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ESSAY

JAPAN'S BIG BANG FINANCIAL REFORMS[†]

*Ernest T. Patrikis**

I. INTRODUCTION

Japan's "Big Bang" reforms will radically alter its financial marketplace. The barriers separating banks, securities, and insurance companies are being lowered, and regulation of the products financial companies offer and the fees they charge are being eased. Once the Big Bang reforms are fully implemented, Japan's cloistered financial system may come to resemble the open, competitive system we know in the United States.

The more competitive environment promoted by the Big Bang promises important benefits for Japan and for its economic partners. For Japanese savers, the reforms should mean higher returns, lower fees, a wider choice of products, and better service. Moreover, increased competition in the financial sector should raise the efficiency with which Japan's savings are invested, which may ultimately boost Japan's prospects for sustained economic growth. For financial companies in the United States and elsewhere, the Big Bang reforms mean new opportunities to market their products and expertise to a vast market—a market which represents the world's second largest pool of privately held savings.

Of course, the path to reform is invariably a bumpy one, and the Big Bang faces important potential obstacles. I will have more to say about the obstacles later. The main theme of this Essay will be opportunity: opportunity for Japan and op-

[†] This essay was originally delivered as a speech to a breakfast round table of the New York Stock Exchange, sponsored by the Brooklyn Law School Center for the Study of International Business Law, on April 27, 1998.

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portunity for the United States, and other nations.

Before I continue, I would like to give you a sense of the scale of the opportunity. The stock of Japanese personal sector financial assets is enormous: ¥1,209 trillion, or \$10.4 trillion, as of the end of March 1997 (Table 1). This figure refers to the gross financial assets of households and unincorporated businesses; if real assets were included as well, the figure would be about twice as high. Japan's household sector asset-to-income ratio is similar to that for other major industrial countries, larger than Germany's, but slightly smaller than those of the United States or United Kingdom.

TABLE 1 PERSONAL SECTOR GROSS FINANCIAL ASSETS¹

	Japan	United States	United Kingdom	Germany
Total ¥ Trillion	1,209	2,404	303	333
Ratio to Nominal GDP	2.4	2.7	2.7	1.3
<i>Percent Distribution</i>				
Currency and Deposits	56.9	18.1	25.3	43.3
Insurance and Pensions	31.5	37.3	52.4	21.3
Securities	12.4	39.1	16.8	28.8
Equities	6.1	22.4	9.3	5.3
Other	0.0	5.5	5.5	6.6

Personal sector assets are now more than 240 percent of GDP (Table 2). A glance at the household sector's liabilities reveals that it is not heavily burdened. At the end of 1996, total liabilities stood at 64 percent of GDP, little changed from 63 percent at the peak of the bubble economy. Net of liabilities,

1. End-1996 for U.S. and Japan, end-1995 for U.K. and Germany. See Bank of Japan, *Comparative Economic and Financial Statistics*, Federal Reserve Board, *U.S. Flow of Funds*.

Japanese household financial assets stood at 178 percent of GDP, nearly the same as the level for the United States.

TABLE 2 FINANCIAL ASSETS² IN THE HOUSEHOLD SECTOR³

	Japan			United States
	1985	1990	1996	1996
Deposits	104.3	115.8	137.5	49.1
Life Insurance	27.7	45.1	60.7	7.6
Pensions	12.3	15.0	15.4	93.5
Bonds	n.a.	10.6	7.1	24.5
Mutual Funds	n.a.	9.1	6.3	20.7
Equities	n.a.	19.3	14.8	60.9
Total Financial Assets	130.9	152.0	177.7	178.9

While the size of Japan's household financial assets is not unusual, the allocation of those assets is most unusual. Of the total portfolio, 57 percent is in cash and deposits, compared with less than 15 percent in the United States. More broadly, Japanese households hold nearly 90 percent of their financial savings in two relatively low-yield instruments: deposits and life-insurance policies. The share of pensions, mutual funds, and direct participation in asset markets—by holding bonds and equities—is very low by international standards.

