United States General Accounting Office

GAO

Briefing Report to Congressional Requesters

March 1988

INTERNATIONAL FINANCE

Market Access Concerns of U.S. Financial Institutions in Japan

041387

GAO/NSIAD-88-108BR

GAO

United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-222898

March 1, 1988

The Honorable William Proxmire, Chairman
The Honorable Jake Garn, Ranking Minority Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Paul Sarbanes, Chairman
The Honorable John Heinz, Ranking Minority Member
Subcommittee on International Finance and
Monetary Policy
Committee on Banking, Housing, and Urban Affairs
United States Senate

In your August 6, 1987, letter and in subsequent discussions with your staff, you requested that we assess the competitive environment of the financial markets in Japan, the United Kingdom, and the United States and examine barriers affecting the operations of foreign firms in these markets. Because of the high level of congressional interest in Japanese market developments, this report focuses on the primary concerns of major U.S. financial institutions operating in the Japanese financial markets. Our work assessing the competitive environment of the United Kingdom and U.S. financial markets is continuing, and a report with that information will be issued at a later date.

Japan has gradually liberalized its financial system in recent years, and U.S. and other foreign financial institutions believe that in some areas they generally receive national treatment, that is, equal opportunities to compete in the Japanese financial markets. However, in our interviews conducted in October 1987, officials from U.S. financial institutions told us that in some market areas, they still find barriers to competition and have been frustrated by their lack of access to certain Japanese market sectors. In particular, these institutions have been frustrated by (1) the lack of access to the Tokyo Stock Exchange, (2) the small role that U.S. firms maintain in the Japanese government bond market, (3) the difficulties associated with introducing some types of new financial products in Japan, such as futures and options, and (4) the fact that higher capital requirements are imposed on U.S. banks by U.S. regulators than are imposed on Japanese banks by Japan's regulators, which gives Japanese banks a competitive advantage in loan pricing.

The Japanese have recently taken steps to address these concerns by, among other actions, expanding the membership of the Tokyo Stock draft of this report, but we discussed its contents with Treasury staff and incorporated their comments as appropriate.

As agreed with your office, we are also distributing this briefing report to interested parties. If you have any questions, please contact me on (202) 275-4812.

Allan I. Mendelowitz

Allan I. Mendelowitz
Senior Associate Director

Given these concerns and disparities, we reviewed Japan's recent progress in liberalizing its financial markets and considered the impact of this progress on national treatment issues and competition from foreign financial institutions.

Gradual Progress Made in Liberalizing Japanese Financial Markets

The Japanese government has gradually liberalized the Japanese financial markets since the late 1970s, a process accelerated by a benchmark 1984 agreement. A working group from the U.S. Department of the Treasury and the Japanese Ministry of Finance developed this agreement, commonly referred to as the Yen/Dollar Agreement. In negotiating this agreement, the U.S. Treasury sought to increase the use of the yen as an international currency, promote the development of the Euroyen market, and liberalize the Japanese capital markets by deregulating interest rates, expanding market instruments, and improving foreign access. By taking these steps, the Treasury believed the Japanese financial markets would more fully reflect Japan's status as a major economic power.

Under the agreement, the Japanese government committed itself to promote the development of a Euroyen market, liberalize its domestic capital markets, and remove barriers to foreign entry into the domestic financial services industry. The United States agreed to continue to try to reduce the budget deficit as part of its effort to reduce the trade deficit and to address other concerns of the Japanese government, such as the use of unitary tax systems[1] by several states. In May 1987, the United States held the fifth follow-up meeting to this agreement with the Japanese Ministry of Finance to discuss additional liberalization measures.

The greatest progress in implementing this agreement has been made in developing an open Euroyen market. Unlike countries' domestic capital markets, the Euromarkets are free from official regulations, such as interest rate controls, reserve requirements, and withholding taxes. The Euroyen bond market, since it was opened to private corporations and state and local governments in 1984, has grown from about $1 billion to $23 billion in 1987.

