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Behold the 'Behemoth'.

The privatization of Japan Post Bank

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JEL Classification: G21, G28, L32, P12

Keywords: Public banking; Japan; privatization; postal savings banks

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Abstract

This paper analyzes the privatization process of the Japanese Post Bank (JPB), the largest bank in the world. We report some evidence in favour of the “political view” of SOB’s and argue that, before privatization, postal savings banks served as vehicles for politicians to reallocate funds in exchange for private rents. We ask why politicians in Japan decided to privatize the postal savings system, predict how the privatization will proceed and study the expected results of the privatization process. We argue that there will be no level playing field in bank competition after the start of the privatization process and discuss possible outcomes of JPB privatization on financial stability in Japan.

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1 Introduction

Public ownership of banks is very common worldwide. According to *Barth et al.* (2006: 148-151) about two-third of the 136 countries surveyed in 2001 exhibit some government ownership in banks; the percentage of bank assets held by government-owned banks was the highest in China (98 %) and exceeded 40% in twenty more countries (among them India, Pakistan and Germany). Similar results were provided by *La Porta et al.* (2002) who show that the share of assets of the top ten banks owned or controlled by the government amounted to 42 % in 1996. This share was especially large in countries with a per-capita-income below average and in countries with underdeveloped financial markets; it was also large in countries with high state involvement in the general economy and in countries with low economic growth.

Interestingly, both studies classify Japan as a country with no government-owned banks (*La Porta et al.*, 2002: 37; *Barth et al.*, 2006: 149) despite the fact that the Japanese Postal Savings System (PSS) is still publicly owned. It laid the basis for an extensive system of financial intermediation by government-run agencies which became known as the Fiscal Investment and Loan Program (FILP, "zaisei toyushi") and which was designed to channel funds from the public to certain sectors of the economy (*Cargill* and *Yoshino*, 2000, 2003; *Cargill*, 2001: 146, 159). While both the PSS and the FILP resisted reforms for decades, a 10-years privatization road map was drawn under initiative of then Prime Minister Koizumi in 2005 which started in October 2007. Accordingly, Japan Post will be split up into four companies and two of them – among them Japan Post Bank - will be completely privatized until 2017 (*NikkeiPB*, 2008).

In this paper, we take this recent transformation of the Japanese Post as a starting point to conduct an explanatory case study on the privatization of the Japan Post Bank (JPB). In general, case studies are the preferred research strategy when the focus is on single contemporary events within some real-time context; they try to illuminate a set of decisions and ask why these decisions were taken, how they were implemented, and what the results were. Explanatory case studies offer several competing but also complementary theories in order to explain the object of interest and compare the ability of each theory to explain the course of events and why decisions were taken (*Yin*, 2003; *Gerring*, 2004; *Marschan-Piekkari* and *Welch*, 2004).

In what follows, we address three main questions: First, we ask what led Japanese politicians decide to privatize JPB. Second, we describe how the privatization will proceed and what measures will be taken. Finally, we try to predict the likely results of the privatization process regarding the flow of funds, bank competition and financial stability in Japan. We have chosen the Japanese case for several reasons. First, Japan Post Bank is – measured by the size of deposits – the largest bank in the world.[1] Second, JPB formed the basis of a unique and intransparent system of borrowing and lending that operated as a shadow-banking system and is sometimes referred to as "Japan`s second budget" (*Cargill* and *Yoshino*, 2000: 201). Finally, while privatizations of state-owned banks also occurred in other OECD countries (*Boehmer, Nash* and *Netter*, 2004; *Meggison*, 2005), the Japanese government followed a privatization strategy that differed in many respects from those chosen in other countries where public post banks were simply abolished or privatized by selling it to an assuming bank.[2] In Japan, privatization was also subject to much a fiercer political debate and became a central topic during the 2005 election campaign of incumbent Prime Minister Koizumi, indicating the special role of the Postal Savings System for Japan.

A number of studies on the Japanese banking system exist. *Aoki, Patrick* and *Sheard* (1994) describe the evolution of the Japanese banking system after World War II; *Suzuki* (1980, 1987) and *Ueda* (1994) illustrate post-war bank regulation in Japan. *Maruyama* (2006) analyzes privatization of the Japanese Postal Service System but does not pay special attention to the Japanese Post Bank; *Porges* and *Leong* (2006) ask whether privatization creates a level playing field for postal services. Several papers cover the role of the Japanese postal bank system before the start of the privatization process. *Kuwayama* (2000) compares postal service systems in Japan and the US and analyzes Japanese bank regulations in favor of the Postal Savings Agency during the 1990s. *Cargill* and *Yoshino* (2000; 2003, Chapter 4) analyze the role of PSS and FILP in government financial intermediation and evaluate their

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1 As of March 2007, Japanese postal savings system owed deposits totalling 187.0 Trillion Yen (*Japanese Bankers Association*, no year; *Japan Post*, 2008a: 1).

2 In the US, the postal savings system stopped accepting deposits and was abolished in 1967; about 60 million USD in unclaimed deposits was turned over to the Treasury Department to be held (*Kuwayama*, 2000; *United States Postal Service*, no year); almost the same procedure was applied in Canada. In New Zealand and in some European countries, like Austria, the post banks were privatized and sold to an assuming bank (to ANZ in the case of New Zealand in 1989 and to BAWAG in 2005 in the case of Austria). A privatization strategy comparable to the Japanese was only pursuit in Germany in 1990, were Deutsche Postbank was formed from the spin-off of the postal savings division of the German Postal Service System (Deutsche Bundespost). For case studies that analyze privatization of public owned banks in other countries see *Haber* (2000) for Mexico; *Clarke* and *Cull* (2005) for Argentina; *Carletti, Hakenes* and *Schnabel* (2005) for Italy; *Clarke, Cull* and *Fuchs* (2007) for Uganda.

impact on the Japanese economy. *Maclachlan* (2006) describes the long-lasting political power struggle before the decision to privatize the Japanese postal service was taken. *Iwamoto* (2002) and *Doi* and *Hoshi* (2003) study the flow of funds from the postal bank system into public investment projects and estimate the percentage of bad loans involved; they also study the effects of FILP reforms undertaken in April 2001. *Imai* (2007) analyzes politician's attitudes towards post bank privatization and addresses the question why some Japanese politicians fiercely opposed or supported the privatization plans. *Imai* (2008) examines whether JPB helped raising untapped savings from savers that did not have access to private depository services. Finally, *Imai* (2009) estimates the political influence on postal bank lending decisions using data on Japan's government loan from 1975 to 1992.

