Corporate restructuring in Japan: Who monitors the monitor?

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1. Introduction

Delayed responses by banks and affiliated companies, the main pillars of corporate governance in Japan, to address corporate debt problems that ballooned during the 1990s led to a devastating economic recession. This failure to address bad debts has been the focus of considerable research, especially by Peek and Rosengren (2005), who documented the existence of pervasive “evergreening” – banks extending additional loans to companies in financial distress to avoid formally recognizing losses. Evergreening is related to moral hazard and adverse selection problems and is made possible by deposit insurance, too-big-to-fail policies, weak supervision, and regulatory forbearance. This paper extends Peek and Rosengren (2005) to explore two implications of their research. First, firms in financial distress with stronger chances of survival should have sought non-bank-led and non-affiliate-led debt restructuring programs. Second, the Japanese stock market should understand this and should have assigned larger, positive abnormal returns to in-court restructurings mediated by external sponsors, bank supervisors, or other third parties result in significantly higher debtor-market valuations. Out-of-court restructurings led by third parties are likely to be free of the perverse incentives associated with restructurings led by banks and affiliated companies.

Unlike what Gilson et al. (1990) and Gilson (1997) found in the United States, we find that, while the proportion of agreements that completed out-of-court restructurings in Japan is higher, the proportion of restructurings requiring additional debt relief is also higher. Further, even where agreements were reached in out-of-court restructurings, increases in corporate value observed as positive stock returns of debtor companies were small. The corporate monitoring mechanism that developed in Japan is not market based but large-stakeholder based – typically, banks and affiliated companies. These stakeholders are expected to efficiently resolve potential bankruptcy or collapse with better information resulting from long-term relationships with the distressed firms. Our study, however, finds that private restructurings led by them failed because of delays in implementing fundamental solutions. Forbearance in addressing the needs of distressed firms demonstrates the weakness of such stakeholders in instituting discipline, hence the need for a system to “monitor the monitor”. © 2008 Elsevier B.V. All rights reserved.

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A B S T R A C T

Peek and Rosengren [Peek, J., Rosengren, E., 2005. Unnatural selection: Perverse incentives and the mis-allocation of credit in Japan. American Economic Review 95, 1144–1166] showed that, when the bubble economy era ended, regulatory forbearance and perverse incentives allowed Japanese banks to engage extensively in evergreening. This is the first comprehensive study to empirically analyze the economics of private debt restructurings of financially distressed companies in Japan, where the corporate monitoring mechanism is not market based but large-stakeholder based – typically, banks and affiliated companies. These stakeholders are expected to efficiently resolve potential bankruptcy or collapse with better information resulting from long-term relationships with the distressed firms. Our study, however, finds that private restructurings led by them failed because of delays in implementing fundamental solutions. Forbearance in addressing the needs of distressed firms demonstrates the weakness of such stakeholders in instituting discipline, hence the need for a system to “monitor the monitor”.

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is believed to solve inefficiency due to information asymmetry and free-rider problems, but the results of our study run counter to this positive view of the delegated monitoring system. Rather, they are more consistent with the soft budget model of Dewatripont and Maskin (1995), with the model of Diamond and Rajan (2001), who argue that systems of delegated monitoring by banks work effectively only when the banks are disciplined by depositors, and with Dewatripont and Tirole (1994), who argue that bank supervisors must play a more active role in monitoring banks than depositors because depositors lack sufficient information and incentives to monitor banks. In other words, if banks escape discipline, then effective restructuring of financially distressed companies requires some alternative monitoring of banks.

The next section reviews related studies and discusses the background of the problem. Section 3 specifies the hypotheses and Section 4 describes the sample and data. Section 5 presents the results of the analysis and Section 6 is a conclusion.

