

JAPANESE BANKING REFORM: A LEGAL ANALYSIS OF RECENT DEVELOPMENTS*

I. INTRODUCTION

The explosive growth of the Japanese economy during the postwar period has brought about fundamental changes in the structure of Japan's financial markets.¹ Japan's transition from a capital-starved, war-stricken economy to the world's largest creditor nation has brought about tremendous structural changes in Japanese financial circles.² Financial reform, therefore, has been a longstanding topic of interest in government and economic circles.

In the summer of 1991, two advisory bodies to the Japanese Ministry of Finance (MOF) issued official reports containing their respective recommendations for reforming the nation's financial system.³ The Financial System Reform Council deliberated on the

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1. See *infra* notes 93-169 and accompanying text.

2. See *infra* notes 9-92 and accompanying text.

3. These reports are: FINANCIAL SYSTEM RESEARCH COUNCIL, ON A NEW JAPANESE FINANCIAL SYSTEM (Federation of Bankers Associations of Japan trans., 1991) [hereinafter BANKING REPORT]; SHÖKEN TORIHIKI SHINGIKAI [SECURITIES AND EXCHANGE RESEARCH COUNCIL], KIHON MONDAI KENKYŪKAI HÖKOKUSHO [REPORT ON BASIC PROBLEMS], May 24, 1991, reprinted in EKONOMISUTO, July 15, 1991, at 154 [hereinafter SECURITIES REPORT]. Together, the Financial System Research Council and the Securities and Exchange Research Council issued a total of ten reports over their seven years of deliberation. See *Zadankai: Kin'yū seido oyobi shōken torihiki seido no kaikaku wo megutte* [Round Table Discussion: On Reforming the Financial and Securities Transaction Systems], JURISUTO, Nov. 1, 1992, at 74, 78 [hereinafter *Round Table Discussion 1*]. This Note is concerned primarily with the fifth and final Banking Report and the fourth Securities Report. The Securities Council issued a fifth report, concerned primarily with fair competition and fair trading practices, on January 28, 1992. *Ōguchi kara jiyūka: Shōtorishin saishū hōkoku de meiki*, NIHON KEIZAI SHINBUN, Jan. 29, 1992, at 1 (reporting on the Securities Report proposal that the commissions on securities transactions

subject of financial reform from the perspective of the banking system, and the Securities Council focused on the securities industry. The reports issued by the two councils formed the basis for a financial reform bill that was submitted to the Diet on April 10, 1992,⁴ and was passed into law on June 26, 1992.⁵ In addition, subsequent rulemaking by the MOF has further clarified the direction of legal and regulatory reform.⁶

Financial reform in Japan, however, has been a gradual process. The Banking and Securities Reports discussed in this Note embody over seven years of deliberation by the Financial System Reform and Securities Councils. The results of these deliberations reflect a number of concerns: structural changes in Japan's economy, the internationalization of Japanese finance, and changing patterns of corporate finance by Japanese companies.⁷ Events occurring after the reports were issued, including financial scandals and Japan's plunge into recession, have further shaped the direction of financial reform.⁸ Examined together, the reports, the Financial System Reform Act, and the developments that surrounded their creation illustrate the issues involved in reforming the legal and administrative framework on which Japan's financial system rests.

This Note will examine recent developments in Japanese financial reform, focusing primarily on the banking industry, the Banking Report, and amendments to Japan's banking laws brought about by the Financial System Reform Act. Part II will provide a historical overview of Japan's financial system. Part III will continue this historical discussion, focusing on the issues and problems that have

should be liberalized gradually, starting with larger transactions); *Shōtorishin hōkokusho: Raishun jisshi ni teikō*, Nihon Keizai Shinbun, Jan. 29, 1992, at 3 (reporting that the liberalization of the securities transaction fee has been slowed by the recent stock market slump).

4. KIN'YŪ SEIDO OYOBI SHŌKEN TORIHIKI SEIDO NO KAIKAKU NO TAME NO KANKEI HŌRITSU NO SEIBI NADO NI KANSURU HŌRITSU AN, Mar. 13, 1992, reprinted in SHŌJI HŌMU, Apr. 10, 1992 (Special Edition), at 13 [hereinafter FINANCIAL SYSTEM REFORM BILL].

5. KIN'YŪ SEIDO OYOBI SHŌKEN TORIHIKI SEIDO NO KAIKAKU NO TAME NO KANKEI HŌRITSU NO SEIBI NADO NI KANSURU HŌRITSU, Law No. 87 of 1992 [hereinafter FINANCIAL SYSTEM REFORM ACT]. The Financial System Reform Act includes numerous amendments, many of them minor, to a variety of existing laws. The most significant changes are to the Banking Law, the Securities Transaction Law, and other primary economic statutes. See *id.* art. 1 (amending Banking Law), art. 15 (amending Securities Transaction Law); *infra* note 158. To avoid confusion, all citations to statutes in this Note refer to the preamendment version of the laws unless otherwise indicated.

6. See *infra* notes 287-96 and accompanying text.

7. See *infra* notes 93-169 and accompanying text.

8. See *infra* notes 298-317 and accompanying text.

emerged in recent times to create pressure for financial reform. Part IV will discuss the recommendations of the Banking Report, contrasting it with the Securities Report, and will discuss the impact of both reports. Part V will discuss developments since the reports were issued, including an overview of the contents of the Financial System Reform Act and proposed administrative regulations that have been issued since the Act's passage. Part V will also present an analysis of financial reform to date. Part VI presents a brief conclusion.

II. HISTORICAL REVIEW

This section briefly describes the system's pre-World War II roots and then focuses on postwar developments. It also describes the types of financial institutions and the regulatory regime to which they were subject prior to the passage of the Financial System Reform Act.

A. The Prewar Period

Japan based its first modern banking law, the National Bank Act of 1872, on the American national banking system, although Japanese banking subsequently developed into a scheme closer to the British model.⁹ Between 1872 and the end of World War II, the banking industry evolved into a heterogeneous system of specialized institutions catering to particular financial markets. In 1921 savings banks were segregated from commercial banks in order to limit depositors' exposure to risk.¹⁰ In addition, a sharp distinction between commercial lending and industrial and agricultural financing led to the demarcation of long-term and short-term lending institutions.¹¹

While ordinary banks were, and still are, the predominant source of short-term loans, a number of specialized (and often heavily government subsidized) institutions were established to provide long-term financing for industry, agriculture, and other specialized sectors of the economy.¹² The Nippon Kangyo Bank, founded in 1896, was

9. FEDERATION OF BANKERS ASSOCIATIONS OF JAPAN (*ZENGINKYO*), *THE BANKING SYSTEM IN JAPAN* 11-12 (1989) [hereinafter *BANKING SYSTEM*].

10. *Id.* at 12. This partial segregation lasted until 1943 when, in order to promote saving as a part of the war effort, the government allowed ordinary banks to take deposits. *Id.* In order to reduce the number of banks, the government embarked on a policy of encouraging bank mergers. As a result, most savings banks, by this time rendered redundant, were merged out of existence; only five remained by the end of the war. *Id.*

11. *Id.* at 13.

12. *Id.* at 13-14.

one of these specialized institutions.¹³ The majority of these institutions eventually disappeared, however, either as a result of the government's wartime policy of encouraging mergers or through postwar occupation reforms.¹⁴ The presence of the Nippon Kangyo Bank, now known as Daiichi Kangyo Bank, and the segregation of long-term and short-term institutions continue to be an integral part of Japan's banking system.¹⁵ As shall be seen, however, changing circumstances render the division between long-term and short-term institutions increasingly anachronistic.¹⁶ In 1922 the trust business was established as a sector separate from ordinary banking and was an area in which only trust companies and specialized trust banks could engage.¹⁷

B. The Postwar Period

Japan's defeat in World War II and the subsequent American occupation brought many changes in its financial system, in that "[t]he existing financial system was basically organized for the purpose of creating a stable supply of limited funds for each industrial sector in the post-war era when funds were short."¹⁸ The most significant change was the segregation of the securities business from banking in a manner similar to the United States' Glass-Steagall Act, which prohibits banks from dealing in most forms of securities.¹⁹ Moreover,

13. *Id.*

14. *Id.* at 14.

15. See generally *infra* notes 38-74 and accompanying text (discussing different types of financial institutions).

16. See *infra* notes 94, 131-35 and accompanying text.

17. BANKING SYSTEM, *supra* note 9, at 14-15.

18. BANKING REPORT, *supra* note 3, at 12. Writing on the separation of banking and securities, a less charitable observer has noted that the purpose of this fragmented system was "to squeeze as much money as possible from Japanese savers so it could be channelled into industry." Nigel Holloway, *Tokyo's Walls Tremble*, FAR E. ECON. REV., May 11, 1989, at 54, 55. Note also that most of the laws that established the specialized banks, discussed *infra* notes 46-65 and accompanying text, were passed between 1947 and 1954.

19. Makoto Yazawa, *A Synopsis of Securities Regulation in Japan*, in JAPANESE SECURITIES REGULATION 23, 29 (Louis Loss et al. eds., 1983). Prior to this, banks were permitted to engage in a variety of securities activities. BANKING SYSTEM, *supra* note 9, at 44. Unlike American banks under Glass-Steagall, however, Japanese banks are permitted to hold equity securities (including stock in securities companies) for their own account, provided that these holdings do not exceed 5 percent of the issuing company's total value. Compare SHITEKI DOKUSEN OYOBI KŌSEI TORIHIKI NO KAKUHO NI KANSURU HŌRITSU, art. 11, Law No. 54 of 1947 [hereinafter ANTIMONOPOLY LAW] with Banking (Glass-Steagall) Act of 1933 § 16, 12 U.S.C. § 24 (1982). More recently, Japanese financial institutions have been permitted to combine banking and securities activities in foreign countries where universal banking is permitted. Richard Dale,

due to the postwar shortage of capital that was vital for economic development, the government was forced to compartmentalize the financial industry by fostering different types of institutions to cater to specific industries. At the same time, the government temporarily empowered the MOF and the Bank of Japan (BOJ) to set ceilings for deposit interest rates.²⁰ Depositors had few other options, and thus banks were able to obtain capital cheaply and to loan it to industries at a significant profit.

The capital shortage rendered whole industries beholden to the banks. To cope with this deficiency, the government began the practice of overloaning: BOJ would loan more money than was economically prudent to the large banks, who would do the same to capital-starved companies.²¹ The companies in turn relied on high leverage to fund rapid growth and market share expansion.²² This contributed to the development of the notorious banking *keiretsu* system.²³ To obtain financing, a company had to cultivate a close relationship with a single, main bank.²⁴ Banks primarily supplied loans which provided significant tax advantages over equity financing: loan interest payments were deductible, whereas dividends to shareholders came out of after-tax profits.²⁵ As a result, many companies became highly leveraged, deriving as much as 80 percent of their capital from bank loans.²⁶ In addition to loans, banks exchanged equity with their debtors and developed long-standing, close relationships.²⁷ While their heavy debt load generated pressure on companies to expand their market share (though not necessarily at a profit) to service their debt,²⁸ both the extent of their debt to, and close relationship with, their banks meant that the banks became

Japan's Banking Regulation: Current Policy Issues, in JAPANESE FINANCIAL GROWTH 33, 35 (Charles Goodhart & George Sutija eds., 1990).

20. This was accomplished by the passage of the Temporary Interest Control Law. RINJI KINRI CHOSEI HO Law No. 181 of 1947. The original purpose of this law was to prevent banks from engaging in potentially ruinous interest rate "price wars." See BILL EMMOTT, *THE SUN ALSO SETS* 101 (1989). This provisional statute is still in force today. *Id.*

21. CHALMERS JOHNSON, *MITI AND THE JAPANESE MIRACLE* 202 (1982).

22. See JAMES ABEGGLEN & GEORGE STALK, JR., *KAISHA, THE JAPANESE CORPORATION* 161 (1985).

23. JOHNSON, *supra* note 21, at 204-05.

24. *Id.* at 205.

25. See *id.* at 203-04.

26. *Id.* at 203.

27. See ABBEGGLEN & STALK, *supra* note 22, at 166.

28. JARED TAYLOR, *SHADOWS OF THE RISING SUN* 156-57 (1983).

increasingly responsible for the continued financial health of the companies.²⁹ Bank shareholdings were limited to 5 percent of a company by the Antimonopoly Law.³⁰ Nevertheless, bank shareholdings of companies within the *keiretsu* groups collectively represented a significant aggregate of control.³¹ By providing the only viable source of finance and equity holdings, banks thus exercised a great deal of influence over the management of their corporate affiliates.³²

At the same time, however, the practice of overloaning meant that all parties had an interest in ensuring that all other parties remained financially solvent. This interest was centralized at the BOJ, which traditionally has been "the ultimate guarantor of the system."³³ By centralizing all loan risks at the government level, the system made the loans virtually risk free for the private sector, leaving banks and companies alike to concentrate solely on increasing their respective market shares by expanding into whatever growth industries the government was trying to foster.³⁴ As guarantor of the whole system, the BOJ "gain[ed] complete and detailed control over the policies and lending decisions of its dependent 'private' banks,"³⁵ just as the banks themselves had control over their own borrowers. Given that the failure of a financial institution would cause catastrophic reverberations throughout this network of debt, the government would always step in to prevent such an event from taking place.³⁶ This whole structure is sometimes referred to as the "convoy system" (*goeiseudan hoshiki*):³⁷ each participant looks out for other participants, and all

29. ABEGGLEN & STALK, *supra* note 22, at 166-67; JOHNSON, *supra* note 21, at 204-05; see also Peter Martin, *Ghosts of the Decade Past*, FIN. TIMES, May 29, 1992, at 16 ("The close ties between lender and borrower often lead the banks to cut interest rates for a troubled debtor.").

30. ANTIMONOPOLY LAW, art. 11, Law No. 54 of 1947.

31. Banks and other financial institutions reportedly own over half the value of companies listed on stock exchanges in Japan. Peter Bohan, *Japan's Banking System Remains Healthy*, *Minister Says*, Reuters, Jan. 16, 1991, available in LEXIS, Nexis Library, Reuters File.

32. See JOHNSON, *supra* note 21, at 205-06; see also KAREL VAN WOLFFEREN, *THE ENIGMA OF JAPANESE POWER 121* (1989) (describing tremendous control gained by banks over corporations because of the capital shortage after World War II).

33. JOHNSON, *supra* note 21, at 203.

34. *Id.* at 206.

35. *Id.* at 203.

36. Saburo Zushi, *How to Go Bankrupt and Still Stay Afloat: the Ataka Affair*, in *POLITICS AND ECONOMICS IN CONTEMPORARY JAPAN* 204, 220 (Murakami Hyoe & Johannes Hirschmeier eds., 1979).

37. See, e.g., *Ōzume kin'yū seido kaikaku 6: Sekai no chōryū: "Gosō-sendan tsūjintai," YOMIURI SHINBUN*, May 17, 1991, at 7 [hereinafter *Gosō-sendan*] (criticizing the convoy system as anachronistic in the time of financial internationalization and liberalization).

parties arrive safely. The term "convoy" also implies that each participant must travel at the speed of the slowest member of the group.

C. The Postwar Financial System

Before discussing events that made financial reform increasingly necessary, it is important to describe the structure and operation of the financial system before reforms took place. This section provides a brief overview of the types of financial institutions and regulatory regimes that existed prior to passage of the Financial System Reform Act.

1. *Types of Financial Institutions.* The first type of financial institutions are the ordinary banks. These are established according to the *Ginkō hō* or Banking Law.³⁸ Their primary activities consist of short-term financing, loans, deposits, and fund transfers.³⁹ Apart from foreign banks, which are established in Japan as ordinary banks, two distinct categories of ordinary banks exist. The first category consists of the large city banks (*toshi ginkō*)⁴⁰ such as banking giants Sanwa and Sumitomo. Well-known at home and abroad, these institutions play a significant role in the Japanese economy.⁴¹ Second, there are the sixty-four regional banks (*chihō ginkō*),⁴² with at least one in each of Japan's forty-seven prefectures.⁴³ These banks have their principal offices in large-sized or medium-sized regional cities and do business primarily within the prefecture in which their principal office is located.⁴⁴ The distinction between city banks and regional

38. GINKŌ HŌ [BANKING LAW], Law No. 59 of 1981.

39. BANKING SYSTEM, *supra* note 9, at 23-24. The banking law itself merely defines the scope of permissible activities an ordinary bank may engage in as "(1) [r]eceiving of deposit or installment savings; (2) [l]oan of fund[s] or discount of bills or notes; (3) [e]xchange transaction[s]." BANKING LAW, art. 10, Law No. 59 of 1981. Ordinary banks may also engage in a variety of other activities that are "ancillary to banking." *Id.* art. 10(2).

40. *E.g.*, KAZUO TATEWAKI, BANKING AND FINANCE IN JAPAN 106 (1991).

41. In 1990, 23.8 percent of fund-raising and 30.2 percent of loans were from city banks. See BANKING SYSTEM, *supra* note 9, at 7.

42. *Id.* at 23. Note this figure does not include the new "second tier" of converted *sōgo* regional banks. See *infra* note 48 and accompanying text.

43. Frances Rosenbluth, *The Political Economy of Financial Reform in Japan: The Banking Act of 1982*, 6 UCLA PAC. BASIN L.J. 62, 65 (1989).

44. BANKING SYSTEM, *supra* note 9, at 23-24.

banks has no legal basis but arises instead from custom and administrative convenience.⁴⁵

In addition to the ordinary banks, there are several categories of more specialized banks, all of which are affected by the Financial System Reform Act.⁴⁶ The first of these is the *sōgo* or mutual bank. These institutions, eliminated by the Financial System Reform Act,⁴⁷ were established under the 1951 *sōgo* Bank Law and existed primarily to provide financing for small- and medium-sized businesses.⁴⁸

Second, there are three long-term credit banks⁴⁹ established in accordance with the Long-Term Credit Bank Law.⁵⁰ Along with several specialized banks, the long-term credit banks have traditionally had the exclusive ability to issue debentures.⁵¹ There have, however, been limits on their ability to take deposits.⁵² Although the Financial System Reform Act does not formally abolish the distinction, the walls

45. *Id.* at 23. Article 8 of the Banking Law requires a bank to obtain the MOF's approval before establishing a branch. BANKING LAW art. 8, Law No. 59 of 1981. This provides the MOF with a very significant administrative tool for preventing city banks from encroaching on the territory of smaller regional banks. The MOF has used this form of administrative guidance to limit the number of branches established by the city banks outside of Tokyo and other major cities. BANKING SYSTEM, *supra* note 9, at 42.

