Merging Law and Business History: Case Study in the Development of Collateral in Japan at the Turn of the Twentieth Century

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Introduction

Business history is an extraordinarily intellectually stimulating subject. It combines the best aspects of both business and history. Business history can not only contribute academically but also to the real world. Because there is nothing more practical than running a business, the study of business study can, and should, contribute to solving today’s challenges that organizations and societies are facing today. It can be a powerful tool to understand and solve today’s problems facing business by situating them in a historical perspective. It is an ideal area for academics who can leverage the professional experiences in business into a broader historical context.

Yet because of the ambiguity and complexities that accompany actual business activities, business history has not been able to establish a uniform methodology among its investigators. As a result, intensive world-wide debates on the methods that should be used in business history has been continuing in the last decade. Various disciplines and methodologies that have been deployed to advance the study of business history. Such efforts include engagement with economics and management studies. Business historians have not been shy from adapting new concepts. They have been incorporating innovative concepts such as “cultural” and “linguistic turn”...
in historical studies that emphasize the importance of context and narrative.³

Surprisingly, however, there are very few business historians who have actively leveraged the development of laws in their studies. Law has not been adequately recognized as a useful device in the business historian’s tool box. In this paper, I argue that by understanding the development and its impact on business, the study of law can substantially advance the study of business history. Specifically, investigating the evolution of collateral that is at the cross section of law and business can be powerful in solving unanswered academic questions. To demonstrate the effectiveness of my argument, I provide a case study. I use the financing of the silk reeling industry at the turn of the twentieth century to demonstrate the potential of deploying the study of law into business history. I hope it demonstrates that understanding the impact in the development of collateral can be quite fruitful in the advancement of banking history.

1. The Question: Who financed the silk reeling manufacturers?

Silk reeling was an ideal industry for Japan to industrialize. It could leverage the indigenous—yet pristine—centuries-old production methods with the latest technology at that time. Abundant cheap labor provided an advantage on manufacturing costs against competitors such as Italy. The strategy proved to be successful: raw silk became the top export item during the 75 years since Japan opened its port in 1859, after over three centuries of seclusion from the rest of the world. The percentage of raw silk in total exports from Japan was consistently around 40%. The export of raw silk significantly accelerated in the early twentieth century, between 1902 and 1923. In 1909, Japan became the world’s largest exporter of raw silk, surpassing Italy.

Merging Law and Business History:  
Case Study in the Development of Collateral in Japan at the Turn of the Twentieth Century

Who financed the silk reeling manufacturers? This has been a key academic question in the study of Japanese industrial finance. Arguably, it is one of the questions that kicked-off this academic field since the publication of the now classic Yamaguchi (1966) study. Previous studies, however, have primarily focused on the role of wholesale merchants as the financiers of the Japanese silk reeling industry. Wholesale merchants were intermediaries who sold raw silk to the foreign trading companies in the settlements in Yokohama and amassed a fortune. To the contrary, the research on the contribution of regional banks was largely neglected, recognized to be fringe players at best.⁴

I agree with the established view that from the 1860s to the turn of the twentieth century, the regional banks “piggy-backed” on the wholesale merchants. This is no surprise as the National Banking Decree, the first ever banking law in Japanese history, was proclaimed only in 1872. Modern banking had just started in Japan, during the same period as the silk reeling industry took off in the late nineteenth century.

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⁴ In this paper, “regional bank” refers to banks that were established and did not mainly operate in large cities such as Tokyo, Yokohama, Nagoya or Osaka.
Yet, as we will see, it was *after* the turn of the twentieth century that the export of Japanese raw silk seriously took off. Who funded the silk reeling manufacturers at the most important stage of the key industry in pre-war Japan?

