Reforming Japan's Financial System

By Wakatsuki Mikio

Japan's post–World War II financial system has featured two points—a system of specialized financial institutions, including separation of short–and long–term lenders, and separation between banking and securities businesses. It can be concluded that such a division of work has performed adequately in efficiently supplying limited funds in the postwar period of reconstruction and the subsequent era of rapid growth, contributing greatly to Japan's economic expansion.

As the Japanese economy became gradually sophisticated, diversified and internationalized, however, the necessity increased for a more efficient and competitive financial system consistent with the international system and for a system giving greater priority to the convenience of consumers. This led to the start of a movement in the 1980s to reform the financial system.

Attempts to overhaul the system that began in 1985 resulted in legislation in 1992, after protracted deliberations and adjustment of conflicting interests, and relevant laws were put into force in 1993. By the time the new system was inaugurated, however, the climate surrounding the financial industry had shown major changes at home and abroad, while an information revolution and computerization had made more progress, requiring additional reform to the industry. As a result, the financial system also requires a further shakeup.

Described below are two points: (1) the outline of the 1992 financial system reform and (2) subsequent changes in the financial situation and the need for, and direction of, new reform.

Financial system reform in 1992

Japan's postwar financial system was based on a system of specialized financial institutions in five categories, featuring the separation of short–and long–term lending. The categories are (1) ordinary commercial banks, (2) long–term credit banks, (3) trust banks, (4) a bank specializing in foreign exchange, and (5) mutual loan and savings banks. Along with the specialized system, the separation of banking from the securities business became a rule under Article 65 of the Securities and Exchange Law.

But financial liberalization and globalization progressed, fueling competition in the financial industry. Moreover, the domain of the financial business expanded in tandem with progress of financial innovation brought on by computerization. Coupled with the securitization trend, this blurred the boundary between the banking and securities businesses. Along with such changes, client needs became increasingly diversified and sophisticated. As a result, it became impossible to meet diversified business requirements and client needs under the conventional financial system, leaving Japanese banks disadvantaged in international competition.

Against that background, moves began in 1985 to reform the financial system. The Financial System Research Council, an advisory body to the finance minister, discussed reform from three viewpoints: (1) convenience for clients, (2) international consistency and (3) maintaining financial order. An initial step toward reform was taken in 1986, on the basis of the council's recommendations, when mutual loan and savings banks were converted to ordinary banks, now known as second–tier, to distinguish them from existing banks. Based in regional cities, regional banks are small commercial banks without nationwide branch networks. After five years of deliberation and horse trading about the relationship between the banking and securities industries, the council proposed in 1991 that banks and brokerage houses be allowed to enter each other's business by setting up subsidiaries. On the part of the securities

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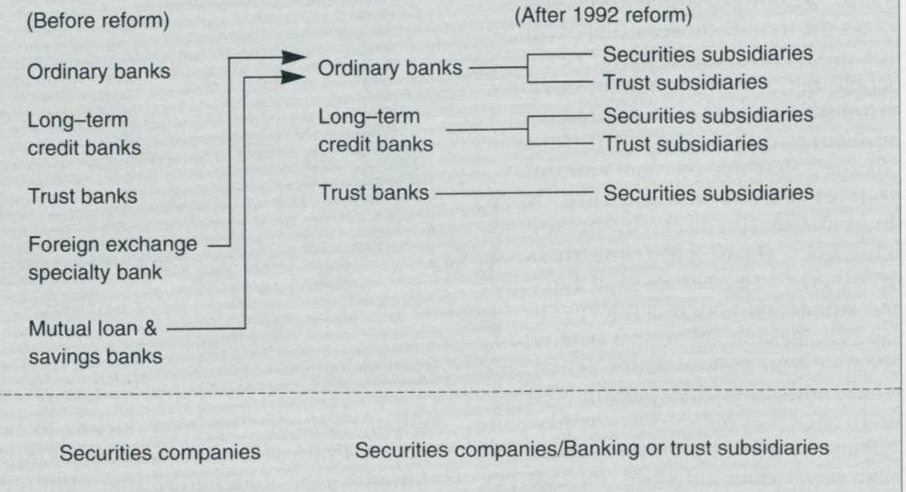

NOTE: (1) Mutual loan & savings banks were converted into ordinary banks in 1986.
(2) The foreign exchange specialty bank (Bank of Tokyo) became an ordinary bank in 1996 through a merger, though it had been no different from an ordinary bank in effect.

