Trap of Financial "Big Bang"

By Hamano Takayoshi

Competing under deregulation: alliance formed among four companies of the Mitsubishi Group on September 11

Japan's financial reform, or the Japanese version of London's 1986 "Big Bang" sweeping securities market overhaul, began to take shape in April 1998 when foreign exchange deals were liberalized. Another reform measure is to be taken in December when commercial banks are allowed to directly sell customers' investment trusts. Now banks can only offer their office counters for use by investment trust management companies to sell trust portfolios.

The Big Bang financial deregulation, set to be fully enforced by March 2001, is forging ahead steadily. But there are some worries whether it will be implemented without a hitch from now on. Let us look into problems and challenges in this regard, mainly from the viewpoint of individual investors.

Urgent Challenges

What is most important for the moment is the disposal of swollen unrecoverable loans held by financial institutions. To ensure sound economic development, it is believed that top priority must be given to measures which will help financial institutions shake off as quickly as possible the aftereffects of the bursting of the late 1980s asset-inflated bubble economy. Mechanisms aimed at disposing of the bad loans are being mapped out under the administration of Prime Minister Obuchi Keizo. But the U.S. complains the process is painfully too slow.

In South Korea, which is also plagued by massive problem loans, tough measures have been taken; five commercial banks saddled with more debts than assets were forced to be liquidated at the end of June, leaving about 9,000 people jobless. "Japan has spent seven years on economic reform but it is yet to be completed, while South Korea has made so much progress in seven months since the financial crisis hit the nation," says a cartoon prepared by Seoul's Financial Supervisory Commission (the cartoon was carried by the Asahi Shimbun newspaper in its August 14 editions). Japan is treated as if it were a bad example.

In order to clear itself of the stigma, Japan apparently has no choice but to dispose of the problem loans as swiftly as possible by showing that its own approach works so well without following South Korea's ironhanded practice.

The second challenge that needs urgent attention is associated with the above issue. It is the public disclosure of relevant information; particularly important is to make the realities of bad loans transparent. Suspicion persists in overseas stock and other financial markets about the transparency of the Japanese economy. Many foreign investors appear to suspect that problem loans of Japanese banks in particular contradict published figures and that they may be hiding more bad loans.

The total problem loans of all Japanese banks, as classified by the same standards as those of the U.S. Securities & Exchange Commission (SEC), stood at ¥29.8 trillion at the end of March 1998, according to data published by the Financial Supervisory Agency, which was established in June as part of administrative reform. There is another method of sorting out problem loans; banks themselves classify such loans on the basis of their own standards so they can write them off or set funds aside as special reserves for the future when loans turn sour. Based on such self-assessment, the "third category" of loans, which lenders fear are likely to end up as losses, totaled ¥6.1 trillion and the "second category" of loans, which carry greater collection risk than usual, amounted to ¥65.8 trillion as of March 31. The second category includes loans which will not result in losses if adequate risk control is exercised and which will become a source of profits rather than bad loans in the event of economic recovery. So problem loans are not necessarily all bad but differ in their nature.

The question is that banks have so far been quite negative toward information disclosure about problem loans. One reason for such an attitude cited by them is that a uniform disclosure of details of "second category" loans, classified under ambiguous standards which differ from bank to bank, could lead to misunderstanding on the part of market players. And some people abroad are said to believe that the Japanese government is tolerant of such a posture taken by banks.

Bank of Japan Governor Hayami Masaru has urged financial institutions to expand information disclosure by regarding the disclosure of details of self-assessed problem loans as an option to ensure the transparency of their operations. The appeal has invited objection from the financial community. But couldn't banks consider making information available in one way or another to help market players make judgment?

Anyhow, it is vital for financial institutions to carry out the following in order to promote the financial Big Bang featuring three principles—free, fair and global—on a full scale. That is, they must disclose the realities of their problem loans and thus establish the practice of information disclosure, and accelerate the disposal of such loans.

Foreign-currency trusts in quiet boom

The third challenge is related directly to individual consumers and thus is the point of greatest concern to them.