2. Literature review and the background of Japan's bad-debt crisis

2.1. Restructuring

Profit-seeking banks and other creditors should accept out-of-court restructurings of distressed debt only when the value of the debt they originated increases by reducing various financial distress costs of the debtor. Since changes in the market value of bank loans are unobservable, changes in the market value of companies’ equity are a reasonable alternative way to measure whether restructuring enhances value. Using this approach, Gilson et al. (1990) analyzed the market value of companies that were subject to private settlements in 169 cases of financial distress in the United States. They showed that at the initial announcement of a debt-relief request average cumulative abnormal returns were negative, but they became positive by the time the negotiations were concluded. Gilson et al. also found for defaulting firms that companies that later reached agreement on out-of-court restructuring had higher cumulative abnormal returns at the announcement of starting negotiations for the restructuring. This implies that the stock market correctly predicts the outcome of out-of-court restructurings. Uchida and Goto (2002) analyzed 18 debt-waiver cases in Japan and reported significant positive abnormal returns within three days of the announcement of the debt-relief request. While these earlier studies focused on whether restructurings led to an increase in the market value of debtor companies, little analysis of the factors involved was made.

Studies of out-of-court restructurings are mainly concerned with impediments to completing restructuring agreements. Gilson et al. (1990), Gilson (1997), and others have reported that direct and indirect transaction costs are lower for out-of-court restructurings than for judicial settlements, and that out-of-court restructurings are generally more efficient than judicial settlements. Of course, there are impediments to out-of-court restructuring, such as asymmetric information, conflicting interests between the affected parties, the holdout problem, and the free-rider problem. Gilson et al. (1990) showed that these obstacles make it difficult to conclude out-of-court restructurings in the United States.

In Japan the situation is different. Out-of-court debt restructurings are far more common than judicial restructurings for listed companies. Sheard (1994) argued that in Japan main banks and affiliated companies have stable long-term relationships with distressed companies; these relationships mitigate information problems and conflicts of interest, making restructuring more efficient. Hoshi et al. (1990) found that bailouts of distressed companies led by main banks and affiliated companies were able to hold distress costs to relatively low levels. Further, Kang and Shivdasani (1997) showed that main banks and affiliated companies could effectively promote the restructuring of troubled companies and instill discipline. But in recent years studies by Morck and Nakamura (1999) and Kang and Stulz (2000) have argued that the main bank system allowed firms to escape discipline by investors and creditors, resulting in a serious misallocation of credit. Peek and Rosengren (2005) documented how bad incentives, accounting tricks, poor transparency, and supervisors’ forbearance let bankers continue evergreening: lending to their most troubled borrowers. They showed that banks were more likely to grant additional loans to deeply troubled firms. These loans and bank-led interventions did not lead to improvements.

No increase in the market value of a distressed company's stock can be expected if the scale of debt relief is insufficient, or if the restructuring plan is not radical enough. One likely cause of insufficient out-of-court restructurings is procrastination by entrenched managers and officers in banks and affiliated companies for fear that full disclosure of the magnitude of the problems would threaten bank capital adequacy ratios and damage their reputations. In these cases, restructuring measures might be limited to continuing financial support and increased capital with little genuine prospect for recovery and an insufficient waiver of debt.

This reluctance to begin restructuring and the attendant incentives to carry out insufficient restructuring is a serious problem; one solution is a monitoring mechanism that directly initiates and intervenes in out-of-court restructurings. Diamond (1984) claimed that delegated monitoring by banks is effective and can lower monitoring costs for shareholders. But even for this idealized system, there remains the question: Who monitors the monitors (banks)? As Diamond and Rajan (2001) point out, it is only when banks are disciplined by the fear of runs by depositors that they will be vigilant in their monitoring. Yet Dewatripont and Tirole (1994) and many other researchers have pointed out that insured depositors lack sufficient information or motivation to monitor banks. Even sophisticated investors in non-insured bank liabilities have little incentive to monitor when the government follows too-big-to-fail policies or convoy-system policies that effectively guarantee all bank liabilities. In the absence of market discipline, bank monitoring is wholly the responsibility of government bank supervisors. Yet bank supervisors have their own concerns. As pointed out by Kane (2000), these concerns are not necessarily limited to the prudential monitoring of banks or to providing reality checks on debt restructurings. If monitoring by bank supervisors is dysfunctional, sufficient incentives to initiate and effectively restructure debt problems will be lacking. Monitoring and mediation by banks vis-à-vis debtors will be directly affected by the quality of monitoring and mediation by bank supervisors, especially when there is weak market discipline on banks.