None of this work, however, is concerned with the now ongoing privatization process or tries to appraise the possible effects of postal bank privatization for the Japanese banking sector. Before privatization will be completed, Japan Post Bank might still keep a dominant role in lending in Japan but shall change its appearance completely. For that reason, we analyze the set of rules under which Japan Post is likely to do business during the upcoming decade and ask for the consequence for the flow of funds, for bank competition and for financial stability in Japan. Our findings are largely consistent with the "political view" on public banks according to which politicians influence lending decisions of public banks to increase their chances to be re-elected. We draw upon evidence according to which before privatization public bank lending was politically influenced with a great percentage of non-performing loans involved. We argue that this exertion of political influence on lending is likely to be reduced after privatization has been completed and that JPB privatization will contribute to an enhanced stability of the Japanese financial system because it improves incentives for depositors to monitor banks and to exert market discipline on them.

The paper is organized as follows: Section 2 provides an overview over the recent literature on the welfare effects of public banks. Section 3 presents the reasons why JPB privatization started in 2007. Section 4 describes the privatization strategy and the time schedule chosen. Part 5 evaluates whether the measures taken are eligible to create a level playing field in banking and to improve financial stability. Section 6 concludes the paper.

2 Welfare effects of public banks

The banking literature offers two views on why public banks exist and what their welfare effects are (overviews in *La Porta et al.*, 2002: 265 ff.; *Sapienza*, 2004). One is the "development" or "social view", which regards public banks as important vehicles to channel private savings into private investments and considers them as an impetus for financial and economic development. According to this view, many investment projects are characterized by positive externalities and private returns are smaller then social returns; these externalities are not internalized by private banks which therefore do not finance socially valuable projects; public banks, however, are capable to internalize these externalities.[3] In contrast, the "political view" considers public banks as vehicles for politicians to reallocate financial funds to public sector entities in exchange against votes, political concessions or bribes (*Kornai*, 1979; *Shleifer* and *Vishny*, *1994; Boycko, Shleifer* and *Vishny*, 1996). Public banks are, hence, according to both views, reallocating financial flows inside an economy with, however, different welfare effects. While they help, according to the "social view", to correct market imperfections and to implement socially valuable investment projects, they serve, according to the "political view", to implement politicians` private goals and to finance socially undesirable projects.

The empirical literature largely supports the predictions of the "political view". Recent cross-country studies (*Faccio*, 2004; *Dinç*, 2005; *Micco, Panizza* and *Yanez*, 2007) find that companies with srong political connections have better access to external finance and pay less taxes than companies without such contacts. Moreover, public-owned banks seem to increase their lendings before elections; they are less profitable then private banks and the difference in profitability increases in election years. These results are confirmed by single-country studies which provide evidence for exertion of political influence on lending conditions of public banks (see *Fisman*, 2001 for Indonesia; *Johnson* and *Mitton*, 2003 for Malaysia; *Ramalho*, 2003 and *Barros*, 2008 for Brazil; *Sapienza*, 2004 for Italy; *Khwaja* and *Mian,* 2005 for Pakistan; *Bertrand, Schoar* and *Thesmar* 2007 for France; *Cole*, 2006 for India).

In contrast to this empirical evidence, the recent theoretical literature provides some arguments in favor of the "social view". *Allen* and *Gale* (2000) argue that public banks might be able to prevent financial contagion and thereby contributing to increased financial market stability; similar positive effects on the stability of the banking sector are derived by *Hakenes* and *Schnabel* (2004).[4] *Hakenes* and *Schnabel* (2006) analyze possible effects of public

[3] The social view can be traced back to *Gerschenkron* (1962); a more recent version is provided by *Stiglitz* (1994).

[4] In contrast, *O`Hara* and *Easley* (1979) argue that the US Postal Savings System acted as a safe-haven for savers during the Great Depression, thereby destabilizing the banking system, especially the savings & loans industry. The US PSS was founded in 1910 after a banking panic as a second best alternative to a

banks` regional limitations on business activities and show that these limitations may contribute to prevent a capital drain from poor to rich regions inside integrated financial markets. *Hainz* and *Hakenes* (2008) consider a situation where a politician may choose among investment projects which generate private rents for him; projects, however, differ in their creditworthiness which is not known to the politician. In their model, granting public aid via public banks may increase social welfare relative to direct subsidies if public banks are not allowed to fully compete with private banks. Finally, *Vollmer* and *Hauck* (2008) study the consequences of a public bail-out for loan supply. When the public owner has to cover losses if the bank's repayment obligations to depositors exceed loan repayments, a bank may finance more socially beneficial projects.

Against the background of these empirical and theoretical studies, we now turn to the case of Japan Post Bank and try to evaluate the effects of JBP privatization on flow of funds, bank competition and financial stability in Japan. We report the reasons why privatization was started and describe the privatization strategy chosen. We are interested in the likely results of JPB privatization for the flow of funds, bank competition and financial stability in Japan.

3. Reasons for privatization of Japan Post Bank

The Japanese Postal Savings System was founded in 1875 and was modeled after the British example; a nation-wide system of post offices was established that also accepted savings deposits.[5] By 1900, services were offered in all Japanese cities, towns and villages. The number of post office locations further grew and soon exceeded that in the US and other countries. During the first years, PSS only provided domestic money order services along with savings deposits; direct transfer (giro) services were added starting in 1906; beginning in 1916, the post offices also offered life insurances.

On the liability side, postal savings banks specialized in offering small size accounts for low-income households and competed especially with private savings banks which paid higher interest rates on accounts but were regarded as being less safe then the postal savings system. Bank safety sometimes played a major role in the late 1920s when private savings banks

governmant guarantee of bank deposits. While it was very small during most time of its existence, it experienced "almost explosive growth" in the early 1930s. During this time, it drained off liquidity from savings & loans and from regions with high rates of bank failures. Moreover, it diverted funds to the US Treasury, thereby reducing bank reserves and the money supply.