ness lines as exceptional cases. But they have been applied unsparingly, as exemplified by the following various combinations—between an ordinary bank and a securities company (as in the case of Daiwa Bank's absorption of Cosmo Securities); between an ordinary bank and a trust bank (Mitsubishi Bank has made Nippon Trust Bank its subsidiary); and between an ordinary bank and a foreign exchange specialty bank (Mitsubishi Bank's merger with Bank of Tokyo, which has allowed the merged bank to take over the special authority of issuing debentures solely enjoyed by Bank of Tokyo among the ordinary banks). Such "backdoor" introduction of the universal banking system has resulted in sharp reactions and strong complaints from competitors. But reorganization of the financial industry may proceed in such a way in the future because, while the need for restructuring is growing, mergers aimed simply at pursuing economies of scale have become less attractive, and because mergers between institutions of different industries are advantageous in terms of enhancing competitiveness by mutually supplementing each other's functions.

(2) Moves to lift the ban on financial holding companies

In Japan, establishing holding companies is banned by the Antimonopoly Law to prevent an excessive concentration of economic clout.

In the 1990s, however, moves have gained momentum in the business community to seek a review of the law as businesses are increasingly interested in using holding companies to diversify business operations, integrating and restructuring group firms smoothly, and bringing the law in line with the international legal system. As for the financial community, a subcommittee of the Financial System Research Council concluded in1995 that the system of holding companies has the advantages of fending off the risk of a subsidiary's collapse affecting other subsidiaries of a financial institution, and of making financial operations and organizational management more efficient, and proposed that the council further discuss the advisability of introducing such a system.

Against the backdrop of these developments, it was agreed under the government's "deregulation promotion program" mapped out in March 1995 that a conclusion be drawn within three years on the holding company system from the standpoint of making Japan's financial market more open and competitive. A similar recommendation was made to the prime minister at the end of 1995 in a report drawn up by the Administrative Reform Committee, which called for the ban on holding companies to be lifted swiftly from the viewpoint of deregulation. Around that time, a study panel hosted by the Fair Trade Commission published a report saying that it is appropriate to permit holding companies within a specified scope of business activities.

Despite these recommendations endorsing the lifting of the ban on holding firms, however, discord within the three ruling coalition parties has led to the shelving for the present of any action toward realizing it. The coalition has only agreed to continue considering the issue.

Nevertheless, moves to seek removal of the ban on holding companies are expected to mount further in view of such factors as the changing economic situation, progress in financial market liberalization, and intensification of competition. It appears that there is a good possibility of holding companies coming into being in a few years. The financial community has indicated it intends to step up efforts to realize such a system, regarding financial holding companies as a means of diversifying operations efficiently, making it easy to shake up management organizations (namely spinning off some divisions into subsidiaries), and smoothly merging and integrating subsidiaries and affiliates.

(3) Restructuring financial cooperatives

Structural changes in the Japanese economy have brought a severe business climate to financial institutions of cooperative form, whose management base is relatively weak. Several credit unions have collapsed, exposing some defective elements, including a supervisory system incompatible with progress in liberalization and poor risk management on the part of cooperative institutions. Financial institutions of agricultural cooperatives have been urged to review their efficiency as such institutions and risk management systems following the emergence of enormous non–performing loans left by failed *jusen* home loan companies.

The financial system of agricultural cooperatives is in the form of a three–stage pyramid. At the bottom are more than 2,000 agricultural cooperatives across Japan. Standing on them as the upper part of the pyramid are 47 prefectural credit federations of these cooperatives, one in each prefecture, and keeping the federations under control is the formerly government–funded now privatized Norinchukin Bank. In August 1996, the Agricultural Administration Council recommended that the cooperatives be consolidated into around 550, through mergers by the year 2000, and that the federations and Norinchukin Bank be integrated to consolidate the agricultural financial system into a two–stage system and make operations more efficient.

The trend to consolidate operations through mergers is also seen at credit associations and unions. Under new legislation enacted in the current fiscal year, ending March 31, 1997, the supervisory system has been strengthened and improved, and a set of measures introduced to allow prompt corrective action when key objective financial indicators such as the capital adequacy ratio worsen below specified levels—a mechanism permitting financial institutions to act before it becomes too late, as has been the case with several failed credit unions. In the case of credit unions, board members often concurrently assume outside jobs, but such a practice has been restricted under newly introduced rules.