2.2. Japan’s bad-debt crisis

Japan’s bad-debt problem and its implications for the banking system became a focus of attention in the early 1990s, shortly after the burst of the bubble economy. Many companies reported as financially distressed in the first half of the 1990s were again reclassified in 1995. In 1992 its main bank, Fuji Bank, implemented a relief plan whereby it waived interest payments amounting to the huge sum of ¥40 billion a year. Yet Tobishima’s problems remained, and from 1997 until 2003 Fuji Bank implemented four more “rescue” schemes, beginning with debt relief amounting to more than ¥600 billion in 1997.

By June 1995 Japanese bank supervisors admitted that bank bad debts totaled ¥40 trillion. Starting to recognize the gravity of the
Function Early Strengthening Law was enacted; it permitted the

tion of deposits up to 2001.

Despite these measures, the crisis continued to worsen; two

major institutions, the Hokkaido Takushoku Bank and the Long

Term Credit Bank of Japan, failed, contributing to a sense of panic

in financial markets. Consequently, in October 1998 the Financial

Function Early Strengthening Law was enacted; it permitted the

injection of governmental funds to recapitalize banks facing insol-

vency before technical default. This helped stabilize the Japanese

financial system, but banks recapitalized by governmental funds

procrastinated in applying drastic solutions to their bad-debt

problems.

In 2002 Prime Minister Koizumi publicly pledged to resolve the

bad-debt problem within two years; at the same time, full protec-

tion of general deposits was extended to April 2005, although a payoff of time deposits was introduced from April 2002. This

measure was intended to avert a financial crisis by easing market pressures on banks until the bad-debt problem had been fully resolved, but it meant that now banks were completely insulated from market forces. Since the government had taken measures to protect banks from market-based monitoring, their monitoring was effectively left to independent auditors and bank supervisors. Of these two, independent auditors generally lacked sufficient information regarding the value of loans to conduct a detailed and accurate analysis of bank-asset quality. This in effect left the important function of examining assets entirely to bank supervisors.

The Financial Function Early Strengthening Law also introduced Special Inspections of banks by regulators. There were five such Special Inspections: in the summer of 1998 and yearly from 2001 to 2004. We analyze these special inspections as a group. Before 1998, bank supervisors conducted normal inspections every 3–5 years but had never been directly involved in rehabilitation negotiations between banks and distressed borrowers. In addition, since credit evaluation standards were less clear at that time, there were large differences in estimates of loan values by bank managers and bank supervisors. Before 1998, banks that had not formally defaulted were not obliged to restate their loan values as a result of supervisory inspections, so little genuine monitoring actually occurred. The special inspections were quite different from ordinary inspections, since their process and results were closely monitored by the government; they were a response to domestic and foreign criticism leveled against the government for failing to address the bad-debt problems of leading banks. They resulted in bank supervisors becoming actively involved in the rehabilitation of debtor companies, with banks facing pressure to initiate meaningful restructuring of such companies. Special inspections directly led to the temporary nationalization of Nippon Credit Bank (December 1998) as well as to large loan-quality restatements by leading banks (March 2002), with further restatements by Resona (2003), UFJ (2004), and Mitsui-Sumitomo (2005). Further, with regard to the total amount of bad debts that the banks wrote off, the largest bad-debt disposals happened in the fiscal year ending March 1999, coinciding with the first Special Inspection. The bad-debt disposal associated with the fiscal year ending March 2002, coinciding with the second special inspection, increased by more than 50% over the previous year. Fig. 1 shows the historic trend of the total amount of non-performing loans and bad-debt disposals by banks in Japan. Table 1 describes the timing and background of the special inspections by bank supervisors.

