Financial Deregulation in Japan

by Valentine V. Craig*

On November 11, 1996, Japanese Prime Minister Ryutaro Hashimoto unveiled a plan to reform Japanese financial institutions and markets by the year 2001. The plan, which consisted of dozens of proposals, was called "Big Bang," an analogy to the decade-earlier British effort to reform its securities industry and capital markets. The goal of Japanese Big Bang, as enunciated by the prime minister, was to create a "free, fair and global" financial system—free, in that it would operate according to market principles rather than regulatory prescriptions; fair, in that it would be transparent and reliable; and global, in that it would be sophisticated and internationally respected.

Japan is the largest creditor nation in the world. It is the world's second-largest economy (after the United States) and accounts for the world's second-largest insurance market. It has nine of the ten largest banks (in terms of loans outstanding) in the world. Its citizens enjoy the world's highest per capita income, and they contribute to one of the highest rates of savings in the world. However, the nation has been facing severe financial problems for much of the past decade. This article begins by examining these problems and describing the reforms proposed to address them. It then surveys the results of Britain's Big Bang, the model for Japanese financial deregulation. It ends by discussing the probable effects of Japanese Big Bang.

Japan's Financial Problems

Japan's financial industry and markets are suffering from a constellation of problems caused, to a large extent, by government protection and excessive regulation. These problems include inadequate investment choices and returns, inefficient and noncompetitive financial institutions, and underdeveloped financial markets that both fail to meet international standards for performance and are characterized by weak financial reporting and lack of transparency. Because of these problems, the country faces a potentially serious pension fund shortfall, a banking crisis, and a lack of respect for Japanese financial markets and currency.

Looming Pension Shortfalls: Inadequate Investment Choices and Returns

The government hopes to stave off a serious pension fund situation by expanding the number of investment vehicles available to the population and by increasing returns to savers.

The portion of the population approaching retirement age is much larger in Japan than in other industrialized nations. In 2007, an estimated 21 percent of the Japanese population will be over 65 compared with 15.5 percent now. It is projected that by 2025 there will be 61 Japanese pensioners for every 100 workers. The comparable projection for the United States is 49 retirees per 100 workers. According to a study by the Organization for Economic Cooperation and Development (the OECD), assuming the current Japanese retirement age and level of worker contributions and returns, government debt attributable to pensions will rise from approximately 25 percent of GNP in 2000 to

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300 percent of GNP in 2030.[1] Japanese firms are not required to report pension liabilities on their balance sheets, but by some estimates, Japanese firms will have to spend 25 percent of profits on pension contributions by the year 2000.[2] These demographics explain Japan's resistance to international calls for tax cuts to spur its economy. The pending pension problem is severe, and returns to investors must improve dramatically for the country to avoid consuming a large portion of its economy with retirement payments.

This pension fund crisis appears paradoxical, as the amount of Japanese savings is huge. Japanese gross national savings represent approximately 30 percent of GDP, or approximately one-third of the world's savings.[3] However, most of this money has been funneled into low-yielding savings accounts. More than anywhere else in the developed world, Japanese investors have relied on savings accounts (offered by either Japanese domestic banks or the Japanese Postal System) as their primary investment vehicles. Approximately 60 percent of Japanese liquid assets are in bank accounts, compared with approximately 25 percent in the United States.[4] And unfortunately for Japanese savers, returns on bank or Postal System savings have historically been very low because of government policies that subordinated the needs of the banks and savers to the needs of Japanese industry. After the Second World War, Japanese industry needed cheap capital to restart itself, and this cheap capital was subsidized through government restrictions on where money could go and what yields it could earn.

Banking Crisis: Inefficient and Noncompetitive Financial Institutions

Government protection and excessive regulation have also resulted in inefficient and noncompetitive Japanese financial institutions, with the banks especially disadvantaged by government policy.[5] The post–World War II government policy referred to above, to promote Japanese industry at the expense of savers and intermediaries, kept bank profitability low in return for shifting risk from banks to the government. The banks funneled money cheaply to industrial firms that desperately needed funding to rebuild after the war—and in return for restricted or "appropriate" profits, the banks received protection from competition at home and abroad, and a tacit guarantee of a bailout should problems arise.

Japanese banks are currently saddled with bad loans and, having been protected for so long, have not been able to compete profitably in the new global arena. Japanese investment firms and insurance companies were also heavily regulated and protected from competition. Most securities firms have not made a profit in years; and the insurance companies, although not required to report the same kind of asset-quality information as the banks, are believed by many analysts to be much worse off financially than the banks.

Underdeveloped Financial Markets

The third major financial problem for Japan is that the nation's financial markets are relatively underdeveloped. Because of a variety of prohibitions, restrictions, and taxes, Japanese capital markets have not kept pace with other world markets and have, in fact, deteriorated greatly over the past decade. During the late 1980s, monthly trading volumes in Tokyo and New York were approximately equal; today Tokyo's volume is approximately 20 percent of New York's, with approximately 70 percent fewer shares traded now in Tokyo than during 1988. Not only has the volume of foreign shares traded on the Tokyo Exchange declined substantially, but the exchange's percentage of domestic shares traded has declined as well. Approximately 18 percent of total trade in Japanese equities is now done in London, a threefold increase in the past five years.[6] One-third of the Nikkei 225 stock futures business is conducted from Singapore.[7] Moreover, the number of foreign companies listed with Tokyo has dropped by approximately one-half over the past five years.