46. *See infra* note 268 and accompanying text.

47. FINANCIAL SYSTEM REFORM ACT, Law No. 87 of 1992.

48. SŌGO GINKŌ HŌ [MUTUAL LOANS AND SAVINGS BANK LAW], Law No. 199 of 1951, *repealed* by FINANCIAL SYSTEM REFORM ACT, art. 4. Only *sōgo* banks were permitted to deal in mutual installment funds. FINANCIAL SYSTEM REFORM ACT, art. 4. Otherwise, they were allowed to engage in the same activities as ordinary banks, except that, with exceptions, they could only issue loans to, or receive mutual installment savings from, companies with three hundred or fewer employees or with capital of less than a designated amount. *Id.* art. 2(2). In practice, the *sōgo* banks catered to a clientele similar to that of the regional banks, except the *sōgos* were not subject to the same geographical branching restrictions. *See generally* BANKING SYSTEM, *supra* note 9, at 41–42 (discussing branch establishment regulation and administrative guidance). There were sixty-eight *sōgo* banks as of December 1988. *Id.* at 25. Having become increasingly like ordinary banks in their activities, many *sōgo* banks began converting to ordinary banks, even before the repeal of the Mutual Bank Law made conversion or merger unavoidable. *See id.* at 25–26. Such conversions were permitted by a 1989 amendment to the law governing bank mergers. *Id.* at 26; KIN'YŪ KIKAN NO GAPPEI OYOBI TENKAN NI KANSURU HŌRITSU [LAW CONCERNING AMALGAMATION AND CONVERSION OF FINANCIAL INSTITUTIONS], art. 3, Law No. 86 of 1968. The conversion of most of the *sōgos* to ordinary banks has effectively created a second tier of regional banks. *See* BANKING REPORT, *supra* note 3, at 10; BANKING SYSTEM, *supra* note 9, at 41–42.

49. BANKING SYSTEM, *supra* note 9, at 24.

50. CHŌKI SHIN'YŌ GINKŌ HŌ [LONG-TERM CREDIT BANK LAW], Law No. 187 of 1952.

51. *Id.* art. 4; Fumiko Fujisaki, *Japan Banks Haggles over Securities Market Entry*, Reuters, May 27, 1991, available in LEXIS, Nexis Library, Reuters File.

52. BANKING SYSTEM, *supra* note 9, at 25.

between long-term and short-term credit banking have been coming down.⁵³

The third major type of specialized bank is the trust bank. Along with nine foreign trust banks, there are seven Japanese-owned trust banks.⁵⁴ These banks are permitted to engage in the trust business under a 1943 law granting this entitlement to ordinary banks and long-term credit banks.⁵⁵ Like the long-term credit banks, the bulk of the trust banks' business is in the form of long-term funding through loan trusts and other devices.⁵⁶

In addition to the types of banks discussed above, there are a host of other specialized financial institutions which need to be mentioned briefly, both to illustrate the diversity of Japan's financial system and to show how together they represent an important conglomeration of economic and political interests. These other depository institutions include: the Bank of Tokyo,⁵⁷ the *Shōkō chūkin* Bank,⁵⁸ the *Nōrin chūkin* Bank,⁵⁹ *shinkin* banks,⁶⁰ credit cooperatives,⁶¹ labor

53. See *infra* note 157 and accompanying text.

54. See *infra* note 157 and accompanying text.

55. FUTSŪ GINKŌ NO SHINTAKU GYŌMU NO KEN'EI NI KANSURU HŌRITSU [LAW CONCERNING THE CONCURRENT ENGAGEMENT OF THE ORDINARY BANK IN THE TRUST BUSINESS], art. 1, Law No. 43 of 1943. Administrative guidance appears to be at least one of the reasons why more banks have not taken advantage of this law to expand into the trust business; article 1 of the law requires the MOF's approval before a bank may become a trust bank. *Id.*

56. BANKING SYSTEM, *supra* note 9, at 25.

57. Though sometimes considered one of the city banks, the Bank of Tokyo (BOT) is chartered under a special statute, namely the Foreign Exchange Banking Law. GAIKOKU KAWASE GINKŌ HŌ [FOREIGN EXCHANGE BANK LAW] Law No. 67 of 1954; THE JAPANESE FINANCIAL SYSTEM 172 (Yoshio Suzuki ed., 1987); see also BANKING SYSTEM, *supra* note 9, app. 1, at 1 (listing the BOT under heading "city banks"). Originally established as the country's only foreign exchange bank, the BOT's *raison d'être* has effectively vanished because all banks are now able to engage in foreign exchange activities. Nevertheless, the BOT's international financial expertise and global network of branches assure its continued viability. *Bank of Tokyo: Just Impediment*, ECONOMIST, Mar. 7, 1992, at 88.

58. Partially financed by the government, the *Shōkō chūkin* Bank is a special institution established in 1936 to provide financial services for unions of small-sized and medium-sized enterprises. BANKING SYSTEM, *supra* note 9, at 28.

59. The *Nōrin chūkin* Bank and its branches function as the central bank of the farming, forestry, and fishing industries. See THE JAPANESE FINANCIAL SYSTEM, *supra* note 57, at 232. Like the *Shōkō chūkin* Bank, it also receives substantial government support. *Id.*

60. *Shinkin* banks are cooperative, not corporate, entities that may be subscribed to by individuals or medium or small enterprises. BANKING SYSTEM, *supra* note 9, at 26. Along with the ancillary activities permitted to ordinary banks, the *shinkin* banks may take deposits and engage in foreign exchange, but they may only issue loans and discount bills for subscribers. SHIN'YŌ KINKO HŌ, art. 53, Law No. 238 of 1951. The viability of these banks is increasingly in doubt. In the eyes of some observers, the *shinkin*, like American savings and loans, may bring down the whole banking system due to excessive involvement in bad property deals. See Anthony Rowley, *Tokyo Worried About Stability of Credit Co-ops: Japan's S & L Crisis?*, FAR

banks,⁶² agricultural cooperatives,⁶³ fishery cooperatives,⁶⁴ and several other types of cooperative institutions which may engage in financial activities.⁶⁵ Many of these individual institutions are also members of institutional federations.⁶⁶ The Financial System Reform Act affects all of these institutions, primarily by expanding the scope of financial activities in which they are permitted to engage.⁶⁷

There are also foreign institutions. By 1985 over one hundred branches of foreign banks and securities firms had been established in Japan.⁶⁸ Foreign bank branches are chartered and regulated as branches of ordinary banks under the Banking Law,⁶⁹ while foreign security branches are subject to a special legal regime.⁷⁰ A number of foreign banks have also been permitted to engage in trust activities in the Japanese market.⁷¹

E. ECON. REV., Jan. 24, 1991, at 36.

61. See BANKING SYSTEM, *supra* note 9, at 27.

62. Similar to the *sōgos* and the credit cooperatives, labor banks are cooperative institutions whose primary activities consist of installment savings, lending, and deposit transactions for labor unions and their members. See *id.* at 27-28; RŌDŌ KINKO HŌ [WORKERS' BANKING INSTITUTION LAW], Law No. 227 of 1953.

63. Agricultural cooperatives actually existed before the Pacific War but did not become widespread until after the passage of the Agricultural Cooperative Societies Act of 1947. Susumu Yamaji, *Agriculture*, in POLITICS AND ECONOMICS IN CONTEMPORARY JAPAN 184, 191 (Murakami Hyoe & Johannes Hirschmeier eds., 1979). These cooperative institutions cater to the financial needs of the agricultural community and engage in a variety of nonbanking businesses, including marketing agricultural products and purchasing farm equipment. BANKING SYSTEM, *supra* note 9, at 29.

64. SUISANGYŌ KYŌDŌ KUMIAI HŌ [FISHERIES COOPERATIVES LAW], Law No. 242 of 1948. The main activities of fishery cooperatives are taking members' savings and lending to members. BANKING SYSTEM, *supra* note 9, at 30.

65. See KYŌDŌ KUMIAI NI YORU KIN'YŪ JIGYŌ NI KANSURU HŌRITSU [LAW CONCERNING THE FINANCIAL ACTIVITIES OF COOPERATIVE ORGANIZATIONS], Law No. 183 of 1949; CHŪSHŌ KIGYŌ TO KYŌDŌ KUMIAI HŌ [LAW FOR SMALL BUSINESS COOPERATIVES], Law No. 181 of 1949.

66. For example, all credit cooperatives belong to the National Federation of Credit Cooperatives, which acts as a central bank for its members. BANKING SYSTEM, *supra* note 9, at 27.

67. See *infra* notes 268, 270 and accompanying text.

68. THE JAPANESE FINANCIAL SYSTEM, *supra* note 57, at 196. Although Japanese banks and their overseas securities affiliates were still prohibited from engaging in securities activities within Japan at the time, in 1986 the MOF began allowing the securities affiliates of foreign banks to establish branches in Japan. See Dale, *supra* note 19, at 35-36.

69. BANKING LAW art. 47, Law No. 59 of 1981; see THE JAPANESE FINANCIAL SYSTEM, *supra* note 57, at 196-97.

70. GAIKOKU SHŌKEN GYŌSHA NI KANSURU HŌRITSU [LAW CONCERNING FOREIGN SECURITIES DEALERS], Law No. 5 of 1971.

71. TATEWAKI, *supra* note 40, at 157-60.

In addition to these private and semiprivate institutions, there are two government banks, namely the Japan Development Bank and the Export-Import Bank of Japan, and a number of government financial corporations.⁷² Finally, there are the other sectors of the financial industry: the life and casualty insurance companies, various forms of nonbanks, and the banking industry's greatest rival in the current reform movement, the securities industry.⁷³

Each of these various types of financial institutions has its own prerogatives, its own customer base, and its own interest in seeing reform proceed or stagnate. This heterogeneity of interests has proven to be an obstacle to the development of new financial products and other changes in the past, and will be the most difficult hurdle for reformers to traverse in the future. In the words of the Financial Reform Council:

[I]n Japan, various restrictions and customs stemming from the existing vertical division system have impeded the development of new financial products and services. . . . [U]nder the existing system, even if a new product is developed involving multiple financial sectors, its offer . . . tends to be restrained since this gives rise to confrontation between sectors.⁷⁴

2. *The Regulatory Regime.* Most types of depository institutions are regulated by the Ministry of Finance.⁷⁵ Apart from controlling entry into the banking business, the MOF exercises administrative guidance over established banks in three main ways: (1) it controls the ability of banks to branch domestically and abroad; (2) it grants the appropriate licenses required for some of the activities in which banks are allowed to engage;⁷⁶ and (3) it makes numerous decisions regarding the daily conduct of the banking business (e.g., the scope of activities permitted through associated businesses).⁷⁷ The terms of the financial laws themselves provide the MOF with a broad range of discretionary powers. For example, the first sixteen articles of the Banking Law contain no less than twenty provisions that delegate

72. BANKING SYSTEM, *supra* note 9, at 34.

73. See THE JAPANESE FINANCIAL SYSTEM, *supra* note 57, at 166-68.

74. BANKING REPORT, *supra* note 3, at 14. Such conflicts, for example, have led to a variety of restrictions being imposed on the private placement of bonds and the sales of commercial paper and housing loan mortgage trusts. *Id.*

75. See BANKING SYSTEM, *supra* note 9, at 37.

76. One increasingly important area of banking activity which requires licensing by the MOF is dealing in government securities. *Id.* at 64-65.

77. *Id.* at 43-52.

discretionary authority to the MOF or the government.⁷⁸ Given its broad powers over banks, the MOF has been able to keep troubled financial institutions from going bankrupt by encouraging other banks to deposit funds with the institution or by promoting the merger of weak banks with strong ones.⁷⁹

Banks are also subject to control by the Bank of Japan. As Japan's central bank, the BOJ controls the official discount rate, sets reserve deposit requirements, and participates directly in financial markets as part of its fiscal policy.⁸⁰ Unlike central banks in most countries, the BOJ is able to control directly the lending volume of major financial institutions through what is known as window guidance.⁸¹ Both the MOF and the BOJ have also been granted a variety of powers to inspect and investigate banks and other financial institutions.⁸²

In addition to the MOF's Banking Bureau and the BOJ, a host of other government bodies exercise some degree of regulatory authority over the financial system. The Securities Bureau of the MOF controls the securities companies and administers the Securities Transaction Law.⁸³ The MOF also has a Finance Bureau, which is responsible for issuing government bonds,⁸⁴ and an International Finance Bureau, which together with the Banking and Securities Bureaus exercises control over the foreign financial activities of Japanese companies.⁸⁵

In addition to the MOF, local government entities exercise some control over credit cooperatives and other small institutions.⁸⁶ The

78. BANKING LAW arts. 1-16, Law No. 59 of 1981. Examples include: bank licensing (art. 4), minimum capitalization requirements (art. 5), branch establishment restriction (art. 8), and caps on loans to a single person (art. 13). *Id.*

79. See, e.g., S.L. Bachman, *Japanese Banks Eager to Make "Love Match,"* CHI. TRIB., Apr. 7, 1991, at 8B.

80. BANKING SYSTEM, *supra* note 9, at 20-22.

81. *Id.* at 22.

82. *Id.* at 47.

83. See *id.* at 44, 64-65.

84. Rosenbluth, *supra* note 43, at 72.

85. See Koichi Hamada & Akiyoshi Horiuchi, *The Political Economy of the Financial Market*, 1 POLITICAL ECONOMY OF JAPAN 223, 254 (Kozo Yamamura & Yasukichi Yasuba eds., 1987). This is the so-called "three bureaus guidance" which began in 1974. *Id.* The guidance favored activities of securities firms to those of banks' overseas securities subsidiaries. See *id.* But see *Shōken no gaitame kisei kanwa*, NIHON KEIZAI SHINBUN, Dec. 15, 1992, at 7 (reporting recent abolishment of the guidance at the same time as the lifting of the restriction on securities firms' foreign exchange business).

86. See, e.g., LAW CONCERNING THE FINANCIAL ACTIVITIES OF COOPERATIVE ORGANIZATIONS art. 7, Law No. 183 of 1949 (allocating the administrative jurisdiction between local governments and the MOF).

Ministry of Labor exercises joint control with the MOF over the labor banks,⁸⁷ and other ministries have authority over credit cooperatives within their jurisdictions.⁸⁸ The Ministry of Post and Telecommunications controls the vast postal savings system, the world's largest depository institution.⁸⁹ The Ministry of International Trade and Industry regulates the nonbanks.⁹⁰ The Fair Trade Commission (FTC) is charged with enforcing the limitations set forth by the Antimonopoly Law on the securities holdings of banks and other financial institutions.⁹¹ There is also a deposit insurance corporation, though the statute which brought it into being grants it few regulatory powers.⁹² Even this picture is far from complete, but it should suffice to illustrate the maze of regulation to which financial institutions are subject.

III. THE GROWING NEED FOR REFORM

If Japan's spectacular postwar economic development is an indicator, the policy of squeezing consumers in order to secure capital for industries through a compartmentalized and highly regulated financial system has been extremely successful. Many banks have also become extremely rich in the process.⁹³ Times have changed, however, and Japan's financial system has now evolved into one where a plethora of inefficient and uncompetitive specialized financial sectors, subject to a heterogeneous regulatory scheme, are actually hampering

87. WORKERS' BANKING INSTITUTION LAW art. 6, Law No. 227 of 1953 (stating that a labor bank must be licensed by the Ministers of both Finance and Labor).

88. For example, the Ministry of Agriculture, Forestry, and Fisheries has regulatory authority over the trust activities of forestry cooperatives. SHINRIN KUMIAI HŌ [FORESTRY COOPERATIVES LAW] art. 10, Law No. 36, 1978.

89. See Hayato Yokota, *Massive Money Shift Alarms Banks*, NIKKEI WKLY., Nov. 9, 1991, at 1.

90. Rowley, *supra* note 60, at 36.

91. ANTIMONOPOLY LAW art. 11, Law No. 540 of 1947. In addition to being able to make exceptions to these strictures, the FTC is responsible for ensuring that businesses, including financial institutions, do not engage in anticompetitive or unfair activities. *Id.* art. 27(2). The FTC was established under Article 27 of the Antimonopoly Law and charged with the power to control monopolistic behavior and unfair trading practices. *Id.*

92. Japan's Deposit Insurance Corporation has a very small staff and is charged with administering the collection of deposit premiums. See YOKIN HOKEN HŌ [DEPOSIT INSURANCE LAW] art. 34, Law No. 34 of 1971. The fact that until very recently not a single claim had ever been made on the deposit insurance company indicates how protective the MOF is of financial institutions. See BANKING SYSTEM, *supra* note 9, at 32.

93. See generally Gunter Dufey, *The Role of Japanese Financial Institutions Abroad*, in JAPANESE FINANCIAL GROWTH 132, 132-54 (Charles Goodhart & George Sutija eds., 1990) (describing growth of Japanese banks in international markets).

Japan's development as a world financial center.⁹⁴ This section will examine the factors which have made financial reform vital, both for the continued well-being of the economy and for the survival of the increasingly troubled banking industry.

The Financial System Research Council approached the subject of financial reform from three different perspectives: the internationalization of finance, the needs of users, and the maintenance of financial order.⁹⁵ They also considered reform in the light of changes in Japan's financial markets, including the liberalization and securitization of finance.⁹⁶ Each of these issues has been a significant factor in the development of the need for financial reform.⁹⁷

By the 1970s banks began to hit the limits of growth in traditional areas of business.⁹⁸ The change to a floating currency exchange rate and the oil shocks of the mid-1970s brought about drastic changes in the demands on the financial system.⁹⁹ Furthermore, as Japan's export driven economy boomed and its consistent trade surplus brought increasing amounts of foreign capital into the country, the capital shortages ceased to be a problem.¹⁰⁰ As noted by the Banking Report, "[t]he structural changes and stable growth that have taken root in the Japanese economy are accompanied by a shift from a shortage of funds to a surplus of funds today."¹⁰¹ By the mid-1980s Japan had become the world's largest creditor nation, and as a result Japan's financial system had become increasingly tied to the rest of the world.¹⁰² These developments created four sources of pressure for financial reform: the increasing public debt; the internationalization of Japanese finance at home and abroad; the securitization and

94. See Holloway, *supra* note 18, at 54.

95. BANKING REPORT, *supra* note 3, at 16.

96. *Id.* at 12-13; see *Zadankai: Kir'yū seido no atarashii tenkai* [Round Table Discussion: New Developments in the Financial System], 966 JURISTO 12, 13 (1990) [hereinafter *Round Table Discussion 2*].