<table>
<thead>
<tr>
<th>Timing</th>
<th>Background</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1998</td>
<td>Uniform inspections of 19 major banks</td>
</tr>
<tr>
<td>November 2001</td>
<td>Special inspection under Government Reform Plan</td>
</tr>
<tr>
<td>January 2003</td>
<td>Special inspection under Finance Reform Program</td>
</tr>
<tr>
<td>November 2003</td>
<td>Same as above</td>
</tr>
<tr>
<td>November 2004</td>
<td>Same as above</td>
</tr>
</tbody>
</table>

3. Hypotheses

From the discussion in the previous section we follow with an analysis of the possibility that the nature of out-of-court restructurings of Japanese companies was affected by whether or not lender banks were subject to effective monitoring. To test this, we analyze whether out-of-court restructurings increase the market values of debtor companies.
When the stock market perceives that managers and bank officers procrastinate in their acceptance of out-of-court restructurings, the presence or absence of third-party monitoring of the settlement is a potentially important factor in the market’s reaction to out-of-court restructurings. Third parties are unfettered by concerns associated with past unsuccessful investments or the perverse incentives documented by Peek and Rosengren (2005); their assessment is based on objective analysis of the expected return from investment in each restructuring plan. Further, rational managers of companies in financial distress with good prospects of recovery should prefer restructurings led by third parties because greater value will be potentially created, and they are more likely to find sponsors for the restructurings who are not affiliates of the debtors or their lender banks. Hence, our first hypothesis is that the announcement of third-party-led debt restructurings will be associated with positive cumulative abnormal returns in the stock market that are significantly greater than cumulative abnormal returns associated with bank-led and related-party-led restructurings.

Further, with regard to bank-led rescues, the efficacy of monitoring by bank supervisors becomes relevant. As a proxy of the efficacy of monitoring by bank supervisors, we use the special inspections. Thus, our second hypothesis is that cumulative abnormal returns associated with debt restructurings announced during special inspection periods will be significantly greater than cumulative abnormal returns associated with debt restructurings outside special inspection periods.

4. Sample and data

This study focuses on debt-relief requests by companies from 1990 to March 2005. The keywords “debt waiver,” “debt forgiveness,” and other similar terms were used in an extensive search of the four business newspapers issued by Nihon Keizai Shimbun Inc. over the period to identify relief requests by listed companies. The focus was further narrowed to those companies described in newspaper articles as suffering from net deficits or in a clear default crisis. This procedure was applied in order to maintain sample homogeneity, because there are cases in which calls for outside financial relief were made in the absence of impending default. Cases in which direct mediation by government was significant (such as the restructuring of housing-loan companies, insurance companies, and banks) were excluded. Also, companies that sought debt relief more than once within 50 weeks were treated as a single observation. As a result of these filters, the number of relief-request observations consisted of 134 companies and 208 events. Of these, 49 companies applied for debt relief two or more times.

The dates of the initial debt-relief request and the dates of the conclusion of an agreement were identified through another newspaper search over the periods before and after the event. As far as could be verified, 72 events had a different agreement date from the initial announcement date. In 19 events, no rescue agreement was reached after negotiations began between the debtor and its financial providers including banks and affiliated companies. Of these 19, 15 changed to judicial settlements soon after the failure of negotiations; of the 4 that did not change, three of the companies involved were subsequently delisted, while the fourth was the object of a separate rescue three years later. Obviously, there were companies other than those included in our sample that sought relief but were not reported in the newspapers. During the analysis period, there were 76 listed companies, including the above-mentioned 15 companies that applied for a judicial restructuring. Even if we conservatively assume all these 76 companies sought debt relief once and failed to reach agreement prior to their judicial settlement, about 70% of debt-relief requests were able to reach agreement.

The market’s valuation of debt-relief settlements was measured with cumulative abnormal returns estimated from weekly stock return data provided by Toyo Keizai Shimposha and Bloomberg. With regard to the measurement of cumulative abnormal returns, the expected returns of the companies in this analysis were measured using the market model with the Tokyo Stock Price Index (TOPIX) as a proxy for the market. Market model parameters were estimated over the period from the 61st week prior to the initial debt-relief request announcement to the 2nd week prior to the initial announcement.

5. Results of analysis

5.1. Descriptive statistics

Descriptive statistics for the sample are shown in Table 2, which also shows details on whether a final restructuring agreement was concluded, information on which agreements were assisted by banks or other parties, and a further breakdown of the cases that were assisted by banks into whether the restructuring was negotiated during, or outside, the Special Inspection periods. Out-of-court, bank-led rescues negotiated during the special inspection periods are assumed to be made with monitoring and mediation by bank supervisors.