5 On this and the following see *Kuwayama* (2000), *Maclachlan* (2006) and *Japan Post* (2008b). According to *Kuwayama* (2000), the UK was the first country offering postal savings services in 1861. It was followed by New Zealand (1867) and Canada (1868) and Belgium (1870); the last OECD country founding a postal savings system was Denmark (1991).

were particularly hard hit by financial panics and when postal savings accounts significantly increased as percentage of all deposits. Matters of bank safety, however, lost importance after Word War II when, under the "convoy system", the government implicitly backed every bank – especially those whose liabilities were households` savings – against any form of default. In this protective environment, concerns over private banks` safety could not form a major determinant of the demand for postal savings – instead, the extent of branching and the pricing of services was a more important factor. Because Postal Savings Banks were widespread, private banks made no serious efforts to collect households` deposits by expanding branches. Interest rates were regulated by the Ministry of Finance (MoF) which fixed a premium for interest rates payed on postal deposits compared to private bank deposits; this spread was more or less kept constant until the beginning of the 1990s when interest rate ceilings on private banks´ accounts were abolished and the postal savings system was required to keep its interest rates in line with those on deposits with private banks (*Kuwayama*, 2000; *Cargill* and *Yoshino*, 2003; *Kinoshita*, 2008).

Matters of bank safety, again, regained importance during the 1990s when the Japanese financial industry experienced an enormous amount of bad loans and witnessed failures of many banks which was encountered by, e.g. injections of public funds into banks, huge public deficits and a streamlining of bank managements. The government abolished the convoy system and established a government-sponsored deposit insurance system which covered deposits without limit; depositors of failing banks, however, were not paid-out but their deposits were instead transferred to a bank which assumed the business of the failed bank.[6] This resulted in a complete reorganization of the Japanese banking industry as existing banks were merged and new banks were established. Though no depositor lost his deposits, a regime shift took place and the safety motive for using postal savings reappeared as postal savings accounts were directly guaranteed by MoF and their holders had not to fear to be transferred to an assuming bank.[7] In consequence, the post office` deposit share increased during the 1990s (*Kuwayama*, 2000).

Moreover, postal savings banks had always offered special time deposits (called "teigaku" savings or "fixed amount postal savings") that were superior to any other time deposit offered by private banks: Teigaku savings were ten-years time deposits that granted savers the

[6] In cases were no assuming bank could be found, the business was transferred to a "bad bank". See *Nakaso* (2001).

[7] Since postal savings accounts are guaranteed by MoF, the Post bank system is not member of the Japanese deposit insurance system DICJ. However, it will become a member after privatization; see section 4 below.

opportunity to withdraw funds on short-notice and without a penalty after a six months holding period. This made them very liquid and reduced the exposure of deposit holders to interest-rate risk. If interest rates rise, the holder may withdraw deposits and redeposit them at a higher interest rate; if interest rates decline, however, the deposit is maintained at the interest rate current when the deposit was established. Though there was a formal limit of 10 million Yen to the amount of postal deposits per individual or household, this limit was not rigorously enforced; moreover, many wealthy savers circumvented the limit by holding multiple accounts.[8]

On the asset side, the Japanese postal service system always conducted narrow banking, i.e. invested into low risk government bonds or assets equivalent to them. Only in the first years after PSS was established, postal savings were deposited in private banks with the intent that funds were managed in cooperation with the government (*Cargill* and *Yoshino*, 2003). From 1884 onwards, however, after some private bank failures, postal savings were removed from private banks and transferred to an account at MoF that was later called the Trust Fund Bureau.[9] The Ministry first invested funds into government bonds but, from 1888 onwards, postal savings were channeled into government-related banks or forwarded to various government-affiliated institutions whose lending was guided by MoF. After the Second World War this system was formalized and named FILP; in effect, postal services became "a huge, opaque pool for funding for various policy lending purposes." (*Kuwayama*, 2000: 93).[10]

Under FILP, funds were channeled to local governments, government-affiliated public companies and to government financial institutions that acted as highly compartmentalized and specialized niche lenders; they gave loans to preferred borrowers, such as small firms, mortgage borrowers and borrowers in underdeveloped areas (*Iwamoto*, 2002: 588; *Amyx*, *Takenaka* and *Toyoda*, 2005). Budget allocation to FILP did not require parliament approval (unlike the national budget). While government-sponsored loan programs do exist in many countries, the Japanese one was outstanding because of its size; by end of March 2001, the FILP program involved more then 400 trillion Yen (which was equal to 82% of Japanese

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8 In effect, virtual every resident in Japan holds a postal savings account: There are a total of 118 million savings accounts for a population of 127 million (*Imai*, 2007). Private banks were not officially prevented from offering teigaku types of accounts but often decided not to offer them because of the interest rate risk involved; postal savings banks were able to supply them because of the government backing (*Cargill* and *Yoshino*, 2003: 50).

9 The account was first called "Deposit Bureau". See *Cargill* and *Yoshino* (2003: 43).

10 Note that FILP ws not an institution or a government agency but a process of decision making that channeled funds to targeted sectors of the economy. Sources for FILP funds came not only from postal savings but also from postal life insurance premiums and from pension premiums. See *Cargill* and *Yoshino* (2003: 16).

GDP; *Doi* and *Hoshi*, 2003). Though the FILP intended to foster social goals by financing projects with large positive externalities, there is some evidence that FILP in fact funded wasteful projects and unviable borrowers for political purposes. According to *Doi* and *Hoshi* (2003), the FILP had outstanding loans amounting to around 350 trillion Yen in 2001 from which 75% were loans to already insolvent recipients; they estimate the cost to tax payers to clear up expected FILP losses to be at least 75 trillion Yen (over 15% of 2001 GDP).

Though one should expect losses if a government agency finances projects with large positive externalities, the bad performance of loans under the FILP program were due to the fact that decisions to grant loans were largely politically influenced. Japanese politicians, especially from LDP, used FILP to benefit their supporters or to provide financial assistance to their voting groups; government ministries or agencies did not intervene because FILP agencies or government corporations through which FILP loans were allocated offered-post retirement positions for bureaucrats or absorbed personnel from ministries that had to reduce their staff (*Amyx et al.*, 2005: 30).