97. BANKING REPORT, *supra* note 3, at 9.

98. Rosenbluth, *supra* note 43, at 68.

99. See THE JAPANESE FINANCIAL SYSTEM, *supra* note 57, at 25.

100. See Ryutaro Komiya & Motohige Itoh, *Japan's International Trade and Trade Policy, 1955-1984*, in 2 THE JAPANESE POLITICAL ECONOMY OF JAPAN 173, 188 (Takashi Inoguchi & Daniel I. Okimoto eds., 1988). Japan's international assets, the bulk of which may be found in the United States, stood at U.S. \$180.4 billion by the end of 1986. Yoichi Shinkai, *The Internationalization of Finance in Japan*, in 2 THE POLITICAL ECONOMY OF JAPAN 249, 249 (Takashi Inoguchi & Daniel I. Okimoto eds., 1988).

101. BANKING REPORT, *supra* note 3, at 9.

102. Shinkai, *supra* note 100, at 249, 255-57.

diversification of Japanese finance; and the hard times recently experienced by banks.

A. The Increasing Public Debt

According to the Banking Report, "banks are now involved in a range of securities businesses relating to public bonds."¹⁰³ A combination of slow growth resulting from the oil shocks, a drop in tax revenues exacerbated by the economic slowdown,¹⁰⁴ and a significant increase in public expenditures¹⁰⁵ increasingly forced the government to rely on deficit financing through the issuance of long-term bonds.¹⁰⁶ The great majority of government bonds were issued through a syndicate, of which many banks and some other financial institutions were members.¹⁰⁷ The government used a syndicate because it enabled the government to issue debt at below-market interest rates.¹⁰⁸ The banks acquiesced because it allowed them to preempt the government from issuing short-term debt which would have competed with their savings accounts.¹⁰⁹

Originally, the members of the syndicate would hold onto the bonds until maturity¹¹⁰ or wait for the BOJ to repurchase them, which it usually did.¹¹¹ Initially, nobody wanted the bonds to be sold to the general public; banks did not want to have to sell bonds which might compete with their own financial products, and the MOF did not want the market forces to raise the interest rates that the government would have to offer.¹¹² The continual growth in the quantity of these

103. BANKING REPORT, *supra* note 3, at 17.

104. EMMOTT, *supra* note 20, at 94; TATEWAKI, *supra* note 40, at 28; Yukio Noguchi, *Public Finance*, in 1 THE POLITICAL ECONOMY OF JAPAN 186, 192 (Kozo Yamamura & Yasukichi Yasuba eds., 1987).

105. Near the end of the 1960s, the Japanese people had reached the limits of their ability to tolerate the industrial pollution, poor infrastructure, and squalid living conditions that were the by-product of industrial growth. By the beginning of the 1970s, these problems had forced the government to increase spending on public works and welfare programs. See EDWIN O. REISCHAUER, *JAPAN: THE STORY OF A NATION* 334-38 (3d ed. 1970).

106. Shinkai, *supra* note 100, at 251-52. Deficit financing was not legally possible until the amendment of the Public Finance Law in 1975. Masazo Ohkawa, *Government Bonds*, in PUBLIC FINANCE IN JAPAN 123, 125 (Tokue Shibata ed., 2d ed. 1986); see also Noguchi, *supra* note 104, at 192-95 (discussing legal and economic aspects of deficit financing).

107. BANKING SYSTEM, *supra* note 9, at 118.

108. Rosenbluth, *supra* note 43, at 68.

109. *Id.* at 69.

110. See EMMOTT, *supra* note 20, at 94.

111. *Id.* At one point the BOJ was repurchasing 90 percent of the bonds within one year of their issue. Rosenbluth, *supra* note 43, at 69.

112. Rosenbluth, *supra* note 43, at 69.

bonds, however, forced the government to allow banks to resell them.¹¹³ This was necessary not only to make the bonds available to a broader market but to continue receiving the cooperation of the banks.¹¹⁴ Otherwise, the banks would have been burdened with an intolerable load of illiquid assets.¹¹⁵

By 1975 the bond issuance had exceeded the syndicate's ability to absorb it, and a secondary market developed spontaneously.¹¹⁶ In 1978 the banks were still dissatisfied enough with the syndicate arrangement to boycott it altogether.¹¹⁷ After much negotiation between the government, the banks, and the securities industry, the new Banking Law was enacted in 1981, allowing banks to sell public bonds.¹¹⁸ Still, the burgeoning government debt was already causing other changes in the financial markets.¹¹⁹ Government debt was a significant factor both in banks' gradual expansion into new financial products and in the development of more sophisticated investment

113. See *id.* at 80; THE JAPANESE FINANCIAL SYSTEM, *supra* note 57, at 178. Initially, the sale of government bonds on the open market was prohibited. BANKING SYSTEM, *supra* note 9, at 17.

114. See Rosenbluth, *supra* note 43, at 74.

115. See *id.* at 70-74. In 1978, city banks lost ¥400 billion on bond holdings. *Id.* at 74. Banks even lost money during the one-year waiting period before the BOJ repurchased the bonds. See *id.* at 72-74.

116. *Id.* at 73.

117. *Id.* at 74.

118. See *id.* at 80; BANKING LAW art. 10(2), Law No. 59 of 1985. It was not until the end of 1982 that the MOF provided guidance on licensing banks to engage in the securities business with the GINKO TOU NO SHÖKEN GYÖMU NI KANSURU SHÖREI, Ministry of Finance Ordinance No. 62 of 1982. Actual sales of government bonds to the public by banks did not begin until April 1983, and it was not until 1984 that banks were allowed to deal in government bonds (i.e., buy and sell outstanding bonds in the marketplace). THE JAPANESE FINANCIAL SYSTEM, *supra* note 57, at 91-92.

119. One commentator noted:

Once a large secondary market in long-term securities (government bonds) had developed, investing institutions also wanted a larger and freer short-term money market in order to diversify their holdings and to ensure that they could raise money quickly. So the Bank of Japan eased its control of interest rates in the call money (very short-term cash) and bill discount markets, and allowed banks to issue yen certificates of deposit. On the back of the government bond market grew a market for *gensaki*, similar to bond repurchase agreements or repos in the United States. . . . This market thus allows institutions to borrow short-term money against their long-term bond holdings. More important still, they can invest that money in other short-term securities if the interest rates available are higher, or vice versa. Such arbitrage opportunities forced interest rates to move freely in associated markets; if the Bank of Japan tried to hold rates in one market artificially low, institutions could (and did) simply move their money elsewhere.

EMMOTT, *supra* note 20, at 94.

opportunities at home and abroad.¹²⁰ Reform became necessary to reflect the shift by banks away from traditional banking activities.

B. The Internationalization of Japanese Finance at Home and Abroad

In something of an understatement, the Banking Report notes that "it is necessary to acknowledge the international position of the Japanese financial and capital markets."¹²¹ As Japan's industries developed in the 1960s, they began to establish plants and branches overseas.¹²² Japan's banks followed in order to provide their customers with financing and other services.¹²³ The oil shock provided further opportunities for Japanese banks overseas:

In the 1970s, a large volume of "oil money" entered the Euromarkets in the wake of the rise in crude oil prices. This money was used to provide loans to the nonoil producers among the developing nations. Japanese banks participated in Euromarket syndicate loans through their overseas branches. At this time they were particularly eager to develop their international divisions because the 1973 oil shock had stunted the country's economic growth and cut private-sector demand for funds for capital spending.¹²⁴

Although the days of Euromarket syndicate loans were relatively short, Japanese banks had become players in the world financial markets.¹²⁵ As the country's foreign exchange reserves swelled, Japanese capital began to flow overseas.¹²⁶ Moreover, the meteoric rise in the value of the yen following the 1985 Group of Five Plaza Agreement was followed by a comparable surge in the value of Japanese assets.¹²⁷ Thus, by the mid-1980s Western observers noted Japanese money

120. See *id.* "As of March 1988, securities accounted for 14.1% of total bank assets, and government bonds accounted for 27.4% of this." BANKING SYSTEM, *supra* note 9, at 64.

121. BANKING REPORT, *supra* note 3, at 15.

122. BANKING SYSTEM, *supra* note 9, at 73.

123. *Id.*

124. *Id.* at 74.

125. See *id.*

126. See EMMOTT, *supra* note 20, at 135-40. During the period 1981-1987, Japan's net external assets rose from 1 percent of its GDP to 12 percent. John Forsyth, *The Future of Japanese Financial Development*, in JAPANESE FINANCIAL GROWTH 175, 177 (Charles Goodhart & George Sutija eds., 1990).

127. See EMMOTT, *supra* note 20, at 5; Koichi Hamada & Hugh T. Patrick, *Japan and the International Monetary Regime*, in 2 POLITICAL ECONOMY OF JAPAN 108, 122 (Takashi Inoguchi & Daniel I. Okimoto eds., 1988).

“sweep[ing] over the world.”¹²⁸ This was accompanied by a dramatic increase in the wealth and the overseas presence of Japan’s banks,¹²⁹ which attained major positions in the United States as a result of Japan’s comparatively low capital-adequacy requirements.¹³⁰

This was not an entirely positive development. As Japanese money spread around the world, complaints of Japanese economic imperialism begin to appear.¹³¹ At the same time, an increasing number of foreign financial institutions came to Japan seeking to participate in its financial success.¹³² When they arrived, they found the administrative maze and the numerous unwritten rules impenetrable and thus were generally unsuccessful.¹³³ Although the Banking Report itself baldly states that foreign institutions “enjoy national treatment,”¹³⁴ foreign criticism of the discriminatory nature of Japan’s financial system and the unfair advantage it gives Japanese banks abroad became increasingly harsh.¹³⁵ This has become a source of friction between Japan, the United States, and other

128. Richard Holloway, *Awaiting the Second Tsunami*, FAR E. ECON. REV., Dec. 17, 1987, at 59.

129. For example, according to one survey, no Japanese banks were counted among the world’s ten largest in 1980. *World Banking: Banks Meet the Marketplace*, TIME TO LEAVE (Supp. at 3, 4), in *ECONOMIST*, May 2, 1992. In contrast, by 1990, six of the ten largest banks, including the top four, were Japanese. *Id.* By 1986 Japanese banks had acquired over 20 percent of the banking assets in California; in addition, 1986 marked the year that Sumitomo Bank acquired a 15 percent holding in Goldman Sachs. CLYDE V. PRESTOWITZ, JR., *TRADING PLACES: HOW AMERICA ALLOWED JAPAN TO TAKE THE LEAD* 12 (1988). This presence has not been limited to the United States. *See, e.g.*, Nigel Holloway, *Global Ambitions*, FAR E. ECON. REV., June 1, 1989, at 59 (reporting on a Japanese bank buying a stake in a London merchant bank). Nor has it been limited to the large city banks; by the end of the 1980s, many of the smaller regional banks had established branches in the United States. Bruce Aronson, *Regionals Are Playing Follow-the-Client*, AM. BANKER, July 27, 1990, at 16A.

130. *See* PRESTOWITZ, JR., *supra* note 129, at 324.

131. *See* EMMOTT, *supra* note 20, at 137.

132. By March 1988, eighty-one foreign banks had a presence in Japan. *BANKING SYSTEM*, *supra* note 9, at 24.

133. Despite some of them having been in Japan for a decade or more, by 1986 foreign financial institutions accounted for only 3 percent of the business done in Japan. PRESTOWITZ, JR., *supra* note 129, at 12.

134. *BANKING REPORT*, *supra* note 3, at 28.

135. *See, e.g.*, John Evans, *Japanese Juggernaut Slackens Its Pace*, AM. BANKER, July 26, 1991, at 6A (noting United States’ criticism of Japan’s interest rate controls); Fumio Okamoto, *MOF Ready to Unveil Financial Decontrols*, JAPAN ECON. J., May 19, 1990, at 1, 34 (listing United States’ criticisms of Japanese financial practices); Robert C. Pozen, *Is America Being Shut Out Again?*, N.Y. TIMES, Jan. 10, 1993, § 3, at 13 (criticizing Japanese application process for lacking “clear objective criteria for approval”); Teresa S. Robinson, *Greater Access to Japan’s Financial Markets Sought*, UPI, Nov. 20, 1991, available in LEXIS, Nexis Library, UPI File. United States lawmakers’ dissatisfaction crystallized into the proposed Fair Trade in Financial Services Act. James R. Kraus, *Senate Bill Spurs Japanese Concern*, AM. BANKER, Mar. 28, 1990, at 10.

countries, which explains the Banking Report's expression of concern that "it is desirable that the Japanese financial system be one that is easy to use for foreign financial institutions."¹³⁶

Once the capital shortage ended, many of the structures which had emerged in response to it began to collapse.¹³⁷ As Japan internationalized, Japanese companies discovered that, rather than cope with the outmoded regulations and expense involved in raising capital at home, it was often cheaper to raise capital in foreign markets.¹³⁸ According to one observer: "[B]eginning roughly in 1984-85, companies . . . deserted the banks. Money was cheaper elsewhere. At first, they went to the bond markets, especially offshore ones. . . . [Then] firms switched to equity."¹³⁹ As Japanese investors became increasingly sophisticated, they realized that they could get better value for their yen abroad, where interest rates were higher and they had more options.¹⁴⁰ As noted by the Banking Report:

In the environment of internationalization of [the] economy and advancement of financial techniques . . . corporations are now able to determine in which markets to invest and to procure capital, strictly based on such factors as profitability of the financial products offered in the world markets and the convenience of each market.¹⁴¹

This resulting capital flight has threatened to "hollow out" sectors of Japan's economy.¹⁴² Reform was therefore necessary to make

136. BANKING REPORT, *supra* note 3, at 28.

137. See, e.g., RODNEY CLARK, *THE JAPANESE COMPANY* 80 (1979) (predicting that "[i]n the longer run the coherence of bank groups is further threatened by the prospect that capital will no longer be in short supply, and that other sources of capital than the domestic banks, notably the stock exchange at home and banks and underwriters from abroad, will become relatively more important") (emphasis added).

138. See *Gosō-sendan*, *supra* note 37, at 7. For example, in Japan issuance fees for corporate bonds are at least 10 percent higher than those in Europe. In addition, fees charged by banks for issuance in Japan are as much as fifteen times higher than those charged by European banks. Atsushi Naoi, *Bond Fees in Japan Down Yet High*, NIKKEI WKLY., Aug. 3, 1991, at 14.

139. *The New State of Corporate Japan*, A SURVEY OF INTERNATIONAL FINANCE (Supp. at 32), in *ECONOMIST*, Apr. 27, 1991.

140. The fact that a tide of Japanese money began sweeping the world in the 1980s is itself indicative of the limited options for investment within Japan. See generally Holloway, *supra* note 128, at 59-61 (describing both the massive Japanese foreign investment and the inconvenience of Japan's domestic market). One scholar regards Japanese corporations' access to competitive markets overseas as "the single most important stimulus toward financial deregulation in Japan." Rosenbluth, *supra* note 43, at 102.

141. BANKING REPORT, *supra* note 3, at 9.

142. See *id.* at 14.

Japanese financial markets globally competitive, while at the same time making these markets more accessible to foreign investors and institutions.

C. The Securitization and Diversification of Japanese Finance

"In recent years, the fund raising of large- and medium-size corporations has shifted from bank loans to the issue of securities."¹⁴³ This comment from the Banking Report reflects the fact that, within Japan, increasingly sophisticated investors and companies began turning away from the banks and seeking alternatives to the banks' outdated products and unfavorable interest rates.¹⁴⁴ Since the 1970s securities, over which securities companies had been granted a virtual monopoly, became an increasingly attractive alternative for firms attempting to reduce their bank debt in the post-oil-shock world.¹⁴⁵ Japanese firms' financial activities paralleled their dealings overseas in becoming progressively more sophisticated. Not only were they raising capital for their own purposes in foreign markets, they also started to get involved in financing as a business.¹⁴⁶ Most of this financial activity involved securities which, despite being issued overseas, were generally purchased by Japanese investors and handled by Japanese securities firms.¹⁴⁷ This shift greatly benefitted the securities firms.¹⁴⁸

Furthermore, according to the Banking Report in 1991, "there is a trend among individuals toward more diversified asset investments."¹⁴⁹ The phenomenal Japanese savings rate, another crucial

143. *Id.* at 12.

144. For example, the special status of the postal savings network enables it to offer interest rates and services with which banks are incapable of competing. See Yokota, *supra* note 89, at 1. In the first seven months of 1991, ¥4 trillion was transferred from banks to post office accounts, a trend which bankers fear may upset the whole financial system. *Id.*

145. See Rosenbluth, *supra* note 43, at 71. Although the relationship between banks and corporations is still close, the roles have been reversed: banks often cater to a corporation in the hope that the corporation will use their services. See EMMOTT, *supra* note 20, 104. There are indicators that banks and corporations may become further alienated: it has been reported that at least one bank is selling its stable shares. Paul Blustein, *Japanese Bank Breaks Tradition, May Sell Long-Held Shares*, WASH. POST, Feb. 21, 1991, at C10. This may simply be a sign of desperation, however, rather than the beginning of any general trend. *Id.* at C16.

146. For example, almost 40 percent of Toyota's pretax profits in 1988 were derived from financial activities rather than car manufacturing. EMMOTT, *supra* note 20, at 104.

147. *Id.* In order to compensate banks, the MOF allowed them to underwrite corporate securities overseas, although they are still unable to do so in Japan. *Id.* at 105.

148. *Id.* at 104.

149. BANKING REPORT, *supra* note 3, at 13.

factor in the formation of Japan's massive capital surplus,¹⁵⁰ has gradually begun to decrease since the 1970s.¹⁵¹ Social welfare system improvements and growing confidence in the economy correspondingly reduced the incentive to save.¹⁵² An increasing variety of things to do with one's money, besides put it in the bank, also arose: stock and real estate investments, foreign travel, and even eating gold-flaked sushi. These systemic changes required a parallel reform in the regulation of the financial sectors.