The underdevelopment of Japanese capital markets has both foreign and domestic consequences. Even though Japan is the world's largest creditor nation, its underdeveloped capital markets have dissuaded foreign investors from holding yen. Thus, the exchange-rate risk for Japanese businesses, particularly Japanese banks, has increased. The banks are particularly sensitive to the weakness in the yen because much of their foreign lending is done in dollars and accounted for in yen. As the dollar has strengthened relative to the yen, the yen-amount of loans outstanding has increased, forcing the banks to set aside more capital to meet the

[1] "A Suitable Case for Treatment," *The Economist* (June 28, 1997): 9.

[2] Ibid., 12.

[3] "A Giant Sucking Sound," *The Economist* (August 23, 1997): 53.

[4] "The Asian Tigers May Falter, but the Japanese Lion Is the Worry," *The New York Times* (November 13, 1997), D2.

[5] "A Time of Crisis," *FDIC Banking Review* 11, no. 2 (1998): 9–17.

[6] "A Big Bang in Slow Motion," *Financial Times* (December 10, 1996), 21.

[7] "Japanese Finance," *The Economist* (June 28, 1997): 1–18.

minimum reserve requirements of the Bank for International Settlements.

From a purely domestic point of view, the underdevelopment of the capital markets has made borrowers overdependent on banks. In the United States, bank loans account for less than 10 percent of corporate funding, but in Japan the figure is approximately 60 percent, according to estimates by Salomon Smith Barney.[8] Bank borrowers (for the most part Japanese corporations) certainly benefited handsomely from the low interest rates on bank borrowings, but at the same time they became overly dependent upon the banks for their capital needs, a potentially serious problem when the banks are in crisis, as they are today.

Weak and Opaque Financial Reporting

Westerners complain of a lack of transparency and materiality in the financial reporting of Japanese firms. Parent-only reporting has served to obscure the financial and legal position of Japanese parent firms. Even in the case where the parent is not legally responsible for its subsidiaries' debt, refusal to honor the subsidiaries' debt can result in a parent's failure. This was brought home recently in the case of Daido Concrete, which refused to honor its *shido nenshoes* (letters of awareness) for its subsidiaries' borrowings and was then brought down by the concerted action of its banks, which refused to roll over the parent's short-term borrowings. Extensive financial arrangements and obligations among firms in a *keiretsu*[9] are also common in Japan and may be very material to the health of a member firm, but are generally not reported.

Japan has neither the laws nor the infrastructure to deal with financial problems of the magnitude it faces today. For instance, Japanese firms often pledge the same collateral repeatedly for different loans, and when the borrower defaults, there is no legal procedure for settling the claims of the different lenders. Japanese law also makes it very difficult for banks to foreclose on bad loans. Nor does a professional infrastructure exist to promote Western ideas of transparency. With just over 12,000 accountants in Japan (the United States, whose economy is twice the size of Japan's, has 470,000 Certified Public Accountants), 710 bank examiners (the United States has approximately 7,000), and a very small judiciary, much financial reporting and enforcement of rules necessarily rests on the honor system.

Proposed Solution: Big Bang

The dozens of reform proposals presented by Prime Minister Hashimoto in late 1996 were the response to these pressing financial problems. The proposed reforms are discussed in this section according to the breakdown used by the Ministry of Finance:

- reforms to increase choice for investors and borrowers;
- reforms to encourage Japanese financial institutions to become more efficient and competitive;
- reforms to encourage better functioning of Japanese financial markets; and
- reforms to establish rules for fair and transparent financial operations and a reliable regulatory framework.

The initial plan called for these reforms to be implemented on a staggered basis over a five-year period. Most of the proposals have been passed by the Diet, and many have already been implemented.

Increasing Choice for Investors and Borrowers

To improve investor choice, Big Bang authorizes new financial instruments and new powers for Japanese financial institutions and removes controls on foreign exchange.

New Financial Instruments and Powers

Banks and securities firms are now permitted to deal in over-the-counter securities derivatives. Previously, there was uncertainty as to whether using them constituted gambling and was therefore banned by Japanese law. Beginning in July 1997, brokerages were allowed to sell options on individual stocks on the Tokyo and Osaka stock exchanges—previously this had been permitted only on indices. Banks are now authorized to engage in over-the-counter trading of derivatives related to securities and commodities, and asset-backed securities are being authorized to improve liquidity.

More choice was also given to investors and savers with the introduction of asset management accounts in October 1997; previously, postal or bank savings accounts were the main alternatives open to Japanese savers. Additionally, banks and insurance companies

[8] "Landmark Deals Indicate the Scale of Change," *Financial Times* (July 14, 1998), 3.

[9] A *keiretsu* is a grouping of businesses held together by cross shareholdings and a common economic purpose. *Keiretsu* groupings typically consist of a large commercial bank at the center, with trust banks, insurance companies, and trading, construction, finance and real-estate companies as other members.

have been authorized to enter the investment trust (mutual fund) sales business indirectly by renting space to investment companies, and they will be permitted to sell these trusts themselves in December 1998. It is expected that banks will eventually be authorized to sell long-term fire insurance and credit life insurance related to housing loans.