Banks led 74% of relief attempts as a main bank. Of the rescued companies, 70% were rescued by multiple banks or companies. More than a third of the sample companies required two or more rescue rounds. Nine out of ten rescues consisted of moratoriums on interest payments or debt waivers that involved changes in debt contracts. More than half the rescues involved fresh capital injections. Also, 4 out of 10 cases for the entire sample and half the bank-led cases involved the non-banking, real estate, and construction industries. These companies were among those most devastated by the collapse of the bubble economy.

What deserves special attention regarding the completion of debt-relief agreements is the distinction between rescues by banks and those by entities other than banks. Almost 90% of failed agreements involved rescues by banks; most of these cases involved more than one bank, so the failure rate reflects the difficulty in reaching agreement when there are multiple parties involved. As for rescue amounts, it seems the amount does not affect the probability of concluding a successful agreement.

With regard to the identity of the creditors, about 80% of debt-relief requests to banks involved several parties. This shows that even when rescue efforts started out with a main bank, completed rescues led by the bank were a minority of cases. About two-thirds of cases of rescue requests made to parties other than banks, however, involved only one company.

The rescue packages led by banks involved more capital reduction than packages led by parties other than banks, and tended to extend greater amounts than those proposed in the initial request for assistance. On average, the size of bank-led rescue packages is four times greater than non-bank-led rescues. This indicates that large-scale out-of-court debt-relief efforts were mainly bank-led rescues.

1 In addition to the 15 cases that failed to reach an out-of-court restructuring, there were 15 events in which out-of-court restructurings were agreed to and concluded but subsequently failed to rehabilitate the companies concerned, and that later changed to judicial settlements. Hence, a total of 30 companies, or 22% of the 134 firms in our sample, were finally resolved by judicial settlements.

2 Of a total of 268 cases of debt-relief-request events, 189 successfully reached agreement. This includes the assumed 76 unsuccessful requests eventually resolved by judicial procedures.
If we separate the rescue efforts by banks into those carried out during the special inspection periods and those conducted outside them, efforts made during the inspections involved debt waivers and an increased likelihood that the banks finally agreed upon larger amounts of assistance than the amounts initially requested. This was the result of strong pressure by bank supervisors.

Though this is not shown in the table, we also examined changes in the character of the rescue measures over the 15 years analyzed here. We identify a shift from evergreening and debt moratoriums to debt waivers and larger levels of assistance from 1998, when the first Special Inspection was conducted. Also, after April 2001, when Prime Minister Koizumi pledged to resolve the bad-debt problem within two years, cases in which the final resolution on the potential nature of the debt relief at the time of the initial announcement, so although emphasis is given to the CAR result at the time of the initial relief request, or that of the agreement period [the announcement week (AW) to the week following conclusion of the agreement (CW+1)]. As the event window becomes longer, the statistical significance of cumulative abnormal returns (CAR) naturally decreases; hence, we emphasize the CAR result at the time of the initial relief request, or that of the announcement period. Often, however, there is insufficient information on the potential nature of the debt relief at the time of the initial announcement, so although emphasis is given to the stock market’s reaction at the initial announcement of the relief request, we also analyze the market values of distressed companies.

Table 3
Cumulative average abnormal returns for all debt-resolution attempts

<table>
<thead>
<tr>
<th></th>
<th>All</th>
<th>Agreement</th>
<th>Not agreed</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>N</td>
<td>CAR (%)</td>
<td>t-stat</td>
<td>N</td>
</tr>
<tr>
<td>Announcement period (AW, AW+1)</td>
<td>208</td>
<td>1.4</td>
<td>0.643</td>
<td>189</td>
</tr>
<tr>
<td>Outcome period (CW, CW+1)</td>
<td>208</td>
<td>-3.2</td>
<td>-1.221</td>
<td>189</td>
</tr>
<tr>
<td>Negotiation period (AW, CW+1)</td>
<td>208</td>
<td>3.1</td>
<td>1.238</td>
<td>189</td>
</tr>
</tbody>
</table>

All: entire sample. Agreed: subsample where the relief request was agreed. Not agreed: subsample where no agreement was reached. AW: announcement week. CW: the week when the restructuring was concluded. AW+1: the week following AW. CW+1: the week following CW. ** and *** indicate statistical significance at the 5%, and 1% levels, respectively, for two-tailed tests.
over the entire period from the initiation of debt-relief negotiations until the agreements are concluded (or abandoned).

