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Abstract

This paper analyzes the events surrounding the takeover of the nationalized Long Term Credit Bank (LTCB) of Japan by the foreign Ripplewood Holdings Incorporated in the context of the preceding "Big Bang" financial reforms and the subsequent two decades. The paper argues three main points: First, that the creation of Shinsei Bank owned and operated at first by foreigners allowed the Japanese government to use a kind of "invited *gaiatsu*" to navigate the politically sensitive collapses of heavily indebted companies in the early 2000s. Second, that the foreign takeover of a Japanese bank led to meaningful change in the financial industry in Japan, even though that bank has not had material success. These two points are then followed by the third, that the cost of the political cover and beneficial financial reform was the large profit extracted by the foreign Ripplewood.

Keywords: Japanese Banks, Japanese Financial Reform, Shinsei, LTCB, Gaiatsu

1 Introduction

Gillian Tett, a reporter for the Financial Times of London, documented the takeover of Long-Term Credit Bank (LTCB), a prestigious and large Japanese bank, by the US-based fund Ripplewood Holdings (Ripplewood) in early 2000 in her book "Saving the Sun" (Tett, 2004). Two decades after that takeover, Shinsei Bank, the name given to what LTCB would become, is still in operation but its US investors are (largely) gone, its stock price did not perform well after its initial public offering (IPO), and it is again in the news as a target of a takeover. Shinsei's IPO was a success from the company's perspective, but in the roughly two years following the IPO, leading up to the Global Financial Crisis (GDC), Shinsei's market capitalization remained largely unchanged, while the four bigger banks (Mitsubishi UFJ, Sumitomo-Mitsui, Mizuho, and Aozora) approximately tripled in size.

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In 2003 Shinsei was the fifth largest bank in Japan with the strongest capital ratio (Collins, 2003), in the two decades since, it has mostly remained 5th largest, with only brief periods when it has slipped to 6th (behind Resona). Questions remain about what happened during that time: Ripplewood made billions on their involvement in the deal, but no domestic investor was willing to participate (Tett, 2004). Why was no domestic entity willing to buy LTCB, given the large available? The Japanese government was persuaded to include a "put" option into the deal allowing Ripplewood to effectively sell the loans back to the government (who had nationalized LTCB) if losses exceeded a certain amount. Did the Japanese Government underestimate the aggressiveness that Ripplewood would use in exercising the put option? Were domestic actors reluctant to participate, even with the available "put" option because they may have been more susceptible to gentle pressure from the government to continue to provide funds to failing companies rather than utilizing the "put" option. Was there any other pathway that the government could have chosen?

2 General Background

After the Nikkei crashed in 1989 and the subsequent bubble bursting in the 1990s, Japan's financial system struggled to cope with the new era. There were bankruptcies, bad loans on banks' books, and pressure from regulators to provide funds to so-called "zombie" companies. The cabinet of Ryutaro Hashimoto in the mid to late 1990s initiated reform of the financial sector somewhat modeled after the Margaret Thatcher-era Big Bang reforms in London. The specific areas targeted for reform were expanding means of asset investment, facilitating corporate fund raising (i.e. away from bank-led towards capital markets-led), providing a wider variety of services, creating efficient markets, assuring fair trading, and lastly ensuring soundness of intermediaries (Financial Services Agency of Japan, 2000).There was much research about the reforms and what they would lead to, with the predominant view that by shifting corporate funding to a more capital markets based system, including by foreign firms, they would be beneficial. (Hoshi & Kashyap, 2001), (Royama, 2000) (Gibson, 2000) and many others.

3.1 From LTCB to Shinsei

Up to the late 1990s, there were three large long-term credit banks in Japan, LTCB, Nippon Credit Bank (NCB), and the Industrial Bank of Japan (IBJ). These banks functioned as what the corporate bond market does in the US. As the Big Bang reforms began to be implemented, the corporate bond market, and both changing domestic and global circumstances started to erode this funding function of the three long-term credit banks. By the mid to late 1990s, circumstances had changed enough in Japan (financial sector reform and internationalization), such that there was no longer need for large long-term credit banks such as LTCB (Suzuki, 2011). LTCB bankers knew their business model was unsustainable, but a reform plan was blocked by vested interests in 1985, so to survive, it began expanding its real estate portfolio (Tett, 2003). This phenomenon is also explored by (Hoshi & Kashyap, 2001) who identify the problem of a high savings rate in Japan providing banks with so much capital, that they had to seek out riskier investments.