[1]The unitary method of taxation is a method used to determine the taxable income of a business that operates across national borders The Japanese had expressed concern that this method could impose a heavy administrative burden on foreign subsidiaries in the United States and thus discourage foreign investment in the United States

restrictions have reduced the attractiveness of such money market instruments as bankers' acceptances, treasury bills, and commercial paper.[5]

The rigidities of the regulated Japanese markets affect U.S. firms' abilities to compete. For example, approximately 60 percent of bank deposits in Japan remain subject to interest rate controls and Japan has not announced a timetable for full interest rate deregulation. Also, foreign banks have trouble funding themselves in the domestic market, where no true interbank market exists. Foreign banks do not have large established retail networks providing access to regulated, low-cost domestic Japanese deposits as do their Japanese competitors. Thus, foreign banks must rely on relatively high-cost money brokers. Furthermore, these brokers occasionally do not have funds available for loans at the broker's quoted price. The lack of a true interbank yen market limits the foreign banks' opportunities for competing in the commercial lending business in Japan. Opportunities to compete in this market are also constrained by the stiff competition, high start-up costs, and relatively low demand for commercial loans.

Status of National Treatment

In our June 1986 report, we noted that (1) the Japanese government completed or was working on all of the commitments outlined in the Yen/Dollar Agreement and (2) bankers and financial specialists we interviewed in Tokyo in 1985 agreed that equal treatment had been generally achieved for foreign banks in Japan.

In addition, the Department of the Treasury has issued a series of national treatment reports to Congress.[6] Its latest assessment, with which we concur, also reports that the Japanese continue to observe the commitments made under the 1984 Yen/Dollar Agreement and generally provide national treatment for foreign banks. However, the Treasury update notes that foreign banks still find the Japanese markets difficult to penetrate with few competitive opportunities, and foreign securities firms receive less than national treatment in some areas.

[5]Bankers' acceptances are drafts or bills of exchange accepted by a bank or trust company. The accepting institution guarantees payment of the bill. Treasury bills are securities issued by the government. Commercial paper is a short-term, unsecured note.

[6]National Treatment Study, 1986 Update (Dec. 18, 1986). This update discusses the degree of national treatment given U.S. financial institutions in 18 banking markets and 8 securities markets. Previous studies were issued in September 1979 and July 1984.

To complete this report we reviewed literature on Japanese financial institutions and markets and related studies, surveys, and memorandums completed by the Department of the Treasury, the Securities and Exchange Commission, the Federal Reserve Board, and various private sector groups. We interviewed representatives of major U.S. financial institutions in Tokyo, which were judgmentally selected, to obtain a wide range of views on the status of regulations governing U.S. financial institutions in Japan. We also discussed these issues with Japanese and U.S. government officials in Tokyo and in Washington, D.C.

We conducted our review from September 1987 to January 1988 in accordance with generally accepted government auditing standards.

An increasing number of foreign firms are attracted to the Tokyo stock market because of its increasing size and importance.[1] Foreign firms regard membership in the TSE as a status symbol necessary to expand their share in the Japanese financial market. The financial advantage of membership is also important because member firms do not have to pay stock commissions to securities houses for executing trades as nonmembers do.

The exchange, founded on April 1, 1949, opened up membership to foreign firms in April 1982 by deleting constitutional provisions against foreign membership. In November 1985, six foreign firms, of which four were U.S.-owned, gained membership to the TSE.[2] These six firms received permission to begin actual exchange trading in 1986. However, several additional foreign applicants with extensive equities market experience were denied membership and believed that they were unfairly excluded from the exchange.

According to TSE officials, the lack of floor space prevented any additional membership at that time. These officials said that because the exchange's auction system of stock trading requires its members to be physically present on the trading floor rather than linked electronically to the exchange, the lack of space was a valid reason for not increasing exchange membership.

Recently, as a result of continued pressure from the foreign community to expand foreign membership, the exchange computerized between 50 and 100 of the its 250 most actively traded stocks, removing the need for floor traders in these stocks. This computerization, along with the building of additional facilities, opened up space for additional members on the exchange. In October 1987, TSE officials announced that 22 additional firms would be added to the membership. The 22 new members were selected in December 1987 and included 16 foreign firms, 6 of which were U.S. firms.[3] Exchange officials told us they award membership to foreign firms using such criteria as the applicant's financial

[1]The TSE's aggregate current market value surpassed that of the New York and London stock exchanges in April 1987. The market value is obtained by multiplying the number of issued shares of listed companies by share price.

[2]These firms were Goldman Sachs, Merrill Lynch, Morgan Stanley, and Citicorp's London-based affiliate, Vickers da Costa Ltd.