As shown by the columns labeled “All” in Table 3, the CARs at the announcement period for the entire sample (including cases where no agreement was reached) are not significantly different from zero. This result indicates that, since there is no guarantee that a relief request will reach a satisfactory mutual agreement, private rehabilitation requests alone do not increase stock value.

Next, the debt-relief requests are divided into cases in which agreement was reached and cases in which no agreement was achieved. First, for cases in which agreement was reached, there were significant positive cumulative abnormal returns at the 5% level for the outcome period and the negotiation periods. The CARs in the announcement period were also positive but not significant. Conversely, cases where no mutual agreement was reached showed large negative CARs for both the outcome and the negotiation periods. The CARs in the rightmost columns in Table 3 show that CARs for the agreed and not-agreed samples are significantly different in the outcome and negotiation periods. Comparing judicial rehabilitation with out-of-court restructuring shows the cost to share owners is painfully high. Cases in which mutual agreement was reached tend to increase shareholder value.

Gillon et al. (1990) reported that, for out-of-court relief efforts where mutual agreement was achieved, negotiation period CARs averaged more than 40%; this is remarkably high compared with the results of our study. These results mean that, though it is easier to reach out-of-court agreements in Japan than in the United States, the resultant restructurings are less radical than necessary.

Next, we divide the restructuring sample into those that were bank-led and those that were not bank-led. The results are shown in Table 4. For the whole sample, those restructurings that were led by parties other than banks had significantly positive CARs during the outcome and negotiation periods. Furthermore, for the subsample that successfully agreed on relief, CARs are positive and significant at the initial announcement as well. This shows that debt restructurings led by parties other than banks raised company value.

None of the mean CARs for the debt restructuring samples led by banks was significantly positive. The market does not regard bank-led restructurings as positive events that are sufficient for the rescued company to avoid/delay default or bankruptcy and increase firm value. This result is consistent with Peek and Rosengren (2005).

Table 4
Cumulative average abnormal returns based on debt-restructuring leader

<table>
<thead>
<tr>
<th></th>
<th>Rescue request to banks</th>
<th></th>
<th>Others</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>N</td>
<td>CAR (%)</td>
<td>t-stat</td>
<td>N</td>
</tr>
<tr>
<td>Whole sample</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Announcement period</td>
<td>154</td>
<td>−1.0</td>
<td>−0.415</td>
<td>54</td>
</tr>
<tr>
<td>Outcome period</td>
<td>154</td>
<td>−7.3</td>
<td>−2.388</td>
<td>54</td>
</tr>
<tr>
<td>Negotiation period</td>
<td>154</td>
<td>0.8</td>
<td>0.281</td>
<td>54</td>
</tr>
<tr>
<td>Successfully agreed</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Announcement period</td>
<td>137</td>
<td>−0.9</td>
<td>−0.364</td>
<td>52</td>
</tr>
<tr>
<td>Outcome period</td>
<td>137</td>
<td>2.2</td>
<td>0.969</td>
<td>52</td>
</tr>
<tr>
<td>Negotiation period</td>
<td>137</td>
<td>4.1</td>
<td>1.443</td>
<td>52</td>
</tr>
</tbody>
</table>

Rescue request to banks is the subsample where the troubled company requests a rescue by a bank. Others are the subsample where the troubled company requests rescue by parties other than banks. Successfully agreed is the subsample where a rescue plan reached agreement. AW: announcement week. CW: the week when the restructuring was concluded. AW+1: the week following AW. CW+1: the week following CW. *, **, and *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively, for two-tailed tests.

5.3. Evaluation of third-party monitoring

Next, we examine potential factors that may influence shareholder returns in the sample that reached debt-relief agreements, to test the hypotheses described in Section 3. So, in all the analysis below, only cases that reached an agreement are considered.

It is likely that procrastination in fundamental restructuring in out-of-court restructuring efforts is observed by the stock market. It may regard lack of third-party monitoring or mediation as signals of the low quality of the proposed out-of-court restructuring scheme. To examine our hypotheses, we applied ordinary least squares regression analysis.