D. Banks Experience Hard Times

As stated euphemistically by the Banking Report, "a significant change has occurred in the earnings structure of Japanese banks."¹⁵³ The increasing public debt as well as the internationalization, securitization, and diversification of Japanese finance, forced the government gradually to deregulate interest rates¹⁵⁴ and to allow banks to offer an increasing variety of financial products in order to stem the flow of capital to more attractive foreign markets.¹⁵⁵ Presumably because small depositors have fewer options for investment, deregulation initially focused on large-denomination instruments.¹⁵⁶ Furthermore, the walls between long-term and short-term

150. The savings rate was as high as 25 percent in the 1960s. Kazuo Sato, *Saving and Investment, in THE POLITICAL ECONOMY OF JAPAN* 1, 137, 140 (Kozo Yamamura & Yasukichi Yasuba eds., 1987). Sato asserts that "[t]he economic miracle of the 1960s owes much to the steady rise in the saving ratio as the demand for investment steadily increased." *Id.* at 137. The high savings rate during this period appears to have been the exception rather than the rule. *See id.* at 140. Therefore, it should not automatically be attributed to some unique by-product of Japanese culture and society. *Id.*

151. Japan's personal savings rate dropped by 7 percent between 1975 and 1985. EMMOTT, *supra* note 20, at 234; *see also* Sato, *supra* note 150, at 140 (discussing the drop in the savings rate in 1970s); THE JAPANESE FINANCIAL SYSTEM, *supra* note 57, at 10-12. *But see Time for a Reagan Tax Cut—in Japan?*, BUS. WK., Mar. 1, 1993, at 22 (reporting a sharp rise in personal savings due to Japan's recent economic problems).

152. *See* EMMOTT, *supra* note 20, at 234-35. In 1988 the government also eliminated a major tax incentive for saving. *Id.* at 235.

153. BANKING REPORT, *supra* note 3, at 12.

154. *See supra* text accompanying notes 103-52. As of December 1991, 65 percent of deposits in city banks were in accounts with unregulated interest rates. FEDERATION OF BANKERS ASSOCIATIONS OF JAPAN, DEREGULATION OF THE FINANCIAL SYSTEM IN JAPAN 2 (1991) [hereinafter DEREGULATION] (on file with author).

155. *See* DEREGULATION, *supra* note 154, at 2.

156. For example, in 1979 interest rates were deregulated on three to six month certificates of deposit (CDs) over ¥500 million. In 1985, interest rates on money market certificates (MMCs) were introduced with a minimum amount of ¥50 million. Tatewaki, *supra* note 40, at 45. Total deregulation was supposed to be completed in 1993. Tomio Shida, *Financial Industry Inches Nearer to Deregulation*, JAPAN ECON. J., Feb. 23, 1991, at 35. Deregulation of demand deposit

banks have gradually been coming down as ordinary and long-term credit banks began to offer increasingly similar financial services.¹⁵⁷ Similarly, the 1981 amendments to the Banking Law and to the Securities Transaction Law permit banks to trade in public bond options.¹⁵⁸ As a result, banks have gradually become active in the securities markets. Thus, over time, the distinctions between different types of financial institutions have become increasingly irrelevant.¹⁵⁹

Despite having been granted these new privileges, the banks still need to offer higher (i.e., market) interest rates while trying to remain competitive in a stagnant loan market, thus creating a two-sided squeeze on the banks' interest rate spread, which has recently caused serious problems for many banks.¹⁶⁰ Large institutions have become increasingly predatory in attracting customers, often at the expense of the smaller institutions.¹⁶¹ As banks expanded into each others'

accounts, however, is not scheduled to take place until mid-1994. DEREGULATION, *supra* note 154, at 2.

157. Long-term credit banks are issuing two-year debentures, while regular banks have begun offering three-year term deposits; previously, long-term credit banks had been limited to five-year instruments, while ordinary banks were restricted to short-term financing. *E.g.*, Tatsuo Itoh, *Japan Long-Term Banks to Launch Two-Yr Debentures*, Reuter Money Report, Oct. 24, 1991, LEXIS, Nexis Library, MONRPT File; *see also New Mid-Term Time Deposits Designed*, Japan Econ. Newswire, May 19, 1992, available in LEXIS, Nexis Library, JEN File (noting that regional banks are designing three-year to four-year time deposits).

158. *See also* BANKING LAW art. 10(2), Law No. 59 of 1981 (authorizing banks some securities-related activities); SHŌKEN TORIHIKI HŌ [SECURITIES TRANSACTION LAW] art. 65(2)(2)(i), Law No. 25 of 1948 (exempting banks from the total ban of securities transactions, provided in the preceding subsection, for certain types of transactions); BANKING REPORT, *supra* note 3, at 17.

159. *See, e.g.*, THE JAPANESE FINANCIAL SYSTEM, *supra* note 57, at 165 ("[I]t is difficult to make very precise distinction [*sic*] in a functional sense among the depository institutions. . . . [After 1975] each type of financial institution began to invade the turf of others.").

160. *See, e.g.*, Paul Blustein, *Profits Slide for Japan's Major Banks*, WASH. POST, May 28, 1991, at E1, E5 (discussing the narrowing gap between deposit interest and loan interest); Evans, *supra* note 135, at 6A (noting that deregulation of interest rates is eroding earnings on deposits); Joe Joseph, *Japanese Bank Balance Upset*, THE TIMES Nov. 2, 1990, at 28 (citing smaller interest rate spread and stock losses as sources of banks' difficulties). More recently, however, bad loans have become the banks' main problem. *See infra* notes 300-01.

161. *See generally* Yūichi Hiraishi, *Jiyūka no naka dewa kyōdo soshiki kin'yū no genten ni modore*, EKONOMISUTO, July 15, 1991, at 48 (discussing the appropriate corporate strategies for the cooperative type of financial institution in the era of liberalization and internationalization); Masahiro Takahashi, *Hokkaidō, hiroi chiiki no 'sumiwake' mo yurusarenaku natta*, EKONOMISUTO, July 15, 1991, at 38 (reporting increasing competition in Hokkaido due to the liberalization of deposit rates and the new entry of larger banks to small-sized firms' corporate finance market). The *shinkin* banks, for example, are in a serious dilemma. As explained by a Sanwa Bank officer, "[The *shinkin*] cannot compete with us. . . . There is no limit to our ability to take their customers away." Henny Sender, *Japan's Not-So-Mighty Banks*, INSTITUTIONAL INVESTOR, Nov. 1990, at 130.

markets, reform became increasingly necessary to protect the sectors of the financial industry which were disadvantaged by this new competition.

In the long run, excessive economic growth may have been the banks' principal downfall. According to the Banking Report, "[a]s a result of liberalization and internationalization of finance, Japanese banks and other financial institutions are confronted with a variety of risks. . . ." ¹⁶² In the case of the larger banks, the expansion of their partners in the *keiretsu* group eventually led to a drop in profits because:

as a company in a bank group gets bigger two things happen. The group bank becomes less able and less willing, for reasons of financial prudence [there are legal restrictions as well] to provide the growing company with most of its funds. At the same time, the company becomes attractive as a potential borrower to a number of outside banks. As the company borrows more from these outside banks its relations with the group bank are attenuated. . . .

Bank groups suffer, therefore, from an inherent defect, that the more successful their member companies are, the less likely they are to remain largely under the control of the central bank. ¹⁶³

Similarly, the dramatic rise in stock and land prices that occurred in the 1980s hurt banks and other financial institutions. Banks had invested heavily in stock and had financed stock and land speculation activities of affiliates. ¹⁶⁴ Most of these loans were made with property as collateral. ¹⁶⁵ As long as land and stock prices continued to spiral, the underlying structural problems of the banking system went largely unnoticed. ¹⁶⁶ When the stock and real estate markets dropped precipitously at the beginning of the 1990s, the value of banks' stockholdings fell rapidly, ¹⁶⁷ and they were stuck with portfo-

162. BANKING REPORT, *supra* note 3, at 13.

163. CLARK, *supra* note 137, at 78, 80.

164. See, e.g., Steven Butler, *Little Cause for Comfort*, FIN. TIMES, Sept. 1, 1992, at 12.

165. See generally *infra* notes 300-01 and accompanying text (discussing nonperforming loans backed by devalued real estate holdings).

166. See, e.g., Butler, *supra* note 164, at 12 ("What Japan's economic bureaucrats have consistently failed to appreciate is the extent to which the heady years also distorted investment and consumption patterns.").

167. See Evans, *supra* note 135, at 6A; J. Terence Gallagher, *Japan Credit Crunch Could Cause First Bank Failure*, Reuter Library Report, Jan. 31, 1991, available in LEXIS, Nexis Library, LBYRPT File (reporting many smaller institutions as sitting on large unrealized losses from securities investments); *infra* notes 298-311 and accompanying text.

lios of bad loans secured by severely devalued land.¹⁶⁸ These losses provided a new urgency for financial reform. As noted by one observer:

The fragmented nature of official supervision of financial institutions in Japan has not mattered too much in the past because the industry's overall asset structure was diversified enough to prevent any undue concentration of risk. But all this has changed with the massive funding of Japan's recent land and property bubble.¹⁶⁹

The Banking and Securities Reports, therefore, had to cover a broad variety of concerns: some long-standing and some arising from relatively new developments. The degree to which these concerns were addressed in the reports is the subject of the following section.

IV. REFORM AT LAST?

The core of the Financial System Research Council's (Council) reform proposals involved removing the legal and regulatory barriers between the following sectors of the financial industry: banking, long-term banking, securities, and trust activities. Citing the worldwide trend toward "the expanding scope of activities for financial institutions,"¹⁷⁰ the Banking Report suggested that such changes would encourage "sufficient competition between financial institutions . . . in *all* financial markets"¹⁷¹ and enable the financial institutions to "meet the increasingly sophisticated and diverse needs of the user. . . ."¹⁷²

The Council was also concerned with "the achievement of a level playing field at the start of mutual entry and the avoidance of excessive impact on existing financial institutions."¹⁷³ With these quite different objectives in mind, the Banking Report discussed five different methods by which the mutual entry of financial industries into each other's markets could be accomplished:¹⁷⁴ (1) universal

168. See generally *infra* notes 300-01 and accompanying text (discussing nonperforming loans secured by devalued real estate). In addition, the larger banks had also lent excessively to fund merger and acquisitions activities in the United States during the 1980s, many of which resulted in bankruptcies. See Sherry R. Sontag, *Japan's U.S. Lesson in Bankruptcy*, NAT'L L. J., Apr. 30, 1990, at 3.

169. Rowley, *supra* note 60, at 36.

170. BANKING REPORT, *supra* note 3, at 16.

171. *Id.* at 19 (emphasis added).

172. *Id.* at 20.

173. *Id.*

174. This part of the reform proposal did not surprise anybody. The Council had, after all, been discussing the subject of financial reform for six years, and this aspect of their deliberation

banking; (2) bank holding companies; (3) multifunctional subsidiaries; (4) a piecemeal approach; and (5) mutual entry through wholly-owned subsidiaries. Each of these methods is described below and is followed by a discussion of the recommendations of the Securities Report and the public reaction to both the Banking and Securities Reports.

A. Options for Reform

The first method for reform proposed in the Banking Report was a universal banking system. This would have allowed financial institutions to engage in a broad range of activities without having to establish subsidiaries or use separate facilities.¹⁷⁵ For example, banks would be allowed to deal in securities and trust instruments, and securities companies could take deposits.

Universal banking was rejected partly because it might be difficult to achieve a level playing field.¹⁷⁶ This euphemistic statement reflects the reality that large banks supported the adoption of a universal banking system, but the securities industry and smaller banks vehemently opposed such a system because it would have placed them at a competitive disadvantage.¹⁷⁷ Under a universal banking system, securities companies and the smaller and/or specialized banks with limited numbers of branches would have been seriously handicapped in competing with the large city banks that had branches throughout the country.¹⁷⁸ Moreover, the securities industry insisted that strict firewalls be maintained between different financial operations.¹⁷⁹ From this standpoint, a universal banking system might not have

was public knowledge at least two years before they issued their final report. See, e.g., *Round Table Discussion 2*, *supra* note 96, at 13, 25–29 (discussing the implications of the various methods of mutual entry); Holloway, *supra* note 18, at 54 (discussing the five possible means of mutual entry).

175. BANKING REPORT, *supra* note 3, at 21.

176. *Id.*

177. See *Gosō-sendan*, *supra* note 37, at 7.

178. *Round Table Discussion 2*, *supra* note 96, at 28. The long-term credit banks appear vulnerable to any form of deregulation, and they will likely acquire regular banks in order to obtain a network of branches through which to engage in new forms of business. See Anthony Rowley, *Marriages of Convenience*, FAR E. ECON. REV., Jan. 30, 1992, at 43.

179. See *Gosō-sendan*, *supra* note 37, at 7. One commentator has also observed that the concern with firewalls is more about equalizing competition than preventing the inappropriate exchange of information between parents and subsidiaries. *Round Table Discussion 2*, *supra* note 96, at 26.

provided sufficient safeguards against conflicts of interest and self-dealing.¹⁸⁰

The second option for reform was to allow mutual entry through bank holding companies, similar to the system of the United States.¹⁸¹ This approach was not discussed at length in the Banking Report. Article 9 of Japan's antitrust law prohibits holding companies,¹⁸² and the Council did not deem it appropriate to "seek a revision of that law for the sake of financial system review alone."¹⁸³

The third approach for reform was mutual entry through multifunctional subsidiaries.¹⁸⁴ This plan would involve different institutions participating in each other's fields of business through a special type of subsidiary.¹⁸⁵ While this method would have synergistic advantages and would enhance user benefits, the Banking Report expressed some concerns about conflicts of interest and self-dealing.¹⁸⁶ These concerns were similar to those about universal banking and made the multifunctional subsidiary approach less attractive than mutual entry through separate subsidiaries.¹⁸⁷

The fourth method for reform was a piecemeal approach, using "desegregation in individual areas of business, while leaving intact the existing regulations that otherwise segregate different types of [financial] operations."¹⁸⁸ Although this approach did have the definite political merit of softening the reform's impact on the various interests involved, the Banking Report rejected its use as an overall

180. The Banking Report gracefully concedes that "[i]n regard to the mutual entry between banks and securities companies, the universal banking system . . . has many problems at this point in terms of maintaining sound banking management and preventing harmful conflicts of interest." BANKING REPORT, *supra* note 3, at 21.

181. *Id.*

182. ANTIMONOPOLY LAW art. 9, Law No. 54 of 1947.

183. BANKING REPORT, *supra* note 3, at 21.

184. *Id.* The Japanese version of the Banking Report refers to this option as the *Tokureihō Hōshiki* ("special legislation") approach. KIN'YŪ SEIDO CHŌSA KAI, SEIDO MONDAI SENMON INKAI HŌKOKU, *reprinted in* EKONOMISUTO, July 15, 1991, at 120, 130. It is difficult to discern the reason for this discrepancy because discussion of this approach by both the Banking Report and the media was extremely limited. Presumably, the two terms—"multifunctional subsidiaries" and "special legislation"—together refer to subsidiaries established under new legislation with licensing criteria and permissible activities that differ significantly from the existing types of financial institutions.

185. *Id.* Foreign observers have described this form as an investment banking subsidiary limited to wholesale activities. Holloway, *supra* note 18, at 54.

186. BANKING REPORT, *supra* note 3, at 21.

187. *Id.* at 20-21.

188. *Id.* at 20. One commentator described this less generously as "[m]ore of the same." Holloway, *supra* note 18, at 54.

method because it “would make it difficult to pursue a consistent and far-reaching mutual entry and would not make it possible to build an internationally acceptable system that extensively promotes users’ benefits.”¹⁸⁹ However, the Council did recognize that this approach, used in combination with another method, would probably be appropriate in specific financial sectors¹⁹⁰ such as for regional banks and smaller financial institutions.¹⁹¹

The final reform alternative, which the Council recommended in its Banking Report after rejecting the other approaches, allowed mutual entry through wholly-owned specialty subsidiaries.¹⁹² A subsidiary approach was preferred because it presented the fewest problems; the separate subsidiary was preferred to the multifunctional subsidiary because it would be more effective in “prevent[ing] harmful conflicts of interest, thus maintaining financial order.”¹⁹³ Observers have also noted that the subsidiary method would be more effective in preserving “fair competitive conditions” (note that these terms do not necessarily carry the same meaning as they would in an American context), particularly if requirements for separate business premises are imposed.¹⁹⁴ Thus, the playing field is not likely to experience any sudden drastic tilts.¹⁹⁵ The separate subsidiary method became law with the passage of the Financial System Reform Act of 1992.¹⁹⁶

In detail, the Banking Report recommended that the subsidiaries be fully established entities. As such, the subsidiaries would be fully

189. BANKING REPORT, *supra* note 3, at 20. As written, the committee’s reasons are not particularly lucid. The quoted passage presumably means that partial deregulation would simply complicate matters further and perpetuate the current system which favors the interests of financial institutions at the expense of their users. Following publication, the most widespread criticism of the Banking Report was that it favored the interests of financial institutions with little regard for consumers. See Holloway, *supra* note 18, at 54–55; *infra* notes 253–54 and accompanying text. Consequently, the reference to promoting “users’ benefits” would appear to be more for effect than out of any actual concern for users’ convenience. See *infra* notes 325, 328–30 and accompanying text.

190. BANKING REPORT, *supra* note 3, at 20.

191. *Id.* at 24.

192. *Id.* at 20–22. This method was also the only possibility mentioned by the Security Council. See SECURITIES REPORT, *supra* note 3, at 162.

193. BANKING REPORT, *supra* note 3, at 21.

194. *Round Table Discussion 2*, *supra* note 96, at 26–28. Several observers have pointed out the need for a more thorough discussion of firewalls. *Id.*

195. Although the regulation of foreign financial institutions in Japan is a subject beyond the scope of this paper, it must be noted at this juncture that, prior to the change in law, foreign banks were permitted to own up to 50 percent of a Japanese securities company. *Foreign Banks to Benefit from MOF Ruling*, NIKKEI WKLY., June 29, 1991, at 12.

196. See *infra* notes 270–75 and accompanying text.

functional entities, licensed, and entitled to complete privileges under the appropriate laws.¹⁹⁷ Banks should be allowed to have securities subsidiaries and trust banking subsidiaries, securities companies should be able to create banking and/or trust banking subsidiaries,¹⁹⁸ and so on. Neither foreign exchange nor long-term banking subsidiaries were discussed, having been dismissed as largely redundant.¹⁹⁹ Still, the Banking Report left open the subject of long-term credit banking subsidiaries "for reasons such as achieving continuity with the existing system."²⁰⁰ At the same time, the Banking Report recognized that there was a need to maintain an orderly deregulation, and for this reason it suggested placing certain provisional restrictions on the scope of activities permitted to some types of subsidiaries.²⁰¹ Specifically, while banking subsidiaries ought to be fully empowered, trust subsidiaries should be excluded from doing some types of trust business and possibly be limited to conducting real estate trust activities.²⁰² Securities subsidiaries should be given all the powers allowed under the Securities Transaction Law, but should be temporarily excluded from brokering and other activities in the secondary market.²⁰³ The Council saw little merit in embodying these limitations in law because doing so "could result in creating new types of financial sectors, which would run counter to the objectives of the system review."²⁰⁴

The Council also recognized that it might be economically impossible for regional financial institutions to set up subsidiaries.²⁰⁵

197. BANKING REPORT, *supra* note 3, at 22.

198. *Id.* In reality, mutual entry is likely to be fairly one-sided; that is, banks going into the securities business. The banking subsidiary of a securities firm would be hindered by the difficulty of establishing the network of branches that would be necessary to take deposits successfully. *Shōtorishin saishū hōkoku an: Kankeisha wa kō miru*, ASAHI SHINBUN, May 16, 1991, at 8. Similar economic considerations would restrict securities firms from entering the trust business as well. See *Ōzume kin'yū seido kaikaku 3: Danko hantai no uragawa, shōkenkai ni tadayou kyodatsukan*, YOMIURI SHINBUN, May 11, 1991, at 7 (describing the fear in the securities industry of facing banks' new entry into the securities business).