[3]The TSE announced that it had received membership applications from 20 foreign and 20 domestic securities firms prior to the November 17, 1987, deadline. The 6 U.S. firms selected for membership in December 1987 were Salomon Brothers, First Boston, Shearson Lehman Brothers, Kidder Peabody, Smith Barney, and Prudential Bache.

the TSE are tightly controlled and thus unavailable even to parties willing to pay the price.

As more foreign firms become members of the TSE, the concerns of the foreign financial community are shifting from gaining access to changing rules concerning how operations must be conducted on the exchange. Some firms have already expressed some of these concerns. Complaints range from the fact that all settlements must be concluded physically and in 3 days (that is, actual stock certificates must be delivered to the buyer) to the number of long and detailed reporting requirements, which add substantially to the cost of doing business on the exchange. Some of these problems may be eliminated when a new clearing system operated through the Japan Securities Depository Corporation opens in 1989. The new clearing system may allow more efficient settlement procedures to be introduced.

Several foreign firms operating on the exchange have also complained about the manner in which brokerage commissions are being deregulated. These TSE members believe that foreign firms have been hurt the most by this action because commissions for the trades they specialize in, the large lot trades of over 10 million yen in size, have been reduced the most in the TSE's drive to deregulate commission rates. According to TSE officials, these commission cuts were not unfair because the large firms trading on the exchange are better able to absorb these cuts because of their size.[6]

The Japanese Government Bond Market

Japanese government bonds make up the largest portion of the bond market in Japan with the 10-year bond being the most important bond issue, especially in terms of secondary market trading. Despite recent measures to increase foreign participation in this issue, foreign firms are still relegated to a small role in the government bond issuance market.[7]

[6]Commission rates have been deregulated on two occasions since 1985, most recently in October 1987, reducing commissions on all size trades. However, the commissions on trades over 10 million yen in size have been reduced by a higher percentage than the rates on trades under 10 million yen.

[7]Japanese government bonds are issued through an auction, an underwriting syndicate, and by direct placement with official accounts, such as the the Trust Fund Bureau and Ministry of Posts and Telecommunication. In 1987, about 29 percent of Japanese government bonds were issued through an auction and about 37 percent through a syndicate. The remaining 34 percent were placed with official accounts. Approximately 78 percent of the bonds issued by syndicate were 10-year government bonds. Changes made in the government bond market in 1987 included issuing 20-year bonds by an auction process instead of through the previously used syndication method and relaxing foreign firms' eligibility criteria for participating in the 2-, 3-, and 4-year bond market.

concern for stability, it appears unlikely the Japanese will substantially modify the current bond allocation process in the near future.

New Products

Foreign firms in Japan sometimes find it difficult to provide a full range of products, particularly new and innovative financial products such as futures and options,[9] because of existing regulations and policies governing the approval process for new products and the less developed futures and options markets. Under the Ministry of Finance's current policy, it is presumed that new products or services will not be allowed without prior Ministry approval.

Many U.S. financial institutions want to sell a full range of futures and options in Japan. Many U.S. firms with a presence in Japan are also active in the U.S. futures and options markets. These institutions have special skills and experience with these products and thus are interested in marketing and using them in Japan, but cannot do so given the less developed state of the Japanese futures and options markets.

The Japanese have recently taken some steps to address these concerns. The Japanese government is currently considering introducing a domestic futures and options market to allow comprehensive futures trading in currencies, interest rates, bonds, and stocks. A January 1988 Ministry of Finance report outlined the shape of the market. However, because legislation will be needed to amend the law prohibiting such products, a full-fledged financial futures and options market is not expected to begin before late 1988. Some U.S. firms have complained about the length of time it will take to develop a full-fledged futures and options market in Japan. They say that new financial products are allowed to be used in Japan only after Japanese firms have mastered their use in other markets, leaving U.S. firms in Japan with little or no competitive edge in using these products.

U.S. financial institutions also have had difficulty receiving permission to sell collateralized mortgage obligations, cash management accounts,

[9]Futures markets are markets in which contracts for future delivery of a commodity or security are bought and sold; options are contracts giving an individual the right but not the obligation to purchase or sell a security or commodity at a specified price. Futures and options products are important risk-hedging instruments.