Government statistics show that when the export of raw silk from Japan reached its peak in 1930, the regional banks surpassed the wholesale merchants in lending to the silk reeling manufacturers. The regional banks, in aggregate, provided 150% more loans to the silk reeling manufacturers than the wholesale merchants. The established view does acknowledge the rise of the regional banks and the relative fall of the wholesale merchants. Yet, this view has failed to articulate the mechanism that enabled the increase of lending to the silk reeling manufacturers happened. How should we investigate this unsolved mystery? Competent FBI agents follow the money to investigate. Capable business historians follow the collateral.
Merging Law and Business History:
Case Study in the Development of Collateral in Japan at the Turn of the Twentieth Century

The study of collateral has been largely ignored in Japan, not just by business historians, but also historians in general, economists and also to a large degree, practitioners in finance. One reason is because in today’s Japan, almost 100% of the type of assets used as collateral for corporate loans is real estate. We have been mentally locked-in to the notion that collateral means real estate. Full stop. Pre-war Japan, however, was different: the variety of assets devoted for collateral was much more diverse. Lenders were creative in developing assets other than real estate that can be deployed as collateral. One study indicates that negotiable securities were used most, followed by real estate. Importantly, moveable assets were widely used as collateral.

Strikingly, however, according to the survey conducted by the Ministry of Agriculture in 1919, almost half of the collateral used in the silk reeling industry were moveable assets. Thus, to articulate the rise of regional banks vis a vis the wholesale
merchants in silk reeling finance, it is critical to understand what kind of moveable assets were utilized as collateral, and how.

![Nagano: Epicenter of silk reeling](image)

*Figure 6*

Let us dive into the details of silk reeling finance conducted by the regional banks, with eyes on the collateral. Our focal point is Nagano prefecture. Nagano, a mountainous area situated between Kyoto and Tokyo, was the epicenter of silk reeling manufacturing in Japan, if not the world. Nagano produced 25% of raw silk in Japan, most of which exported to the US and Europe. Banks in Nagano delivered one third of all loans to the silk reeling manufacturers in Japan. Approximately 64.6% of all silk cocoons were used as collateral in Nagano prefecture in 1927.

![The Nineteenth Bank: Nagano’s leader in silk reeling finance](image)

*Figure 7*
The Jyukyu Bank, established in Nagano in 1877, was the leader in Nagano’s silk reeling finance. In 1924, when Japan’s export of raw silk was booming, 80% of the Bank’s loans were delivered to the silk reeling manufacturers. The Jyukyu Bank was the “institutional bank” for the epicenter of silk reeling in Japan.

Until the beginning of the twentieth century, however, the Jyukyu Bank lacked the capital and technology to finance the silk reeling manufacturers. At the turn of the century, the president of the bank, Takajiro Kurosawa, spearheaded the effort of innovating the capabilities and culture of the Jyukyu Bank to become the leading bank in financing the silk reeling manufacturers in Nagano. What did he do? He built massive warehouses to convert silk cocoons into collateral.

Creating and preserving the asset value was a necessary condition for converting silk cocoons to collateral. Another important condition was ensuring that the security interest in the collateral was legally protected against the debtor and a third party. Warehouses were needed to overcome these challenges. Silk cocoons are moveable goods, thus making it tricky to be used as collateral compared to other assets, such as real estate. To begin with, they are a liquid commodity, i.e., they tend to be moved around and frequently change their value.

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5 Which literally means the Nineteenth Bank, indicating that it was the nineteenth national bank established under the National Banking Decree. All national banks were private banks. The bank is one of the origins of the current Hachijuni Bank.


Hence, the secured lender must monitor the condition and value of the collateral. Maintaining a professional warehouse to do these tasks proved beneficial. In addition, having advanced scientific expertise to dry and store the silk cocoons helped preserve their value. Under the Japan Civil Code in the early Meiji era, the only way to treat a moveable asset as collateral was to treat it as a pawn item. That would be fine for a pawnbroker; however, for the silk reeling manufacturers, it would in effect prohibit them from using the raw material that is essential for producing silk.\(^8\)

The new Commercial Code that came into effect in 1899 created a breakthrough, as a section on the deposit of goods to warehouses was established.\(^9\) It clearly stated

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\(^8\) Real estate did not have such issues because if a mortgage was permitted, it allowed the debtor to freely use the pledged asset as long as conditions pertinent to lending were met. To this day, Japanese law does not allow lenders to pledge for a mortgage with moveable goods.