199. BANKING REPORT, *supra* note 3, at 22.

200. *Id.* Some view the breakdown of the distinction between long-term and short-term financing as a threat to the continued existence of the long-term credit bank system. *Ōzume kin'yū seido kaikaku 3: Danko hantai no uragawa, shōkenkai ni tadayō kyodatsukan*, *supra* note 198, at 7.

201. BANKING REPORT, *supra* note 3, at 23.

202. *Id.*

203. *Id.*

204. *Id.* at 22.

205. *Id.* at 24. In addition to the regional banks, other "regional financial institutions" include the numerous smaller institutions such as credit associations, farm cooperatives, etc. *Id.*

For this reason and to benefit local users, the Banking Report suggested that regional financial institutions be allowed to choose between establishing subsidiaries and expanding the scope of some of their own activities on a more limited basis.²⁰⁶ The Banking Report clearly deferred the difficult question of what special dispensation should be granted to regional institutions. It stated that the activities allowed to regional institutions should "be those which are necessary for meeting the needs of local users and for supporting the development of the region, and which pose virtually no problems in maintaining financial order when undertaken by regional financial institutions themselves."²⁰⁷ This rather nebulous statement is followed by two examples of such activities: land trusts and charitable trusts.²⁰⁸ But again, the Banking Report did not make any definite recommendations.

In addition to proposing the basic format by which mutual entry should be accomplished, the Banking Report made several other recommendations. First, it proposed broadening the scope of activities in which banks could engage without being required to establish a subsidiary,²⁰⁹ focusing primarily on loosening the restrictions on banks' involvement in private bond placements and various "securitization-related" products.²¹⁰ Second, the Banking Report hinted at possibly allowing banks to deal in domestic corporate bonds and freeing them to issue bonds of their own.²¹¹ Third, the Banking Report recommended an immediate review of many regulations and practices which it did not specifically address.²¹²

The Council recognized that any form of major change in the financial system was likely to be traumatic for all the parties involved. The Banking Report concluded, however, that the combination of the

206. *Id.*

207. *Id.*

208. *Id.* Doubtless, the functions in which regional financial institutions eventually will be allowed to participate will not be those that the users need, but rather those that other types of institutions are willing to concede.

209. *Id.* at 20-21.

210. *Id.* at 23.

211. *See id.* at 24. The report also equivocated on the question of allowing securities companies to engage directly in foreign exchange activities. *Id.* at 23-24. It is conceivable that several questions such as these were deliberately brought up, then left unanswered, in order to provide bargaining chips for future disputes between the various industries.

212. *Id.* at 25. Examples of recommended regulations include further liberalization of interest rates and the diversification of trust products and bank debentures. *Id.*

subsidiary format, existing laws, and institutional self-regulation would suffice to prevent "harmful side effects of mutual entry."²¹³

To supplement the existing regime, the Council proposed four additional areas of reform.²¹⁴ First, it proposed instituting higher capitalization levels in order to "attain sound management."²¹⁵ Adherence to the Bank for International Settlements (BIS) capitalization standards had been discussed in Japan for several years,²¹⁶ and the Banking Report formally proposed "further studies" regarding making it the legal standard.²¹⁷ In the case of subsidiaries, the Banking Report suggested examining the feasibility of consolidating the capital-adequacy requirements of parents and subsidiaries,²¹⁸ as is the practice in other countries.²¹⁹ Second, the Banking Report mentioned the need to reinforce the disclosure system, although it did not provide any details.²²⁰ Third, it suggested that the monitoring function of supervisory authorities should be improved, particularly with regard to risk management, given the various transactions in which banks may become involved after liberalization.²²¹ Fourth, the Banking Report briefly recommended improving the deposit insurance system.²²² Finally, the Banking Report made some brief observations and suggestions regarding foreign financial institutions, the insurance industry, nonbanks, governmental financial institutions, and cooperative financial institutions.²²³ The extent to which the Banking

213. *Id.* at 26.

214. *Id.* at 26-27.

215. *Id.* at 27.

216. See, e.g., *Japan's Banking Uncertainties*, *ECONOMIST*, June 30, 1990, at 75 (discussing the possibility of BIS requirements for reporting large scale bank mergers). The so-called BIS Accord of 1988 proposes a minimum capital-to-risk weighted assets ratio of 8 percent for internationally active banks. Roy Goode, *The Insolvency Implications for Banks*, in *THE SINGLE MARKET AND THE LAW OF BANKING* 139, 141-42 (Ross Cranston ed., 1991); Henry Hu, *Swaps: The Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 *U. PA. L. REV.* 333 n.28 (1989).

217. *BANKING REPORT*, *supra* note 3, at 27. To date, capital-adequacy requirements have been set by the government. *BANKING SYSTEM*, *supra* note 9, at 40-41; *Finance Ministry May Push for Rule on Bank Ratio*, *NIKKEI WKLY.*, July 27, 1991, at 3. Since the Report was issued, however, the MOF proposed making BIS's capital-adequacy standards a statutory requirement. See *Capital Adequacy Standards Proposed as Law*, *NIKKEI WKLY.*, Nov. 30, 1991, at 4.

218. *BANKING REPORT*, *supra* note 3, at 27.

219. *Id.*

220. *Id.*

221. *Id.*

222. *Id.* at 28.

223. *Id.* at 28-30.

Council's recommendations were reflected in the Financial System Reform Act is discussed in Part V.

B. The Securities Report

In contrast to the Banking Report, the Securities Report was shorter and much less equivocating in its demands. Unlike the Banking Report, which had to reflect the delicate balance of interests of various types of banks, the Securities Report was primarily concerned with limiting the encroachment of banks into securities companies' domain to a bearable minimum.

Described briefly, the Securities Report contained three main ideas on the subject of financial reform.²²⁴ First, the Securities Report advocated that the term "security" be given an all-encompassing, American-style definition in order to bring a broader range of financial products under the ambit of the Securities Transaction Law.²²⁵ The Securities Report suggested that new "securitization products" should be classified as securities in order to protect investors and enhance the distribution of securities.²²⁶ Securities could only be sold by licensed dealers, and banks were prohibited from direct dealings in most securities.²²⁷ Consequently, broadening the ambit of what constituted a security would have given the securities industry a comparative advantage over banks by expanding the role of securities in Japan's capital markets.²²⁸ Although banks would have been able to deal in securities through subsidiaries, a broad definition of securities still would have benefitted the securities industry in three ways. It would have completely blocked smaller banks, which could not afford the expense of establishing a subsidiary for securities dealings, with the possible exception of participation in private placements. Furthermore, banks' securities subsidiaries would have been temporarily limited in the scope of their securities activities,²²⁹ and therefore be less competitive. Finally, through the redefinition of "security," it would have been possible to shut banks out of existing

224. *MOF Market Reforms a Long Way Off; Flap over Securities Plan Slows Progress*, Int'l Fin. Daily (BNA), June 7, 1991, available in LEXIS, Nexis Library, BNAIFD File.

225. See SECURITIES REPORT, *supra* note 3, at 155-56.

226. See *id.*

227. See *supra* note 118 and accompanying text.

228. See SECURITIES REPORT, *supra* note 3, at 155.

229. See *infra* notes 263-348 and accompanying text.

product markets in which they were already involved, such as the burgeoning commercial paper market.²³⁰

Second, the Securities Report called for a revision of the concept of what constitutes a public offering.²³¹ The classification of a transaction as a public offering triggers disclosure obligations.²³² Under the preamendment definition, any invitation to acquire securities made to a number of unspecified persons on equal terms was regarded as a public offering.²³³ The Securities Report argued that a variety of transactions made with informed investors should not be considered public offerings and hence excluded from disclosure requirements and other protective regulations.²³⁴ While this proposal did not have direct relevance to banking reform, it appears to have represented an effort by the securities industry to make securities, and thus securities companies, more accessible to investors.

Third, the Securities Report discussed the entry of banks into the securities business in a section euphemistically titled "Deliberations on Market Intermediaries."²³⁵ Given the increasing variety of securities-related products, the Report conceded that "it is possible that, in certain exceptions, depending upon the type of securitization product, cases may develop where it may be appropriate to allow persons not engaged in the securities business to act as a market intermediary."²³⁶ It also conceded that banks should be allowed to participate in private placements.²³⁷ The Securities Report even bowed to the inevitability of banks entering the securities market through subsidiaries.²³⁸

At this point, however, the Securities Report became less accommodating. It listed a number of specific concerns regarding the increased involvement of banks in the securities industry. These include: banks' safety and soundness, conflicts of interest, self-dealing, and the possibility of banks acquiring undue influence over companies

230. See *Round Table Discussion 2*, *supra* note 96, at 23. The Securities Report does indicate that it would be appropriate to allow banks to continue dealing in commercial paper and certificates of deposit, even if they are reclassified as securities. SECURITIES REPORT, *supra* note 3, at 161. However, this issue clearly provides the leverage for future bartering with the banks over the details of the reform.

231. SECURITIES REPORT, *supra* note 3, at 158.

232. *Id.*

233. *Id.*

234. *Id.* An example of transactions which should be exempted from disclosure requirements are offerings made to less than fifty persons. *Id.*

235. *Id.* at 161.

236. *Id.* (author's translation).

237. *Id.*

238. See *id.* at 163.

and the marketplace.²³⁹ In order to prevent such negative side effects, the Securities Report made two proposals. First, it advised that mutual entry be a gradual process to prevent market confusion.²⁴⁰ In particular, it recommended the creation of a legal prohibition on banks engaging in brokerage activities.²⁴¹ Second, although it did not use the term directly, the Securities Report called for an extremely strict system of firewalls to compartmentalize risk and prevent self-dealing.²⁴² If fully implemented, this network of firewalls would have negated much of the benefit which banks or other financial institutions might have hoped to derive from establishing a securities subsidiary.²⁴³

C. The Impact of the Reports

Both the Banking Report and the Securities Report were highly criticized. This criticism can be divided into three issues: (1) that the Reports failed to advocate true, meaningful reform; (2) that the substance of the Reports ignored some of the supposed goals of reform; and (3) that those proposals the Reports did make were too vague with respect to the details of reform.²⁴⁴ Although both

239. *Id.*

240. *Id.*

241. *Id.* at 164. This is one area where the recommendations of the Securities Report diverge from those of the Banking Report, which advocates only informal restrictions. Compare *id.* with BANKING REPORT, *supra* note 3, at 18–19. The intent of the Securities Report is clear: once in place, a statutory prohibition on brokering by banks would be both harder to circumvent and far more difficult to remove than a mere regulatory understanding. See generally *Round Table Discussion 1*, *supra* note 3, at 87 (commentators agreeing it will take a long time before the restriction on brokering by banks is finally lifted).

242. See SECURITIES REPORT, *supra* note 3, at 163. The call for firewalls is not addressed solely to banks but to any parent subsidiary relationship where one entity is a securities company. See, e.g., *Round Table Discussion 1*, *supra* note 3, at 90–92 (discussing the firewall issue in general).

243. See *Round Table Discussion 1*, *supra* note 3, at 90–92. Doubtless this is precisely what the securities industry wanted. See *Ōzume kin'yū seido kaikaku 3: Danko hantai no uragawa, shōkenkai ni tadayou kyodatsukan*, *supra* note 198, at 7. Some of the proposed firewalls reflect legitimate concerns, such as a parent making imprudent investments in order to prop up a failing securities subsidiary. Other firewalls, however, appear more concerned with making securities subsidiaries as unattractive as possible to prospective entrants into the securities business. For example, some firewalls would prevent parent companies from granting favorable terms (e.g., for loans) to their securities subsidiaries or their customers, parents and subsidiaries doing business on the same premises, and interlocking directorships. *Round Table Discussion 1*, *supra* note 3, at 90–92; see also *Round Table Discussion 2*, *supra* note 96, at 27–28 (discussing firewalls in connection with market competition).

244. Criticism of the Reports began even before they were officially released because their contents were known beforehand. See, e.g., *Kinseichō hōkoku an: Gyōkai e no hairyo yūsen*,

Reports repeatedly stressed the need for more competitive financial markets, neither provided a clear guideline, as observers had hoped, regarding what kind of competition should be engendered on the road to reform. Should there be completely free competition sacrificing weak and inefficient institutions? Should competition be encouraged only to the extent that such institutions would not be eradicated, or should there be some intermediate alternative?²⁴⁵ Although the Banking Report briefly refers to the need for competition, stating that "to support the present system is rather to protect the vested interests of existing financial institutions of each sector,"²⁴⁶ nothing within the Report suggests that these vested interests either could or should be seriously endangered by the proposed reforms. It is not surprising, therefore, that some observers regarded the proposed reforms as a continuation of the convoy system.²⁴⁷ While the media generally recognized the need to avoid excessive confusion in the process of reform,²⁴⁸ at least one commentator felt that the MOF's concern for *kin'yū chitsujo* (financial stability) was misplaced.²⁴⁹ Such criticism was hardly new; it had been made over ten years earlier, when the Banking Law was amended in 1981,²⁵⁰ and perhaps indicated how little things had really changed.²⁵¹

YOMIURI SHINBUN, May 22, 1991, at 7 (criticizing the Banking Report for its lack of attention to the user's interest and the internationalization of the Japanese market).

245. See *Round Table Discussion 2*, *supra* note 96, at 27-30. Although recognizing that the traditional Japanese concept of competition might be unique, observers noted a year before the Report was issued that it would be necessary to consider the reform in terms of the Anglo-European concept of competition; otherwise it would be meaningless. *Id.* at 30.

246. BANKING REPORT, *supra* note 3, at 12.

247. *Gosō-sendan*, *supra* note 37, at 7.

248. See, e.g., *Ōzume kin'yū seido kaikaku 3: Danko hantai no uragawa, shōkenkai ni tadayou kyodatsukan*, *supra* note 198, at 7 (describing the need to avoid a deregulation like Britain's "Big Bang").

249. See, e.g., *Shikin chōtatsu no sentaku haba hiroku*, YOMIURI SHINBUN, June 14, 1991, at 7 (President of Nippon Steel stating: "I don't consider it financial stability when not a single financial institution doesn't go bankrupt. It can't be helped if banks that invest only in land or stray from sound management go bankrupt. While it may be necessary to strengthen the insurance system in order to protect small investors, . . . overprotectiveness is not financial stability. . ."). One observer has characterized the content of the Reports as being nothing more than a discussion of what sort of handicaps should be imposed on city banks during the reform process. *Ginkō saihen daigappei, Tokumei zadankai: Doko ka ga kutsukeba issei ni hashiridasu*, EKONOMISUTO, July 15, 1991, at 16, 26 (anonymous discussion by insiders on possible bank mergers).

250. See Rosenbluth, *supra* note 43, at 92-97.

251. The subsidiaries as proposed will have to be licensed by the MOF under existing laws. See generally FINANCIAL SYSTEM REFORM ACT, *supra* note 5, *passim* (providing no amendments to existing laws requiring financial institutions be licensed by the MOF). This provides the MOF

A second related and common complaint was that by focusing too much on the continued well-being of all sectors of the financial industry the Reports neglected the two other themes supposedly underlying the reform proposals: user needs and the internationalization of finance.²⁵² Criticism that the convenience of financial consumers had been neglected was particularly widespread.²⁵³ Only a short section of the Banking Report was devoted exclusively to user benefits,²⁵⁴ and, while the Securities Report purports to be greatly

with the opportunity to render the proposed reforms meaningless by refusing to grant licenses to subsidiaries when, in its view, doing so might threaten the stability of other institutions or the economy in general.

252. *Kinseichō hōkoku an: Gyōkai e no hairyo yūsen*, *supra* note 244, at 7; Sumiko Takahara, *Tanka wo kitta to iwaretemo*, *ECONOMISUTO*, July 15, 1991, at 92; Shinichiro Ohta, *Riyōsha Fuzai, Gyōkai ego ni shūshi shita kakine ronsō*, *ECONOMISUTO*, July 15, 1991, at 95.

253. *See, e.g., Kinseichō hōkoku an: Gyōkai e no hairyo yūsen*, *supra* note 244, at 7 (criticizing the Report for excessive concentration on industry interests at the expense of users and other interests); *Interview with Kii Nakamura [Vice President of Housewives' Association]*: *Riyōsha mo shinken shōbu no toki*, *YOMIURI SHINBUN*, June 15, 1991 at 7 (stating that the Reports' focus on efficient competition will only benefit rich investors). At least some politicians apparently view this as an excellent opportunity to score some political points without doing much else about the problem. The chairman of the Liberal Democratic Party's (LDP) own Financial Problem Research Council is critical of the report for its failure to deal with consumer needs. *See, e.g., Tetsuo Kondo, Kin'yū seido kaikaku wa dare no tame ni okonawareru no ka*, *ECONOMISUTO*, July 15, 1991, at 66. The LDP also sought to gain political recognition by proposing a more user-friendly, European-style banking system after it was already too late to actually alter the direction of reform. Emiko Terazono, *Call for Japan Banking to Adopt European Style*, *FIN. TIMES*, May 20, 1991, at 17.