Under the December 1987 proposal, banks will be allowed to include 45 percent of unrealized securities gains in their capital base computations, reflecting a compromise between Japanese and foreign bank regulators. U.S. regulators believed that including more than 45 percent of unrealized securities gains in the computations of capital would have been unwarranted, given the price volatility of Japanese banks' securities holdings and the relatively thin markets for those securities.

Nov. 1987	First limited auction of 10-year government bonds
	Opening of a new yen commercial paper market
	Filing of membership applications with the TSE by 40 securities firms (20 Japanese and 20 foreign)
	Increase of foreign dealers' share of a 10-year Japanese government bond limited auction from 1 5 percent under the old syndicate system to about 5 percent
Dec 1987	TSE announcment that it will grant membership to an additional 16 foreign institutions, including six U.S firms
	The Federal Reserve Bank of New York allowance of a fourth Japanese firm to become a primary dealer in U S government securities

Requests for copies of GAO reports should be sent to:

U.S. General Accounting Office
Post Office Box 6015
Gaithersburg, Maryland 20877

Telephone 202-275-6241

The first five copies of each report are free. Additional copies are $2.00 each.

There is a 25% discount on orders for 100 or more copies mailed to a single address.

Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.

Recent Developments in Financial Deregulation in Japan

Mar 1985	Introduction of Money Market Certificates (MMC) for banks (denomination of 50 million yen or more with maturities of 1 to 6 months)
Apr. 1985	Reduction of the minimum denomination of CDs (from 300 million yen to 100 million yen)
June 1985	Start of yen-denominated Bankers' Acceptances market.
	Approval of direct entry into trust banking by nine foreign banks
Oct. 1985	Decontrol of interest rate ceilings on time deposits of 1 billion yen or more
	Start of government bond futures market
Nov. 1985	Allocation of six seats to foreign securities firms in the TSE
Mar 1986	TSE relaxation of its listing requirements for large non-Japanese companies
Apr. 1986	Decontrol of interest rate ceilings on time deposits of 500 million yen or more
Sept 1986	Decontrol of interest rate ceilings on time deposits of 300 million yen or more
	Reduction of the minimum amount of MMC (from 50 million yen to 30 million yen)
Oct 1986	Bankers Trust becomes the first foreign trust bank in Japan to co-manage a major Japanese corporate pension fund
Dec. 1986	Start of Japan Offshore Market, Japan's new international banking facility. Initial size of the market was about $50 billion
Apr. 1987	Removal of interest-rate ceilings on time deposits of 100 million yen or more
	Lowering of minimum denomination MMCs from 30 million yen to 20 million yen, and lengthening of maturity from 1 year to 2 years
	Expansion of share of Japanese 5-, 10-, and 20 -year government bond market for foreign securities firms
May 1987	Permission granted to four foreign securities firms to join the underwriting syndicate for yen bond issue by Nippon Telegraph and Telephone in the domestic market
June 1987	Opening of the Osaka stock exchange trading in a new futures product known as the "Osaka 50"
	Establishment of non-majority-owned securities branches in Japan by U.S banks
July 1987	Bankers Trust becomes the first foreign trust bank permitted to manage Japanese government pension funds
Sept. 1987	First auction of 20-year government bonds
	Achievement of an all-time low of 8.2 billion yen in the outstanding volume of yen-denominated Bankers'Acceptances
Oct 1987	Reduction of minimum denomination of MMCs (from 20 million yen to 10 million yen)
	Reduction of brokerage commission fees for stock and bond trades on the TSE
	TSE announcment that 22 new members would be added to the exchange

(continued)

mutual funds, and some types of zero coupon products and certificates of deposit (CDs) in Japan.[10]

Capital Standards

Some U.S. bank officials in Japan believe that Japanese banks have an unfair competitive advantage because higher capital requirements are imposed on all U.S. banks by U.S. banking regulators than are imposed on Japanese banks by the Japanese banking regulators. Bank capital is the cushion banks maintain to protect themselves against unexpected losses. Although technically not a national treatment issue, U.S. banks have often cited this disparity as a significant competitive disadvantage for them because it means that U.S. banks must either price their loans higher than the Japanese banks or reduce profit margins.

