Financial Reform in Japan*

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Abstruct

The agenda of Japan's financial reform calls for the creation of a balanced financial intermediary system by correcting the over-emphasis on indirect financing and strengthening the functions of the securities markets.

Because the Japanese financial system is experiencing a major turning point amid an unprecedented financial crisis, it is critically important to prevent systemic risk. To do this, accurate and timely disclosure of information remains the only effective measure.

Furthermore, the strengthening of the depositor protection system and investor protection fund is indispensable.

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I. Introduction

The separation between long-term and short-term financing, the separation between the banking and securities sectors, and a system of specialized financial institutions that characterized Japan's financial system in the post-war era have ended their historical roles, giving way to prominent new moves towards a reconstruction of the financial system. However, it has become evident from the experience of the past few years that this is an agenda that involves an extremely difficult process which must be pursued at the same time as resolving the negative legacy of the 'Bubble Economy' – the bad loans problem at Japanese banks. The collapse of Hokkaido Takushoku Bank, a major commercial bank, was followed by the failures of the Long-Term Credit Bank of Japan and the Nippon Credit Bank, which one after the other were temporarily placed under state control. Along with the chain of banking failures, the lack of inadequate disclosure of banks' bad loans have led to various speculation in the financial markets, causing major disturbances throughout the entire banking system. As a result, the banks have accelerated their efforts at loan collection and have become extremely reluctant to provide new lending, thus severely limiting financial procurement by corporations and in turn worsening the economic downturn.

The agenda of Japan's financial reform calls for the creation of a balanced financial intermediary system by correcting the over-emphasis on indirect financing and by strengthening the functions of the securities markets, while at the same time preventing systemic risk from manifesting itself. The purpose of this paper is to offer an overview of aspects that have characterized Japan's post-war financial system, to clarify the process through which the system became incompatible with the real economy, thus making restructuring unavoidable, and to examine the current status of financial reform and issues to be taken up in future.

II. Overview of Japan's Post-War Financial System

In the post-war era, Japan created a unique financial system aimed at recovering an economy devastated by war. First of all, the absence of a securities market that normally would have taken on long-term financing functions necessitated the allocation of such functions to the banking system. The aim of the Long-Term Credit Banking Law of 1952 was to create a new long-term credit bank and to allow it to issue bonds as a means for procuring funds, which were to be used as capital for providing industry with long-term financing. The policy of separating trust banks adopted by the Ministry of Finance was also designed to create banks that specialized in trust banking operations in order to give them long-term financing functions. The fact that in recent years it is these banks that were created in the early post-war era that have either collapsed one after another, or are at the center of restructuring, clearly demonstrates that the financial system that had played its historical role between the post-war era and the high-growth period is now showing discrepancies with the real economy.

Secondly, Japan adopted a specialized banking system. Examples include banks that specialize in the provision of finance to small- and medium-sized companies (former Sogo banks and Shinkin banks) and a bank that specializes in foreign exchange (former the Bank of Tokyo). While such divisions in operational areas have already been abolished, until recently banks operated within their allotted business areas, and stability in the banking sector was maintained by distributing a set amount of business. Financial administration was geared to the standard of the financial institution with the least effective management structure, which is why the system was commonly referred to as the 'Convoy' system.

Thirdly, Japan separated the banking and securities businesses, with exceptions in some areas of operation. In America, the ban on combined management was said to have had its aims in preventing the risks accompanying securities operations from affecting the banking sector. In fact, true to that purpose, in America that rule is laid out in its banking law. However, in Japan the same piece of regulation is found under Article 65 of the Securities and Exchange Act, and many have observed that the rule is not necessarily aimed at ensuring sound management in the banking sector. In their view, the rule aims rather at stabilizing the management of securities companies by cutting out an area of operation for them. Judging from the actual effects, the separation between the banking and securities businesses seems to have been intended more as a policy to support and nurture the securities companies, which were weak in terms of management compared to the banks, which were first to be provided for with a structure befitting their central role as financial intermediaries.

The fourth characteristic was the preventive administration practiced by the Ministry of Finance. It virtually limited new entry through a licensing system for both banks and securities companies (in fact, no newcomers obtained a license to operate a securities business during the 30 years since the license system was adopted in 1968), and managed to keep monitoring costs low through preventive regulation. On the other hand, such a regulatory policy gave enormous power to the Finance Ministry, with its grip on licensing authority, and at the same time created a backdrop for the introduction of administrative guidance, which lacked transparency and had no clear legal basis. And that has provided cause for scandals concerning collusion with a specific industry in recent years, which in turn blemished the ministry's prestige.

Setting that aside, it was such financial administration that also prevented the collapse of financial institutions. Should such a situation arise, the failed bank was to be absorbed by a healthy bank which was seen to have been making excess profit under the 'Convoy' administration.

Ⅲ. Pressures For Financial Reform

1. The Limits of Specialized Financial Institutions

The financial system centered on banks functioned well until the end of the high economic growth period of the late 1970s. However, large companies that flourished during the period began seeking more favorable terms for capital procurement, and increased the weighting of fund procurement from the securities markets. The trend was especially marked among corporate clients of major commercial banks whose client base consisted of major corporations, and long-term credit banks and trust banks whose main operation was providing long-term capital.

