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Japanese Financial Market Reform

by

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1. Introduction

The Japanese financial community has been under surge of so-called bubbles in stock market and real estate market. There has been the long rise in stock prices since 1982 and the collapse of stock prices since January 1990. For real estate market we have observed the remarkable rise in land prices from the middle of 1986 to the middle of 1988 in Tokyo and Osaka and the fall in prices since the beginning of 1991 in the same areas. Financial-system reform began in September 1985 and the Research Committee on the Financial System (hereafter abbreviate as the Committee) of and the Securities and Exchange Council (hereafter abbreviate as the Council) of the Ministry of Finance (MOF) presented the proposals on financial-system reform around the end of May last year. Though the Committee and the Council expected that the required revision of the various banking laws i.e. the Banking Law, the Long-Term Credit Banking Law the Credit Union Law and the other related Laws and the Securities and Exchange Law had been prepared smooth in Autumn 1991. However, since the end of last June the scandals mainly related to the compensation for loss in security business has bitterly shaked securities market and MOF was forced to restructure its administrative framework on securities transactions by adopting the proposal made by the Commission for Promoting Reform in Public Administration. Since then the financial-system reform has broaden its scope by paying more attention to secure fairness in transactions in securities market. At the current session of the diet the government proposes the revision of the Securities and Exchange Law for securing fairness in transactions and also the revision of related banking laws and the Securities and Exchange Law for reform of financial-system. Though

the prospect of passing of the revisions in the diet would not be so bright because of the negative attitude of the opposition party, this paper reviews not only the original proposals of the Committee and the Council and the subsequent revision of the various laws but also the newly enlarged reform mainly in securities market.

2. Features of the Reform

(1) Proposed reform in the banking and investment services

The final proposals made by the Committee and the Council are not sufficiently concrete to enable them to be written into laws immediately, and contradictory parts of the Committee's and the Council's opinions have deliberately been left vague. However, the ways in which the reform will be implemented became clearer in the proposed revision of the various laws and can be summarized in the following three points: (a) Institutions in each specialized field within the banking industry (ordinary banks and the Norinchukin Bank, long-term credit banks and the Bank of Tokyo, and trust banks) may enter each other's fields through the establishment of subsidiaries in different specialized fields. (b) Banks may establish securities subsidiaries, while securities companies may set up banking and trust-banking subsidiaries. Thus banks and securities companies will be able to participate in each other's fields in the form of subsidiaries through the revision of important basic principles of the Securities and Exchange Law (Article 43), which provides the separation of the banking business and the securities business in the same way as the Glass-Stegal Act in the United States. (c) The business of trust subsidiaries and of securities subsidiaries will initially be restricted, and in the

case of securities subsidiaries owned by banking, operations will be limited to underwriting of bonds.

Why has this method of using subsidiaries been adopted? In its interim report issued in May 1989, the committee presented four alternative forms of entry into each other's fields by financial institutions: (a) through subsidiaries, (b) by establishing investment banks specializing in wholesale banking, (c) through the establishment of holding companies, (d) by adopting universal banking. The reasons why this subsidiary method has been selected from among those four alternatives includes purely economic reasons and other ones.

One economic reason is the dangers posed by the strong competitiveness of ordinary banks —— in particular the upper ranking city banks —— and by their power to influence companies as lenders. Despite the fact that these dangers were not given detailed study by the Committee and the Council, the dangers divides into two reasons. The first reason is that in view of the strong competitiveness of the upper-ranking city banks, if the universal-banking method were to be chose, this would give rise to destructive competition that would ultimately lead to the creation of a natural monopoly, as a result of which the financial market would no longer be competitive. The second reason is that one of the factors in the strong competitiveness of the upper-ranking city banks is their influence over companies as lenders, and in particular, their participation in securities business would create distortions in the securities market resulting from conduct embodying conflicts of interest. For these two reasons, the universal-banking method was rejected. The holding-company method permits banks to own holding companies which are prohibited under the present Anti-monopoly Law, and it was judged that this method was not feasible

as the prohibition against holding companies owned by banks were regarded as being an basic component of that law. The method involving the establishment of investment banks specializing in wholesale banking was not completely rejected as an alternative in the proposals by the Commission. However, in the revision of the various banking laws there is no room for investment banks because it is needed to keep the generality of the subsidiary method in the reform apart from the difficulty in the implementation of separating wholesale business and retail business.