(4) Reform of public financial institutions

As part of financial system reform in its broad sense, an overhaul of public financial institutions is being considindustry, meanwhile, a separate advisory panel, the Securities and Exchange Council, also recommended mutual entry through subsidiaries in 1992 after similarly long discussions.

Based on the two sets of recommendations, the laws concerned were revised in the spring of 1992 to allow mutual entry by way of subsidiaries, and went into force in the following year.

The chart shows Japan's financial system before and after the overhaul. Ordinary banks, three long–term credit banks and the foreign exchange specialty bank—Bank of Tokyo, which merged with Mitsubishi Bank in April 1996 to become Bank of Tokyo–Mitsubishi—were to enter the trust and securities sectors through their respective subsidiaries. Trust banks were to move into securities operations and brokerage houses into banking or trust business, also through subsidiaries. Parent institutions were allowed direct entry into some securities–related operations. Local banks, on the other hand, were permitted either to enter a specified scope of trust business directly or to become agents for trust banks.

But economic conditions had changed greatly by the time the reform was implemented. Consequently, the overhauled system was obliged to start operating under considerable restrictions. With the collapse of the inflated "bubble" economy of the late 1980s and the slumping securities market, wariness and resistance built up against the planned entry of banks into the securities industry, prompting the financial authorities to allow entry in groups of a few banks on a step–by–step basis as a compromise measure to cushion the impact. Another constraint was the 'temporary' exclusion of bank securities subsidiaries from equities underwriting, dealing and sales.

Need for new reform and its direction

As described above, the 1992 reform, based on compromise and gradualism, was somewhat inconclusive. New reform efforts are required now in the wake of subsequent dramatic changes at home and overseas in the Japanese economic situation, persistent computerization and progress in technological renovation.

Namely, in the 1990s, incentives for banks to pursue new business fields have become stronger following new developments such as an end to continuous rapid economic growth, a decline in the weight of conventional deposit–taking and lending operations, and the growing need for better profitability to improve capital adequacy. As a result, banks have complained about the slow pace of the removal of banking/securities barriers through the establishment of subsidiaries. In addition, the glut of banks worldwide has led to the ongoing restructuring of the financial industry in Western countries; in Japan, too, it has become indispensable to shake up and reorganize the industry for the sake of more efficient banking management. Moves are also afoot to seek an internationally consistent financial system due to mounting competition, while attempts are under way to correct legal constraints on banking.

Meanwhile, the major issue has become how to handle nonbank financial firms under the financial system as non–banks have come to offer various financial services, taking advantage of rapid progress in computerization and technological renovation, thus leaving the distinction between non–banks and traditional banks unclear. Also, some banks are moving to take control of non–banks.

Besides the institutional reform covering private financial institutions, another notable trend in connection with deregulation and administrative reform reviewing and overhauling public financial institutions, which have many problems in terms of competition with the private sector and operating efficiency. And the risk management system of banks and the supervisory system of the financial authorities have been called into question in the wake of the rupture of the economic bubble, the swelling of bad assets, and a variety of financial scandals. Demand has thus mounted for a financial system based on "deregulation and self–accountability" in place of the conventional principle of "regulation and protection." In this connection, a review and overhaul of the organization of the financial authorities (the Finance Ministry and the Bank of Japan) have become a political agenda.

Ministry of Finance in midst of stormy debates on administrative and financial system reform.

With these developments in the background, the following chapters specifically describe the main focuses of the forthcoming financial system reform.

(1) Further reduction in banking/securities barriers

As previously discussed, entry into mutual domains under the subsidiary formula has taken place in incomplete form because of the temporary conditions that restrict mutual entry in various ways, leaving the parties concerned dissatisfied in terms of the efficiency and international consistency at which the reform is targeted. Therefore, what should be done is to eliminate the transitional restraints at an early stage, thus liberalizing subsidiary activities while relaxing various "firewalls" or banking/securities barriers introduced for the purpose of risk management.

Meanwhile, the door has been opened in effect for universal banks that can undertake both banking and securities operations by allowing the application of special merger rules to the bailout of failed institutions and to mergers aimed at beefing up the financial standing of those involved. The original purpose of the rules is to permit mergers between financial institutions of different busiered. In1994, reorganization of such institutions was taken up as part of administrative reform under the government of then Prime Minister Murayama Tomiichi. Several restructuring plans were discussed at that time, but what eventually ensued were minor changes.