Removal of Controls on Foreign Exchange

Controls on foreign exchange have been largely removed. On April 1, 1998, the Foreign Exchange and Foreign Trade Control Act was amended, and among other changes, Japanese nonbank companies and individuals were allowed to open financial accounts in institutions in foreign countries and to deal directly with overseas banks and brokerages. Additionally, the monopoly that licensed banks and securities firms had on the foreign-exchange business was lifted. The foreign-exchange business was opened to nonbanks, and licensing requirements were removed.

Improving Efficiency and Competitiveness of Financial Institutions

The Big Bang reforms have created a different competitive structure for financial institutions by authorizing competition through financial holding companies. The reforms are also stripping away many of the protected powers enjoyed by the different kinds of financial firms and will allow for broad-based competition; in particular, foreign entities are being allowed to compete more freely with Japanese firms. All of these reforms designed to increase competition will necessarily increase investor choice as well.

Competition through Holding Companies

Initially, competition among the different sectors of the Japanese financial industry is being channeled through a holding company structure. Holding companies had been outlawed since the end of the war, but the Japanese Diet has repealed (subject to some restrictions) its general ban on them. The walls between banks and securities firms have been removed through the use of area-specific subsidiaries. It is planned that beginning in April 2000, insurance companies will be able to enter the banking, trust, and securities businesses through subsidiaries; in December 1998, securities companies will be able to enter the insurance business; and in April 2001, banks will be able to enter the insurance business. Head-to-head competition (not through a holding company structure) by the different financial sectors is to be decided on at a later date.

Removal of Monopoly Power and Other Industry Protections

A major thrust of Big Bang is to abolish the monopoly powers enjoyed by each of the three sectors of the financial industry in Japan: banks, securities firms, and insurance companies.

Reforms particularly relevant to banks. Some of the reforms particularly relevant to banks are mentioned above: the removal of the licensed bank and securities firms' monopoly on foreign exchange, and the opening up of the distribution of mutual funds to banks and insurance companies. In addition, bank securities affiliates have been allowed to trade convertible bonds, warrants, stock options, and futures, and will be allowed to broker cash equities.

Reforms particularly relevant to securities firms. Independent investment groups organized as investment advisors (Western-style fund managers), including foreign firms, will be allowed to compete more freely for Japan's $2 trillion pension fund business. Also, as already mentioned, since October 1997, securities firms have been allowed to offer asset management accounts—multi-purpose securities accounts which can be used to make payments and settlements. Fixed commissions on securities sales are being gradually abolished, first on transactions of more than 50 million yen; by the end of calendar year 1999, fixed stock commissions will be completely eliminated. Commission rates on securities transactions in Japan have been among the highest in the world. Requirements mandating the specialization of securities firms are also being abolished, so that the firms will be allowed to diversify; and a simplified registration system will replace the long process needed for licensing new brokerage firms. Finally, the securities transaction tax and the exchange tax will be reduced in December 1998 and may be totally abolished in 1999.

Reforms particularly relevant to insurance companies. Detailed restrictions on pension fund investments are being replaced with general requirements of prudence. According to the previous "5-3-3-2 Rule," 50 percent of pension fund assets had to be invested in assets that guaranteed a return of principal (bonds primarily, or cash); not more than 30 percent of assets could be in domestic equity; not more than 30 percent in foreign equity; and no more than 20 percent in property. In addition, insurance premiums will be deregulated.

Improving the Functioning of Financial Markets

A number of the Big Bang reforms are designed to make Japanese securities markets more like other global capital markets. Restrictions on off-exchange trading for listed securities will be abolished in December 1998, and the ban on broker trading of unlisted and unregistered stocks has already been lifted. Measures are being taken to improve the liquidity of the over-the-counter market (JASDAQ); and in cross-border capital transactions, requirements for permission and prior notification have been abolished for external settlements and capital transactions.

Improving Transparency and Accountability and Providing a Regulatory Framework

A number of the reforms improve the transparency and accountability of Japanese institutions and markets. Implementation of these reforms is necessary if the goals of the other reforms (better choice, more efficient institutions, and more respected financial markets) are to be achieved.

Japan has adopted a "prompt corrective action" system under which banks are required to classify loans into one of four credit categories (healthy loans, loans requiring close attention, potentially unrecoverable loans, and unrecoverable loans); to establish loss reserves; and to write off bad loans according to a set schedule. As part of this system, a new method for calculating capital adequacy ratios for banks, with specific corrective measures, was to have been adopted in April 1998. The corrective measures were postponed for a year, however, for banks engaged exclusively in domestic lending. The new standards require that internationally active banks with less than 8 percent capital prepare a management improvement plan (the threshold is 4 percent for banks engaged in domestic business only); internationally-active banks with capital below 4 percent are required to implement specific corrective measures (the threshold is 2 percent for banks engaged in domestic business only); and all banks with capital below 0 percent are required to suspend operations. Regulators will be empowered to shut down banks that do not meet capital reserve requirements.

Also, the classification of nonperforming loans was changed and strengthened in April 1998 to include those with interest arrears of more than three months (the previous requirement had been six months). Additionally, loans whose rates had been lowered and restructured are now considered bad loans. Outside auditors are empowered to examine the classifications and can force banks to adjust them if the auditors find them unrealistic.