This skewed distribution represents an opportunity for financial institutions to market their expertise to Japanese households, and an opportunity for Japanese households to reallocate their portfolios to gain higher yields. The ¥1,200 trillion yen question is how firmly these opportunities will be grasped.

2. Percent of GDP, end of year. Pensions include those held by Japanese life insurance companies. See Bank of Japan, *Flow of Fund Accounts*, Federal Reserve Board, *U.S. Flow of Funds*.

3. Includes pensions held by Japanese life insurance companies.

II. THE DEVELOPMENT OF JAPAN'S FINANCIAL MARKETS

The roots of Japan's financial system on the eve of Big Bang can be traced back in large part to the United States occupation of Japan after the Second World War. General MacArthur and his team of economists and lawyers mandated revolutionary change for Japan's financial system. They dismantled Japan's *zaibatsu*, the dominant industrial groups, by banning and dissolving the holding companies that controlled them, and by firing and blacklisting their managers. In order to keep the securities business out of the hands of the former *zaibatsu* banks, the occupation authorities also gave Japan's financial markets a Glass-Steagall, in the form of Article 65 of the Securities and Exchange Act of 1948.⁴ Article 65 prohibited banks from participating in the domestic securities industry, from holding more than five percent of a securities company, and from selling equity or underwriting securities. To the extent that independent, major securities companies grew up after the war, the architects of the law were successful. Nomura, Daiwa, and Nikko Securities—small institutions trading bonds before 1948—exist today as major international securities firms thanks to Article 65. The major *keiretsu* banks with their array of branch networks and corporate clients could otherwise have ended up dominating the securities business in Japan.

But the byproducts of prohibiting most bank participation in securities markets have been particularly severe in Japan. To maintain the predominance of banks in the financial system, securities and securities market activity were repressed. Until the late 1980s, the corporate sector remained dependent on bank loans rather than on the direct issuance of equity and debt securities, and the Japanese household sector had precious few alternatives to bank deposits to maintain their savings. While corporations have taken advantage of increasing access to international markets to diversify the sources of their

4. See Securities and Exchange Law, Law No. 25 of 1948, art. 65. See also KAZUO TATEWAKI, *BANKING AND FINANCE IN JAPAN: AN INTRODUCTION TO THE TOKYO MARKET* 10 (stating that Law No. 25 of 1948 was "[p]robably the most important post-war reform affecting commercial banks"); Ken Tsunematsu & Shuji Yanase, *Japan-Documents: Laws & Regulations*, in 2 *INTERNATIONAL SECURITIES REGULATION* 99 (Robert C. Rosen et al. eds., 1997) (offering an English translation of the Securities and Exchange Law of 1948).

financing over the past fifteen years, the household sector—as I discussed earlier—still remains undiversified in its asset selection.

Three features exemplify the traditional practice of financial market regulation in Japan. First, in accordance with Article 65 and other laws, Japanese financial regulators have compartmentalized the financial industry by kinds of financial services, required a license for each segment of the industry, and usually required that institutions operate exclusively in the area specified by the license. The regulatory authorities consistently denied entry of new participants into any of the compartmentalized markets of banking, securities, and insurance. The banking sector was further subdivided in terms of long- and short-term finance, and a few long-term credit banks were given exclusive authority to issue five-year fixed-rate debentures, dominating the bond market.

Second, the authorities had restricted price and non-price competition among the participants in each of the markets through the regulation of deposit rates, stock brokerage commissions, and insurance premia. All kinds of financial services were to be offered at the same price. Even means of non-price competition such as branching and advertising were regulated. Innovations by any group of institutions that attracted savers' funds from another group by offering higher effective yields or a better product were usually disallowed. As a result, the number of Japanese financial intermediaries has decreased very little, if at all, in the major segments of the financial industry in the past fifty years.