But moves to reorganize and streamline public financial institutions appear inevitable as the next course of action in light of mounting calls for administrative reform. A more thorough review and overhaul will be necessary from the viewpoint of competitive pressure on the private sector, screening of public institutions in terms of efficiency, introduction of a market mechanism and better public disclosure of information. Furthermore, as a longer–term agenda, it will also be necessary to seek a comprehensive review of the public financial system as a whole, including the postal savings scheme that is the main source of funds for public financial institutions, and the fiscal loan and investment system, which is also funded in part by postal savings.

(5) Reform of the central bank

The Bank of Japan (BOJ) Law, which provides for the central bank's objectives, functions and organization, was legislated in 1942 in the midst of World War II. The BOJ's independence as a central bank is weak as the law authorized the government to supervise the bank, direct its activities and fire board members in order to prosecute the war effort.

As financial liberalization proceeds and the weight of the market mechanism grows, the central bank's independence and neutrality have come to greatly affect market determination of interest rates and market players' confidence in its monetary policy. And the extent of central bank independence has become a yardstick of credibility in the monetary policy and financial system of the country concerned as financial business becomes increasingly globalized. Major Western countries are pursuing reform in the direction of enhancing central bank independence, relegating the task of ensuring the stability of currency value to an independent central bank.

In Japan, efforts are being made to specify and strengthen objectives and functions of the central bank, which is the core of the financial system. The move has been prompted by the above international developments and the bitter experience of the BOJ's easy credit policy, blamed in part for the "bubble" economy. Following discussions by a coalition task force, an advisory panel to the prime minister is studying reform of the central bank. The financial System Research Council is to formally take up the issue of revising the BOJ law on the basis of the panel's conclusions.

The anticipated main points of the proposed revision are as follows: (1) to clarify the central bank's objectives, namely that these are to ensure currency value stability and keep the financial system in order, (2) to ensure no outside interference in monetary policy and, in parallel with this, to specify the BOJ's accountability, (3) to provide specifically for the BOJ's supervision and inspection of private banks, (4) to review the composition of the BOJ's Policy Board, and (5) to specify the BOJ's role in international finance.

(6) Reform of the financial supervisory system

It has been requested, besides reforming the financial system, to review ways of supervising the financial industry and screening financial institutions in order to secure the soundness of the financial system amid increasingly complicated risks in line with the internationalization of finance. The Financial System Research Council subcommittee, previously mentioned, published a report at the end of 1995 which stressed two points: financial institutions must improve their risk management capability on the basis of the principle of self–accountability rather than allowing the authorities to tighten regulations and supervision, and priority should be given to the role of markets in checking the soundness of financial institutions' management by way of tightened information disclosure requirements and other measures.

In response to the report, the Finance Ministry has made it clear that: (1) financial institutions will be encouraged to improve their own screening of operations while the authorities monitor such a move, (2) auditing by outside experts will be required, and (3) guidelines will be laid down to help financial institutions establish a system of managing market–related risks such as possible losses from derivatives trading. At the same time, the ministry has decided to introduce aforementioned "prompt corrective measures" based on the use of objective indicators to ensure the transparency of financial administration and switch over to an administration which keeps the authorities and the industry in "strictly business" relations instead of the cozy bilateral ties enjoyed so far.

In view of the series of financial scandals, however, criticism persists that the current organizational setup leaving the financial administration and supervision in the hands of a single ministry may not necessarily lead to ensuring the soundness of the financial system. As a result, it has made the political agenda, as has the proposed consolidation of the Finance Ministry's finance–related departments, to divest the ministry of its supervising authority and relegate it to an independent organization.

This ends a look at the need for an overhaul of the financial system and its future direction. But what is questioned is not simply financial system reform. In order to make reform effective, it is also necessary to improve a climate for activities of financial institutions, or, in other words, to improve financial infrastructure in its broad sense. For example, the nation's tax system should be made more consistent internationally, the legal system should be adapted to various financial innovations, and the accounting system should be changed in such a way as to contribute to better risk management and greater information disclosure. A comprehensive reform involving such improvements in the financial industry's situation is desired in order to make Japan's financial system more sound, efficient and competitive.

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