The Japanese have recently taken steps to bring their capital standards more in line with those of other major industrialized countries. In 1986, the Japanese bank regulators raised the minimum capital guidelines for Japanese banks and in December 1987 agreed, in principle, to comply with a higher risk-adjusted capital proposal developed jointly by a group of central bankers from 12 leading industrial countries.[11] The central premise of this proposal is the more risky a bank's assets, the greater its capital requirements should be. When implemented, this new risk-based proposal may help to remove the competitive disadvantage arising from differing bank capital requirements among countries. The proposal establishes a minimum capital standard of 8 percent by 1992, half of which should be shareholder's equity.

[10]Collateralized mortgage obligations are a type of mortgage-backed security, that is, a security backed by a pool of mortgages assembled by a servicer. Cash management accounts transfer funds automatically from a checking account to an investment account when the checking account exceeds a specified level. Zero coupon bonds, unlike full-coupon bonds, do not pay out annual interest; the return consists of the payment in effect of accumulated interest when the bond comes due. Mutual funds are broadly diversified, continously supervised investment accounts. Issuance of domestic mutual funds in Japan is the exclusive preserve of 12 securities trust management companies.

[11]Under guidelines issued in May 1986, Japanese banks were required to raise their capital-to-asset ratios to 4 percent by 1992. Banks with overseas branches were required to raise their capital-to-asset ratio to 6 percent by April 1987 but could include 70 percent of unrealized securities gains as capital. Unrealized securities gains are an important component of Japanese bank capital. As of September 1987, none of the 13 large Japanese city banks had met this new capital standard when 70 percent of unrealized securities gains were excluded from the measure of capital—their ratios ranged from 2.6 to 3.5 percent. On the other hand, when these unrealized security gains were included in the measure of capital, all of the 13 city banks easily met the 6 percent guideline—the ratios ranged from 8.8 to 11.9 percent.

To improve foreign firms' share of the 10-year issue, the Japanese government (1) increased foreign firms' share of bonds allocated through the underwriting syndicate responsible for selling the 10-year issue and (2) introduced a limited "auction" for a portion of each 10-year issue. However, neither of these steps has satisfied the U.S. community, as discussed below.

The underwriting syndicate consists of approximately 800 financial institutions. As of April 1987, 12 U.S. banks and 12 U.S. securities firms were members of the underwriting syndicate. Members of the syndicate are allocated bonds through a set formula. On April 1, 1987, the underwriting syndicate increased the allotment of 10-year bonds underwritten by foreign securities companies. Under the new formula, foreign securities firms increased their total share of the 10-year issue from 0.3 to 1.5 percent.

As of November 1987, a limited "auction" had been introduced for about 20 percent of each 10-year bond issue. Under this process, firms bid on the volume of bonds desired without knowing the issue terms.[8] This system is not actually an auction because the price of the bond is still set through negotiations between representatives of the underwriting syndicate and the Japanese government. Nevertheless, as a result of this new scheme, foreign securities dealers increased their total share of the November 1987 10-year issues from the 1.5 percent share allocated under the previous formula to about 5 percent.

Despite these changes, foreign firms have not been able to play a significant role in the primary market for government bonds in Japan. The U.S. Treasury and major foreign financial institutions in Japan have urged but have not succeeded in persuading the Japanese to adopt a full auction process for government bonds in which issue terms are freely determined through open market competition. Although Ministry of Finance officials acknowledge that it is important to give foreign firms greater access to the government bond market, their primary objective is to maintain a smooth distribution system for all government bonds. These officials believe that a full auction process for government bonds would introduce an unacceptable level of uncertainty in the bond market, that is, there would be no assurance that purchasers would fully absorb all issues regardless of market conditions. Given this overriding

[8]The maximum bid per institution is one percent of the total 10-year bond issue for the month. Oversubscribed bonds are allocated to each bidder in proportion to each firm's bid.

standing, past business performance, and experience in the Japanese securities market. The TSE may also, "when it deems necessary," consider the consolidated financial data of the applicant's parent firm. This loophole can give the exchange substantial flexibility in awarding seats because it allows the exchange to give greater consideration in awarding memberships to relatively new or small-sized foreign firms in the Japanese securities market.