\(^9\) It may be the case that the Commercial Code formalized the business practice from the Edo period by using warehouses to secure assets.
that warrants issued by warehouses (warehouse receipts, *kura’ni shoken*) were allowed to have the legal status of a commercial bill that could be negotiable.

![Figure 11](image)

As such, goods in the warehouse would be deemed to be legally transferred to other parties by negotiating the warehouse receipts, without any actual physical transfers.³⁰ In effect, silk cocoons were emancipated from being treated as a pawn item and became much closer to being mortgaged.

![Figure 12](image)

Such legal framework significantly facilitated the use of silk cocoons as collateral. Establishing the Suwa Warehouse in 1909 was a major breakthrough.¹¹ Takajiro Kurosawa simultaneously became president of the Jyukyu Bank and the Suwa Warehouse.

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¹¹ Ueda Warehouse merged with the Suwa Warehouse in 1910. The company still exists today. The Suwa Warehouse and the Jyukyu Bank were legally separate entities with no capital relationships.
The warehouse business proved to be successful.\textsuperscript{12} In 1918, the Suwa Warehouse operated the largest warehouse facility in Asia, with a land area of approximately 100,000 square meters (over twice the size of Tokyo Dome) with 55 warehouses.\textsuperscript{13} The percentage of moveable assets in the Jyukyu Bank’s collateral pool increased from under 10\% in 1901 to over 60\% in 1912.\textsuperscript{14} The amount of loans provided by the Jyukyu Bank to the silk reeling manufacturers dramatically after the Suwa Warehouse was established. The collateralization of silk cocoons played a significant role in propelling the effort. That contributed to the increase in the export of raw silk from Japan.

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{suwa_warehouse.png}
\caption{Suwa Warehouse: storage, drying amount of silk cocoons and floor space}
\end{figure}

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{loan PROVIDED by JYUKU bank.png}
\caption{Loan provided by Jyukyu Bank}
\end{figure}

\textsuperscript{12} The Suwa Warehouse has never reported a loss in its net earnings to this date.
\textsuperscript{14} Hachijuni Bank, Hachijûni Ginkô’shi [History of the Hachijûni Bank]. 57.
2. Question: What was the relationship between the government and banks?

In the previous section, I demonstrated that focusing on collateral could help decipher how regional banks were able to surpass wholesale merchants in lending to the silk reeling manufacturers. Using silk cocoons as collateral by means of issuing warehouse receipts played a crucial role. That was one of the primary drivers that enabled the Suwa region to become an industrial cluster in silk reeling. In this section, I illustrate that collateral played an important role in achieving the delicate balance of government intervention and maintaining market discipline.

Money, finance and capital are crucial when a country is leapfrogging from an underdeveloped country to an economically developed one. The role of the state, with focus to its adequate level of involvement with the private sector, has been the central question in the studies of banking history. If the state intervenes too much it could dampen or kill the vibrant animal spirit of the private sector. Yet, if the state does not actively engage when it should in times of market failures, the game itself could well end. During an economic crisis, when and how should the central bank save a private bank without creating “zombie” companies? We continue to face today the challenges of balancing these often-conflicting objectives. In this presentation, I focus on how Japan resolved this challenge in the early twentieth century.

A multitude of previous studies have investigated the over-arching role of the government in modernizing Japan after the Meiji Restoration in 1868. I argue, however, that some regional banks also played a crucially important role in enabling state intervention in a time of crisis, while maintaining market discipline. Specifically, I demonstrate that collateral played an important role in establishing the fine line of keeping the vibrant market mechanism while having the public sector jump in during market failures. The Jyukyu Bank and the Bank of Japan, the central bank, were able to achieve this goal through the Suwa Warehouse.

Collateralized silk cocoons helped the Jyukyu Bank tap into the vast liquidity pool of the central banking system. As explained later, the Suwa Warehouse became the first “authorized warehouse” by the Bank of Japan, Matsumoto Branch, in 1914, enabling the Bank of Japan to provide secured lending to the Jyukyu Bank with silk cocoons as collateral.15 Using silk cocoons as collateral for lending to silk reeling man-

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15 Suwa Warehouse, Suwa sobô nanajûgonen’shi [75 year history of the Suwa Warehouse] (Okayama: Suwa Warehouse Co., Ltd., 1986), 129-133. This mechanism was similar to those established by the wholesale merchants in Yokohama.
ufacturers along with funding from the Bank of Japan helped position the Jyukyu Bank to become the leading lender in silk reeling finance.\(^6\) It also helped the regional bank from collapsing during a financial crisis.