Turning now to reasons that are not purely economic, so to speak, a politico–economic reason that cannot be overlooked is that the position taken by the city banks which support the universal–banking method conflicted with the interests of other banks and of the securities companies, and the strength of these conflicts eventuated in the defeat of the universal banking method. Though originally the Securities Bureau and the Banking Bureau of MOF wanted wider participation of banks into securities business. the continued strong opposition of the securities companies to participation in securities business by banks forced the Securities Bureau to be content with the subsidiaries of banks in the field of underwriting business.

We could not deny that the prevalence of the malpractices in securities market is partly due to insufficient competitiveness in the market caused by the entry barriers to the investment services industry. Viewed in this light breaking up detailed segmentation in banking and between banking and investment services would also contribute to better performance of the securities markets.

(2) Reform in the capital markets

The capital market constitutes another important field in the reform of the financial system. As in the case of Big Bang in the United Kingdom, the question of whether to change the institutional framework of the capital markets is the major point at issue. That is to say, as securitization advances in the financial sector, the problem is that of establishing how banking business and securities business —— the boundaries dividing which have become blurred —— should be placed from the standpoint of securities transactions. The present Securities and Exchange Law first legally defines marketable securities, and the regulates securities companies as being firms acting as intermediaries for the buying and selling of these securities. The question that arisens is that of whether or not to change this legal framework.

The proposals of the Council with respect to this question can be summarized as follows: (1) In place of the narrow concept of securities that has prevailed hitherto, "a wider concept of securities" should be employed, new securities could be flexibly included in the concept of securities without being nominated in the law, and firms that act as intermediaries for the resultant wider range of securities should be treated as securities companies and brought within a broader regulatory framework. (2) Products backed by securitized assets should be included among these new securities, and regulations governing securities business should be applied to the arrangements for their securitizaiton. (3) Under the present Securities and Exchange Law, privately placed bonds are not regarded as being securities. The definition of these instruments should be clarified; They should be regarded as securities and subjected to regulations governing securities business.

Though these are originally proposed by the Council, the actual revision in the Securities and Exchange Law is differed from the original proposals in two

respects. One is that a wider concept of securities is not adopted literally and new securities need to be listed explicitly. The other is that regulations governing securities could not be applied at least to the initial stage of securitization, for example, in the case of assets formed through leasing. Therefore, it is possible to say that the revision of the Securities and Exchange Law introduces more flexibility in its implementation but does not change the basic character of the concept of securities.

Apart from the original proposal by the Council, the substantial reform on the regulations in capital market has been initiated after the scandals in security business last summer. The reform includes the change of regulatory framework for transactions in stock market and also the liberalization of fixed commission of brokerage in the Stock Exchange.

The present regulatory framework for capital market is administered by the Security Bureau in MOF. The Security Bureau regulates conducts of participants of the open market. The prohibition of insider trading and of the manipulation of stock prices belong to this category of regulations. We call them regulation for market participants. The Security Bureau also imposes a number of rules on investment services, including regulations concerning examining the fitness of a security company to commence business, and granting a licence, rules of conduct relating to canvassing for investment. We call these rules regulation for investment services.

Regulation for market participants covers all investors and needs to be applied impartially to an investor independly of his status. In contrast with the regulation for market participants, regulation for investment services is applied to securities companies who provides investment services. The present administration tends to lean on administrative guidances on securities

companies and this tendency has been publicly criticized since the scandals related to the compensation for loss in security business has been brought to light.

In response to the criticism the administrative framework of the Security Bureau is divided into two parts, namely the Committee of Surveilance on Securities Market and the regulatory sections mainly for investment services for disclosure. The former Committee is separated form the Security Bureau and is expected to work rather indepently of the administration for investment services even the Committee belongs to MOF. The Committee is also empowered to do criminal investigation through the permission of courts and to indict a suspect to courts.

The final report of the Council last May was reluctant to liberalize fixed commissions of brokerage though it admit the need to lower the level of commissions. However, it has been argued since the end of June that such malpractice as compensation for loss in security transactions is mainly due to fixing of the commissions. It is also indicated that these malpractices had been prevalent before Mayday in the Wall Street in 1975 when brokerage commission had been fixed.

The Commission for Promoting Reform in Public Administration proposed abolishing the fixed commission and MOF accepted the proposal. However, the Council did not accept the complete liberalization of the fixed commission though the Council agree to abolish fixed commissions for big transacions for the time–being.

3. Goals of System Reform

The currently proposed reform of the financial system becomes easier to understand if examined from the perspective of the objective of the reform. Both the Committee the Council were conscious of the necessary requirements of the reform. The Committee which dealt with the banking system, lays down three key requirements: the convenience of users, internationalization, and the maintenance of financial stability. The Securities and Exchange Council which covered the capital markets, puts forward the requirements of efficiency, internationalization, and soundness (stability).