We create dummy variables based on resolutions with equity capital injections from a third party (not lender banks or affiliated companies), to test our first hypothesis. The third party analyzed here is not the lender bank, nor does it own 20% or more of the equity of the distressed company. Because restructurings led by main banks often bring in third parties that have close relationships with the banks, and hence may not be perceived as a positive signal of objective monitoring or sufficiently radical reorganization of the troubled borrower, we identify whether the equity capital injections from a third party are actually schemes led by banks.

For the bank-led cases, another situation that the stock market may perceive as a positive signal of the quality of the proposed relief scheme would be cases with effective monitoring and mediation by bank supervisors. To examine this, we identify completed out-of-court restructurings negotiated during the special inspection periods. Further, even when bank supervisors were effective monitors, the tax treatment of debt waivers may impede the restructuring process. The tax law in Japan states that, when a creditor waives his claims over a distressed company, the debt waiver can be treated as a loss for tax purposes only when the waiver is the minimum amount necessary to rehabilitate the distressed company. Should a debt waiver not qualify as a loss for tax purposes, it is treated as a form of charitable donation, and this puts bank management under threat of litigation from shareholders for breach of fiduciary duty. When the assets of distressed companies are clearly proven to have deteriorated, there is a greater probability that a debt waiver would be considered as a loss for tax purposes. In the non-banking, real estate, and construction industries (hereafter, collectively referred to as “Asset-base Business Categories”), where the market value of their collateral assets

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3 This result is contrary to the findings of Uchida and Goto (2002), who report significant positive CARs for bank-led restructurings in Japan. Their different result probably arises from their much smaller sample over a shorter period.

4 According to Japanese GAAP, if a company holds more than 20% of shares of other companies, the companies are deemed equity method affiliates.

5 A recent example of this is the rehabilitation of Mitsubishi Motors in 2004, in which a private equity fund originated by a retired staff member of Bank of Tokyo-Mitsubishi was the sponsor.
and real estate was clearly going down, sales of obligations and real properties at market prices to third parties or receiver companies allowed them to demonstrate unambiguous losses. At the same time, since companies that receive debt relief could also claim large losses from their asset disposals for tax purposes, these companies can offset the debt-waiver “profit” against these losses and achieve a tax-free debt restructuring. In this situation, restructurings for these Asset-base Business Categories would cost less, and there would be less threat of shareholder litigation. For this reason we assume that relatively large amounts could be treated as tax losses by the Asset-base Business Categories and that these debt waivers will be highly valued by the market. So, to test the effectiveness of monitoring by bank supervisors and tax implication simultaneously, we add a cross-dummy variable that identifies bank-led restructurings during the special inspection periods for companies without impact from tax associated with debt waivers. The group includes debt waivers for companies in the Asset-base Business Categories and restructurings without debt waivers for all business categories.

In addition, since the fear of possible capital reductions might influence investor sentiment, we add a dummy variable to identify restructuring schemes with capital reductions. Capital reductions were imposed by banks as a symbol of the “penalty on shareholders of the rescued company.” This was particularly noteworthy during the Special Inspection periods. Since capital reduction alone is merely an accounting change, it should not have any impact on shareholder wealth in theory.

We also include several control variables: size of the rescue package, and two time dummies. We use log of the agreed rescue package amount for the size measure and a dummy variable that is one if the rescue was requested before December 1997 and zero otherwise. Note that the first special inspection was in 1998. We also use another time dummy variable that is one if the rescue was requested after April 2002. Note that from April 2002 the payoff of time deposits was introduced.

We use announcement period CARs, our main focus, as the dependent variable. We show these results in Table 5. We show results for all observations (see Model (1)) and subsets of our population that eliminate three extreme observations (see Models (2), (3) and (4)).