Several studies indicate such a political use of funds deposited in PSS accounts. *Imai* (2006) uses prefecture level panel data on Japan's government loans from 1975 to 1992 and shows that prefectures that were represented by more influential LDP members received more governmental loans from the FILP program. She also founds out that the amount of FILP loans increased in prefectures were the ruling LDP candidates became more electorally vulnerable. Similar evidence is provided in *Patterson* (1994) for the period 1975 to 1981. These statistical links between loans and political factors did only exist in governmental loans, not in loans by private banks, so that these findings are no artefacts of fluctuations in prefectural loan demands. She concludes from these findings that government loans have served private interests of LDP members and their supporters, supporting the political view of government banks.

These results are completed by another study that finds empirical support for a crowding-out effect of JPB on local economies which also point in the direction of the political view (*Imai,* 2008). Beginning in 2000, a large share of postal time deposits were maturing and PSS experienced a large outflow of funds. Prefectures with higher shares of postal savings tended to experience larger outflows of deposits from PSS to private banks. More important, the precedent shift of funds (in the early 1990s) from private banks to PSS had negative effects in particular on small firms which – more than large firms – rely on local banks that directly compete with JPB for deposits.

Discussions about privatization of the postal savings system already started in the 1980s under Prime Minister Nakasone as a reaction to a rising government deficit.[11] While three other major public companies (Japan National Railway JNR, Nippon Telegraph and Telephone NTT and Japan Tobacco JT) were partially privatized, the government, however, hesitated to privatize the postal service system for a long time. This hesitation only ended in 1997, when the Administrative Reform Council ("Gyōsei Kaikaku Kaigi"), headed by then Prime Minister Hashimoto, recommended the privatization of the postal system's financial business parts. After some fierce resistance from opposition parties and especially from some fellow LDP members, the "postal lobby" forced the council members to find a compromise that did not aimed at privatization of JPB but urged a change in the formal relationship between PSS and FILP.

The reformed PSS and FILP system, starting April 2001, provided a shift in the management of the postal system from the Ministry of Post and Telecommunication to Japan Post as a newly independent public corporation (in which employees retained their status as public servants).[12] The reform further called for complete autonomy over the manner in which Japan Post invested postal savings and insurance funds; the Trust Fund Bureau ceased to exist. Finally, the new regulations urged government agencies that traditionally relied on FILP loans to issue own securities to finance their projects. Hence, Japan Post had no formal obligation to finance FILP and FILP agencies had no more automatic access to postal savings funds. Instead, FILP entities had to raise funds either by issuing own bonds or by loans from a newly founded Fiscal Loan Fund that was financed by bonds issued by MoF.

These reforms were intended to introduce some form of market discipline into the operations of government agencies and to cut off the flow of savings into obviously unproductive public investments. In effect, however, Japan Post still absorbed the bonds issued by the government agencies and the flow of funds from postal savings to MoF and government agencies did not change significantly immediately after the creation of Japan Post and FILP reform; one reason was that postal savings invested into a FILP accounts earned interest rates higher than Japanese Government Bonds (*Iwamoto*, 2002: 585-591; *Maclachlan*, 2006: 8; *Doi* and *Hoshi*, 2003: 16; *Taki*, 2005: 24).

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[11] On this and the following see *Amyx (2004); Amyx at al.* (2005); *Imai* (2007).

[12] In June 2001, the Ministry of Post and Telecommunication was renamed in Ministry of Public Management, Home Affairs, Posts and Telecommunications (MPHPT), from 2004 onwards the Ministry of Internal Affairs and Communications (MIC).

In 2001, the newly appointed Prime Minister Koizumi set up a panel clarifying the true extend of Japan Post's unrealized losses and sent bills to the Japanese National Diet implementing the reform proposals of the reform report mentioned before. The main motivation behind this reform effort was to increase efficiency in the financial sector, to relief postal savings from the power of vested interests and to reduce bureaucratic mismanagement of public funds. In 2004, numerous articles in Japanese newspapers focused on inefficiencies in postal savings operations and on low return on capital compared to private banks (*Amyx et al.*, 2005). The anti-privatization lobby countered that privatization causes a loss of "universal services", i.e. the provision of postal services at uniform rates to all communities across the country. Especially post offices in small cities and in rural areas were expected to close down or to merge with other post offices. Personnel in these offices feared losing their jobs (*Maclachlan* 2006: 9).[13]

Opposition against privatization came from the postal lobby which included local politicians and the "National Association of Commissioned Postmasters", a pressure group with close connections to LDP.[14] The majority of post offices in Japan, especially in rural areas, are "special post offices" which are run by commissioned post masters, i.e. private citizens contracted by the state to perform government services.[15] Though postmasters were, by law, not allowed to campaign for specific candidates in elections, they acted, in fact, as vote-gatherers for LDP and helped to mobilize votes. Postmasters were able to perform this function because they enjoyed a high social status and were often engaged in prestigious volunteer activities that gave them authority within their networks. These functions made the special postmasters association very influential inside LDP and decisive to the question what reform proposal could be considered in the LDP. Members of the "postal tribe" inside LDP headed

[13] This fear of loosing universal services, however, seemed to be somehow exaggerated. According to a 2003 report by the Japaese Bankers Federation only 10 out of more then 3200 cities, towns and villages in Japan lacked any type of private financial institution and solely depended on postal financial services. The number of individuals left without access to a financial institution in their immediate locality, should PSS be closed, amounted to only around 6,800 persons nationwide. See *Amyx at al.* (2005: 40-41).

[14] The historical reasons for these connections are explained in detail in *Maclachlan* (2004).