In April 1999, the consolidated method of reporting will replace parent-only reporting. This change is intended to improve the reporting of corporate activities; it will also be needed, now that holding companies have been authorized. Additionally, in the year 2000 Japan plans to change its accounting standards to conform more closely to international accounting standards as set forth by the International Accounting Standards Committee (IASC). Mark-to-market of securities and derivatives investments will be reported at that time. And after the liberalization of foreign-exchange markets in April 1998, an ex post facto reporting system for capital flows was created.

Various measures are being undertaken to protect investors and to ensure a fair playing field. Fair-trading rules are being promulgated to cover new financial products. Penalties for insider trading abuses are being strengthened, and the existing civil dispute system is being improved. The Securities and Exchange Surveillance Commission is being strengthened to improve its systems for inspection, surveillance, and punishment. Measures to reduce settlement risk will be undertaken.

The government infrastructure is being enhanced to support increased surveillance and reporting. The Financial Supervisory Agency (FSA) opened in July 1998. Independent of the Ministry of Finance, it reports to the new Financial Revitalization Commission (which reports directly to the Prime Minister). The FSA is charged with supervising the financial sector, including banks, securities firms, insurance companies, and some nonbank lenders. It is also empowered to close insolvent lenders, issue and revoke financial licenses, arrange mergers, and direct the Japanese Deposit Insurance Corporation (DIC) to pay depositors of failed banks.

The DIC, started in 1971 before Big Bang, reports to the FSA. It collects premiums on bank deposits and insures deposits of failed banks. It was recently strengthened in response to the banks' bad-loan problems. In 1996, it was granted authority to purchase the assets and deposits of failed institutions and to represent depositors in court proceedings. In 1998, in response to recent large failures, the Deposit Insurance Act was amended, providing 17 trillion-yen of government funds for bank assistance through the end of

March 2001. In October 1998, the Diet approved an additional 43 trillion-yen banking package to recapitalize and restructure the sector: 25 trillion-yen for capital injections into institutions, and 18 trillion-yen for the establishment of bridge banks and the purchase of financial institutions' assets. Earlier measures in this bill requiring the banks to provision against losses were dropped.

Two agencies were created to deal specifically with bad loans resulting from the failure of the *jusen* (real-estate lenders) and other Japanese financial institutions. In 1996, the Housing Loan Administration Corporation (HLAC) was created, and the Tokyo Kyodo Bank was restructured into the Resolution and Collection Bank, modeled after the U.S. Resolution Trust Corporation. Under new legislation, these two entities will be merged into the Resolution and Collection Organization. The new organization is charged with maximizing the recovery on nonperforming loans.

London's Big Bang: Changes Wrought

The model for the Japanese deregulation effort was London's Big Bang. British Big Bang officially took effect on October 26, 1986, but the chain of events that led to it began in 1979 when controls on foreign exchange ended. The removal of these controls resulted in a flight of British money out of the country as British businesses (in particular), seeking higher returns, invested in overseas securities. For these transactions they primarily used cheaper foreign securities firms. Because fixed-commission rates had been abolished in the United States four years earlier, the U.S. firms were cheaper competitors and the recipients of much of this new business. Furthermore, many U.S. firms, which had established London offices for their Eurobond business, branched out and began to trade securities of large-capitalization British firms on the London Exchange. In addition, some British financial institutions, rather than using the London Stock Exchange for their transactions, began to trade British securities on the New York Stock Exchange as American Depository Receipts (ADRs), again for reasons of price.

One of the first reforms of Big Bang was the removal of restrictions on London Stock Exchange membership. British law did not require separation among the securities business, investment banking, and commercial banking, but London Stock Exchange (LSE) membership restrictions effectively maintained such separation, protecting member firms from competition. The abolition of these restrictions in March 1986 allowed outsiders, including foreign banks and securities firms, to become members of the London Stock Exchange or to purchase members.

Also ended were fixed commissions on securities transactions. This reform allowed British brokers to compete with one another and with international competitors on price. Restrictions requiring separation of the two types of British securities firms—jobbers (firms that traded on their own account and made markets in securities) and brokers (firms that acted only as agents for a commission) were also abolished. Previously, a firm could be either a jobber or a broker, and brokers were required to use jobbers even if they could match both buy and sell orders.

The bond market was also opened up to all interested parties. Twenty-nine firms were immediately granted licenses (18 survived through the end of 1996), whereas until then, one firm had issued bonds and two others had dominated trading.[10]

Finally, an electronic quote-driven trading system replaced an order-driven trading system. Under the earlier system, brokers matched buy and sell orders provided by jobbers. Under the new system—the Stock Exchange Automated Quotations (SEAQ)—system, similar to the NASDAQ in the United States two-way firm-competing quotes caused marketmakers to risk their own capital.

Increased Efficiency, Improved Liquidity, and Lowered Cost

With the entry of new competition into the London securities market, efficiency and liquidity in these markets increased and the cost for institutional trades decreased. In 1991, five years after the introduction of Big Bang, capacity had increased by 500 percent, total costs had increased 200 percent, and fees were halved. By 1991, 25 marketmakers in equities and 18 in bonds had replaced the handful of jobbers that previously provided this function.[11] With improved liquidity, spreads were cut approximately in half; commissions almost disappeared in the wholesale markets.[12] The new market for gilts functioned effectively and provided a liquid market for investors, the government, and the Bank of England, with much of the growth in this market coming from foreign investors. Institutional in-

[10] "The Morning Ten Years After," *The Economist* (October 26, 1996): 91.