There was some degree of confusion with respect to the requirements for the reform of the banking system. The view was advanced that most emphasis should be placed upon convenience as one of the requirements for the reform. However, if this convenience is taken literally for customers, the universal banking would be the most desirable method to adopt. From the standpoint of an economists, it is convincing to put forward efficiency as a key requirement of reform. Indeed, from the point of view of efficiency, there are ambiguities in the proposed reform. Efficiency is enhanced by competition, and competition is effectively stimulated by new entry. To what extent would the limited entry permitted by the subsidiary method serve to stimulate competition? With respect to entry through trust and securities subsidiaries, if pension and other trusts were excluded in the case of the former and brokerage business were excluded in the case of the latter, participation would be limited. Conversely, it is possible that when establishing subsidiaries business would not be sufficiently diversified to generate earnings. In addition, if solid firewalls were built between subsidiaries and parent companies, this possibility would become even greater. Naturally, these are depends on the way how financial reform actually implemented and we need to watch the process of reform.

The extent to which the requirement for internationalization would be fulfilled depends upon the moves towards financial integration in the European Community and the progress of financial–reform legislation in the Unites States. Nevertheless, it is essential that the system maintains a minimum degree of international conformity. A tendency towards protectionism has characterized recent trends in the world economy, and it would be undesirable if protectionist tendencies were also to be exacerbated in financial systems by means of reciprocity. In Japan's case, the degree of mutual entry permitted to the countries in reform proposals will probably not guarantee viable entry, and thus the danger remains that entry from Japan into other countries will be curbed. This may make it necessary to permit foreign banks and securities companies effectively to operate universal banks. Apart from international conformity, in the case of the system in Japan, problems will be created by a lack of transparency resulting from administrative guidance and other factors.

With respect to the final requirement, that of maintaining financial stability, within the proposed reform this is regarded as being at most only a limiting condition. The reason for this is that Japan has never experienced instability caused by bank failures. This is in stark contrast with the reform of the U.S. financial system —— destabilized as it has been by numerous failures of commercial banks and savings and loan associations —— which places emphasis on measures such as the reform of the federal deposit insurance system. In the case of Japan, as issue to be addressed in the near future is that of assessing how to guarantee the stability of the banking system within the financial system under the following condition: Banking institutions have been suffering from deteriorating business conditions, typically as a result of unsound policies on loans on real estates and risky investment on stocks. As is well known the

vanishing of bubbles has wiped out profits expected from these loans and investment. However, it is questionable whether restructuring banking institutions soley depending the use of conventional method as mergers and acquisitions by big banks is the viable solution or not.

4. Main Issues

(1) Pros and cons on of universal banking

As mentioned at the beginning of this paper, in the process of formulating these reform proposals the biggest point at issue was the evaluation adopting universal banking. The economic reasons behind this issue were not throughlly studies by the Committee and the Council. However, from an economist's standpoint, it contains such very complex factors as follows: an assessment of the extent of economies of scale and economies of scope in the banking and securities industries; even if these economies are strong, an assessment of opportunities for entry exist in various activities in banking and security business (that is, whether there is contestability or not); an assessment of the influence of banks over corporate borrowers; and assuming that they do possess the influence, an assessment of the effect of this on capital markets.

The Committee indicated the importance of economies of scope, but made virtually no mention of economies of scale. Recent empirical research has identified an increasing number of examples of economies of scale in banking business, and thus the danger of destructive competition cannot be completely ignored. On the other hand, as nonbanks have been growing at a remarkable pace, competition is being stimulated in individual types of banking business —— loans for example.

The Committee and the Council are very conscious about the influence of banks as lenders over companies. The Committee admits that by taking advantage of their superior information, banks' financial-intermediation functions play an important economic role in the efficient allocation of funds, but the committee is skeptical about banks' influence over corporate borrowers. Meanwhile the Council places emphasis in banks' influence as lenders over companies, pointing out the possible negative effects of this influence on securities markets, and stressing consequent necessity to provide firewalls. In other words, the banks' influence over companies constitutes the most important grounds for rejecting universal banking, as to permit it would give rise to harmful effects as a result of the entry of banks into securities business.