As LTCB's balance sheet became increasingly awash with bad loans, help was sought out: An Alliance with Swiss Banking Corp (SBC) was initiated to expand into investment banking. But SBC looked at LTCB books and were surprised at the level of bad debt (that had been legally shielded from disclosure) and withdrew from the alliance. Two camps emerged in the Japanese Diet: one wanted LTCB liquidated, the other wanted the companies (to whom LTCB had lent) to be continued to be supported. Finally, it become clear that there was no other alternative in the short-term than to nationalize LTCB and then look for a buyer. (Tett, 2004)

The problem was that like SBC, other potential buyers were wary of many of the loans on LTCB's books. Government nationalized some of the bad debts that LTCB held but didn't do more because then they would be admitting how many more companies were in trouble (which they did not want to do, risking their own popular mandate to govern). The idea emerged to include a "put option" in the deal so that if there were losses of a certain amount incurred that the buyer would be able to sell the loan back to the government. But the government hoped the "put" would never be used. Goldman Sachs (notably a foreign firm) was employed to find a buyer. In the end, Ripplewood was the only bidder (Tett, 2004).

The Japanese Government implicitly assumed that the corporate borrowers would continue to be protected/supported if they nationalized LTCB and then subsequently sold it. This implies that the Government could have removed the worst loans, then sold the bank. In the end, the worst loans *did* come back to the government. The inclusion of the non-performing loans in the portfolio caused most potential investment banks (both foreign and domestic) to refrain from wanting to participate in the deal. Problems identified were both a lack of necessary financial information regarding the loan book and a lack of time to evaluate given its complexity. Ripplewood buys LTCB, but importantly receives the right to put back any loans to the government if they incur a loss of greater than 20% (Iwaisako, 2004). That Ripplewood was able to negotiate the right to put the loans back to the government seems like an error: if the loans had simply been nationalized other buyers likely would have emerged and Ripplewood would not have been able to extract its bountiful windfall. Was the government aware of this outcome but took advantage of the implicit assumptions made by politicians that the borrowers would be protected to get the deal done. To put it in other words, if the public had known of the likely outcome, would the government had been blamed?

3.2 Gaiatsu

Gaiatsu (外圧) is a Japanese word of two characters: *gai* (外), meaning external, and *atsu* (圧), meaning pressure. It is generally translated as "foreign pressure" and is often noted as "the only way to get Japan to do something it doesn't want to do" (Nadeau, 2018). Admiral Perry and his Black Ships in 1953 are perhaps the first example of the idea: powerful external force imposes unwanted change. But Nadeau notes that in the case of Perry, there were certainly those in the leadership that recognized that some change was inevitable and wanted to be part of shaping how that change might occur. In this sense, the gaiatsu can be viewed as a tool to bring about change from within a country by using a foil (the external power) to trigger it.

This is not unique to Japan: An American example might be of a company whose management does not relish the idea of laying off long-time employees but concludes that layoffs are necessary. A management consultant is employed to produce a report saying that layoffs are essential for the survival of the business. The company's managers can then have a convenient foil, in the form of the management consultants demanding change, for the resulting layoffs.

In the LTCB example, the bad debts of LTCB were what made it undesirable for a buyer, thus the need for the "put" option agreement with the government. Despite a brief dalliance with Sumitomo Trust for some sort of capital agreement or merger, there were simply no interested domestic parties. But even after the "put" agreement was included, there was scarce participation from domestic investors. Even the Mitsubishi Corporation, who were backers of Ripplewood and held a seat on its board, were unwilling to participate in directly supplying funds to buy LTCB, fearful of political controversy (Tett, 2004). They may have had good instincts: two decades later, though there are no such liabilities on its balance sheet, there is some indication that there are those in the government that feel somehow that Shinsei still owes money (Givens, 2021).