Third, the Japanese authorities had limited the range of available securities in the name of investor protection. In many markets, including our own, securities market regulators and self-regulated exchanges restrict access to capital markets through minimum criteria and disclosure requirements. But in Japan, the criteria have been much more severe and wide-ranging. There have been rules and numerical standards on matters that in other countries would have been left to the discretion of issuers, investors, and other related parties. For example, complicated and restrictive eligibility criteria were imposed on the issuance of straight bonds based on financial ratios and credit ratings. Even for issuers able to satisfy those criteria, a trustee system required that banks hold in trust collateral for which they collected substantial fees.

Of course, Japanese financial markets have seen a fair degree of deregulation over the past two decades. As a result of negotiations with the United States, the Yen-Dollar Accord in 1984⁵ greatly increased the freedom of Japanese companies to independently raise funds overseas in the Euromarkets. Interest rates on bank deposits in Japan were deregulated in the 1980s and early 1990s. Our own Primary Dealers Act⁶ in the late 1980s pressured Japanese regulatory authorities to open up the underwriting and trading of Japanese government debt to foreign competition. And in 1993 and 1994, banks were allowed to establish subsidiaries that underwrote corporate bonds. Many of these changes—while significant—have been undertaken incrementally. In contrast, the Big Bang initiative represents dramatic, rather than evolutionary, change planned by the Japanese largely of their own initiative.

III. THE BIG BANG

Each of the above-mentioned traditional characteristics of the Japanese regulatory regime promises to be shaken, and eventually eliminated, by the reforms of the Big Bang. It has been a year and a half since Prime Minister Hashimoto launched the concept of a Big Bang reform of the Japanese financial system. Some important Big Bang reforms have already been put in place, while others are scheduled for implementation over the next three years.

TABLE 3 OUTLINE OF THE BIG BANG REFORMS

Enacted in Fiscal 1997 (ending March 31, 1998)

- Brokers allowed to handle unlisted or unregistered stocks.
- Brokerage houses allowed to offer "wrap accounts," which function like combined stock investment and bank checking accounts.
- Investment trust companies allowed to sell their products at banks.

5. *U.S.-Japan Yen-Dollar Agreement Expected to Strengthen Japan's World Economic Role*, INT'L TRADE REP.'S U.S. EXPORT WKLY., June 5, 1984 at 1012-13.

6. See Primary Dealers Act of 1988, 22 U.S.C.A. § 5341 (West 1998).

- Investment allocation rules for pension fund management liberalized.
- Financial institutions allowed to establish holding companies.

Enacted on April 1, 1998

- Stock brokerage commissions liberalized for transactions of ¥50 million or more.
- Specialized foreign exchange bank system abolished, thus allowing companies and individuals to conduct foreign exchange transactions without government authorization.
- Prompt Corrective Action guidelines for banking sector introduced.
- New Bank of Japan Law takes effect.

To be Enacted in Fiscal 1998

- Banks allowed to sell their own mutual funds over-the-counter.
- Securities firms allowed to expand their asset-management services, to include any derivatives and other new investment instruments.
- Requirement for government licensing of securities brokerages to be eliminated.

Fiscal 1999

- Stock brokerage commissions fully liberalized.
- Banks allowed to issue straight bonds.
- Banks, trust banks, and securities companies allowed to enter each other's markets.

Fiscal 2000

- Insurance companies allowed to enter the banking sector, and banks and securities companies allowed to enter the insurance sector.

A. *Breaking Down Barriers*

The Big Bang promotes competition by lowering, or even eliminating, the barriers separating different sectors of the financial industry. I described earlier how Japan's banking industry developed its current divided structure, with commercial banks, trust banks and long-term credit banks separated by regulatory and informal barriers. Similar divisions characterize Japan's financial industry more generally. To cite just two examples, companies have not been allowed to compete in both the life and non-life insurance markets, and brokerage and asset management services have been rigidly separated.

An important tool for tearing down these barriers is a new law which allows financial institutions to establish holding companies. Parent corporations will now be able to offer a range of financial services under one umbrella. Holding companies allow members of the group to cut costs by consolidating overlapping operations. They also allow the group to pursue integrated product development and market strategies. Already, the Fuyo group is working to establish a holding company that will offer services in commercial banking, trust banking, and life and non-life insurance. A similar plan is being studied by the Mitsui group.