Despite its attractiveness, the cost of a seat on the TSE is high compared with other major stock markets (see table II.1). New memberships cost about 1.1 billion yen per seat (about $8.8 million at Yen 125/$1.00). In comparison, the cost for an equity seat on the New York Stock Exchange (NYSE) ranges from $625,000 to $1.2 million. In general, some membership costs on both exchanges can be recovered when a member leaves the exchange and sells the seat. Officials of the TSE contend that the costs for seats on the TSE and the NYSE are comparable because NYSE corporate members have many seats. Overall, however, the NYSE has 1,366 seats and about 650 public members, or about two seats per member.[4] In addition, trading on the NYSE can be done by other methods without buying a full seat, such as through limited memberships.[5]

Table II.1: Cost of Membership on the World's Largest Stock Exchanges

Stock exchange	Number of members	Number of foreign members	Cost
Tokyo	114	22	$8.8 million
New York	1,366	58[a]	$625,000 to $1.2 million
London	362	80	$35,000[b]

[a]Equity seats as of March 1, 1987

[b]Average membership fee

According to NYSE Officials, a major difference between the NYSE and the TSE is that membership on the NYSE is open to all qualified applicants willing to pay the price of a membership, whereas new memberships on

[4]Four U.S. securities firms that specialize in wholesale investment banking functions also have seats on the TSE; these firms hold an average of 4.75 equity seats on the NYSE.

[5]For example, instead of acquiring a full equity seat on the NYSE, interested firms may (1) lease a seat, (2) acquire an electronic access membership, or (3) acquire a physical access membership. These memberships carry limited or no voting rights. A lessee may execute orders on the trading floor. The price of a leased seat is negotiated between lessor and lessee and has recently averaged between $110,000 to $168,000 per year. An electronic access membership gives a firm telephone access to the floor facilities of an exchange member and costs about $77,000 per year. A physical access membership is limited to a maximum of 24 at any one time and allows a firm to execute orders on the trading floor. A physical access membership costs about $140,000 per year.

Concerns of U.S. Financial Institions in Japan

Japan has gradually liberalized its financial system in recent years, and U.S. and other foreign financial institutions believe that in some areas they generally receive national treatment, that is, equal opportunities to compete in the Japanese financial markets. However, officials from U.S. financial institutions told us in October 1987 that in some market areas, they still find barriers to competition and have been frustrated by their lack of access to certain Japanese market sectors. In particular, these institutions have been frustrated by (1) the lack of access to the Tokyo Stock Exchange (TSE), (2) the small role U.S. firms maintain in the Japanese government bond market, (3) the difficulties associated with introducing some types of new financial products in Japan, such as futures and options, and (4) the fact that higher capital requirements are imposed on U.S. banks by U.S. regulators than are imposed on Japanese banks by Japan's regulators, which gives Japanese banks a competitive advantage in commercial lending.

The Japanese have recently taken steps to address some of these concerns by, among other actions, expanding the membership of the TSE; increasing foreign firms' share of 10-year government bond issues, the most heavily traded bond in that market; and introducing higher capital requirements for Japanese banks.

The increase in the TSE membership may be sufficient to provide membership to the most interested major foreign firms and appears to have addressed a major concern of the foreign community. In contrast, the actions taken to increase the foreign firms' share of the government bond market appear to have had little effect in increasing their share and alleviating their concerns—U.S. firms are still relegated to a minor role in Japan's primary market for government securities. When implemented, new capital standards may help remove a major source of competitive inequality in pricing loans arising from differences in Japan's and U.S. banks' capital requirements. Some problems remain in introducing new products, however, as trading in futures and options is not expected to begin before the end of 1988.

The Tokyo Stock Exchange

A long-standing national treatment concern of U.S. firms has been access to the TSE. Some U.S. firms complained that they had been unfairly discriminated against by being denied membership on the exchange. In October 1987, exchange officials announced a second expansion of foreign membership, after the first expansion in 1985 allowed six foreign firms to become exchange members. This expansion should accommodate most major firms currently seeking membership.

Pending Legislation

Based on these continuing concerns about U.S. financial institutions' access to foreign markets, in particular the Japanese markets, Congress is considering legislation to enhance this access. The House and Senate versions of the trade bills in the 100th Congress contain language seeking to improve the treatment of U.S. financial institutions in foreign markets, particularly in Japan.[7] The bills increase the possibility of using a policy of "reciprocity" instead of national treatment as an underlying negotiating strategy when considering foreign firms' applications to operate in the United States.[8] The bills encourage foreign countries to give U.S. financial institutions fair competitive opportunities to operate in foreign financial markets by requiring U.S. regulators to deny foreign firms' applications for primary dealer[9] status for U.S. government securities if the foreign country does not accord similar competitive opportunities to U.S. financial institutions.