One of the purposes of the Big Bang is to make effective use of Japan's personal financial assets totaling ¥1,200 trillion. Nevertheless, we cannot help feeling that measures taken in favor of individuals are insufficient. Given the reality in particular that investment trusts quoted in foreign currency are enjoying a quiet boom of late, it appears as if individual investors are rowing in a small boat, defenseless, into the ocean where they might face any heavy storm. We do understand the psychology of them, though, seeking to earn any better yield in this era of ultra-low interest rates.

As is known widely, investment trusts allow money collected primarily from individual investors to be invested, mainly in bonds and stocks, and investors share out returns, thus permitting large-lot investment as a whole like institutional investors even though the amount of individual investment is small. In Japan, individual investors have continued to flee from investment trusts largely because prices of many trust funds have fallen below those of their purchases made during the bubble economy era due to sagging securities market prices.

But Japanese investors have been attracted to "imported" investment trusts, or those written in foreign currency like the U.S. dollar and the German mark, because of their high-flying yields. Their interest in those trusts has been aroused by market talk that prices of certain trust funds, including yields, soared tens of percent in a year, permitting investors to enjoy handsome profits. It is reported that particularly U.S. trusts focusing on stock market investment have continued to swell, with their balance already reaching $5 trillion (¥700 trillion). In contrast, the balance of Japanese investment trusts is much lower, hovering around ¥40 trillion. Of the total, trusts featuring stock investment shrank from ¥45 trillion in 1989 to a little less than ¥10 trillion at the end of 1997.

Behind the U.S. investment trust boom are moves among the first generation of baby boomers, now in their 50s, to buy such trusts in preparation for post-retirement pension life, according to analysts. The number of Japanese investors purchasing foreign-currency trusts has shot up, with their combined market value reaching ¥2,753 billion at the end of August or three times the previous year's level. Besides, there are Japanese companies managing foreign-currency investment trusts. The combined total of the individual and institutional foreign-currency trusts exceeds ¥7 trillion to reach a record high. Several factors are cited for this, including stock market rises led by Wall Street, the prevailing prospect of the Japanese yen losing its value against the U.S. dollar, the diversity of foreign investment trusts which include those paying returns each month, and investor aversion to record-low interest levels at home, as exemplified by the official discount rate now at an all-time low of 0.5% per annum.

If the Big Bang financial reform gets into full swing, an even wider array of options for investment will be available to individual investors. But will they be prepared?

Ready for high risks?

As mentioned at the beginning of this article, banks will be allowed to handle investment trusts for direct sale to depositors under the schedule of the Big Bang deregulation package, effective December 1. With their eyes riveted on that new opportunity, foreign investment trust management companies are entering the market one after another in joint ventures with Japanese partners and various other forms. Their Japanese rivals, on the other hand, are gearing up for the looming cutthroat competition.

What must be kept in mind by individual investors is that high returns are available only at the cost of high risks if they are to reap fat profits. For example, they may suffer losses and see their investment principal shrink if U.S. stock prices plummet and the yen appreciates against the dollar.

So what matters is to have the courage to withdraw from such investment at the risk of some losses to fend off even bigger potential losses. But it is a difficult decision for amateur investors to make. Then it is desired that Japan will also have an advisory system like in the U.S. where financial planners (FPs) have been established. FPs advise individual investors about their asset management in favor of their customers' interests. The number of Japanese acquiring the qualification of FPs is increasing sharply. Those who have obtained qualifications from the Japan Association for Financial Planners and the Institute for Financial Affairs already number 80,000. But most Japanese FPs belong to banks and insurance companies, not siding with individual investors. So they appear unlikely to recommend services and products of rival financial institutions, failing to truly represent the interests of individual investors.

On the other hand, it is said to be difficult to acquire the qualifications of securities solicitors and investment advisers if FPs are to become independent and give preference to investor interests. It is feared that the financial Big Bang may not succeed unless the ground is laid for such practical aspects.

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