

# Individual Investors Unprotected in Japan

By Hamano Takayoshi

Japan's "Big Bang" financial system reform that went into full swing with the deregulation of foreign exchange dealings in April 1998 has entered the final stage with the full liberalization in October 1999 of brokerage commissions on stocks which was regarded as the *piece de resistance* of the reform process. Meanwhile, plans for enacting a financial services law aimed at requiring financial institutions to observe fair transactions for the protection of investors are being imperiled.

Unless immediate measures are taken, Japanese investors will soon find themselves without legal protection in a deregulated financial market.

Why is Japan not taking steps to protect its investors? Is it not possible to provide investors with a minimum safety net balanced with deregulation?

## Environment surrounding individual investors

"High risk-high returns" is the byword of the financial and investment worlds. It suggests that investors must be prepared to take risks if they hope to earn high profits and that there is no easy way to make a fortune.

Even so, investors tend to think that they may have a chance to reap windfall profits. There is no end to cases of investors being swindled by dishonest traders who take advantage

of such investor psychology and disseminate deceptive information. A succession of complicated and versatile financial products and services have been introduced following the financial deregulation, but Japan's characteristic "vertical"

charges for financial transactions over the Internet and boosted the number of individual investors who participate in online trading. But this raises the question of the safety of such new financial dealings.

Financial specialists often point to the necessity of regulating the marketing, promotion and advertisements of financial products across the board to ensure an open and transparent process for the approval of new financial products and services.

The United Kingdom implemented its financial "Big Bang," including deregulation of brokerage commissions, back in the 1980s and enacted the Financial Services Act to keep step with the reform. But, as an additional step to alleviate investors' misgivings, the country has also introduced an ombudsman system.

The U.K. government is reportedly reviewing measures for protecting consumers in connection with the planned second "Big Bang" financial reform.

## What is the Financial Services Law?

The Finance Council, an advisory body to the finance minister, re-leased in July 1999, an interim recommendation on a draft Financial Services Law based on what its members discussed. The report suggested that the law cover the entire financial sector and



A new trading room in the Tokyo Stock Exchange

Photo: The Tokyo Stock Exchange

legal system, which regulates traders sector-by-sector, can hardly cope with all the irregularities.

In the financial world, the wide disparity between the information available to mammoth financial institutions and minor individual investors often becomes a bone of contention. Recent mega-mergers and acquisitions of financial institutions in Japan make it imperative to correct this imbalance.

Deregulation of brokerage commissions in October has reduced



that "professional" investors and "amateur" investors be protected in different ways. The report classified "amateurs" into two categories: 1) those capable of taking risks on their own responsibility if they are provided with a certain amount of information, and 2) those not capable of fully taking risks. To put it simply, "amateurs" are to be carefully looked after, while "professionals" will be favored with low charges and wide dealing options in exchange for not being provided with as much information as amateurs.

The legalization of such an idea involves various government ministries and their affiliates - not only the Finance Ministry and the Financial Supervisor Agency but also the Posts and Telecommunications Ministry, which handles postal savings; the Agriculture, Forestry and Fisheries Ministry, which supervises agricultural cooperatives; the Labor Ministry, which manages workers' credit cooperatives; and even the Ministry of International Trade and Industry, which supervises installment sales and other sales credits. As such, coordinating opinions on the matter will be no easy task. Some ministries have reportedly commenced moves to oppose legalization under the pressure of financial organizations averse to legal restrictions. In order to rid the industry of dishonest dealers, the proposed law should have as wide a scope as possible.

At the same time, the drafting of a financial services law will entail a vast amount of clerical work on the part of the government ministries concerned. This is said to be one reason why the Finance Ministry has abandoned its plan to submit the proposed bill to a regular session of the Diet next year. The Finance Ministry's slowness has given rise to speculation that the government finds it difficult to enact a financial services law, though Finance Minister Miyazawa Kiichi has denied this, telling a recent press conference that he has not given up enacting such a law. In any event, it will be some time before it is enacted.

### EPA urges consumers to take risks

Financial assets held by individuals in Japan total 1,300 trillion yen. It is interesting to note that even at a time when interest rates are nearly zero, more than half of investors' portfolios consist of risk-free deposits and savings, in which the principal is guaranteed. The ratio of investments in stocks still remains low in stark contrast to asset management in the U.S.

However, the 1999 economic white paper released by the Economic Planning Agency in July challenged households to take more risks, a remark which could be interpreted as encouraging financial gambling. The annual EPA report can be summarized as follows: 1) It is impossible to safely manage a huge amount of financial assets without taking risks, 2) the government, financial institutions and business corporations can spread and shift risks but cannot eliminate them outright, 3) people have hitherto taken risks from their economic activities broadly and lightly in one way or another, such as taxation, and 4) it will be wiser for people to offer capital for production activities from their own pockets rather than have their income taxed.

Total social costs resulting from risk-taking may be lighter this way. The white paper also states that investment in production activities through the purchase of stocks and other financial products would help activate the macro-economy and contribute to the creation of jobs and stabilization of the employment situation, though such investment also entails risks. Yet such investment is wiser than investment in land, because the myth that land prices will never come down belongs to bygone days, it said.

At the same time, the white paper, taking heed of investors' misgivings, pointed to the need to establish a minimum safety net for failed investors and assuring them of another chance.

As the financial reform gains momentum, more financial institutions can be expected to go under. If unregulated competition further

accelerates without disclosure of sufficient information, which is necessary for the protection of investors, individual investors will be left in an extremely vulnerable position.

In the pension sector, there are moves to introduce in Japan the 401K-style defined-contribution pension schemes increasingly popular in the U.S. Pension plans in Japan are currently limited to defined-benefit plans, in which companies assume responsibility for paying out fixed benefits. As defined-contribution plans operate on fixed premiums, fund managers have to skillfully manage pension funds if they are to increase returns. If they fail, they will see their funds erode. Under free competition in an unregulated financial arena, proper management of pension funds brings profits. However, unsuccessful management of pension funds is a serious matter since it concerns people's daily lives. Here too, the establishment of a safety net is important so that failed fund operators can have another chance, and hopefully recover their losses.

In addition to a finance services law, the government is drafting a consumer contract law, which will hopefully be passed in next year's regular Diet session. The law is intended to set common rules for consumer contracts, and establish a mechanism under which consumers can easily file suits against what they regard as contract violations. The proposed law will reportedly include a provision entitling consumers to nullify a financial contract which fails to mention important matters in clear terms.

From an investor's viewpoint, such a law will be a minimum requirement for the protection of investors and must be enacted at an early date. The financial "Big Bang" should not be allowed to leave only consumers exposed to risks.

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*Hamano Takayoshi is a news commentator at NHK (Japan Broadcasting Corporation).*