Objectives, Scope, and Methodology

Given this legislative background, the Senate Committee on Banking, Housing, and Urban Affairs, as part of its oversight of national treatment issues, asked us in an August 6, 1987, letter and in subsequent discussions with committee staff to assess the competitive environment of the major financial markets, particularly Tokyo and London, and to examine barriers affecting the operations of U.S. firms in these markets.

Because of the high level of congressional interest in Japanese financial market developments, this report focuses on the primary concerns of major U.S. financial institutions operating in the Japanese financial markets. Our work assessing the competitive environment of the United Kingdom and U.S. markets is continuing, and a report providing that information will be issued at a later date.

[7]H R 1463 was introduced to the House in March 1987 and incorporated into H.R. 3 as section 428 S. 1101 was introduced to the Senate in April 1987 and incorporated into S. 1420 as title XV.

[8]A policy of strict reciprocity gives to foreign firms from a particular country only the same rights that the particular country extends to U S firms operating in that country.

[9]Primary dealer status is important to foreign firms seeking to become major players in the U.S. securities markets because primary dealers are the major market makers for U.S. government securities and are an important link between Treasury's debt management activities and the overall market for government securities in the United States and abroad. Primary dealers purchase a large portion of the Treasury securities sold at auction and are involved in the over-the-counter secondary markets for Treasury and federal agency securities. As of January 7, 1988, 10 of the 42 primary dealers were foreign-owned—4 Japanese, 3 British, and 1 each from Australia, Hong Kong, and Canada. In addition, Japanese firms are currently negotiating to acquire two existing primary dealers. The foreign-owned primary dealers account for about 15 percent of total primary dealer volume; Japanese firms account for about one half of the foreign volume.

Some progress has also been made in improving foreign firms' access to the Japanese markets:

- Four U.S.-owned firms and two other foreign firms were admitted to the Tokyo Stock Exchange (TSE) in 1985 and began exchange operations in 1986. The exchange had been closed to foreign firms since its opening in 1949.
- Six U.S. banks out of a total of nine foreign banks were licensed in 1985 to perform trust banking functions in Japan.[2]
- Six of the 59 firms newly licensed in 1987 to engage in investment advisory functions were foreign firms. Four of the six were U.S. firms.
- Seven U.S. banks in Japan have affiliates licensed to engage in securities activities.[3] In effect, these foreign banks receive "super-national treatment" because domestic banks in Japan, as in the United States, are currently restricted from engaging in similar activities. This advantage may be short-lived, however, if the distinctions required to be maintained between investment banking and commercial banking in Japan under current law continue to blur.

In general, Japan has more quickly liberalized its international financial market than its domestic market. Although the United States continues to press Japan for increased domestic money market liberalization, progress has been slow, reflecting the greater political sensitivities and "turf" questions of domestic deregulation. The Ministry of Finance's cautious approach to liberalizing the domestic markets has been driven by its concern for the health and stability of the financial system as well as the political difficulties encountered in liberalizing a system in which many participants have powerful, vested interests in maintaining the status quo. As we noted in our 1986 report,[4] Japan has made little progress in deregulating domestic money markets, which, as a result, remain underdeveloped in terms of size and depth. Interest rate, tax, or other

[2]The U.S.-owned trust banks are Morgan Trust, Bankers Trust, Chase Manhattan Trust, Cititrust, Chemical Trust, and Manufacturers Hanover Trust. Several of the foreign trust banks have exceeded initial profitability projections.

[3]The U.S banks with securities affiliates are Citicorp, Chase Manhattan, Security Pacific, J.P Morgan, Chemical, Bankers Trust, and Manufacturers Hanover. Entry guidelines are the same that apply to European banks and require that the Japanese unit be a branch of an offshore subsidiary that is not more than 50 percent owned by the parent foreign bank. The remaining shares must be held by a nonfinancial institution. The decision to grant these U.S. banks additional securities powers stemmed from a prior Japanese government decision to grant some European universal banks expanded securities powers. Universal banks can underwrite securities and conduct commercial lending in their own countries. The United States successfully argued that the denial of similar treatment for U.S. banks would constitute discrimination.