The barriers separating financial institutions are receiving additional blows from the Big Bang hammer.

- Starting last December, mutual fund companies were allowed to sell their products at banks. In effect, a mutual fund company simply rents space at a bank branch. However, within the year, banks will be allowed to sell their own mutual funds.

- By the end of 1999, banks, trust banks, and securities companies will be able to enter each other's markets. Soon after, insurance companies will be allowed to enter the banking sector, and banking and securities companies will be allowed to enter the insurance sector.

Let me give you a more concrete sense of what this lowering of barriers will mean in practice. Today, only trust banks, insurers, and certified asset managers are allowed to manage pension funds. By the end of 1999, brokerage firms' trust-banking subsidiaries will be allowed to manage pension funds. Bro-

kerage firms would also compete with banks by offering "wrap accounts," in which customers could deposit paychecks or pay bills.

B. Freeing Prices

Reducing barriers to entry brings a meaningful increase in competition only when prices are set by market forces. The Big Bang reforms also include important steps in this direction.

- Starting this month, securities companies were allowed freedom to set commissions on trades of more than ¥50 million (\$384,000). Trades had previously been subject to fixed brokerage fees. Already, securities companies have announced cuts in brokerage fees as much as 50 percent for large trades. Commissions on securities trades will be fully liberalized by 2000.
- Auto insurance rates were liberalized last September. The Japanese government plans to lift all restrictions on property and casualty insurance premiums by July of this year.

C. Opening Japan to the World

The liberalization of foreign-exchange transactions, effective this month, is another element of the Big Bang reforms that deserves note. Previously, only authorized foreign-exchange banks were allowed to conduct transactions in other currencies. Designated banks were supposed to determine whether a customer's foreign-exchange transactions met Ministry of Finance (MoF) guidelines. Under this protected system, the foreign-exchange fees of Japanese banks were much higher than those of their U.S. counterparts. This encouraged Japanese multinationals to transfer much of their foreign-exchange operations to subsidiaries in London, New York, Hong Kong, and Singapore and helps explain why the yen lags far behind the dollar and the deutschemark as a vehicle for international transactions.

Under the new foreign-exchange law, authorized banks lose their monopoly on foreign-exchange transactions. Now, any business enterprise can enter into foreign-exchange transactions without government authorization. Japanese parent companies should now be able to catch up with their overseas

subsidiaries and foreign multinationals in global money-management techniques.

More important, the new foreign-exchange law allows domestic investors to open accounts in any currency with foreign banks and securities companies, without prior MoF authorization. The fact that Japanese residents now have unfettered access to foreign markets represents a crucial spur to financial reorganization. If Japanese financial companies do not offer investors the returns, products, and services available abroad, they may find their customers fleeing to the United States or European markets.

The potential for increased Japanese holdings of non-yen deposits is especially great, precisely because the household sector's exposure to non-yen assets is so limited. Direct holdings of deposits and securities amount to only 0.5 percent of total assets. Indirect holdings, through life insurance policies, pensions, and trusts, total only two percent of total assets. This represents only a fraction of the corresponding figures for the United States and other G-7 countries.

D. Greater Transparency in Monetary Policy and Bank Regulation

No review of the Big Bang program would be complete without mentioning import reforms affecting monetary policy and bank supervision.

The new Bank of Japan Law,⁷ effective this month, increases the independence of the monetary authorities and lends greater transparency to the conduct of monetary policy. Increased independence is achieved through changes in the Bank's governing structure. Under the old system, representatives of the MoF and the Economic Planning Agency sat as voting members on the Bank of Japan's (BoJ's) policy board. Under the new system, representatives of these government agencies cannot be members of the policy board, although they can express their opinions at board meetings. Greater trans-

7. See *The Bank of Japan Law: Preliminary Translation* by the Bank of Japan (unpublished manuscript on file with the *Brooklyn Journal of International Law*). See also Tomohiko Takahashi, *The New Bank of Japan Law: Moving Toward Greater Central Bank Independence* (visited on Aug. 5, 1998) <<http://www.nli-research.co.jp/ENG/resea/econo/eco9711b.HTM>> (outlining the history of the revisions to the Bank of Japan Law).

parency is achieved through release of the minutes of the policy board's deliberations, with a lag of only a few weeks.