[11] "Five Years Since Big Bang," *The Economist* (October 26, 1991): 23.

[12] Norman S. Poser, *International Securities Regulation, London's "Big Bang" and the European Securities Market*, Little, Brown and Company, Boston, 1991, 68.

vestors were big winners. Commissions on large, heavily traded shares fell dramatically. Additionally, brokers on large transactions were often able to receive prices better than those offered on the SEAQ. By 1989, 45 percent of deals (by volume) were done at prices better than the best SEAQ quotes.[13]

London: A World Financial Center

Big Bang financial deregulation is generally credited with propelling London into its position as the major European financial center. Three years after Big Bang, there were 521 banks in London, and the city was the center of the Eurobond market, responsible for issuing 65 per cent of all Eurobonds.[14] Within five years of Big Bang's passage, roughly as much trading in foreign equities as in domestic equities was conducted in London. London had become Europe's leading stock market: approximately half of the transactions in large French and Italian shares and a quarter of the trades in German shares were done through London, as well as 90 percent of all global cross-border transactions. Also in 1991, more than 600,000 people worked in finance and business services in London, approximately 100,000 more than in New York.[15] In 1996, ten years after Big Bang, London surpassed Frankfurt and Paris as Europe's leading financial center. London is the world's largest swap trader, it arranges more international mergers than any other city in the world, and it is home to the largest foreign-exchange and international insurance markets in the world.[16]

Consolidation in the Financial Industry

Improvements in efficiency, liquidity and cost came about largely as a result of consolidation in the financial industry. Deregulation of fixed commissions resulted in much tighter margins and a decline in the profitability of securities firms. The decline in profitability, in turn, led to the demise of many small or medium-sized British securities firms. By February 1987, over half of the 200 LSE member firms had merged or been acquired.[17] Capital was in great demand, and for the most part foreign firms provided it. British merchant banks and brokers had insufficient capital to compete according to international standards and were unsophisticated in the use of capital. They were also technologically backward, and this deficiency hurt their competitiveness.

The previously deregulated U.S. firms, particularly the bond trading firms, proved to be formidable competitors. U.S. and other foreign institutions bought up British jobbers, brokers, and merchant banks. Attempting to stay competitive, British brokers merged with jobbers, merchant banks bought both jobbers and brokers in order to compete with investment banks, and commercial banks bought securities firms to provide capital to businesses.

Too-Hasty Entry into the Market

Afraid of missing out on the seemingly limitless opportunities, firms (many of them foreign) rushed into the London market, acquiring and merging with local firms. Not all of these acquisitions and mergers made good business sense. Many of them were not well thought out and were executed in great haste and at inflated cost. Many acquiring firms underestimated the difficulties of integrating different corporate cultures and overestimated the extent of the market. The result was severe overcapacity in professional personnel and capital. And the timing for an increased stock market presence could not have been worse. The worldwide stock market crash of October 1987 added to overcapacity, as existing markets shrank. In all, 7 of the 32 marketmakers that entered the equities market after Big Bang, and 9 of the 27 new marketmakers in bonds, had left by 1991. Moreover, at the same time that London was experiencing a general overcapacity in personnel and capital, clearing and settlement functions were deficient because of inadequate computerization and inexperienced back-office personnel. In the years immediately following Big Bang, settlement problems accounted for approximately half of all losses from dealing in British securities.[18]

Many of the mergers formed in the aftermath of Big Bang were later annulled at great cost. A notable failure at the time was Citibank's purchase of the British broker Scrimgeour Vickers, which Citibank subsequently sold at a substantial loss. In many cases, firms that remained independent had a comparative advantage. Not until 1990 did profitability return to London, brought back by increased volume, a good market, and more new issues.[19]

[13] "Five Years Since Big Bang," *The Economist* (October 26, 1991): 23.

[14] Poser, 75.

[15] Norman S. Poser, *International Securities Regulation, London's "Big Bank" and the European Securities Market*, 1992 Supplement, Little, Brown and Company, Boston, 1992, 3.

[16] "The Morning Ten Years After," *The Economist* (October 26, 1996): 91.

[17] Poser, *International Securities Regulation*, 1991, 32.

[18] "London's Certified Lunacy," *The Economist* (March 11, 1989).

[19] Poser, 1992 Supplement, 20.

Conflicts of Interest and Insider Trading

As barriers were removed, new conflicts of interest arose. The British Securities and Investment Board (SIB) reported that in the three years after Big Bang, unauthorized trading resulted in losses of at least 15 million British pounds.[20] No Chinese walls were in place to protect investors,[21] nor was there a strong regulatory apparatus, like the Securities and Exchange Commission in the United States. For the most part, securities regulation in Britain had consisted of self-regulation via the London Stock Exchange.[22] The post-reform conglomeration of banks, brokers, and jobbers made insider trading easier, and no infrastructure existed to police the industry effectively.