[15] Currently, there are more then 24,500 post offices in Japan and most of them are so-called "special post offices" with only one or two employees per office (*Japan Post* 2008a). They are barely engaged in delivery services but mainly offer deposit services and thus directly compete with private banks for loanable funds. The number of Post Offices outperformes the total number of bank branches (just over 22,000 in the early 2000s); see *Maclachlan* (2004: 284) and *Imai* (2008: 6).

committee's on the LDP`s Policy Research Council where new legislation was discussed before being submitted to Parliament (*Amyx et al.*, 2005; *Machlachlan*, 2004; 2006).[16]

Due to demographic and technological reasons, however, the special postmaster association's political influence dropped during the 1990s (*Amyx,* 2004). Migration decreased the electorate in rural areas so that the number of people fell who looked at the postmaster for guidance on whom to vote for. Voters got access to different sources of information about politics and candidates. In consequence, opposition from the postal lobby weakened and Prime Minister Koizumi started the postal reform process: In November 2004, he shuffled his Cabinet, appointed reform-minded persons as new ministers and created the new position for postal privatization in early 2004.[17] Moreover, Koizumi initiated the Council on Economic and Fiscal Policy (CEFP) that started discussion of postal privatization and, in September 2004, released a report ("Basic Guideline for Postal Privatization") that served as a blue-print for the coming legislation (*Council on Economic and Fiscal Policy,* 2004). In spring 2005, Koizumi brought in to Parliament a proposal for a post privatization law, vowing to "discipline" bureaucrats or opponents from his own party and to call a general election should the privatization bills do not pass the Diet. After the Upper House did not pass the privatization bills, Koizumi dissolved the Lower House of the Diet and called for a general election in September 2005. A few weeks later, the postal privatization plans passed both chambers of the Diet (*Maclachnan*, 2006: 13-14).[18]

4. JPB privatization strategy and time schedule

Even before the start of JPB privatization, the Japanese government had decided to reform those public financial institutions that had as FILP agencies access to funds deposited into the postal savings system. By end of March 2007, two FILP were completely privatized, one was abolished, and a fourth one was replaced by another agency. The remaining five FILP

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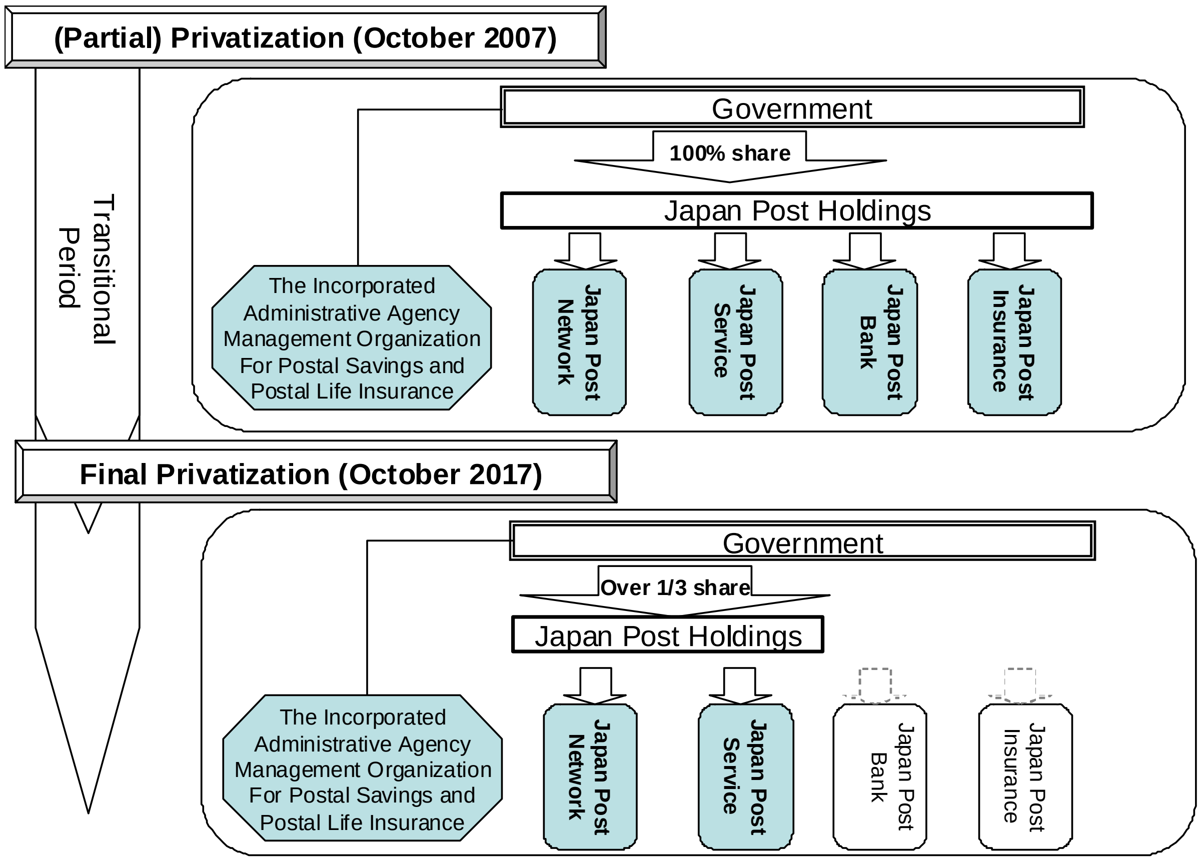
16 *Imai* (2007) uses data from the 2003 pre-election survey of all candidates for the House of Representatives in 2003 and also from the voting patterns of LDP members on a set of postal privatization bills in 2005 to investigate the reasons why politician were in favour or against postal savings privatization. She found out that politicians coming from areas with a higher concentration of special post offices were more likely to oppose privatization because workers and postmasters were likely to be adversely affected by the planned privatization. Moreover, she finds evidence that politicians with a stance for a more interventionist government were more inclined to oppose postal privatization.

17 Heizo Takenaka was appointed Minister of Postal privatization; he had served as Minister for Economic and Fiscal Policy since 2001 and kept this position even after appointment as Minister of Postal Privatization.

18 A bill proposed by opposition parties to freeze privatization of Japan Post was voted down in December 2008. See *Japan Times Online* (2008b). In February 2009, new Prime Minister Taro Aso called for a review of the current division of Japan Post into four firms. See *Daily Yomiuri Online* (2009).

agencies were merged into one “Policy Finance Institution” whose function shall be limited to fund procurement support to small- and medium-sized enterprises and individuals. As a result, flows of funds into FILP agencies decreased significantly during recent years. FILP budget has shrunk to 14.2 trillion Yen in 2007 from a peak level of 40.5 trillion Yen in 1996; FILP-related debt accumulation has also contracted from 418 trillion Yen in 2000 to 250 trillion Yen in 2007 (*Ministry of Finance*, 2007).

Figure 1: Privatization process of Japan Post



Source: *Ministry of Internal Affairs and Communication* (no year); modified by the authors.