This issue pertaining to the influence of banks on companies is not a straightforward one that can be answered with a simple "yes" or "no." To a greater of lesser extent, the current financial theory recognizes that as a result of their superior information, banks and other financial intermediaries make a positive contribution to allocation of funds. However, this does not appear to impair the functions of the capital markets, for example through the immediate creation of problems with respect to anti-trust policy. For example, banking business in the Unites States and the United Kingdom is not considered to be harmful to anti-trust policy in this sense. By contrast it can readily be pointed out that in the case of Germany, for example, banks have an oligopolistic status by holding corporate borrowers' shares and assigning directors to these firms, and can exert control over these firms. In Japan, banks function as "main banks," and unlike typical U.S. commercial banks and U.K. clearing banks, they have stable long-term customer relationships with corporate borrowers. But

could these main-bank functions lead monopolistic competition? There are arguments both for and against, making this an issue on which no final conclusion can be reached.

Incidental to this issue there remains another question that has not been discussed in depth: Supposing that banks do have influence over companies, can this be eliminated through the use of the subsidiary method? It can be argued that as subsidiaries will be wholly owned by their parent banks, this influence will be unable to be eliminated. If this influence is to be eliminated, solid firewalls must be erected. However, mutual entry in this way will do little to promote competition, and may thus weaken the effects of the reform.

(2) The problem of conflicts of interest

Pros and cons concerning conflicts of interest has been debated widely with respect to the advisability of mutual entry. This is because those who oppose mutual entry regard conflicts of interest as constituting a powerful reason why it should not be permitted.

The issue of conflicts of interest can be traced back to the time of enactment of the Glass-Stegal Act during the first half of the 1930s. When the Pecora Hearing was held in the U.S. Senate at that time, it was believed that transactions involving conflicts of interest between the banking business and the securities business of banks brought about the financial crisis on the Great Depression, though the attribution of the cause of the financial crisis to the conflicts of interest has been questioned in the recent literature. Even since then, there has been a tendency to regard problems of conflicts of interest as being the harmful effects of the entry of banks into securities business. This same tendency can be seen in the debate that has recently been taking place in

Japan.

I would like to explain here briefly why this view of the problem of conflicts of interest is misdirected. As long as banks and securities companies do business with large numbers of customers, there will always be the potential for conflicts of interest to arise. For example, if trust banks engage in both lending business and trust business, certain transactions in one of these fields of business may conflict with the interests of customers in the other. The same conflicts may occur if securities companies engage in underwriting business and brokerage and dealing business simultaneously. If the degree of such conflicts of interest becomes very serious, then this may well give rise to legal problems, although in any event these cases would be contrary to rules of conduct prescribed in the law.

Cases in which problems affecting mutual entry into banking and securities business could arise would be, for example, when conflicts of interest — in the form of the impairment of the stability of settlement services provided by banks — readily arise as a result of the entry of banks into securities business. and when through entry into securities business, banks' influence over companies may, through conduct embodying conflicts of interest, cause distortions in price formation in the securities markets. The Committee and the Council are not particularly concerned about the possibility of the former, and with respect to the latter the debate has focused not on whether conflicts of interest themselves would be the problem, but on the advisability of banks having the power to influence companies. Therefore, the issue returns to that related to pros and cons of universal banking.

(3) Administrative framework for capital market and securities companies

As was already explained, MOF has proposed recently the new administrative framework for capital markets responding to the raged criticisms in last summer on the malpractices in capital markets. The related problems ranges over outsides of the scope of the field of economists. However, here it is needed for me to comment briefly at least on a few issues.

The raged criticisms since last summer has been centered on the adoption of the SEC-type institution like U.S. I do not deny the probability of more stringent regulation on capital market by the adoption. At the same time I think that a new institution need to be more transparent than the current one in order to regain the confidence among investors. In this respect the current proposal of the Committee of Surveillance on Securities Market is to the point because the division of regulation between investors and security companies is needed for making regulation more transparent for investors. The proposal of the Committee could be considered the important step for transforming the club-like or guild-like framework of regulation to such a more transparent framework in the Anglo-American world.

Another issue which has been frequently argued is the legal form of permitting entry to investment services. After the crash of stock market in 1965, a new entry to investment services has required the license from the Security Bureau. It is said that this legal form has introduced a rather protective attitude of the regulator and could be one of factors from which malpractices or scandals in last summer resulted. Most economists probably agree that investment services need not to be required the same degree of cautious judgement for fitness and properness as granting banks the license. In this respect the issue remains to be a unsettled problems and a reconsideration would be needed in the future.

5. Concluding Remarks

Recent situation in Japanese financial reform is very complex one because the original intention of the financial reform has been mingled with another reform in the capital market originated from scandals in securities market. I hope that my paper could clarify various aspects of this complex situation.

Even though the current proposal on financial market reform leaves unsettled problems, I believe that the direction which the current proposal point to would be proper one. I also believe that the financial market reform could contribute to making our market more transparent and more efficient and to making the function of the global financial market better.