Japan's Big Bang Reforms: Likely Outcome

Outcomes similar to those that occurred in Britain, both the positive and the negative, can be expected to occur in Japan if Big Bang proceeds as planned. Improved returns and more vibrant institutions and markets, as well as the closure of domestic firms, initial overcapacity, and increased fraud are likely. However, there remain implementation and enforcement problems, and certain unaddressed problems, that stand in the way of the full attainment of the stated Big Bang goals.

Improved Returns, and More Vibrant Financial Institutions and Markets

Over the long run, the Big Bang reforms should result in greater competition, which should produce increased choice and returns and more vibrant financial institutions and markets. Japanese investors and savers should be able to earn global rates of return, with the result that looming Japanese pension shortfalls are lessened. In terms of helping to heal Japan's domestic banking crisis, the proposed reforms should enable the nation's banks (and securities firms and insurance companies) to become more efficient and competitive. In the short run, however, increased international competition will probably exacerbate their problems. Finally, given such a large economy and the problems afflicting other Asian financial centers, with decreased government intervention and increased transparency Japanese financial markets should once again become internationally significant.

Closure and Consolidation of Financial Institutions

As in Britain, the withdrawal of protections and the increase in competition will require consolidation in the Japanese financial industry, with all the attendant pain and dislocation. According to some analysts, if Big Bang succeeds, a third of Japanese financial institutions will disappear through mergers and closings.[23] Japanese banks, securities firms, and insurance companies are expected to fare differently under deregulation, with the banks and insurance companies likely to have a more difficult time during the adjustment period.

Prospect for Banks

Burdened with high costs, low demand, old debt, and new competition, the banks are particularly vulnerable as Big Bang reforms unfold. Morgan Stanley Dean Witter estimates the net capital of the 19 largest banks at August 1998 at an approximate negative $7.6 billion, after bad loans are written off.[24] There are simply too many banks, so that even with current competition and protection, many are unprofitable. Once more attractive investment alternatives are available and financial activities become more transparent, many Japanese investors are expected to reduce their dependency upon the banks and the Post Office and to invest in the Japanese stock market and overseas capital markets. This has already begun to happen. In 1993, Japanese households owned virtually no foreign securities; today, Japanese households own approximately $685 billion in offshore investments, much of it invested in U.S. savings bonds.[25] This capital outflow occurred despite onerous tax-reporting requirements for cross-border capital transactions and despite higher tax rates applied to nondomestic bank and postal savings accounts.

To deal with new competition, banks will need to restructure. Already some banks, particularly the larger ones, have begun to dispose of bad loans and are entering into arrangements to securitize and sell real-estate loans in international markets. They will also have to raise deposit interest rates to attract depositors.

[20] Ibid., 1.

[21] "Chinese wall" refers to the forced separation in a firm of investment banking and its trading and investment research functions to eliminate the use of insider information.

[22] Big Bang was followed ten days later by the Financial Services Act, which, for the first time in England, introduced a comprehensive system for regulating financial services.

[23] Jesper Koll of J. P. Morgan and Co. quoted in "Two Japans, The Gulf Between Corporate Winners and Losers Is Growing," *Business Week* (January 27, 1997): 24–28.

[24] "Japanese Bank Crisis Said to Be Worsening," *The Washington Post* (September 9, 1998).

[25] "Flight of Savings," *The London Daily Telegraph* (August 9, 1998), 4.

Loan demand from strong businesses will weaken, as these stronger borrowers are better able to access the capital markets for their funding needs. Weaker, smaller companies, used to subsidized lending rates, will remain as borrowers. To prosper in this environment, banks will need to price risk into the lending decision, and as businesses are forced to pay interest rates in line with their risk profiles, marginal businesses will fail.

The banks that remain in business will need to develop new financial products to replace lending. Again, this process has begun: Japanese banks and securities companies are beginning to compete for pension fund money management and mutual fund sales. Commercial banks have also been entering the bond business, gaining a market share of 60 percent in the year ending March 1997, up from 36 percent a year earlier.[26] On the whole, the larger banks are expected to weather the transition better than medium and small banks.

In Britain, foreigners rushed in to purchase British banks, but this is unlikely to occur in Japan, where the banks are saddled with huge debts and are still expensive. Instead, many foreign financial institutions that already have a presence in Japan are expected to expand internally. Others will form alliances, partnerships, and ventures with Japanese banks. Although U.S. banks have been cutting their exposure to Japan—it fell nearly 19 percent in the first quarter of 1998—foreign banks have done well overall, as Japanese consumers and corporations have flocked to these banks' relative safety. Citibank, for instance, currently reports more than half a million customers and more than one million accounts in Japan.[27]

Prospect for Securities Firms

Japanese small and medium-sized securities firms are also not expected to compete very well in the new deregulated environment. As the major beneficiaries of regulated commissions and other government protections, they are high-cost, low-tech producers and are weak in mutual funds, asset management, derivatives, and research. Commissions have accounted for at least half of the revenue of many smaller brokers. Almost all of the second-tier brokers suffered losses last year. Even the larger Japanese securities firms have not done well. Of the "Big Four" houses, Yamaichi was bankrupted last year, and the earnings of the remaining three—Nomura, Daiwa, and Nikko—plunged during the first quarter of 1998 as trading volumes and commissions were eroded by foreign competition.[28] The bigger firms are expected to do better, however, as they are not as dependent on commissions and have good research capabilities.