The privatization laws that passed the Diet in 2005 only roughly outlined the parameters of the change for Japan Post. The details of the privatization will be settled by two government-affiliated committees, the “Headquarters for Promoting Postal Privatization” and the “Postal Services Privatization Committee (PSPC)”. The first committee was established in 2005, is ranked at cabinet level and consists out of all cabinet members with the Prime Minister as chairperson and vice-chairpersonship of several cabinet ministers. It had to prepare submission and enactment of privatization bills; it will debate broad policy measures relating to implementation of privatization. The second committee (i.e. the PSPC) was established after the start of the privatization process and consists out of five non-government experts. It works as a surveillance group; it will track the process of postal privatization between 2007 and 2017 and will make recommendations for change to the relevant ministries or to the head of the first committee, i.e. to the Prime Minister (*Maclachnan*, 2006: 14).

In October 2007, privatization of Japan Post started with the division into four separate private entities – Japan Postal Service Co., Japan Post Network Co, Japan Post Bank Co. and Japan Post Insurance Co. – under the roof of one holding company, named Japan Post Holdings Co. Of these companies, Japan Post Service Co. will manage the mail delivery services and Japan Post Network Co. will control the post offices and their real estate. At first, the Holding Company holds the entire issued stocks of all four companies and, in turn, it will be completely owned by the Japanese Government, which has to reduce its stake in the Holding Company to (more than) 33 percent of the total number of issued stocks and dispose the rest as soon as possible. This obligation imposed on the government has no time limit.[19]

As early as fiscal year 2010, Japan Post Bank Co. and Japan Post Insurance Co. are expected to go public and no later than September 2017 all shares of the two companies will be traded on the market; after 2017, however, the government holding company will be allowed to by back a few percent of the total shares of the savings and insurance companies.[20] The stocks of the two remaining firms - Japan Post Service Co. and Japan Post Network Co. - will be entirely held by the Holding Company; besides, these two units will also be allowed to buy shares of the financial units to form a group through cross-holding (*Council on Economic and Fiscal Policy CEFP*, 2004; *Maclachlan*, 2006: 13; *Takahara*, 2007; *Japan Post*, 2008c, see also Figure 1). After privatization is completed, JPB will be fully obliged to pay taxes and - like any other financial institution - be subject to the Japanese banking law.[21]

During the transitional period, however, special bills granting additions to the banking law shall be enacted which apply to the bank's deposit taking business as well as to its asset management and scope of business; furthermore, the two postal companies are subject to additional regulations stipulated by the Privatization Law. Before the start of privatization, deposits with Japan Post mainly consisted out of "floating deposits" that could be withdrawn

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[19] According to the Japanese commercial code, some decisions taken on a company's shareholders' meeting require a two-thirds majority; hence, the Japanese government keeps a blocking majority in the Holding Company.

[20] In December 2008, the government considered a delay in the planned final sales of JPB shares beyond 2017 because of falling stock market prices. See *Japan Times Online* (2008c)

[21] Moreover, at the time of privatization, employees of Japan Post will loose their status as civil servants and will instead become employees of the new private companies.

at any time on short notice and various types of time and savings deposits which earn a higher interest rate but stipulated a fixed investment period or a fixed notice period. Among postal savings, teigaku savings deposits played a dominant role (around 65% of all time and savings deposits with Japan Post at the end of fiscal year 2006 were of this type; see Table 1). Until end of September 2007, all deposits were guaranteed by the government, but on October 1, 2007, teigaku installment savings and time deposits were differentiated between those concluded before privatization ("old contracts") and those concluded after ("new contracts"); all floating deposits were defined as new contracts.

For all new contracts (floating deposits and 'new' teigaku savings), government guarantees on postal savings were abolished and deposits are insured by the Deposit Insurance Company of Japan (DICJ); the nonexistence of government guarantees for floating deposits concluded after October 1, 2007 has been explained to the public.[22] "Old contracts" together with corresponding assets accounts were assigned to a corporate body that succeeded the Japan Post. They are still guaranteed by the government but the administration and investment of assets and liabilities are commissioned to JPB which has to pay "virtual" deposit insurance premiums on these accounts to the government (*Council on Economic and Fiscal Policy CEFP*, 2004: 7-9; *Office of the United States Trade Representative*, 2007).[23]

Table 1: Balance of postal savings by type; FY 2003-2006; billion yen

Classification	*End of FY 2003*	*End of FY 2004*	*End of FY 2005*	*End of FY 2006*
Ordinary and Collection Savings	54,155.7	56,039.6	56,639.3	56,336.3
Teigaku Savings	160,189.8	146,440.1	135,393.1	120,994.7
Time Savings (incl. Housing Collection and Education Collection Savings)	13,036.6	11,669.2	7,971.0	9,638.2
Total	227,382.0	214,149.0	200,002.3	196,969.2

Source: *Japan Post* (2008a: 12).

As a by-product of these privatization procedures chosen, the above-mentioned exceptions from the banking law were stipulated to create a level playing field between JPB and other private banks. First, before privatization, a fixed ceiling of Yen 10 million deposits per de-

22 All floating deposits, however, are currently covered 100% by DICJ.

23 This public successor company is called "Incorporated Administrative Agency Management Organization for Postal Savings and Life Insurance" and is independent of Japan Post Bank Co. (and Japan Post Insurance Co.). It has to separate "old" and "new" contracts and to prepare and disclose annual financial statements. Asset management arisen from the old contracts is delegated to Japan Post Bank by way of deposit contracts. The FSA and MIC ensure that "profits arising from pre-privatized accounts are not unfairly transferred to Japan Post Bank …through the deposit …contracts" (*Office of the United States Trade Representative,* 2007: 53).

positor existed that was meant to create a level playing field with other private banks where deposits were not guaranteed by the government but were insured up to the same amount by DICJ. This cap still existed after the start of privatization but JPB has already requested to remove the ceiling on floating deposits to achieve smoother settlement of individual customers; the government's reaction to this request is still open.[24] Second, JPB is obliged to hold sufficient safe assets corresponding to the amount of postal savings inherited from Japan Post (i.e. corresponding to the amount of "old contracts"). Accordingly, a large proportion of assets of JPB's assets (around 75% as of March 2008) constitute of Japanese Government Bonds (JGB) which are free of any default risk; they are, however subject to substantial interest-rate and liquidity risks (*Kinoshita*, 2008). Finally, when JPB wants to expand its business, it must be approved by the Prime Minister (who delegates this power to the Commissioner of the Financial Services Agency (FSA) and the Minister of Internal Affairs and Communications MIC).[25] MIC and FSA will examine whether business expansion is appropriate, taking into account a "level playing field" (i.e. conditions affecting competition between JPB and other financial institutions) and JPBs business conditions; before taking a decision, they must take into consideration the opinion of PSPC.[26]