Therefore, it seems clear that domestic buyers felt implicit pressure from the regulators, but not the foreign buyer. In the end, Ripplewood had no qualms about exercising its agreed-to "put" option and came away with a very profitable return for their purchase and later sale of LTCB/Shinsei. Also, the Financial Services Agency (FSA) pressured Shinsei to increase lending to several Small and Medium Enterprises (SMEs) of questionable credit worthiness (Ahmadjian & Song, 2004), which they refused. They also refused to throw good money after bad, for example, one of the most controversial things about Shinsei was its unwillingness to roll over bad debt. The government had expected Shinsei to do more and in the contract Shinsei was expected to "respond to funds demand, including rollover and seasonal funds, for three years." But the contract also said Shinsei could deny rollover if losses were reasonably expected. And that they did. Further going against custom, Shinsei departed from Japanese norms and signalled they'd use collateral seize (Spiegel, 2002).This was clearly a new, and harsher, form of lender borrower relationship than what had existed in Japan.

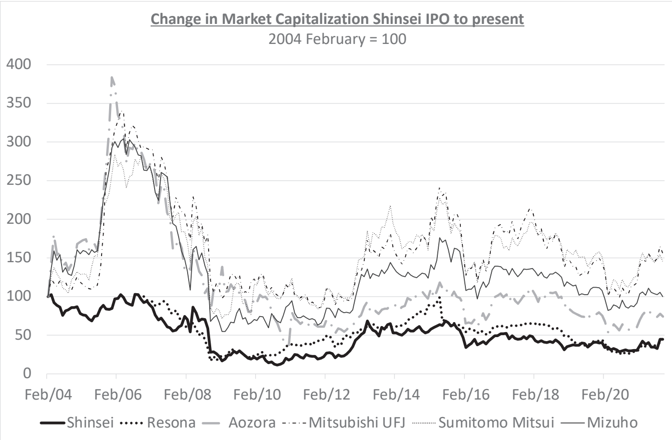
3.3 Shinsei's birth and IPO

Shinsei's new management implemented changes that were trailblazing in Japan. Many of the innovations that Shinsei implemented were things that other banks had wanted to do but had not yet had the courage: new services, new approaches, a smaller loan book (Tett, 2003). Shinsei took a common (but ruthless) stand towards its lending book, not supporting the companies with bad loans. The case of Sogo's bankruptcy is a useful example of how Shinsei behaved: Banks were incentivized to take part in a potential Sogo (or other) bailout because though the Industrial Bank of Japan (IBJ) was the lead bank in this case, if a bank was the lead bank in a different case, they would need other banks to support them. Only Shinsei was exempt from this thinking because of the put option. This new way of operating forced Japanese banks to realize that endless bailouts could not work. (Iwaisako, 2004)

Two years of changes and a cleaning up of the loan book led to the opportunity to cash in on their investment and so Ripplewood arranged for Shinsei's Initial Public Offering (at the time approximately one third of the ownership was put up for sale). "By all accounts, Shinsei's IPO was a huge success and proof that banking reform in Japan is possible and is being realized." "However, many observers also believe that the game is not over. The general opinion is probably that Shinsei by itself will not be able to survive competition once other major Japanese banks have fully recovered from their troubles. Many forecast that Shinsei will eventually be bought by, or merge with, a major player". The two quotes from (Iwaisako, 2004) provide prescience: though the prediction of being taken over did not immediately emerge, Shinsei is again currently in the news as the target of a takeover (by SBI). Echoing the hope surrounding what the Big Bang would herald for the financial sector in general (Hayes, 2000) and others, Tett writes about the considerable optimism about what Shinsei could become and how it could shake up the domestic banking industry. Indeed, its title is the presumptuous "Saving the Sun" (Tett, 2004). 20 years later, how does that view hold up? Was the Sun saved?

