were required to submit confidential reports including an explanation of the banks’ risk management measures (Hotori 2011: 37–38).

The main objective of bank examinations during the period 1915–1934 was to ensure the soundness of banks by minimizing the incidence of bad loans and insider lending (Hotori 2011: 36–37). To achieve this objective, the conduct of an on-site bank examination was fully detailed through 42 provisions in the bank examination manual. The focal points of an on-site examination were summarized as follows:

- a. to identify any violation of laws, guidelines, or articles of incorporation
- b. to evaluate management and business performance

- c. to confirm the details of the bank's assets
- d. to investigate any close relationships between the bank and companies or individuals.

Specifically, bank examiners were required to look for evidence of insider lending with any special conditions such as low-interest loans. For example, bank examiner of the Ministry of Finance, Makoto Okada, pointed out much amounts of insider transactions (borrowing) between the vice-president, Kahichi Yamazaki, of the Daihachijū-go Bank in Kawagoe (25 km northwest of Tokyo). In response, the president of the bank directed to reduce such transactions, and the rest of insider transactions should be audited by the internal auditors.²³

Due to the financial crises in the 1920s, the Ministry of Finance got more cautious about bad loans and insider lending. There are many examples to show this—we just introduce a case of medium-sized regional bank, Seibu Bank in Chichibu (50 km northwest of Tokyo).²⁴ Through bank examination on Seibu Bank taking place in October 1931, bank examiners classified the bank's doubtful loans by uniformed category as: (1) uncollectible, (2) delayed repayment, or (3) need early collection. In addition, examiners identified huge amount loan (one-fourth of all loans) with applying special lower interest rate to the president of the bank, Manzo Kakiyama. On 18 June 1932, the business improvement order was issued to Seibu Bank, and the bank was obliged to submit a monthly report on the disposal of those problem loans to the Ministry of Finance.

The bank examination manual also contained the sequence to be followed during the on-site examination: (1) cash and securities, (2) bills, notes, and paper, and (3) books and records. Moreover, the Ministry of Finance provided every examiner with official pre-printed forms on which they were required to record the bank's assets, liabilities, and other key information (e.g., insider lending lists).

Kiyoji Hoshino (1893–1979), whose father was a merchant of a Sake brewing company, and a graduate of the University of Tokyo, entered the

²³Daihachijū-go Bank, Response Report on Bank Examination, 25 November 1916, *Documents on Bank Examination of the Daihachijū-go Bank*, Prefectural Bureau of Banking and Industry, Administrative Materials, Tai970G, Saitama Prefectural Archives: Saitama.

²⁴Seibu Bank, Response Report on Bank Examination, 23 October 1932, *Documents on Bank Examination of Seibu Bank*, October 1931–February 1935, Materials Collection of Saitama Bank, No. 78, Saitama Prefectural Archives: Saitama.

Ministry of Finance in 1918. After working initially as a bank examiner, he was promoted to the Director of the Bank Inspection Section. In October 1937, he made a speech on bank examination to country bankers, which provides details of bank examination and its philosophy at that time.²⁵

First, the “protection of depositors” was de novo emphasized as the main purpose of bank examination. This reflected the increase of middle-class depositors as the result of the economic growth. *Second*, the main role of bank examiners shifted from education to consultation with bankers regarding their management. On this issue Hoshino stated that:

Cooperation between bankers and examiners was indeed important. Without hesitation bankers should ask examiners the ways of improvement. Examiners shared similar ‘mindset’ with banks which enabled improvement... A bank examiner was just like a ‘doctor’. Although ‘a good medicine sometimes tastes bitter’, bankers should follow the examiners’ advices after on-site examination.²⁶

Third, Hoshino stressed the following lending items should be examined carefully: bad loans, large loans, and insider loans. Especially, insider loans were the most “troublesome” because the directors were tempted to break the rules of sound banking. In his view, bank failures had been caused by such bad insider loans. To make matter worse, if a bank had already given insider loans, non-insider borrowers blamed such bank management to avoid collection.

Hoshino’s speech represented the shift in the nature of bank examination. The priority of bank examination changed to reflect growing concerns over the insider loans (and large loans at the same time). The enhanced stricter sanctions introduced in 1927 made it simpler for examiners to instruct bankers for improvement of the bank management.

The on-site examination took approximately 1 week for an average-sized bank, and the arrival of the examiners was supposed to be a surprise, although some bankers were able to receive early warning of an impending visit through their community network, such as a call from

²⁵Hoshino gave the speech for two days (11–12 October 1937). See Hoshino (1967: 1–64).

²⁶Hoshino (1937: 15–20, 62–63).

a hotel or railway station.²⁷ A typical on-site examination proceeded as follows. The first day was spent checking cash and securities held in the bank's safe, and the relevant pre-printed forms were required to be completed by the chief examiner. The second day was dedicated to examining the books, records, and forms kept by the bank's head office. The third and fourth days were spent conducting interviews with the managers of the bank's major branch offices. The fifth day was dedicated to interviews with the president and directors of the bank, wherein they were presented with any formal queries generated by the bank examination. On the sixth day, the bank submitted their response to the aforementioned queries (Hotori 2006: 102).

* * *

The main driver of the formalization of banking supervision in Japan was not a financial crisis. The gradual development of the banking sector and better-educated bankers in the early twentieth century provided the background for the positive transformation of the supervisor's role.²⁸ The major trigger for the introduction of formal banking supervision was the outbreak of the First World War, which made it necessary to minimize confusion among depositors.²⁹ The costs of banking supervision such as travel expenses for on-site examinations were covered by tax revenues. The political rationale for formalizing and enhancing banking supervision was the government's desire to protect small depositors at a time when the universal suffrage movement was becoming widespread.³⁰ Notably, the Japanese case shows that not only the supervisors' but also the bankers' good understanding of systemic risk enabled the implementation of supervision because it included a reversal of the formalization process³¹ that was in place in the decades prior to the First World War.

²⁷The frequency of on-site examinations was approximately once every 2 years (see Table 3.5). This interval also helped the bankers to predict the likely date of arrival of the examiners.

²⁸Hotori and Wendschlag (2019: 216–217) detailed this aspect of the development of the Japanese economy.

²⁹Transcript of a speech by Minister of Finance Reijiro Wakatsuki in April 1915.

³⁰Universal suffrage was introduced in Japan in 1925 (Takeda 1992: 241–245).

³¹The suspension of on-site bank examinations from 1893 to 1914 and the bank deregulation implemented in 1895 represented a reversal of the process of formalization of banking supervision.

Essentially, the formalization of banking supervision in Japan was largely a process of maturation, including a reversal, which aligned with the incremental change approach.

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