[4]Implementation of the Yen/Dollar Agreement (GAO/NSIAD-86-107, June 1986).

The Japanese Financial Markets

Background

Japan has made numerous efforts to gradually liberalize its financial markets since the late 1970s. However, a perception still exists that foreign institutions are denied "national treatment," that is, equal opportunities to compete, in some sectors of Japan's financial markets. National treatment is the basis for the regulation of foreign banks operating in the United States. The International Banking Act of 1978 (IBA) established a federal regulatory framework governing the entry and operation of foreign banks in the United States. The act created a nondiscriminatory framework based on the principle of national treatment. Under this policy, foreign enterprises operating in the United States are treated as equals with their U.S. counterparts. The law, therefore, established the principle of parity of treatment between foreign and domestic banks at the federal level.

Some members of Congress believe U.S. financial institutions continue to face discrimination abroad and have been critical of our national treatment policy. In addition, some members of Congress are also concerned that U.S. institutions face obstacles that do not violate the principle of national treatment but do limit the range and types of products and services that these institutions can offer in Japan.

These concerns have grown as Japan's financial institutions have become more successful abroad. Japanese financial institutions have established a major presence in many areas of the world financial markets because of their access to large pools of domestic funds and financial deregulation within the world's major financial markets.

- In December 1986, ranked by assets, 7 of the 10 largest banks in the world were Japanese. Only one was a U.S. bank.
- In December 1986, ranked by capital, 5 of the 10 largest securities and financial services firms in the world were Japanese. Four were U.S. firms.
- During the first half of 1987, 5 of the 10 largest underwriters of Eurobonds were Japanese. Two were U.S. firms.

In contrast, foreign financial institutions have had limited success operating in the Japanese markets compared with their success operating in the U.S. markets. For example, in 1986, foreign banks held about 19 percent of the total U.S. banking assets—Japanese banks held almost half of these assets—while foreign banks held only about 3 percent of the total Japanese banking assets.

Contents

Abbreviations

GAO	General Accounting Office
IBA	International Banking Act
NYSE	New York Stock Exchange
TSE	Tokyo Stock Exchange

Exchange; increasing foreign firms' share of 10-year government bond issues, the most heavily traded bond in that market; and introducing higher capital standards for Japanese banks. Some problems remain in introducing new products, however, as trading in futures and options is not expected to begin before the end of 1988.

The Tokyo Stock Exchange is now the largest in the world. In November 1985, six foreign firms, four of which were U.S.-owned, gained exchange membership. However, several foreign applicants with extensive equities market experience were denied membership, reportedly because of floor space limitations. In December 1987, as a result of foreign pressure and the addition of new facilities, the Tokyo Stock Exchange significantly expanded foreign membership by admitting 16 new foreign members, 6 of which were U.S. firms. This expansion may be sufficient to provide membership to the most interested foreign firms and appears to have answered a major concern of the foreign community.

The actions taken to increase the foreign financial institutions' share of the government bond market appear to have done little to ease the concerns of many members of the U.S. financial community in Japan. While some government bonds are sold through auction, the most important maturity issue, the 10-year bond, is allocated through a syndicate without price bids. During 1987, the syndicate increased the foreign securities firms' share of 10-year bond issues from 0.3 to 1.5 percent and introduced a way for foreign firms to obtain a larger portion of each of the 10-year issues. Neither of these steps satisfied the U.S. financial community, which is still confined to a small role in Japan's primary market for government securities.

In December 1987, the Japanese agreed, in principle, to abide by new risk-weighted capital standards developed jointly by a group of central bankers from 12 leading industrial countries. The fundamental premise for these new standards is the more risky a bank's assets, the greater its minimum capital requirements should be. When implemented, the new standards may help mitigate an important competitive disadvantage for U.S. banking institititions by reducing the disparity between U.S. banks' and foreign banks' capital adequacy requirements. More detailed information is presented in the appendixes. Appendix I discusses recent developments in and issues associated with the Japanese financial markets. Appendix II discusses some specific concerns of the U.S. financial community in Japan, and Appendix III presents a chronology of recent steps taken to further liberalize the Japanese financial markets. The Department of the Treasury did not provide official comments on a