The two banks were mutually dependent. The BoJ needed a thriving silk reeling industry to collect and accumulate gold, the specie to drive the modernization of the country. The Jyukyu Bank had to rely on the central bank during a market crisis, and together, they anticipated and prepared for the crash in the global silk market.

The crisis happened in 1920 when the wartime boom for exporting Japanese raw silk caused by World War One upended. The price of the raw silk traded in Yokohama plummeted 71.5% in 1920, from a record high of JPY 3,860 to 1,100. The crash was a major blow to the silk reeling manufacturers in Nagano.

There have been speculations on how the Jyukyu Bank and the Bank of Japan collaborated to manage the crisis. Although we knew that there were crucial meetings held as to resolve the market crash, to the best of my knowledge, there was no evidence to prove what exactly happened. I recently found a 32-page meeting memorandum that documents, in detail, on what the two banks agreed upon in the archives of the Hachijuni Bank, the successor of the Jyukyu Bank.

![Meeting at the Bank of Japan Head Office on June 8, 1920.](image-url)

**Figure 15**

The memorandum produced by the Jyukyu Bank vividly depicts the meeting with Hosaku Iijima, the president of Jukyu Bank and Eigo Fukai, the executive director the BoJ (who later became the governor). To sum up, the Jyukyu Bank faced a funding crisis. Funding was the Achilles heel of the regional bank—before the crash, it relied heavily on other banks, 33 in total, to procure funds. In effect, Jukyu Bank was an avenue for these banks to invest in the thriving silk reeling industry. After the market crash, however, these banks were the first to withdraw the investment, being opportunistic, rather than strategic providers of capital. As a result, the Jukyu Bank’s external funding dropped by 61.5% compared to its previous year, from JPY 25.0 to 9.3 million. Hence, the Jyukyu Bank had to lean on the central bank to receive liquidity.

Figure 16

Even by vastly reducing the total amount of lending in the latter half of that year to 60% of the previous year, the Jyukyu Bank still needed JPY 3.8 million to enable the silk reeling manufacturers in Nagano to continue their business. Without them, Japan could not earn enough specie needed for further industrialization and economic growth.

The BoJ could not and cannot, by law, be a binge lender. It needed a solid ground to assure that they were lending to a credible borrower. For this purpose, the Jukyu Bank had established its own internal credit rating system, ranking the silk reeling manufacturers from A to E, and no rating.
Rediscounting bills for creditworthy debtors was one of the core operations of the central bank stipulated in its bylaws. Thus, the regional bank could request the BoJ to discount bills for borrowers who had a high credit rating of A or B. Such measure brought JPY 2.2 million from the BoJ to the Jyukyu Bank. But the regional bank still needed JPY 1.6 million to the less creditworthy but nonetheless important borrowers with credit ratings of C, D and no rating.

<table>
<thead>
<tr>
<th>Borrowers</th>
<th>Credit Rating</th>
<th>(JPY '000)</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>B</td>
<td>1,490</td>
<td>68%</td>
<td>0</td>
</tr>
<tr>
<td>C</td>
<td>520</td>
<td>24%</td>
<td>0</td>
</tr>
<tr>
<td>D</td>
<td>150</td>
<td>7%</td>
<td>0</td>
</tr>
<tr>
<td>No rating</td>
<td>30</td>
<td>1%</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,190</strong></td>
<td><strong>100%</strong></td>
<td><strong>0</strong></td>
</tr>
</tbody>
</table>

The question that needed resolving was how could the central bank indirectly lend to borrowers with weak credit, via the Jyukyu Bank, without jeopardizing its own credibility as a prudent and equitable lender? The BoJ and the Jyukyu Bank relied on a warehouse company to achieve these conflicting goals.