As for bank supervision, new Prompt Corrective Action guidelines should help bring Japan's domestic institutions up to global standards of capital adequacy. The guidelines require banks to grade their loan portfolios according to new, more stringent standards, and to maintain loan-loss reserves consistent with the loan portfolio's quality. The internal grading and corresponding loan-loss reserves must be approved annually by a certified public auditor, and a new bank supervisory authority, the Financial Institution Supervisory Agency, will conduct on-site examinations.

IV. THE RESTRUCTURING OF JAPAN'S FINANCIAL INDUSTRY

I have described above how Big Bang enhances competition in Japan's financial industry. This increase in competition should bring higher returns for savers, a wider choice of products, lower fees, and better service. However, competition creates losers as well as winners, even if it is good for the economy as a whole. To survive in the new, competitive environment, Japanese financial firms will have to improve their skills in asset management, develop innovative financial products, strengthen their distribution systems, and cut costs by streamlining their operations. If the experience of financial reform in the United States and United Kingdom is any guide, some weaker firms will not be up to the challenge. A certain degree of consolidation in the Japanese financial industry is inevitable—and healthy.

It is too early to say precisely what course the on-going restructuring of the Japanese financial industry will follow. However, there are already some encouraging signs. I have already mentioned that some companies are planning to unite under a holding-company umbrella to pursue an integrated market strategy and eliminate redundant operations. I also noted that many securities companies have responded to the recent liberalization of brokerage fees by adopting steep fee cuts. Recent months have seen the announcement of several mergers among smaller securities companies. Banks, insurers, and securities companies alike have announced plans to cut costs by trimming staff and closing money-losing branches. Several financial companies have announced plans to link pay

with performance—an important departure from the traditional emphasis on seniority. Innovative financial products are also being developed. Sakura Bank is offering a three-month deposit which has a higher yield if the dollar does not depreciate.

One important aspect of the restructuring of Japan's financial industry is already well-advanced. Foreign financial firms have dramatically increased their presence in Japan. To cite one recent, well-publicized example, Merrill Lynch—starting essentially from scratch—has established a major retail brokerage presence in Japan, absorbing over 1,000 former employees of failed Yamaichi Securities in the process. Much of the increased foreign presence in Japan comes in the form of tie-ups with local companies.

TABLE 4 RECENT INTERNATIONAL TIE-UPS

April 1997	Nippon Credit Bank and Bankers Trust New York Corp.	Securitizing assets in Japan
June 1997	Nippon Life Insurance and Putnam Investments	Developing financial products
July 1997	Sumitomo Trust & Banking Co. and NatWest Gartmore Investment Management Japan	Managing pension funds in Europe
July 1997	Long-Term Credit Bank of Japan and Swiss Bank Corp.	Alliance on investment banking, asset management and private banking
July 1997	Nikko Securities and Smith Barney International	Joint venture for "wrap accounts"

October 1997	Daiwa Securities and Bankers Trust New York Corp.	Selling investment funds
December 1997	Sumitomo Trust & Banking Co. and Citibank	Guaranteeing trust deposits
February 1998	GE Capital Services Inc. and Toho Mutual Life Insurance	Selling insurance through Toho's branches
March 1998	Meiji Life Insurance and Dresdner Bank	Joint venture for asset management services
March 1998	Jardine Fleming Holdings Ltd., Yasada Mutual Life and others	Establish securities company specializing in investment trust sales in Japan

The entry of foreign firms into the Japanese market is a sign that some of the opportunities I mentioned at the outset of this Essay are indeed being grasped. Japanese savers will now enjoy expanded access to foreign expertise in asset management and in handling derivatives and other complex financial products. At the same time, Japanese firms will now have to compete on an equal footing with firms that have honed their skills in more liberalized markets. This will undoubtedly accelerate the consolidation of the financial industry that I mentioned earlier. At the end of the day, however, Japanese financial firms may become as competitive as its manufacturers.