5. Consequences for bank competition, flows of funds, and financial stability

Observers both in Japan and abroad expressed concerns that a privatized JPB will enjoy some regulatory advantages over their competitors and will not act on a level playing field. In Japan, private-sector financial companies feared that JPB will enter into their markets and may distort competition by introducing new products before the implicit government guarantee of deposits is abolished; moreover, until the completion of the privatization process, JPB can use state-owned assets (like post office buildings) without bearing any cost. Critics argue the new postal group should not be allowed to launch new businesses as long as the government holds a stake in it.[27] Likewise, the US Trade Representative asked the Japanese gov-

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24 In July 2008, the Japan Post Bank has asked the government for a lifting of the ceiling on ordinary accounts; the ceiling will still apply to other types of deposits, such as time deposits. See *Japan Times Online* (2008a).

25 It is not stated what happens in the case of conflict between both Ministries.

26 The following businesses have been approved on December 19, 2007: Syndicated loans and loans to SPC (starting 1/2009); trading of public bonds (start after ending of preparations); trading of securities (3/2008); acquisition and transfer of loans (2/2008); derivatives trading (3/2008), reserve repo transactions (start after ending of preparations). On April 18, 2008, the following businesses were also approved: Credit card business (5/2008); sales of life insurance products such as individual variable annuity (5/2008); brokerage of allied bank's housing loans (5/2008). The granting of consumer loans has not yet been applied but JPB is willing to provide consumer loans in the future.

27 See *Japan Times Online* (2007) and *Japanese Bankers Association* (2007). For fiscal year 2004, experts estimated the government's implicit subsidies to Japan Post amounting to 943 billion Yen. The implicit sub-

ernment to clarify the relationship between Post Bank's new companies and to guarantee that regulatory obligations meet arms-length rules; moreover, cross-subsidization between pre-privatized accounts and new accounts shall be prevented and measures should be taken to eliminate perceptions that an implicit government guarantee exists for JPB deposits opened after October 1, 2007.[28]

The Japanese government responded by announcing that a privatized Post Bank will be subject to the same regulations as any other financial institution:[29] According to Japanese banking laws, FSA has sole authority over the supervision and inspection of Japan Post Bank and applies the same standards as those applied to other banks. FSA may also impose stricter orders, such as business suspensions (*Takahara*, 2007). JPB will be subject to the same licensing, disclosure, and supervisory requirements as other financial institutions. Japan Post Network is allowed to make agency contracts with any private bank other than Japan Post Bank and in terms of access to post branches equivalent conditions are secured between Post Bank and other private banks. Finally, the government promised to ensure that the relationship between Japan Post Network Co. and Japan Post Bank Co. are like between independent partners, i.e. with arms-length-rule. Ex-post cross-subsidization among postal companies shall be prevented.

Despite of all these provisions taken by the Japanese government, however, there are still doubts whether JPB is really able to act on a level playing field with other private banks in particular during the transition period. First, until 2017, JPB may remain at least a partially government-owned bank and could retain its image as a government-managed entity where all deposits are implicitly government-guaranteed. While, e.g., the chairman of PSPC has emphasized that "the 'implicit government guarantee' has no place to exist" (*Tanaka*, 2008), it remains an open question to what extend this is credible to the public. Besides, despite the fact that JPB is loosing market share to competitors, it is still a very large bank that may be "too big to fail". While this hold true for other large city banks, too, JPB is still very important for households` savings since it enjoys a broad customer base in rural areas and it has access to savings from regions that have been neglected by other banks.

Second, as mentioned above, "old" deposits are still guaranteed by the government. While the Holding Company bills JPB with costs equivalent to insurance premiums on these depos-

sidy comes from saved deposit insurance fees, stamp and corporate taxes, and from government support needed to offer higher deposit interest rates. See *Japan Times Online* (2005)

28 See *Office of the United States Trade Representative* (2007); *International Herald Tribune* (2007).

29 On this and the following also see *Office of the United States Trade Representative* (2007: 51-54).

its, there will be no flow of funds since premium payments are only "virtual" or "actuary"; hence, JPB receives a zero-interest loan from the government amounting to unpaid yearly insurance premiums on old contracts. Though deposit insurance premiums are very low at the moment,[30] postal savings amounted 186 trillion Yen in March 31, 2007, i.e., shortly before privatization (*Japan Post*, 2008a: 126); hence, the premium payments saved by JPB may sum up to 151 billion Yen (USD 1.5 billion) yearly which represents 8.5% of JPB ordinary income resp.15.8% of ordinary expenses (1,768 billion Yen resp. 954 billion Yen in fiscal year (FY) 2007; *Japan Post*, 2008a: 13, 17).[31]

Doubts are also in order about whether or not JBP will be able to contribute to financial stability in Japan during the coming decade, and this could depend on the future course of interest rates in Japan. As mentioned above, JPB has invested around 75% of its assets in Japanese Government Bonds which are default-safe but subject to a significant interest rate and liquidity risk. Currently, interest rates are very low in Japan; once they increase, the bank will incur a huge capital loss.[32] JPB, hence, has gradually to shift its asset composition away from government bonds and to diversify its portfolio; if it tries to sell government bonds at once, yields would jump and this would hurt the value of its remaining government bond holdings.[33] Before privatization, the President of Japan Post had already announced that the bank intends to diversify into retail banking – mortgage, credit cards and lending to small businesses – and thus to intrude into the traditional business realm of regional banks (*Ogata*, 2007; *Tanaka*, 2008).

Solvency problems could be accompanied by liquidity problems if depositors shift their deposits from JPB to private banks. Massive shift of funds away from the postal savings system into other Japanese banks have already begun. While at the end of FY 1997, deposit holdings with Japan Post consisted out of 36.2% of all domestic deposits in Japan, this market share has fallen to 24.8% at the end of FY 2008; especially severe was the outflow of time and savings deposits where the market share dropped from 36% at the end of FY 1997

[30] They amount to 0.108% for "Payment & Settlement Deposits" and to 0.081% for "General Deposits" in 2008. See DICJ-website.