Foreign competition is much fiercer in the securities industry than in banking and insurance, where foreigners still account for only a small portion of Japanese business. Foreign securities firms have made great progress in developing their securities, fund management, and investment banking business. At the end of 1997, foreign securities firms accounted for a third of the turnover on Tokyo's stock exchange. The previous year they accounted for approximately a quarter of total business.[29] They have drawn their customers both from overseas and from Japan, with many Japanese investors having switched their business to foreign securities firms after scandals were exposed at the big four Japanese firms.

Mutual fund sales represent a potentially large market for foreign investment firms. Currently, mutual fund investments account for only 4 percent of Japan's household savings. In June 1998, the foreign share of this market increased from 2 percent to 7 percent.[30] The foreign firms have also excelled in pension fund management. Money managed by all investment advisory firms increased approximately one-third from 1996 to 1997; although from a very small base, the amount managed by foreign firms increased by 80 percent.[31] Two years after its entry into the investment trust business in Japan, Goldman Sachs was managing $6 billion; after a four-month presence, Merrill Lynch was managing $2.5 billion; and after 17 months in Japan, Alliance Capital had $5 billion under management.[32] However, foreign firms have achieved perhaps their greatest success in investment banking, where they have enjoyed great success in raising foreign capital for Japanese businesses, underwriting new issues, selling Japanese companies' cross-share holdings, and managing derivatives.

Although no Japanese securities firm has been purchased outright by a foreign firm, several major foreign firms have established relationships with them. For instance, Barclays established a joint venture with the

[26] "Japanese Securities Firms: Once There Were Four," *The Economist* (September 27, 1997): 80.

[27] "Japan's Down, Citibank's Up," *U.S. News and World Report* (September 7, 1998): 34–37.

[28] "Competition Hits Japan's Brokers," *Financial Times* (July 16, 1998), 41.

[29] "Rich Pickings for the Gaiijin," *The Economist* (May 16, 1998): 83.

[30] "Financial Big Boys of the West Go on a 'Dating Frenzy,'" *Financial Times* (August 12, 1998), 21.

[31] Ibid.

[32] "Finance Firms Hope to Strike Gold in Japan," *Star Tribune* (June 5, 1998), 1D.

third-largest Japanese securities firm, Nikko; and Travelers Group recently purchased a 25 percent stake in Nikko, effectively taking over its investment banking and international operations. Merrill Lynch acquired a national retail network with its purchase of 30 Yamaichi branches and its hiring of 2,000 of Yamaichi's laid-off staff. To ward off foreign competition, Japanese securities firms have also been undertaking cooperative arrangements with other Japanese financial entities.

Prospect for Insurance Companies

Prospects for the insurance industry will not be clear until more is known about which protections are waived for this industry. Many of these decisions have been postponed to the turn of the century. However, the life insurance industry in Japan is in serious trouble—according to some analysts, the industry as a whole is insolvent. Low interest rates, cancelled policies, and a bad stock market have hurt the industry badly. Additionally, insurance firms have been big lenders to brokerages and banks, so financial problems in those industries will be felt by the insurance companies as well.

The opening up of the asset management business to other participants—previously the almost exclusive territory of the insurance companies and trust banks—will further affect this fragile industry. Life insurers currently manage approximately one-third of the assets of corporate Japanese pension funds. The returns on these pension funds have been very low, even by Japanese standards. New disclosure laws will require these investments to be reported at market value in April 1999, and it is expected that the movement of pension fund money away from the insurance companies will then accelerate. The competition is not just from foreign firms; Japanese securities companies and banks have also expressed an interest in developing their asset management business.

Some foreign interest has been expressed in Japanese insurers. GE Capital entered a joint venture with Toho Life to develop and distribute Western insurance products. Putnam, the fifth-largest U.S. mutual fund family, has entered into an agreement to manage approximately $700 million for Nippon Life, focusing on non-Japanese securities, and to develop products for Nippon Life's pension clients.

Overcapacity

Deregulation of the British securities markets resulted in an influx of foreign firms, resulting in initial overcapacity and lowered profitability. Many foreign entrants sustained substantial losses for a number of years, and many chose to leave the market. Similarly, over the past several years, foreign businesses have been rushing into Japan in what one observer has likened to "a financial dating frenzy."[33] Foreign financial firms would be wise to learn the lessons of British Big Bang and think twice before committing themselves to a large presence in Japan on the basis of unrealistic earnings expectations.

Increased Fraud

As the British experience also shows, another unwanted development likely to result from financial deregulation is increased fraud. And much like the British a decade ago, the Japanese do not appear to have the infrastructure necessary to support transparency and to discourage fraud. As mentioned previously, there are approximately 12,000 accountants in Japan, 710 financial examiners (the FSA is requesting an increase of approximately 15 percent in FY 1999), and a small judiciary; and the country is significantly more low-tech than most other developed countries. Additionally, the Japanese underworld, the *yakuza*, is reportedly deeply involved in the Japanese banks' bad-debt problem. A lesson from both the British experience and the U.S. savings-and-loan experience is that deregulation must be accompanied by supervision, but this will not be easy to do in Japan.