The results of the regression analysis are consistent with our hypotheses. New capital injections are valued by the stock market only in cases in which restructuring plans are not led by banks and new capital comes from a third party (see Models (1), (2) and (4) in Table 5). This supports our first hypothesis. Bank-led restructuring plans are valued by the stock market during special inspection periods and for non-tax-impacted rescues (Models (1), (2) and (3) in Table 5). Neither the size of the rescue package nor the time dummies have significant relations with CARs. These results conclusively demonstrate that company value is only enhanced when bank-led, out-of-court restructurings occur with monitoring by bank supervisors without tax penalties, which is consistent with our second hypothesis. Resolution of bad-debt problems and corporate restructuring requires an environment in which the monitoring and the tax regimes complement each other to provide proper incentives.

In additional research not reported here, we find that restructurings led by parties other than banks with capital injection via third parties had significant positive CARs (N = 21, mean CAR = 29.7%, t-stat = 2.824). The difference in resolutions with and without third-party capital injections is also statistically significant at the 1% confidence level for both the announcement and negotiation period CARs. Although we find a positive effect from third-party mediation for cases other than those led by banks, we do not find

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6 We analyzed CARs for bank-led completed restructurings for the companies in Asset-base Business Categories and other companies. If we consider only restructurings with debt waivers, the Asset-base Business Categories had significantly higher CARs both in the announcement and negotiation periods. Yet this difference was not statistically significant for out-of-court restructurings unaccompanied by debt waivers, where we do not expect impediments from tax treatment. These results are consistent with the hypothesis that debt-waiver restructurings led by banks are hindered by tax treatment.

7 We find essentially the same results when these three observations are included in the models.
a positive effect for bank-led cases. These results further confirm our first hypothesis. As for bank-led cases, restructurings in the Special Inspection periods without adverse tax impact from debt waivers have positive and significant CARs both in the announcement period ($N = 32$, mean $\text{CAR} = 11.6\%$, $t\text{-stat} = 2.138$) and in the negotiation period ($N = 32$, mean $\text{CAR} = 12.2\%$, $t\text{-stat} = 2.099$). On the other hand, the CARs for the bank-led restructurings outside the Special Inspection periods are negative and significant in the announcement period ($N = 105$, mean $\text{CAR} = -4.7\%$, $t\text{-stat} = -1.712$) and positive but insignificant in the negotiation period. These results further confirm our second hypothesis.

6. Conclusion

This study extends the research of Peek and Rosengren (2005), who documented how perverse incentives lead Japanese banks to evergreen—provide credit to the weakest and least promising firms in financial distress. We analyze cumulative abnormal returns for Japanese companies that underwent out-of-court debt restructurings after the collapse of the bubble economy in 1990 to the time that the excessive debt problems of major firms were proclaimed resolved in March 2005. The main results of the analyses are that the announcement of out-of-court restructurings had a positive effect on the market value of the distressed companies only when the rescue packages were likely to be effective. Since there was a tendency for banks and affiliated companies to procrastinate in carrying out radical rehabilitation, only those restructurings with third-party monitoring were associated with increases in market value. Firms in financial distress with good prospects of recovery tended to have debt restructurings that involved third parties, which were less likely to have the perverse incentives that undermined bank-led restructurings.

This study shows that the main pillars of Japanese corporate Governance—banks and affiliated companies—did not function effectively in addressing insolvency and bad debts in the 1990s. Compared with out-of-court restructuring in the United States, Japanese restructurings seem to reach agreement more easily, but there results less improvement in corporate value (and performance). Sheard (1994) and others have noted that formerly, when banks and affiliated companies played a central role in crafting effective rescue measures. Still, market forces in those out-of-court rescues by related parties were weak. There was a danger that necessary fundamental changes would be delayed. These conclusions complement and extend Peek and Rosengren (2005) and Morck and Nakamura (1999): main banks and affiliated companies may not contribute to the resolution of problems at troubled companies.

On the other hand, the stock market regarded mediation by bank supervisors in bad-debt problems as a positive signal. Banks insulated from market discipline may not be able to impose the appropriate restructuring measures; this is consistent with Dewatripont and Tirole (1994), who argue that proper monitoring and mediation by bank supervisors is necessary. The conclusion to be drawn is that a system to “monitor the monitor” is indispensable in the governance of Japanese corporations. The prolonged and painful resolution of Japan’s bad-debt problem was a consequence of bank supervisors’ failure to perform their monitoring function, and perverse incentives.

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