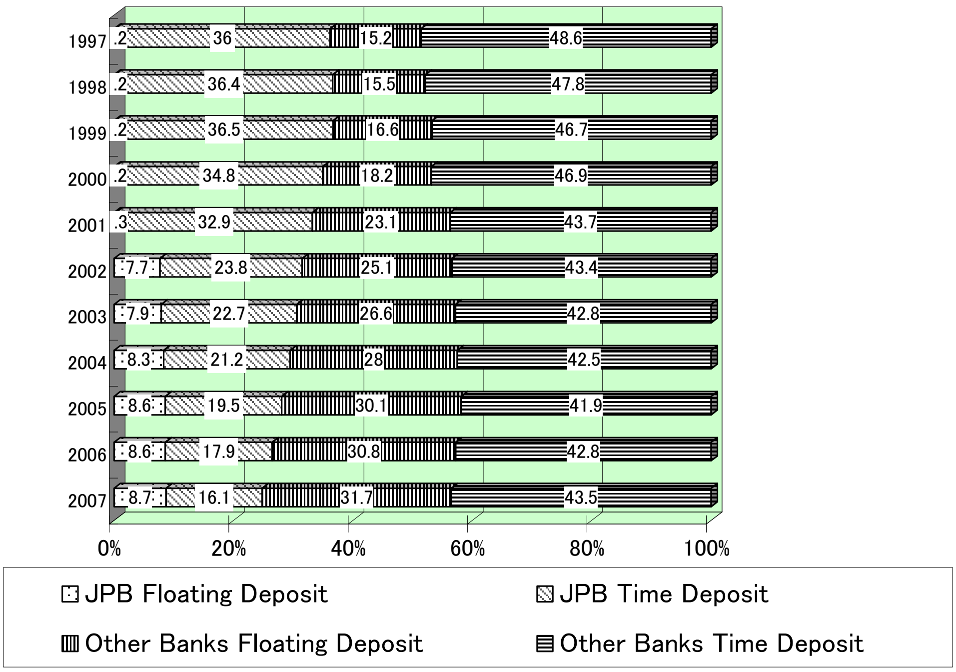
[31] The estimate of premium payments saved, however, does not take into account the existence of the 10 million Yen caps for postal savings.

[32] Even a small increase of 50 basis points every year for five years could expose JPB to a substantial profit reductions from 507 billion Yen to 131 billion Yen in FY 2011; information from interview conducted by Bebenroth and Vollmer.

[33] JPB has, instead, increased its holdings of long-term and medium-term government bonds during FY 2007. See *Japan Post* (2008a: 9).

to 16.1 % at the end of FY 2008.[34] In March 2008, total deposits with JPB amounted 181 trillion Yen falling from 262 trillion Yen at the end of FY 1999. At the same time, there was a large shift of funds away from savings deposits into floating deposits which almost doubled their share during the time of period considered and covered nearly 40% of all domestic deposits at the end of FY 2007 (see Figure 2).

Figure 2: Share of JPB in domestic deposits: 1997-2007 (in %)



Source: *Bank of Japan, Japan Post,* own calculations.

With interest rates rising, this shift away from JPB deposits could accelerate in the future, because holders of “old” teigaku savings might take the put option and terminate their teigaku holdings before maturity. While old savings are still government guaranteed, this risk-advantage could loose some of its attractiveness if interest rates rise beyond a certain level where savers value interest incomes foregone more than safety. A redeposition of teigaku savings with JPB might not be attractive anymore for savers since “new” deposits are no more guaranteed by the government but are insured by DICJ - like deposits with any other private bank. Hence, raising interest rates could put JPB at risk and could unhinge the `Behemot´.

6. Conclusions

[34] The sharp decrease in FY 2000-2001 was due to a large volume of teigaku savings that reached maturity. Because interest rates were declining in the 1990s, savers had strong incentives to hold teigaku time deposits until maturity.

In this paper, we studied the ongoing privatization process of Japan Post Bank (JPB). We reported that, before privatization, postal savings were channeled into a government-directed investment program (FILP) where loans were politically determined with a large extent of non-performing loans. While reforms of FILP began as early as 2001, Japan Post privatization started in October 2007 and made JPB subject to banking regulation and supervision through FSA.

The major goal of the privatization process is to unlock JPB`s financial assets and to make postal savings available to private investors. While this goal may be reached, the Japanese government was also eager to ensure a level playing field in bank competition and to secure financial stability. We argue that some of the existing provisions put JPB on a competitive advantage vis-à-vis its competitors: It may retain the image of a government-managed bank with an implicit government-guarantee of its deposits and does not have to pay deposit insurance premiums on "old deposits" that are still guaranteed by the government. Moreover, while Japan Post Bank may enjoy some privileges which other Japanese banks do not possess, JPB, bears the burden of a large interest rate risk on Japanese government bonds and is prone to the risk of massive disintermediation if depositors use their put option on "old" teigaku savings and search for better investment opportunities. This scenario could come true if interest rates rise.

As mentioned in the introduction, the privatization strategy chosen by the Japanese Government differs from strategies chosen in other countries where PSS were simply abolished or were PSS were privatized and sold to an assuming bank. A privatization strategy similar to Japan, however, was used in Germany in 1990, were Deutsche Postbank was formed from the demerger of the postal savings division of the German Postal Service System (Deutsche Bundespost). At first, Postbank became a wholly-owned subsidiary of Deutsche Post which itself was privatized in 2000, from June 2004 on, Postbank shares were traded on the Frankfurt Stock Exchange and Deutsche Post kept the majority until September 2008, when almost 30% of this was sold to Deutsche Bank.[35] In Germany, however, the government did not give a blanket guarantee for old savings as it is the case in Japan. Instead, deposits with Deutsche Postbank are insured by the German deposit insurer, since Deutsche Postbank is a member of the Deposit Protection Fund of the Association of German Banks.

[35] In January 2009, Deutsche Bank decided to further increae its ownership of Deutsche Postbank. For the history of Deutsche Postbank see http://www.postbank.com and *Bundesministerium für Finanzen*, (2005: 9).

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