Implementation and Enforcement

Most of the Big Bang legislation has been passed, and many of the reforms have been implemented. Especially on the first three goals of Big Bang—increased choice, increased competition, and vibrant financial markets—a great deal has been accomplished. New financial instruments and powers have been introduced, controls on foreign exchange have been largely removed, many industry protections have been removed, and competition has been allowed through a holding company structure. Foreign businesses have been allowed to compete more freely. These reforms are not likely to be turned back.

In the area of increased financial industry transparency and accountability, however, less progress has been made in Japan. The new minimum capital ade-

[33] "Financial Big Boys of the West Go on a 'Dating Frenzy,'" *Financial Times* (August 12, 1998), 21.

quacy requirements have been postponed for most banks until 1999, and Japan's accounting standards are not slated to conform to international accounting standards until the year 2000. Even if and when these standards are brought into conformance, potentially serious deficiencies exist that could seriously undermine these reforms. As mentioned previously, no adequate infrastructure (or culture) currently exists in Japan to enforce increased financial reporting and to question the accuracy of reported financial results. For instance, one need not be a skeptic to question the validity of bank loan classifications based on self-assessment, the current reporting mechanism. And, the new minimum capital adequacy requirements will be mere window-dressing without realistic loan classifications. Auditing by respected external auditors is essential for investor confidence, and at this point in time, there is no such capability in Japan. Unfortunately, without investor faith in firms' reported financial positions, the other Big Bang goals—investor choice, competition, and financial market respect—are undermined.

The very dire situation of the banks and probably of the insurance companies, a deepening recession, and recent political upheaval also bring into question the ability and willingness of the government to stand aside and let market forces determine financial winners and losers. The government's commitment to full disclosure and accountability and to a reliance on unfettered market forces has been unclear in the light of some recent actions: the postponement of the new capital adequacy requirements for some banks; the adoption of accounting gimmicks for banks and insurance companies;[34] the pressure exerted by the government on an unwilling Sumitomo Bank to acquire the long-suffering Long Term Credit Bank; and calls during the summer by some leading politicians for short-term controls on capital flows. A bill was recently passed providing an additional 43 trillion-yen to recapitalize and restructure the banking sector. However, strict provisioning requirements were dropped from the bill, and it is not at all clear at this time whether the authorities will require the banks to restructure in a meaningful way or whether this capital infusion will represent only a temporary bailout and a continuation of "business as usual."

Deregulating the nation's financial institutions will be very difficult because deregulation will affect not only Japan's financial institutions and businesses (how they are financed and operated) but also basic Japanese values. In a deregulated, competitive environment, business practices in Japan will have to change. If capital is to earn global returns, there can be no more cheap money for well-connected marginal businesses—*keiretsu* loyalties and the concept of lifetime employment will need to be modified substantially, if not jettisoned. Changing such basic Japanese values will be difficult and painful.

Unaddressed Problems

There are also problems that have not been addressed by the Big Bang proposals but that cannot be ignored. The Big Bang proposals do not deal with the role of the world's biggest bank, the Japanese Post Office, which holds approximately $2 trillion in savings and over $800 billion dollars in life insurance policies. It pays no taxes or deposit insurance premiums; it is not required to hold reserves against losses; it is fully guaranteed; and its time deposits are more liquid than those of banks. The existence of this huge publicly financed, risk-free competitor to banks and insurance companies must be addressed to ensure a level playing field for financial participants.

Japanese tax policy, too, must be examined. The government is instituting consolidated reporting, which will provide an incentive for mergers between profitable and unprofitable firms, and it may totally abolish securities transaction taxes. However, preferential taxation on bank and postal savings accounts needs to be addressed. Bank and postal savings accounts are currently taxed at a flat 20 percent rate, whereas other investment income is subject to a maximum capital gains and interest tax of 65 percent. Furthermore, after foreign currency controls were removed, onerous tax reporting requirements were instituted for cross-border capital transactions. If the tax treatments for different investment alternatives remain substantially different, the effect of removing foreign-exchange restrictions and increasing the investment options for investors will be limited.

Additionally, many decisions about the deregulation and opening up of the insurance industry have been postponed for action until later. Government behavior toward the insurance industry will have a substantial effect on the outlook for Japanese deregulation.

Conclusion

Big Bang financial reform holds much promise as a way to alleviate the Japanese problems of inadequate

[34] New rules allow banks and insurance companies to inflate their balance sheets by booking some stocks at cost, and real estate at current value.

investment return and choice, underdeveloped financial markets that do not meet international standards for performance, and nontransparent financial reporting. Over the long run, these reforms should also make Japanese financial institutions more efficient and competitive. Over the short run, however, they will quite possibly exacerbate the problems of these institutions, in particular, the banks and insurance companies. As the history of British Big Bang shows, not all the results of deregulation are benign. Deregulation and increased competition can be expected to lead to the closure of marginal financial firms; and the three groups—banks, securities firms, and insurance companies—will vary in their capacity to weather the new competition. Recently, foreign financial firms in these markets have been doing well, but at some point the increased competition may lower returns for all participants. Also, if the British model holds, conflicts of interest will increase—an outcome for which the Japanese appear to be unprepared. Finally, although much of the legislation authorizing these reforms has been passed, and many have been implemented, in the area of transparency and accountability it is not clear that the government is willing or able to make great changes in the short run. A lack of an enforcement infrastructure, a banking crisis, a deepening recession, and political dissension may prevent or weaken the necessary implementation or enforcement of these reforms.