For silk reeling manufacturers with weak credit, the Jyukyu Bank had developed a unique lending technology around the turn of the twentieth century: secured lending
using silk cocoons as collateral. For this purpose, a significant warehouse company was
established. By storing silk cocoons in the warehouses, the Jyukyu Bank could use the
cocoons as collateral for providing secured loans to the silk reeling manufacturers.

Such measures were possible because a new Commercial Code came into effect in
1899, allowing the warrants issued by the warehouses, or “warehouse receipts (kurani
shōken),” to have the same legal status of a negotiable commercial bill. Although loans
secured by silk cocoons consisted 22% of total lending, it served only silk reeling manu-
facturers with weak credit. The credit rating of the borrowers of such loans were
47% C, and 53% D or no rating.

The Suwa Warehouse, was established in 1909. (Suwa was the region where the
bulk of silk reeling manufacturers in Nagano congregated). The warehouse receipt
issued by the Suwa Warehouse was designated by the BoJ as officially qualified col-
 collateral. By providing such warehouse receipts issued by the Suwa Warehouse, the
Jyukyu Bank was able to use silk cocoons as collateral as a condition to receive loans
from the BoJ.

On such terms, the BoJ agreed to lend JPY 1.0 million to the Jyukyu Bank, just
enough to avert the funding crisis. The central bank was able to indirectly lend to
the weaker silk reeling manufacturers by relying on the regional bank’s credit risk
management capabilities.

The measure of using silk cocoons as collateral for loans by the BoJ was also an exe-
cution of a significant policy change. At the turn of the century, the Meiji government
changed its industrialization policy from a top down, centralized approach to a more
localized one by encouraging regional banks to promote local businesses. Because silk

Figure 19
reeling was one of the most important businesses, the BoJ establish its branch in Matsumoto city, Nagano prefecture in 1914. One month after establishing the Matsumoto Branch, the Suwa Warehouse was authorized as a “designated warehouse” thereby allowing its warehouse receipts to be used as official collateral of the BoJ.

So, what was the relationship between the Suwa Warehouse and the Jukkyu Bank? These were independent companies without capital ties, yet they were deeply connected. Takajiro Kurosawa who presided as president of the Jukkyu Bank was also president of the Suwa Warehouse. The warehouse business proved to be financially and operationally successful: in 1918, the Suwa Warehouse became the largest warehouse facility in Asia, with a land area of approximately 100,000 square meters (over twice the size of Astro Dome), and held 55 large warehouses.

The Suwa Warehouse acted, in effect, as the independent collateral agent for the Jukkyu Bank. The cost of silk cocoons consisted of approximately 80% of the total cost of silk reeling. Thus, by monitoring the flow of silk cocoons, the Jukkyu Bank was able to collect, synthesize and generate information about the local silk reeling manufacturers. The BoJ relied on and trusted the monitoring and screening capabilities of the Jukkyu Bank and the Suwa Warehouse. Because the Bank and the Warehouse could allocate capital to the “right” silk reeling manufacturers—which the BoJ could not do by itself—the central bank was able to provide liquidity in times of need to the market without creating “zombie” borrowers.

Such cooperation between the State and the private sector, as demonstrated by the relationship between the Jukkyu Bank, Suwa Warehouse and the BoJ was crucial in industrializing and modernizing Japan. The collaborative network between the state and the commercial market, by allowing the state to intervene only in time of crisis, was the prime driver for Japan’s pre-war industrial development.

As we have seen, having a legal prism helps clear the business historian’s eyes. The establishment of a new legal framework had a profound effect in the rise of regional banks in silk reeling finance. The new Commercial Code that came into effect in 1899 created a breakthrough to enable moveable assets such as silk cocoons to become collateral by using warehouse receipts. The Bank of Japan actively leveraged this change in law to provide liquidity by means of loans secured by silk cocoons to the Jukkyu Bank when liquidity virtually evaporated from the market. This case study, focusing on the development of law and its impact, demonstrated how a major regional bank became the leader in silk reeling finance once dominated by the wholesale merchants. I hope that following the collateral will further advance studies in business history.

（本学教授）