254. *See BANKING REPORT*, *supra* note 3, at 16. It is perhaps illustrative that the English translation of the Report states that "[u]sers' benefits to be brought about by this revision of the financial system are discussed . . . in the addendum." *Id.* This addendum, however, was apparently so unimportant that it was not included in the translation. Examples of user benefits promised in this addendum include such basic ideas as improved service and varieties of products through increased competition and more assertive handling of housing loans by ordinary banks once they are able to acquire long-term capital. *See, e.g., id.* at 9 (advocating increased competition as a means to providing better service and more products). There was criticism that such matters should have been included directly in the body of the Report. *See Ginkō, Shōkengaisha ga kawaru: Yokin kakumei-shinshōhin kaikin de kakine kuzushi*, *YOMIURI SHINBUN*, June 6, 1991, at 1; *Kin'yū kaikaku no riten kyōchō*, *YOMIURI SHINBUN*, May 26, 1991, at 1. It is also hardly surprising that the criticism that the institutions which have expressed the greatest concern for the needs of the user are also those which would be most disadvantaged by the reform: the long-term credit banks and the securities companies. *See, e.g., Yoshio Matsumoto, Baransu kaku fugin no saiken hakkō gyōmu sannyū*, *ECONOMISUTO*, July 15, 1991, at 88 (noting criticism of both the Banking and Securities Reports by a representative of the long-term banking industry). With respect to consumer protection, a senior BOJ official commented that excessive concern for consumer protection would create a counterproductive "moral hazard," particularly if consumers and institutions knew that they would always be aided by the government "whatever risk they take." *Financial Regulators Split on Benefits of Japanese Financial Restructuring Plan*, *Banking Report (BNA) No. 22*, at 969 (June 1, 1992). Why this would be different from the current system—in which institutions, rather than consumers, know that the government will step in to

concerned with protecting investors, the sincerity of this concern appears to be questionable.

Similarly, the internationalization of the financial system was addressed only in very general terms, despite being one of the primary reasons why reform had become necessary. The Banking Report made two extremely nebulous recommendations regarding the subject, namely that "consideration should be given to ensuring smooth entry of foreign financial institutions . . ." ²⁵⁵ and that "the process of liberalization and internationalization needs to be furthered by reviewing the existing vertically divided system and customs stemming from it." ²⁵⁶ In addition, one observer noted that the various conditions and stipulations exhorted by both Reports, if implemented, would only make the system even more opaque to outsiders. ²⁵⁷ Certainly, there was scant praise from foreign observers for the proposed reforms. ²⁵⁸

Another grievance with the Reports was that they made few concrete proposals and were often in disagreement when they did. As one foreign commentator noted, the Reports had "a long way to go before agreeing on the basics, let alone the details." ²⁵⁹ In addition, language in some crucial places was deliberately ambiguous, sparking renewed skirmishes over interpretation. ²⁶⁰

Finally, observers also acknowledged that the Financial System Reform Council and the Securities and Exchange Council left most of the difficult problems for the MOF bureaucrats to solve. ²⁶¹ To some,

prevent failures—is unclear.

255. BANKING REPORT, *supra* note 3, at 28.

256. *Id.* at 15 (emphasis added).

257. See Ohta, *supra* note 252, at 95 (criticizing the reform process from the viewpoint of corporate customers).

258. Neil Weinberg, *Ministry of Finance Short on Cataclysms*, NIKKEI WKLY., July 6, 1991, at 16. Still, some financiers, such as trust bankers, are happy about the subdued nature of the proposed changes because they benefit from limited competition under the current system. *Id.*

259. *MOF Market Reforms a Long Way Off; Flap Over Securities Plan Slows Progress*, *supra* note 224.

260. For example, though not directly translated in the English version of the Banking Report, the Japanese original uses "etc." ("nado") at crucial junctures, usually where a proposal might be too controversial to state specifically. Naoyuki Isono, *Vague Phrase Boosts Ministry's Power*, NIKKEI WKLY., June 29, 1991, at 4. In one instance, the Banking Report states that new entrants to trust banking should initially be excluded from "some aspects of trust of money, etc., including pension trusts, loan trusts, etc." BANKING REPORT, *supra* note 3. This type of vague wording obviously prevents banks from making any concrete plans, barring further clarification by the MOF. *Id.*

261. See, e.g., *Gutaisaku wa sakiokuri*, YOMIURI SHINBUN, May 25, 1991, at 7 (noting that solutions to the real problems had simply been deferred by the Reports, and that further

this outcome may seem unusual, considering that the Reports were issued by advisory bodies attached to the same ministry. In fact, the discrepancies between the Reports are symbolic of the frequent criticism that the MOF is "all bureaus and no ministry."²⁶²

V. WHAT, IF ANYTHING, HAS BEEN ACCOMPLISHED?

A. The Financial System Reform Act of 1992

Nearly a year after the release of the Banking and Securities Reports, the Japanese cabinet finally agreed upon a proposed financial reform bill.²⁶³ It was submitted to the Diet on March 17, 1992²⁶⁴ and passed into law largely unamended two months later.²⁶⁵ The Financial System Reform Act is comprehensive, containing amendments to sixteen existing statutes, including the laws governing most types of financial institutions, with the notable exception of insurance companies.²⁶⁶ The Financial System Reform Act does not contain anything that should surprise anyone familiar with the deliberations of the two reform councils. Nevertheless, it diverges from the Securities and Banking Reports in several small but significant respects. Consequently, it is worthwhile to review the main provisions of the new law that pertain to the banking and securities industries and to compare them to the recommendations contained in the Banking Report and Securities Report.

1. *Impact on Banking Industry.* First, the Financial System Reform Act expands the definition of a bank's primary activities from "acceptance of term deposits" (*teiki tsumikin no ukeire*) to "acceptance of term deposits, etc." (*teiki tsumikin nado no ukeire*).²⁶⁷ Second, the

accommodation of the two Reports would probably be difficult); Ohta, *supra* note 252; *Kin'yū kaikaku ōkura an: Shōtorishin to nao zure mo*, YOMIURI SHINBUN, Apr. 26, 1991, at 7 (describing the difficulty of reconciling the Banking and Securities Reports because the parties involved had conflicting interests).

262. See *Kin'yū kaikaku ōkura an: Shōtorishin to nao zure mo*, *supra* note 261, at 7.

263. Kenro Kakeya, *Banks Lukewarm on Finance Reform Bill: Entry to Securities Industry Will be Limited*, NIKKEI WKLY., Mar. 28, 1992, available in LEXIS, Nexis Library, Nikkei File.

264. FINANCIAL SYSTEM REFORM BILL, *supra* note 4.

265. See *supra* notes 4-5 and accompanying text.

266. Hiroshi Naka & Akio Nakamura, *Kin'yū seido/shōken torihiki seido kaikaku hō no gaiyō*, 1293 SHŌJI HŌMU 2, 2 (1992).

267. BANKING LAW art. 10(1)(i), Law No. 59 of 1981, amended by FINANCIAL SYSTEM REFORM ACT, Law No. 87 of 1992. The term "*nado*" is equivalent to "etcetera" in English. Although there has been virtually no comment on this apparently minor semantic change, it seems clear that the addition of "*nado*" to the list of banks' primary activities opens the door to

Financial System Reform Act amends the Banking Law to permit all types of banks to participate in the private placement of securities in the secondary market.²⁶⁸ Third, the Financial System Reform Act adds a provision to the Banking Law granting the MOF the authority to establish capital-adequacy requirements and other standards for judging the financial health of banks.²⁶⁹ Fourth, and most significantly, the Financial System Reform Act enables banks and other depository institutions to establish securities and trust banking subsidiaries subject to the condition that they hold at least 50 percent of the shares of such entities.²⁷⁰ However, a rider to the Act stipu-

a vastly expanded interpretation of what those activities are.

268. *Id.* art. 10(2)(vi), amended by FINANCIAL SYSTEM REFORM ACT. Other types of financial institutions are granted the same permission. See SHINYŌ KINKO HŌ [CREDIT ASSOCIATION LAW] art. 53(3)(vi), Law No. 238 of 1951, amended by FINANCIAL SYSTEM REFORM ACT; WORKERS' BANKING INSTITUTION LAW art. 58(2)(xii), Law No. 227 of 1953, amended by FINANCIAL SYSTEM REFORM ACT; CHŪSHO KIGYŌ KYŌDŌ KUMIAI HŌ [LAW FOR SMALL BUSINESS COOPERATIVES] art. 9-8(2)(xi), Law No. 181 of 1949, amended by FINANCIAL SYSTEM REFORM ACT; NŌGYŌ KYŌDŌ KUMIAI HŌ [AGRICULTURAL COOPERATIVE LAW], art. 10(6)(vii), Law No. 139 of 1948, amended by FINANCIAL SYSTEM REFORM ACT; NŌRIN CHŪŌ KINKO HŌ [NŌRIN CHŪKIN BANK LAW] art. 13(1)(ix-ii), Law No. 42 of 1923, amended by FINANCIAL SYSTEM REFORM ACT; SHŌKŌ KUMIAI CHŪŌ KINKO HŌ [SHŌKŌ CHŪKIN BANK LAW] art. 28(1)(xii), Law No. 14 of 1936, amended by FINANCIAL SYSTEM REFORM ACT. Long-term credit banks also benefit from the change by article 17 of the Long-Term Credit Bank Law which makes the relevant sections of the Banking Law applicable to them. LONG-TERM CREDIT BANK LAW, art. 17, Law No. 187 of 1952.

269. BANKING LAW art. 14(2), Law No. 58 of 1981, amended by FINANCIAL SYSTEM REFORM ACT. The Banking Report recommended that in order to achieve a balance with other countries, and for administrative transparency, capital adequacy requirements should be specified by statute. See *supra* note 217 and accompanying text. It has been suggested by some that it is inappropriate to require banks only engaged in domestic banking to meet an international standard and that the flexibility granted by allowing the MOF to set standards was necessary. *E.g.*, Yamashita Tomonobu, *Kin'yū seido ni kansuru horitsu no seibi*, SHŌJI HŌMU, Aug. 15, 1992, 17, 18. This argument does not explain, however, why the rationales for a statutory capital-adequacy requirement are no longer operative.

270. BANKING LAW art. 16(2), amended by FINANCIAL SYSTEM REFORM ACT; FOREIGN EXCHANGE BANK LAW art. 9(8), Law No. 67 of 1954, amended by FINANCIAL SYSTEM REFORM ACT; WORKERS' BANKING INSTITUTION LAW art. 58(3), Law No. 227 of 1953, amended by FINANCIAL SYSTEM REFORM ACT; LONG-TERM CREDIT BANK LAW art. 13(2), Law No. 187 of 1952, amended by FINANCIAL SYSTEM REFORM ACT; CREDIT ASSOCIATION LAW arts. 54(15)-(16), Law No. 238 of 1951, amended by FINANCIAL SYSTEM REFORM ACT; LAW CONCERNING THE FINANCIAL ACTIVITIES OF COOPERATIVE ORGANIZATIONS art. 4, Law No. 183 of 1949, amended by FINANCIAL SYSTEM REFORM ACT; AGRICULTURAL COOPERATIVE LAW art. 11(16), amended by FINANCIAL SYSTEM REFORM ACT; NŌRIN CHŪKIN BANK LAW arts. 22(2)-(4), Law No. 42 of 1923, amended by FINANCIAL SYSTEM REFORM ACT. Note that in the case of *shinkin* banks, labor banks, agricultural and other cooperatives, only federations of these entities rather than individual institutions are permitted to acquire and own securities or trust subsidiaries. See sources cited *supra*. Because trust banks are ordinary banks empowered to engage in trust activities by a separate statute, authority for the acquisition of subsidiaries by trust banks is

lates that, for "the time being," licensing of bank securities subsidiaries will be conditioned on their not engaging in securities brokering.²⁷¹ The same section of the Act also clarifies the rules governing bank ownership of foreign-incorporated trust and securities subsidiaries.²⁷²

In addition, the Financial System Reform Act establishes that certain transactions between parent banks and their subsidiaries will be restricted or prohibited,²⁷³ although the creation of specific firewalls is left largely to administrative discretion.²⁷⁴ The Financial System Reform Act also allows smaller institutions, which are generally too small to establish full subsidiaries, to engage in certain trust and securities-related activities by themselves.²⁷⁵ Similarly, the Financial System Reform Act expands the scope of other activities in which the smaller banks and depository institutions are permitted to engage.²⁷⁶ Finally, as a possible indicator of the troubles experienced throughout the banking industry, the Financial System Reform Act amends the 1968 Law Concerning Amalgamation and Conversion of Financial Institutions by making it possible for all types of depository institutions to merge or convert to a more viable format.²⁷⁷ This will

derived from the Financial System Reform Act's amendments to the Banking Law. *See supra* note 55 and accompanying text. The Act does not alter the Antimonopoly Law's basic prohibition on ownership of greater than 5 percent of a company's shares by a financial institution. *Compare* ANTIMONOPOLY LAW art. 11, Law No. 54 of 1947 *with* FINANCIAL SYSTEM REFORM ACT *passim* (containing no amendments in this area). This means that not only will subsidiaries have to be licensed by the MOF, but the parent companies will have to apply to the FTC for an exemption from the Antimonopoly Law's prohibition. ANTIMONOPOLY LAW art. 11, Law No. 54 of 1947; *see* Naka & Nakamura, *supra* note 266, at 4.

271. FINANCIAL SYSTEM REFORM BILL, *supra* note 4, app., art. 19.

272. BANKING LAW art. 16(4), Law No. 58 of 1981, *amended by* FINANCIAL SYSTEM REFORM ACT.

273. *Id.* art. 16(3), *amended by* FINANCIAL SYSTEM REFORM ACT.

274. Ōkura Shō [Ministry of Finance], *Kin'yū seido kaikaku jissshi no gaiyō ni tsuite*, Dec. 17, 1992, *reprinted in* KIN'YŪ ZAISEI JIJŌ, Jan. 4, 1992, at 107 [hereinafter *Reform Outline*].

275. *E.g.*, AGRICULTURAL COOPERATIVE LAW art. 10(7), (8), *amended by* FINANCIAL SYSTEM REFORM ACT.

276. Although a detailed discussion of the full extent of changes wrought by the Financial System Reform Act is beyond the scope of this Note, some examples of activities opened up to smaller institutions such as *shinkins* and labor banks include dealings in local government and certain corporate bonds, safekeeping of valuables, and guaranteeing of debts. *See, e.g.*, LABOR BANK LAW art. 58(2)(vii), Law No. 227 of 1953, *amended by* FINANCIAL SYSTEM REFORM ACT (guarantee of liabilities); CREDIT ASSOCIATION LAW art. 53(8)(i), Law No. 238 of 1951, *amended by* FINANCIAL SYSTEM REFORM ACT (dealing with local government bonds); LAW FOR SMALL BUSINESS COOPERATIVES art. 9(8)(2)(xiv), Law No. 181 of 1949, *amended by* FINANCIAL SYSTEM REFORM ACT (safekeeping deposit of valuables). Note again that the Act repeals the *sōgo* Bank Law. *See supra* notes 47-48 and accompanying text.

277. LAW CONCERNING AMALGAMATION AND CONVERSION OF FINANCIAL INSTITUTIONS arts. 3, 4, Law No. 86 of 1968, *amended by* FINANCIAL SYSTEM REFORM ACT. Under the

presumably make it easier for the MOF to save troubled institutions by encouraging them to merge with healthy ones.

2. *Impact on Securities Industry.* With respect to the securities industry, the Financial System Reform Act makes substantial changes which are largely outside the scope of this Note. Briefly, the Financial System Reform Act permits securities companies to establish trust and banking subsidiaries,²⁷⁸ gives a more complete definition to the term "private placement,"²⁷⁹ and expands the definition of "security," although without providing a thorough American-style statutory definition as recommended by the Securities Report.²⁸⁰ The Financial System Reform Act also establishes new and more stringent disclosure rules and generally establishes a more well-defined legal structure for securities transactions.²⁸¹ Under its amendments to the Securities Transaction Law, the Financial System Reform Act permits banks to act as intermediaries for some of the instruments that the Act newly designates as securities.²⁸²

preamendment version of the merger law, a number of types of institutions, such as labor banks and long-term credit banks, were precluded from merging with other types of institutions. LAW CONCERNING AMALGAMATION AND CONVERSION OF FINANCIAL INSTITUTIONS arts. 3, 4, Law No. 86 of 1968 (amended 1992).

278. SECURITIES TRANSACTION LAW art. 43(2), Law No. 25 of 1948, amended by FINANCIAL SYSTEM REFORM ACT.

279. *Id.* art. 2(8)(vi). The amendments clarify that private placements are "securities activities" for legal purposes, but that banks may, with the MOF's permission, participate in private placements. *Id.*

280. SECURITIES TRANSACTION LAW art. 2(1), (2), Law No. 25 of 1948, amended by FINANCIAL SYSTEM REFORM ACT; SECURITIES REPORT, *supra* note 3, at 155-57. In fact, apart from a few specific instruments such as commercial paper, the definition of security is expanded only to the extent that the Act lists a number of instruments that may be designated as securities by administrative order some time in the future. FINANCIAL SYSTEM REFORM ACT, amending SECURITIES TRANSACTION LAW art. 2(1), (2). An example of such a provision is as follows: "[t]he term 'securities' in this law shall mean those as mentioned in the following: . . . (viii) *Those promissory notes issued by a judicial person in order to procure necessary funds for its business as may be designated [as securities] by Ministry of Finance Order.*" FINANCIAL SYSTEM REFORM ACT, amending SECURITIES TRANSACTION LAW art. 2(1)(viii) (author's translation)(emphasis designates amendment). Some industry insiders have voiced dissatisfaction over the legislation's disregard for the recommendations of the Securities Council in this regard. *Tokumei Zadankai: Tōsho no kaikaku no rinen to kairi shite inai ka?*, KIN'YŪ ZAISEI JIJŌ, Apr. 20, 1992, at 18 [hereinafter *Round Table Discussion 4*].

281. SECURITIES TRANSACTION LAW arts. 3-66(3), amended by FINANCIAL SYSTEM REFORM ACT.

282. *Id.* art. 65, 65(2), amended by FINANCIAL SYSTEM REFORM ACT.

B. New Factors Affecting Reform

Three important factors must be kept in mind when looking at the Financial System Reform Act as the end product of the reform process: (1) the manner in which the Financial System Reform Act is to be implemented; (2) the effects of changing economic conditions within the financial industry; and (3) the role of recent financial scandals in shaping the reform process.

1. *Implementation: The MOF Tightens its Grip.* Financial "reform" has not been in any way synonymous with "deregulation" or "liberalization" as some originally thought.²⁸³ Amended Articles 16-2 and 16-3 of the Banking Law make this perfectly clear.²⁸⁴ These articles leave a great deal of discretion to the MOF, either directly through the grant of rulemaking authority or indirectly through the MOF's ability to interpret the etceteras and ambiguous language. These two provisions also set the tone for the entire Financial System Reform Act. For every new sphere of activity the Financial System Reform Act makes available to the different types of financial institutions, the more the MOF is granted the gatekeeping power to regulate entry into the sphere and the authority to fine tune activities within this sphere.²⁸⁵ In effect, the Financial System

283. See Sender, *supra* note 161, at 131 ("To MOF officials the very term deregulation sounds . . . too messy . . . ; they prefer 'rationalization' or 'consolidation' or even 'reregulation.'").