4.1 Shinsei performance vis a vis other banks 1: Stock Market Valuation

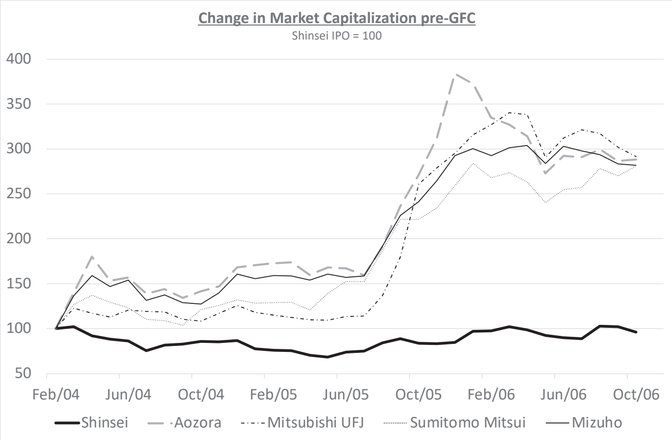
Using the metric of market capitalization of equity to measure Shinsei's performance compared to other banks, it first appears that Shinsei (and Resona) has lagged the other four of the largest six banks in Japan by a significant margin. Compared to 2004 (and in the case of Resona 2006, because the stock did not trade until then), Shinsei and Resona are valued at less than half of what they were. Aozora is valued about three quarters, Mizuho about the same, and Mitsubishi UFJ and Sumitomo Mitsui about 50% more, than what they were valued in 2004.



Data source: Bloomberg, Author’s calculation

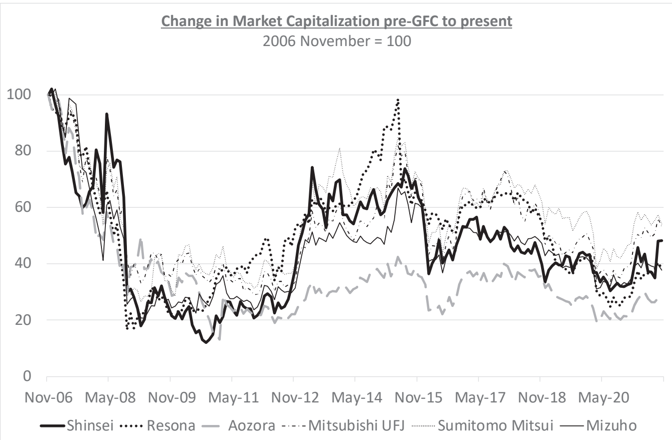
Shinsei’s IPO was widely seen as a very successful and popular offering. As noted above, there was considerable optimism that this would be a new kind of bank, more focused on customer service and thus would be able to out-perform its peers. But many of the innovations instituted by Shinsei were soon copied by the other banks with little benefit seen by Shinsei in the form of first mover advantage. For example, if Shinsei, offered better hours or services, Mitsubishi UFJ could simply match. This is apparent in the stock valuations of the six banks.

Also, there is evidence of significant selling of Shinsei stock during this period, that would have been unique (other banks would not have been subjected to this selling): Ripplewood had sold off its entire stake by the end of 2006 (Haraguchi & Matsumura, 2020). It initially only sold approximately one third of the the company at the initial IPO in February of 2004, therefore over the next two and a half years, the remaining two thirds would have been sold in the market (Sanchanta, 2005). This volume of selling would have thus been a steady source of downward pressure on the stock. Indeed in this period after its IPO, the market’s valuation of Shinsei remained largely unchanged, while the other banks grew almost threefold. The selling pressure of the market absorbing two thirds of Shinsei at this time could explain this price action in the market.



Data source: Bloomberg, Author's calculation

If we remove the two years post IPO, and begin before the beginning of the GFC, we can get a different view of the longer-term performance of Shinsei. Excluding the most recent outperformance of its stock price, likely due to the takeover rumblings in the news, we can see three clear groupings of performance of the big six Japanese banks post GFC. Aozora lags at just roughly 30% of its pre GFC valuation. Shinsei (again discounting the most recent month or so), Mizuho, and Resona are all at roughly 40%, and Mitsubishi UFJ and Sumitomo Mitsui are around 55%.



Data source: Bloomberg, Author's calculation

4.2 Shinsei performance vis a vis other banks 2: foreign vs. domestic ownership

LTCB was bought by foreign investors, who created Shinsei bank. Shinsei then was owned and operated by these foreign investors for an extended period before the IPO while implementing some best practices from foreign banks, and foreign managers and board members brought on. The IPO was lauded as very successful in the foreign press, and Shinsei has generally received positive press since. Yet Shinsei Bank has the lowest percentage of shares held by foreigners of the six biggest banks in Japan. Though if the SBI stake (counted as domestic) is valued at SBI's one-third domestic and two-thirds foreign breakdown, the level becomes similar to that of Aozora and Resona (but still below the big three). But the SBI stake seems to have mostly come as domestic investors such as Japan's Government Pension Investment Fund, have reduced their holdings indicating that until quite recently Shinsei still had a significantly smaller proportion of foreign ownership than the other five of the six largest banks (Bloomberg, 2021). So despite recent significant foreign interest (from the mostly foreign-owned SBI holdings) steadily building an equity stake to prepare for a takeover bid, Shinsei still has the lowest proportion of its shareholder equity held by foreigners.