V. UNRESOLVED ISSUES

So far, I have outlined the Big Bang reforms, pointed to the opportunities they represent, and described how Japanese and foreign firms are responding to those opportunities. Before closing, I would like to turn to two unresolved issues that will become important as the Big Bang unfolds.

A. *Public Financial Institutions*

Reform of Japan's Postal Savings System represents an important missing piece of the Big Bang program. The Postal Savings System, with ¥240 (\$1.83 trillion) in deposits, is the world's largest bank. This System accounts for more than one-third of all personal deposits in Japan. Private-sector competitors have long complained that the Postal Savings System enjoys an unfair advantage because it is backed by the full faith and credit of the government. Indeed, over the last several years, as concerns about the health of the private banking sector have mounted, growth in postal savings deposits has far out paced growth in private bank deposits.

The Postal Savings System also enjoys other important advantages. Because it is free from the need to generate a return for shareholders, the System has consistently been able to offer higher returns than private banks. It also possesses an unparalleled distribution system because every post office is in effect a bank branch. In fact, your local letter carriers will pick up your passbook and cash deposit during his morning rounds, and return the stamped passbook that evening.

The original Big Bang program called for the Postal Savings System to be privatized by 2001. Instead, the government now plans to transfer control over both institutions from the Ministry of Posts and Telecommunications to a new public corporation. In effect, the System will remain under government control, and its employees will remain public servants.

At the simplest level, leaving one-third of the banking system in the public sector appears at odds with the goal of fostering a financial system governed by market principles. More generally, the presence of a large competitor unconstrained by the need to maintain profits may encourage private banks to take risks that they otherwise would not need to take.

B. *Disclosure and Corporate Governance*

Increasing expected returns to the Japanese investor may also require significant changes in disclosure and corporate governance in Japan. At present, outside shareholders have little voice in corporate management, and little realizable claim on corporate assets beyond small dividend payments. The market for corporate control is undeveloped and remains

stified by extensive cross-shareholdings.

Banks have traditionally been seen as playing the critical role in the governance of firms in Japan, as they used various means of influence to enforce the restructuring of poorly managed firms in bad times. But they can no longer fulfill this role as they face their own need to restructure. Cross-share holdings are unwinding among banks and firms, and corporations are changing the basis upon which they choose banks. Banks are less willing to bail out members of their group. These are healthy developments, but alternative means of ensuring adequate corporate governance should be encouraged.

For markets to provide adequate feedback to poorly managed companies, transparent and credible sources of financial information must be available to those markets. Japan's accounting standards are at odds with international standards. The recent financial failures in Japan are cases in point. Nissan Life was hiding latent losses of \$1.4 billion when it failed. Yamaichi Securities held nearly \$2 billion in hidden losses on securities investments when it collapsed. Hokkaido Takushoku Bank, which was paying dividends and declaring profits through 1997, had window-dressed its accounts by around \$3 billion prior to bankruptcy.

One prominent Japanese economist has encouraged Japanese financial institutions to list on the New York Stock Exchange and disclose GAAP-based financial statements to earn the credibility and trust that they have had trouble achieving based on domestic financial statements.

Alternatively, the incentives for accountants to do a better job might be put in place through a greater use of private legal recourse as in the United States. The creditors of Japan Housing Finance, the largest of the failed *jusen*, have sued its auditors for compensation. If large judgments result, this precedent may provide a healthy incentive for auditors to do better jobs—as well as an array of new business opportunities for the lawyers.

In sum, the infrastructure of a competitive market economy includes adequate supervision and oversight of financial institutions, as well as adequate internal and external auditing procedures, by credible accountants and rating agencies. In the long-term, restoring financial competitiveness in Japan will involve more than lowering the barriers to competition. However, the changes that Japan is undertaking with the Big Bang are certainly large steps in the right direction.