284. The text of the law reads as follows:

ARTICLE 16-2 (OWNERSHIP OF STOCK IN SECURITIES COMPANIES, ETC.)

A bank may, *with the permission of the Minister of Finance*, acquire and own a number of stocks (limited to those with voting rights) greater than 50 percent of the total number of outstanding shares in a securities company, trust bank, or other bank (*limited to those designated by Ministry of Finance ordinances*)

ARTICLE 16-3 (TRANSACTION, ETC., WITH SUBSIDIARIES) A Bank may not engage in the following conduct with its subsidiaries, *etc.* . . . or customers (provided this may not be applicable in situations where the performance of the transaction in question is necessary for the public interest and *permission has been received from the Minister of Finance*):

1) Transactions with the subsidiary, *etc.*, where its conditions *are determined* to be disadvantageous to the [parent] bank when compared to the bank's normal conditions for such a transaction.

2) [T]ransactions or activities [between a parent bank and its subsidiary or the subsidiary's customer] that are *designated by Ministry of Finance Ordinances* as potentially hindering the [parent] bank's sound and proper operations.

SECURITIES TRANSACTION LAW arts. 16(2), (3), *amended by FINANCIAL SYSTEM REFORM ACT* (author's translation) (emphases highlight discretionary elements left to the MOF).

285. As mentioned previously, the amendments to the definitional article of the Securities and Exchange Law leave the process of defining new types of securities almost entirely to MOF or Cabinet ordinances. See *supra* note 280 and accompanying text. The Act also adds a new requirement for a bank to obtain authorization from the MOF when it tries to establish a

Reform Act greatly expands the authority of the MOF to regulate financial institutions. This is an interesting result considering that the liberalization of finance was a primary motivation for the reform process.²⁸⁶

On December 17, 1992, the MOF filled many of the gaps left in the Financial System Reform Act when it issued its blueprint for reform, titled "Concerning the Outline for the Implementation of Financial System Reform" (Outline).²⁸⁷ Projecting that implementation of the Financial System Reform Act will commence in April 1993, the Outline summarizes some of the regulations that the MOF intended to establish in order to implement the Financial System Reform Act.²⁸⁸ First, securities subsidiaries of banks will not be permitted to engage in the issue, distribution, or brokering of most forms of equity securities.²⁸⁹ Similarly, trust bank subsidiaries will be

securities or trust subsidiary abroad; this requirement is likely to strengthen the MOF's supervision over overseas activities of banks. See Kazumi Akiyama & Akio Nakamura, *Kin'yū seido oyobi shōken torihiki seido no kaikaku no tame no kankei hōritsu no seibi nado ni kansuru hōritsu ni tsuite*, JURISUTO, Sept. 1, 1992, 129, at 131.

286. See *Round Table Discussion 4*, *supra* note 280, at 19.

287. *Reform Outline*, *supra* note 274, at 107. Immediately before publication of this Note, a number of MOF and cabinet ordinances implementing the details of the Financial System Reform Act were issued. Due to the timing, quantity, and scope of these ordinances a detailed analysis of their content is impossible. A preliminary examination, however, indicates that they are largely consistent with the proposals contained in the Reform Outline: minimum capitalization of securities companies was raised to ¥10 billion; minimum capitalization requirements of most other types of financial institutions were doubled or significantly raised; detailed rules pertaining to firewalls, securities transactions, etc., were also established. See generally KANPŌ, Mar. 3, 1993 (Special Edition), at 1-127.

288. *Id.*

289. *Id.* Specifically, securities subsidiaries of banks will not be permitted to deal or broker convertible bonds, warrant bonds, and warrant securities. *Id.* They are prohibited from all dealings, including underwriting, in stocks, stock index futures, and stock index options. *Id.* This effectively limits banks' securities subsidiaries to dealing in bonds, investment securities, and primary market transactions involving convertible bonds and warrants. *Id.* A question that remains unanswered is what will happen if, instead of establishing a securities subsidiary, a bank acquires a majority interest in an existing brokerage house. The MOF has indicated that, with very limited exceptions, the FTC would deem such a transaction anticompetitive and refuse to grant an Antimonopoly Law Article 11 exemption. See Naka & Nakamura, *supra* note 266, at 4. This approach avoids a specific answer to the difficult question of whether a securities house acquired by a bank in this manner would be allowed to continue its brokerage activities. The MOF has held out the possibility of participating in the full range of securities activities through an acquired subsidiary as a carrot to enlist the aid of banks in bailing out Japan's many troubled smaller securities firms. See *Bankers' Embrace*, *ECONOMIST*, Nov. 28, 1992, at 88. *But see* David Sneider, *Financial Services Reform in Japan*, *INT'L SEC. REG. REP.*, Feb. 9, 1993, at 6 ("MOF has made it clear that acquisitions [of existing securities firms] will not be approved except in a 'rescue' context."). Because the Act only requires a majority interest, another question that remains is whether the MOF will permit banks to establish jointly-owned subsidiaries, with a

restricted in the scope of trust activities in which they may engage.²⁹⁰ The MOF will, however, in two or three years, reconsider the scope of activities in which subsidiaries are permitted to engage.²⁹¹

The Outline also establishes a large number of firewalls. These include restrictions on personnel exchanges between parent and subsidiary, dealings with common clients, transactions between parent and subsidiary, and the shared use of facilities.²⁹²

As for the timing of mutual entry, the Outline will allow long-term credit banks, trust banks, and central cooperatives, such as the *Nōrin chūkin* Bank, to establish securities subsidiaries first.²⁹³ Securities companies, long-term credit banks, the Bank of Tokyo, and the national federations of specialized financial institutions will have priority in establishing trust subsidiaries.²⁹⁴ One year after these institutions have established subsidiaries, the MOF will consider allowing other banks (i.e., city banks) to set up their own subsidiaries.²⁹⁵ Finally, the Outline eliminates the "three bureaus guidance" controls on foreign bond issues and raises the minimum capitalization requirements for banks and securities companies to ¥20 billion and ¥100 billion respectively.²⁹⁶

Although the Outline substantially clarifies the content of the Financial System Reform Act, it nevertheless leaves several details undefined, particularly concerning the question of firewalls.²⁹⁷ Thus,

minority interest held by another bank or company. *See Round Table Discussion 4, supra* note 280, at 21.

290. *Reform Outline, supra* note 274, at 108. Perhaps the only bright spot in the whole Outline was the MOF's indication that it intends to allow regional financial institutions to engage in land trust, public benefit trust, special gift, and movable properties trust activities without establishing trust subsidiaries. *See id.* at 109.

291. *See id.* at 107.

292. *Id.* at 107-08; *see also* Sneider, *supra* note 289, at 6 (summarizing firewalls to be established).

293. *Reform Outline, supra* note 274, at 109.

294. *Id.*

295. *Id.*

296. *Id.*

297. For example, in its discussion of firewalls, the Outline states that:

Restrictions on Sharing of Business Premises, etc.: Regulations, such as disallowing the establishment of the head office of a securities subsidiary in the same building as the head office of the parent financial institution, will be imposed. In addition, regulations on the establishment of branches or business offices of a securities subsidiary sharing the same building as the offices, etc., of the parent financial institution and regulations on the joint use of computer facilities, dealing rooms, etc., will be imposed.

Id. at 108 (author's translation). Obviously it would be difficult to consider establishing a subsidiary without greater elaboration of these firewalls.

the Outline itself will have to be further clarified before anyone can begin to consider establishing a subsidiary.

2. *More Bad Times.* Times have changed since Japan's financial industries first began developing new products and expanding into new fields of activity. Many of the economic factors that originally stimulated reform are no longer operative. The bursting of the bubble economy and consequent plummeting of share and land prices have had serious consequences throughout the Japanese economy.²⁹⁸ The financial industry has been hit particularly hard by "Japan's monetary implosion."²⁹⁹

The magnitude of banks' bad debt problems came to light at the peak of the reform process. Many banks are saddled with a huge portfolio of nonperforming loans,³⁰⁰ collateralized primarily with illiquid real estate whose value has sunk drastically.³⁰¹ The drop in

298. See, e.g., *Corporate Japan Attempts Another Rebirth*, ECONOMIST, Nov. 21, 1992, at 75. ("[F]or the third time since the second world war, Japanese business is facing massive and painful readjustment."); *Japanese Banks: From Bad to Worse*, ECONOMIST, Nov. 7, 1992, at 99 ("Japanese firms now face their third year of declining profits. . . . Businesses with net debts totalling 5.2 trillion yen went bust in the first nine months of 1992.").

299. *Japan's Monetary Implosion*, ECONOMIST, Oct. 31, 1992, at 75; see also Steven Butler, *Gloomy Report from Bank of Japan*, FIN. TIMES, Aug. 26, 1992, at 10; Butler, *supra* note 164, at 12.

300. Estimates of the extent of these loans vary greatly. See, e.g., Martin, *supra* note 29, at 16 (citing MOF estimates that Japan's top twenty-one banks hold ¥7-8 trillion in loans); *Japan's Monetary Implosion*, *supra* note 299, at 75 (estimating bad loans held by banks at up to ¥60 trillion yen).

301. See Martin, *supra* note 29, at 16. See generally *Bad-Debt Troubles*, ECONOMIST, Sept. 14, 1991, at 97, 98 (explaining that banks used non-banks to bypass official restrictions on loans to property companies); *Deep in Bad Debt*, ECONOMIST, Nov. 2, 1991, at 70, 72 (noting problems arising from property lending). When property prices were booming in the 1980s, in order to circumvent restrictions on bank lending to real estate companies, banks lent money to nonbank affiliates which in turn lent heavily to real estate speculators. Once land prices fell, the banks were left holding the bag. See *Japan's Non-banks: What a Mess*, ECONOMIST, Oct. 26, 1991, at 96, 98; Martin, *supra* note 29, at 16. The bad debt problem has reached such a magnitude that in January 1993, under government auspices, the banking industry established the Cooperative Credit Purchasing Company (CCPC). See Robert Thomson, *Restoring Faith in a Banking System—Japan's CCPC will Tackle the Industry's Problems*, FIN. TIMES, Jan. 28, 1993, at 20. Similar in function to the United States Resolution Trust Corporation, the CCPC will buy up property used as collateral for bad loans. See *Much Ado About Nothing*, ECONOMIST, Nov. 7, 1992, at 99. While it was originally envisioned that the government would help fund this corporation, it ultimately did not, thus rendering the whole operation little more than an accounting artifice. See *id.* The nonbanks and MITI are reportedly discussing the establishment of a similar institution to buy up the bad loans of nonbanks. *Agency Proposed to Protect Investors in Leases and Credits*, Comline Daily News-Tokyo Financial Wire, Dec. 11, 1992, available in LEXIS, Nexis Library, COMLIN File.

share prices has similarly had direct, negative effects on banks.³⁰² Furthermore, the overall economic climate has seriously affected the ability of banks to make a profit. Troubled companies are drawing down their deposits,³⁰³ and stagnant loan growth means that it will be difficult for banks to increase lending, which has been their traditional technique for offsetting bad debts.³⁰⁴ Securities companies have similarly been battered by the collapse of stock prices, and all but the largest are currently operating at a loss.³⁰⁵

As a result of these economic woes, banks and other financial companies are going bankrupt,³⁰⁶ restructuring,³⁰⁷ cutting personnel,³⁰⁸ and reducing the scope of their overseas activities.³⁰⁹ Given the present economic climate and the substantial barriers to, and limitations on, the establishment of subsidiaries, few financial institutions have any interest in taking such action.³¹⁰ Most are

302. See *supra* note 167 and accompanying text. Apart from the obvious economic loss caused by the drop in share prices, and because banks are allowed to count up to 45 percent of unrealized capital gains (hidden assets) towards meeting the new international capital adequacy requirements, any drop in the stock market hinders a bank's ability to fulfill these requirements. See *Japan's Banks Count Their Capital*, *ECONOMIST*, Feb. 8, 1992, at 82; *Japanese Shares: Not What They Used to Be*, *ECONOMIST*, Jan. 25, 1992, at 79, 80.

303. *Japan's Monetary Implosion*, *supra* note 299, at 75.

304. *Bad-Debt Troubles*, *supra* note 301, at 98. See generally *Lending by Japan's Banks Grows 2.0% in Jan.*, Japan Econ. Newswire, Feb. 9, 1993, available in LEXIS, Nexis Library, JEN File (loan growth continued to be slow and the limited growth that did occur was attributable to relief loans to troubled companies rather than loans for capital investment). The requirement that banks meet the BIS 8 percent capital-adequacy requirements that are scheduled to come into force in March 1993 have also restrained banks' ability to expand lending. See *BIS Rule Restained Bank Lending in FY '91, Sources Say*, Japan Econ. Newswire, June 4, 1992, available in LEXIS, Nexis Library, JEN file; *Japan's Banks Count Their Capital*, *supra* note 302, at 82.

305. *Japanese Shares: Not What They Used to Be*, *supra* note 302, at 80; see also *Bankers' Embrace*, *supra* note 289, at 88.

306. In 1991 Japan's Deposit Insurance Corporation was, for the first time since its inception in 1971, called on to bail out a troubled bank by financing its merger with another bank. See *Japanese Banks: More Pain*, *ECONOMIST*, May 9, 1992, at 105. A second bailout took place in spring of 1992. *Id.* Because the MOF has previously been able to "encourage" banks to assist troubled comrades without relying on the Deposit Insurance Corporation, these events indicate a breakdown of the traditional informal safety net. See, e.g., Sender, *supra* note 161, at 135.

307. See, e.g., Emiko Terazono, *Leading Japanese Bank to Restructure*, *FIN. TIMES*, Sept. 4, 1992, at 21. Some of the smaller securities companies are reported to be considering mergers in order to survive. *Bankers' Embrace*, *supra* note 289, at 88.

308. See, e.g., *Dismal Performance Driving Japanese Banks to Streamline*, Japan Econ. Newswire, Aug. 4, 1992, available in LEXIS, Nexis Library, JEN File.

309. See, e.g., Richard Waters, *Japanese Banks Step up Pace of International Withdrawal*, *FIN. TIMES*, Nov. 13, 1992, at 23 (reporting that Japanese banks reduced their overall international banking assets by U.S. \$53 billion in the second quarter of 1992).

310. See *Japanese Savings: Safe as Post Offices*, *ECONOMIST*, Dec. 26, 1992, at 100. ("Banks . . . are no longer in a hurry to enter the securities business, which is conspicuously unprofitable

concerned with mere survival. In fact, insiders from each financial sector have indicated that they would prefer to see the reform process frozen for the next one or two years.³¹¹

3. *Scandals.* Recent financial scandals have been an important factor in the process of financial reform. During the summer of 1991, when the Financial System Reform Council issued its Banking Report, a number of scandals within the financial industry came to light. Scandals involving large securities houses were perhaps the most egregious. Nomura Securities was eventually punished for financing the securities transactions of organized crime leaders, compensating favored clients for losses, and manipulating the market.³¹² Several prominent banks were also involved in a highly publicized scandal in which bank employees issued forged certificates of deposit to a restaurant owner who used them as collateral to borrow ¥240 billion worth of loans, which she spent on stock speculation before going bankrupt.³¹³ These highly publicized scandals called into doubt the ability of the MOF to control the financial industries through informal

these days.”). In an anonymous symposium published shortly before the Outline was issued, industry insiders discussed the prospects of establishing subsidiaries. *Zadankai: Kin'yū seido kaikaku no ketchaku to wa nani ka?*, KIN'YŪ ZAISEI JIJŌ, Dec. 7, 1992, at 22 [hereinafter *Round Table Discussion 5*]. The representative of the trust banking industry stated unequivocally that there was virtually no merit in establishing a securities subsidiary. *Id.* at 24. The securities industry representative voiced similar sentiments, noting that the costs of establishing trust banking subsidiaries would be prohibitive even for the largest securities houses, which are currently making drastic cuts in costs and personnel. *Id.* at 25. Less delicately, the same representative suggested that any businessman who expanded into the trust business given the current climate was an idiot. *Id.* Even the representative of the city banks, which are generally regarded to be the winners in the reform process, indicated that the current economic climate was at its worst for entry into new business, and the substantial cost of establishing a subsidiary would be money better spent in other endeavors. *Id.* at 23, 26; see also *Give Us Deregulation—But Not Yet*, EUROMONEY, Dec. 1992, at 66. Paradoxically, now that the MOF has decided to allow two of the troubled long-term credit banks to establish securities subsidiaries, there has been some discussion that the MOF may actually force several of the large securities houses to establish trust subsidiaries, ostensibly to balance the mutual entry. *Kin'yū seido kaiku: Nitsumaru rigai chōsei*, KIN'YŪ ZAISEI JIJŌ, Dec. 7, 1992, at 16; *Round Table Discussion 5, supra*, at 26; see also Toshio Shinmura & Naoyuki Isono, *Institutions Face New Game as Financial Reforms Pass: Phased Liberalization Expected to Take Years to Complete*, NIKKEI WKLY., June 27, 1992, at 1 (reporting on financial system reform plan that will allow financial services to form various subsidiaries).

311. *Round Table Discussion 5, supra* note 310, at 27.

312. See *Unmasking Honourable IBI*, ECONOMIST, Oct. 12, 1991, at 79; see also *Under the Volcano*, ECONOMIST, Sept. 7, 1991, at 75.

313. *Unmasking Honourable IBI, supra* note 312, at 79. Although the securities scandals garnered greater publicity, the banking scandals were much larger than the securities scandals in monetary terms. Anthony Rowley, *Ministry of Myopia*, FAR E. ECON. REV., Sept. 12, 1991, at 48.

administrative guidance.³¹⁴ The scandals also brought the FTC, until recently dubbed "the watchdog that never bites," into the field of administrative financial regulation, and thus into the MOF's territory.³¹⁵ The scandals highlighted the lack of transparency in the MOF's administration of financial markets. As stated by David Mulford, United States Treasury Undersecretary for International Affairs, the difference between recent financial scandals in Japan and the United States is that rules were clearly broken in the United States, whereas there were no clear rules in Japan.³¹⁶ Finally, the scandals hurt the securities companies economically, especially through the loss of customers who had begun to doubt the integrity of the stock market.³¹⁷

C. Analysis

It is still too early to pass final judgment on the Financial System Reform Act. At the time of this writing, implementation of the Financial System Reform Act has just begun. Many issues remain to be worked out, and in the coming months, new and unforeseen developments will undoubtedly arise. In addition, financial reform will not be complete until other sectors of the financial system are addressed. Although the Financial System Reform Act will have a significant impact on the trust banks, it does not significantly alter the pre-World War II Trust Business Law and Trust Law which need to be updated to reflect a host of new trust-related products.³¹⁸ The insurance industry is also suffering from its own economic problems that need to be addressed,³¹⁹ as do those of the nonbanks.³²⁰ Re-

314. *A Ministry Diminished*, ECONOMIST, Feb. 1, 1992, at 86; see also Kenji Nagano, *Push Seen for New Rules of Integrity*, NIKKEI WKLY., July 6, 1991, at 4 (reporting severe public disapproval of four large securities companies which were involved in scandals).