Ownership breakdown		
	Domestic	Foreign
Shinsei	76%	24%
Aozora	65%	35%
Resona	65%	35%
Mizuho	60%	40%
Sumitomo-Mitsui	57%	43%
Mitsubishi UFJ	61%	39%
***Shinsei**	65%	35%

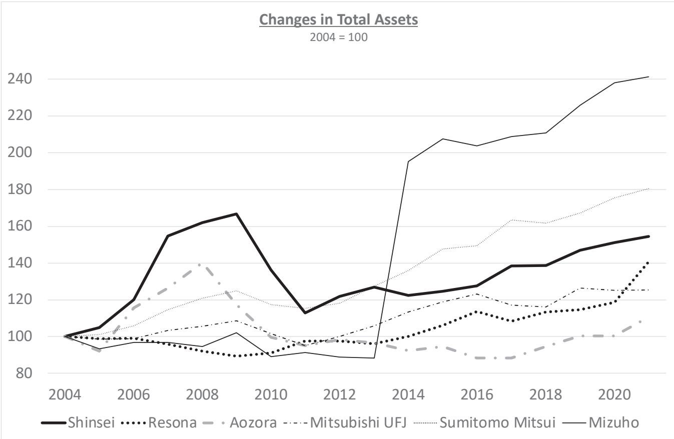
Data source: Bloomberg terminal. Accessed 2021-12-1. (See footnote[2] for *Shinsei ownership breakdown calculation and explanation)

4.3 Shinsei performance vis a vis other banks 3: Assets

After its IPO, Shinsei's assets grew quite quickly approaching the onset of the GFC. As is evidenced in the chart below, Aozora also grew during this period. Both Aozora and Shinsei were birthed out of former long-term credit banks, so it seems likely that the asset mix of these two banks made the pre-GFC period (where risk assets globally were growing)

[2] According to Bloomberg, Shinsei is 76.44% owned by domestic Japanese investors. However, in that group is SBI investments (the entity attempting to acquire control of Shinsei), which itself, although classified as a domestic Japanese investor, is only owned 33.35% by domestic Japanese investors. So, if we count only 33.35% of SBI's stake (16.5% of Shinsei) as domestic, Shinsei is owned 65% by Japanese investor.

particularly successful but also the GFC had the largest effect on. Further evidence that the pre-GFC period was built on risky assets is the contrast of the balance sheet expansion and the lagging stock price. But Post GFC, it seems that the Shinsei balance sheet has grown steadily in a magnitude very similar to that of all the other banks except for Aozora. (It should be noted that Mizuho's growth jump in 2013 was the result of a merger between it and Mizuho Corporate bank).



Data source: Japan Banker's Association, Author's calculation

5 Conclusions

Was the sun saved? This paper argues that the Japanese government likely employed a form of "invited Gaiatsu" to rescue itself from having to take more responsibility for a banking crisis. As such the "invited" foreigners provided cover and could be blamed for the collapse of several of its former clients. Of course, the sun was not "saved", and the "invited" foreigners made handsome profits for their involvement, but there are two areas where material improvements can be observed from this foreign involvement, managing risks and implementing changes in services. Through "inviting" this ruthless Western-style banking philosophy into Japan, other banks could also take the opportunity to make better decisions about which borrowers to continue to support. And banking services (products, hours, access, etc) are notably better at domestic banks than they were in the days of LTCB. This paper does not attempt to quantify these improvements, but rather argues that they exist, and that is important itself. Though this paper has focused on the six banks that are not classified as "regional banks" in Japan, a similar analysis of the dozens of regional banks (and the consolidation of many of them into several group holding companies) may be an interesting topic for further study.

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