315. *A Ministry Diminished*, *supra* note 314, at 86; see Hayato Yokota, *Bankers Pressed to Heighten Competition*, NIKKEI WKLY., Nov. 30, 1991, at 15. With regard to the securities scandal, the FTC forced the four largest firms to sign consent decrees agreeing not to pay secret compensation or guarantee returns on pain of criminal sanctions. *A Ministry Diminished*, *supra* note 314, at 86.

316. Satoshi Isaka, *U.S. to Japan: Speed Financial Reforms*, NIKKEI WKLY., Oct. 26, 1991, at 4. The same official also stated that "[t]he scandals, in a more general way, reflect the very problems we have concentrated on for eight years." *Id.*

317. See Robert Thomson, *A Besieged Industry Draws up Plans for Survival*, FIN. TIMES, Nov. 20, 1992, at 21.

318. See Yoshihiro Kataoka, *Kin'yū seido kaikaku hōan to sono haikai*, KIN'YŪ ZAISEI JIJŌ, Apr. 5, 1992, at 4, 6.

319. See *Withdrawal Symptoms*, ECONOMIST, Dec. 19, 1992, at 75. In October 1992, a council of insurance industry representatives issued an interim report endorsing major reform of their

form of the postal savings network will also be crucial if the Financial System Reform Act is to have any meaningful impact.³²¹ True change, therefore, is projected to take several years. Nevertheless, this examination of the progress of financial reform to date merits some comments, albeit from an outsider's point of view.

Compared to England's "Big Bang" financial reform³²² of several years ago, the Financial System Reform Act is a dull thud at best. Yet, given the recent turn of events this is hardly surprising. The almost exclusive delegation of authority to the MOF to implement the Financial System Reform Act and to define its terms reflects the concerns of the Act's drafters, the MOF officials.³²³ Accordingly, it is possible to interpret the final shape of the Financial System Reform Act in two different ways. The more charitable interpretation is that MOF officials, faced with a financial crisis of historic magnitude, felt that the only way to reform the financial system without causing an economic calamity was to retain firm control over the speed and

industry. *Japanese Insurance: Change in the Air*, ECONOMIST, Dec. 5, 1992, at 85. A major new insurance law is expected to be enacted in 1995. *Id.*

320. See *Japan's Non-banks: What a Mess*, *supra* note 301, at 96. A MOF advisory panel was set up in October 1991 to discuss reform in the nonbank industry, and numerous new rules regulating nonbanks were passed contemporaneously with the Financial System Reform Act. *Japan Still Shies From Embracing ABS, MORTGAGE-BACKED SECURITIES LETTER*, July 6, 1992, available in LEXIS, Nexis Library, IDD File; Yoko Kobayashi, *Japan Panel Proposes Tighter Rules for Non-banks*, Reuters, June 15, 1992, available in LEXIS, Nexis Library, OMNI File; Neil Weinberg, *Nonbank Institutions in Japan to be Supervised Although the Heavy Damage is Already Done*, 2 THOMSON'S INT'L BANKING REGULATOR, July 6, 1992, at 3, available in LEXIS, Nexis Library, INTREG File. It was also reported that the MOF was planning to establish a section within its Banking Bureau to monitor nonbanks. *Japan MOF to Set up Section to Monitor Non-banks*, Reuters, June 29, 1992, available in LEXIS, Nexis Library, OMNI File.

321. Because of its status as a government controlled institution, the postal saving network is able to offer interest rates and terms to individual depositors with which banks cannot compete. See *Japanese Monetary Growth: Slow, However You Slice It*, ECONOMIST, Oct. 19, 1991, at 96. In addition to their competitive advantage postal accounts are reliable. Thus, as a result of the financial scandals and rising concern about the health of many financial institutions, money has been flowing into postal coffers at a phenomenal rate: ¥10 trillion during the period of June 1991 to April 1992. See *A Better Deal for Customers?*, ECONOMIST, Apr. 4, 1992, at 100. The existence of the postal savings network distorts the financial marketplace by rewarding risk-averse behavior. See generally *Japanese Savings: Safe as Post Offices*, *supra* note 310, at 100 (noting the advantages of deposits in the postal savings system over private banks).

322. In October 1986, the British government carried out a sweeping reform, the "Big Bang" of the British financial system, including the complete removal of the wall between banking and securities activities. DEREK F. CHANNON, GLOBAL BANKING STRATEGY 238-40 (1988).

323. In Japan, "most legislation is drafted and sponsored by the concerned ministries. . . ." 2 DOING BUSINESS IN JAPAN § 3.02[2][c] (Zentaro Kitagawa ed., 1992). The Prime Minister of Japan is empowered to represent the cabinet and thus the Ministries in submitting bills to the Diet. KENPŌ [Constitution] art. 72 (Japan).

direction of change. Under this view, the MOF's concern for the continued health of existing financial institutions and the economy in general has resulted in the MOF's slow and cautious implementation of the Financial System Reform Act.

A less generous interpretation of the Financial System Reform Act is that deregulation of some aspects of the financial system such as interest rates, the globalization of Japanese financial markets, the spontaneous expansion of the activities of Japanese banks at home and abroad, and the damage caused to the MOF's prestige by the scandals of 1991, together constitute a serious threat to the MOF's dominance in the field of financial regulation. The Financial System Reform Act may be seen as a brilliant maneuver by the MOF to regain control. By granting privileges to engage in new areas of business to each type of financial institution with one hand and tightening its grip on the whole system with the other the MOF is subjecting these privileges to its own administration. Similarly, the MOF had to ensure that its constituents, the financial institutions, remained stable throughout the reform in order to prevent a challenge to its authority to administer them.

Both of these interpretations are probably correct to a certain extent. Financial reform, however, was not supposed to be about protecting the authority of the MOF. Furthermore, when the Financial System Reform Act is viewed together with the Banking and Securities Reports, several problems become apparent. First, many of the buzzwords repeatedly used by the reformers—"financial liberalization," "internationalization," and "user convenience"—were nothing more than that, buzzwords.³²⁴ As noted previously, given the amount of control the MOF will have over the reform process, "liberalization" is not the best description of the Financial System Reform Act.³²⁵ Similarly, nothing about the Financial System Reform Act makes it readily apparent that its drafters were concerned with the increasingly international nature of Japan's financial markets. The only significant proposal in the Banking Report that had a specific international orientation, the statutory imposition of the BIS capital-adequacy standards,³²⁶ was ignored.

324. See *Kinseichō hōkoku an: Gyōkai e no hairyo yūsen*, *supra* note 244, at 7. Participants in the discussion wished that the legislators had kept the original objectives of reform in mind during the process of enactment. See *Round Table Discussion 4*, *supra* note 280, at 21.

325. See *supra* notes 283–86 and accompanying text.

326. See *supra* note 217 and accompanying text.

Furthermore, "user convenience" must have a hollow ring to many in Japanese financial circles.³²⁷ After all, under the Financial System Reform Act, consumers may soon hypothetically walk into the local branch of the Industrial Bank of Japan Securities Co. to purchase one hundred shares of NEC, only to be told politely that as a long-term credit bank securities subsidiary, it is not currently permitted to engage in brokering.³²⁸ In the business context, it also remains to be seen whether companies will actually be interested in doing business with a securities company that can underwrite bonds but not securities, can participate in private placements but not actually sell stocks, and so on.³²⁹ If not, it is difficult to see how subsidiaries can develop a customer base while they wait to be allowed to expand into other spheres of activity.

The only consistent desire on the part of the reformers appears to have been that reform be gradual and that no institutions be sacrificed in the process.³³⁰ A comparison of the Banking Report, the Financial System Reform Act, and the Outline best illustrates this aspiration. As noted above, the Banking Report discusses internationalization, financial liberalization, securitization, and user needs at great length. However, it only makes a few proposals of secondary importance. The Statement of Reasons at the end of the Financial System Reform Bill also explains the need to expand the activities of financial institutions and reform the securities laws to protect investors and depositors by ensuring the sound management of financial institutions, encouraging efficient competition, and establishing a financial system that can interact with those of other countries.³³¹ In contrast, the Outline makes little mention of protecting either investors or foreign markets. It does, however, frequently refer to "the soundness of securities companies,"³³² "the healthy development of capital markets,"³³³ and "disciplined entry" into new spheres of business.³³⁴

This is not to suggest that the stability of institutions is not a legitimate concern or that the MOF has completely ignored other

327. See generally *Kukyō no shōken makikaeshi kenmei*, ASAHI SHINBUN, Dec. 13, 1992, at 3 (citing fears that true reform leading to financial liberalization from the point of view of user convenience will be effectively stymied by the turf battles of the banks and securities companies).

328. See FINANCIAL SYSTEM REFORM ACT, *supra* note 5, app., art. 19.

329. See *supra* notes 209-10, 268, 271, 289 and accompanying text.

330. See generally *supra* notes 248-51 and accompanying text.

331. See FINANCIAL SYSTEM REFORM BILL, *supra* note 4, at 68.

332. *Reform Outline*, *supra* note 274, at 107.

333. *Id.*

334. *Id.* at 109.

aspects of reform. From across the Pacific, it is easy to suggest that troubled institutions should be allowed to fail. Yet, as noted by one observer, "Japan lacks the safety net of a sturdy deposit insurance system. . . . To allow banks to fail in this environment would be to risk panic."³³⁵ A wave of bank failures in 1927 and the resulting economic and political chaos were factors in both the pre-World War II rise of the militarists and the concentration of financial resources under the control of a few large banks which came to serve their cause.³³⁶

Nevertheless, by focusing on protecting financial institutions, the MOF may have inadvertently destroyed the spirit of financial reform. As we have seen, the cost and inconvenience to financial users of raising capital at home was one factor in the flight of Japanese money overseas. It is debatable whether the MOF has done much to alleviate this situation. Similarly, Japan's financial system has become a very important part of the world economy. Accordingly, just as the current economic problems of Japan's banks are having an impact worldwide, failure to adequately address the international aspects of financial reform is also likely to have global repercussions.³³⁷

Additionally, insofar as reform was inevitable, the securities industry may have lost the battle but appears to have won the war. From the terms of the Financial System Reform Act, the securities companies would appear to have been the biggest losers. One of the securities industry's most important proposals, a unified definition of security, was not included in the Financial System Reform Act. In addition, the securities scandals, coming at the peak of reform activities, forced the MOF to shift the focus of reform more onto cleaning up the securities industry.³³⁸

335. Rosenbluth, *supra* note 43, at 100.

336. *See id.* at 81-82; SHIGEKI TOHYAMA ET AL., SHŌWASHI 34-38 (1987).

337. *See* Charles Leadbeater & Robert Thomson, *At a Loss for a Speedy Solution*, FIN. TIMES, Nov. 27, 1992, at 18 ("[I]nternational consequences could also be profound because of the pivotal role that Japanese banks now play in the world economy."). *See generally Weak International Bank Performance Largely Due to Events in Japan, BIS Says*, 59 Banking Rep. (BNA) No. 18, at 709 (Nov. 16, 1992) (noting impact of the retrenchment of Japanese banks in the international market).

338. One securities industry insider has noted that due to the scandals, both the MOF and the industry have shunned the close communication which previously existed between them, resulting in disadvantageous treatment of the industry in the final stages of drafting the Act. *See* Shōichirō Shimamura, *Kannenron ni ikkoku no shōrai wo yudanete yoi no ka*, KIN'YŪ ZAISEI JIJŌ, Dec. 7, 1992, at 32; *Kukyō no shōken makikaeshi kenmei*, *supra* note 327; *see also Round Table Discussion 4, supra* note 280, at 18 (noting that the timing of the scandals was "unfortunate"). Further evidence of the security industry's downfall is found in news that shortly after the Act was passed, the MOF announced a radical reorganization of its Securities Bureau, with many high

Yet by virtue of its very weakness, the securities industry appears to have won the war at the implementation stage. As described above, the MOF has structured the details of the Financial System Reform Act so as to protect the battered securities companies as much as possible.³³⁹ The activities of bank securities subsidiaries are to be severely restricted for the foreseeable future, and strict firewall requirements³⁴⁰ and extremely high minimum capitalization requirements³⁴¹ ensure that entry into the securities business will be an unattractive prospect for most. Trust subsidiaries have been similarly hobbled. The city banks, the only banks that still have the capability and motivation to establish subsidiaries, are being prevented from doing so for the time being.³⁴² This is being done precisely because the city banks presented the most serious competitive threat to existing securities companies.³⁴³

VI. CONCLUSION

Reform has thus become a tool for protecting sectors of the industry in distress. Some banking industry analysts have adjudged the Financial System Reform Act as merely being "aimed at rescuing troubled banks and brokerages by encouraging them to merge."³⁴⁴ This itself is clearly a worthwhile goal and is a continuation of a trend that was being encouraged by the MOF before passage of the Act.³⁴⁵

ranking officials being replaced by personnel from other bureaus. *Japan Ministry of Finance is Drafting Ordinances to Implement Financial Reform*, 59 Banking Rep. (BNA) No. 1, at 37, 38 (July 6, 1992). In contrast, many Banking Bureau personnel will be promoted within the Bureau, a sure sign of a job well done. *Id.* at 38. The scandals also resulted in the creation of the Securities and Exchange Surveillance Commission in July 1992, which is charged with auditing institutions involved in securities activities. See *Japan Said to Increase Probes of Banks and Securities Houses*, 59 Banking Rep. (BNA) No. 16 at 648 (Nov. 2, 1992).

339. See *supra* notes 330-34 and accompanying text; Robert Thomson, *Japan to Slow Pace of Financial Reforms*, FIN. TIMES, Dec. 17, 1992, at 16; *Togin, issei ni fuman no koe*, NIHON KEIZAI SHINBUN, Dec. 18, 1992, at 7; *Japan Ministry of Finance is Drafting Ordinances to Implement Financial Reform*, *supra* note 338, at 38.

340. The so-called "no-return rule," which is likely to be contained in an upcoming ordinance of the MOF, will prohibit directors who are sent to a subsidiary from ever returning to the parent bank. *Torishimari-yaku no oya-ginkō fukki kinshi*, NIHON KEIZAI SHINBUN, Nov. 30, 1992, at 5.

341. The minimum capitalization requirement for securities subsidiaries is to be ¥10 billion, five times the capital required of trust bank subsidiaries. *Reform Outline*, *supra* note 274, at 109.

342. *Togin, issei ni fuman no koe*, *supra* note 339.

343. *Id.*

344. *Japan's Diet Passes Bills to Reform Financial System*, 58 Banking Rep. (BNA) No. 26, at 1151 (June 29, 1992).

345. See, e.g., Takashi Akahashi, *Batoru roiyaru ni hi wo tsuketa kyōsai gappei*, ECONOMISUTO, July 15, 1991, at 28, 30 (discussing mergers of regional banks and the possible

Looking back at the Banking and Securities Reports, however, one is reminded that financial reform was supposed to do more. By using the Financial System Reform Act almost exclusively as a means of accomplishing immediate, utilitarian goals, the MOF has rendered the reform process legally incoherent. Instead of lowering walls between different segments, the MOF has created whole new categories, albeit temporary, of mutant trust banks and emasculated securities companies, each subject to their own new rules. Rather than making the financial system more transparent by clarifying the regulatory structure, the Financial System Reform Act has rendered it opaque with its vague provisions that delegate substantive implementation to the MOF. And while banks that do want to expand into other fields of business are rebuffed, securities companies that have no desire to establish subsidiaries are faced with the prospect of being forced to do so.³⁴⁶

In effect, the subsidiary approach as implemented by the MOF has essentially become the piecemeal approach that was rejected by the Banking Report because it "would make it difficult to pursue a consistent and far-reaching mutual entry and would not make it possible to build an internationally acceptable system that extensively promotes users' benefits."³⁴⁷ Recall that these are precisely the criticisms currently being leveled at the Financial System Reform Act and its implementation by the MOF.

Even if several years down the road, with the wave of mergers completed and the financial industry stabilized, subsidiaries are eventually permitted to engage in the full range of activities, it seems unlikely that the subsidiary approach will ever be more than a transitional device. Leaving politics and the self-interests of the parties aside, the ultimate goal of the reform, after all, is to allow banks and securities companies to participate in each other's markets. With this simple truth in mind it is difficult to rationalize, in jurisprudential terms, why a bank that is forbidden from engaging in certain activities can overcome this prohibition merely by establishing a wholly owned subsidiary.³⁴⁸ Furthermore, logic suggests that if the *raison d'être* behind the adoption of the subsidiary approach was, as the evidence

emergence of "super" regional banks as a result); Tomio Shiba, *Financial Industry Inches Near Deregulation*, JAPAN ECON. J., Feb. 23, 1991, at 35 (table of expected financial liberalization in 1991 indicates the planned merger of over one hundred agricultural cooperatives).

346. *Supra* note 310 and accompanying text.

347. BANKING REPORT, *supra* note 3, at 20.

348. *See* Shimamura, *supra* note 338, at 33.

suggests, protection of existing institutions from the harmful side effects of mutual entry, then once mutual entry has been successfully achieved and the financial industry has reached a new equilibrium, subsidiaries should theoretically no longer be necessary. If this state of affairs does come to pass, the system of financial laws and regulations may again come to hamper the proper development of Japan's capital markets, necessitating a new round of reforms.

Given the above, it seems that the Financial System Reform Act can only be the first step on the road to a universal banking system.³⁴⁹ If so, the current round of legal reforms is merely a beginning, a slow, tortuous detour planned by the MOF to ensure that everyone arrives safely one way or another. Reports of the demise of the convoy system, therefore, seem quite premature.³⁵⁰

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349. See, e.g., *Bankers' Embrace*, *supra* note 289, at 90 ("The finance ministry has said that it is not yet ready for German-style universal banking in Japan, but this is what it may have to settle for.").

350. E.g., *The Convoy Scatters*, A SURVEY OF WORLD BANKING (Supp.), in *ECONOMIST*, May 2, 1992, at 44, 47 (predicting the break-up of the "convoy system" due to the current financial crisis and ongoing financial reform).