This break away from banks had serious implications for these financial institutions. As their operational foundation – which constituted the very basis for their existence – began to shrink, they were forced to expand into new business areas. As a result, the ratio of lending to small- and medium-sized companies and real estate financing increased, and they actively sought to enter the securities business. Under Article 65 of the Securities and Exchange Act, banks were banned from operating securities businesses. However, while Article 11 of the Anti-Monopoly Law of 1947 prohibited them from acquiring more than 5% of total outstanding stock in any given company, it placed no limitations on banks holding other companies through affiliates. So major commercial banks already owned affiliated securities companies through indirect shareholdings. But as the ratio of capital procurement from the securities markets rose among top corporations, commercial banks which felt threatened by a shrinking operational base played a central role in seeking full-scale involvement in the securities business. That resulted in a heated discussion with the securities industry, which was opposed to the idea, but in the end the Financial Reform Act was enacted in 1993, allowing banks to establish fully-owned securities subsidiaries. Securities companies and trust banks were similarly allowed to set up banking and securities subsidiaries, respectively. However, certain limits were placed on reciprocal entry into each other's business areas, because such moves would have had a significant impact on the operational foundation of either industry.

Despite such deregulation, long-term credit banks and trust banks, whose main clients were the major corporations, and financial institutions catering to small- and medium-sized companies could not avoid a contraction in their basic operations, and were forced to turn to business areas involving higher risk. While it is correct to attribute the direct cause of the current bad loans problem in the banking sector to their speculative investment activities during the 'Bubble Economy' era in later years, the roots of the problem can also be traced to the domino effect that resulted from the confusion in the specialized banking system. In that respect, the continued existence of the specialized banking system, and especially that of the long-term credit banks and trust banks which had out-lived their historical purpose, should have been reconsidered at that time.

2. Hollowing Out Effect on Financing

Another problem posed by the progress of economic globalization was the financial administration pursued by the Ministry of Finance, which had come to place significant restrictions on the activities of corporations and financial institutions. A typical example was the collateral requirement, where the provision of collateral was an absolute prerequisite for companies that sought to issue bonds. As a result, companies that could not meet the requirement went ahead and began issuing bonds in the Euromarket or the Swiss market, where they could sell their bonds without having to provide collateral. And often enough, Japanese institutional investors turned out to be the buyers of such bonds.

Faced with this pressure, the Finance Ministry began to indicate a significant shift towards abolishing or easing regulations in its financial administration. The epoch-making event occurred in 1984, when the Yen-Dollar Commission Report declared the liberalization of the entire financial markets. Thereafter, Japan was to take the course of deregulation following steps laid out in the Report, as in the liberalization of deposit interest rates.

During the 'Bubble Economy' years, the Tokyo market acquired the weighting that gave it a corner of the world's financial centers on par with London and New York, and Japanese banks raised their presence to the extent of sweeping the top ranks among global financial institutions in terms of asset value. However, as the 'Bubble' burst, the deterioration of the Tokyo market was again taken up as an issue. The symptoms included the continuing departure of foreign financial institutions, the decline in the number of foreign corporate listings on the Tokyo Stock Exchange, the decrease in foreign exchange transactions in the Tokyo market, and the shift in trading of Nikkei 225 index futures and options to the Singapore market. To a certain extent, these moves were the direct results of the slump in Tokyo's financial markets, but there was a further question concerning the possibility that what regulations that still remained were acting as obstacles to free activity and making Tokyo a cumbersome market to operate in.

3. Competitive Decline Among Financial Institutions

Financial institutions continued to operate within the divisions allotted under the specialized banking system, and since deposit interest rates were regulated, there was hardly any competition among them in terms of product development. The only competition that existed - if it can be called that - was over obtaining permission from the Ministry of Finance for opening a new branch in the best possible location.

Lacking innovation in operations, product development and marketing channels, banks wasted away in their race to capture deposits, and as a result, their high-cost structures significantly reduced their Return on Equity (ROE). Even in the late 1980s, when they prided in their overwhelming presence in terms of asset size, ROE levels at Japanese banks were not high. More importantly, domestic coexistence based on business allotment took the edge off any efforts to develop new businesses such as derivatives or securitization, and drained their vitality to compete with U.S. and European financial institutions in international financial markets.

4. Slow and Partial Reform of the Financial System

As we have seen, though discrepancies between Japan's financial system and the real economy, or systemic fatigue, had been pointed out from a relatively early period, no effort was made towards comprehensive reforms until the 1990s. This is due to several reasons.

The first is the Ministry of Finance's experience of successful financial administration, which caused a delay in shifting its stance. Japan's dazzling post-war economic recovery – dubbed the 'Japanese Miracle' – and subsequent economic growth were in effect guided by policy decisions at the Ministry of Finance and the Ministry of International Trade & Industry. While the Ministry of International Trade & Industry saw its powers greatly reduced as core industries gained competitiveness in the global markets, the Ministry of Finance managed to continue exercising its formidable authority by maintaining protective regulatory administration of the financial markets and financial institutions, which were still well behind in terms of global competition. If any one of the financial institutions created cause for concern, all the others cooperated in maintaining the financial system, thus avoiding major rents from appearing. A typical example might be the provision of special loans by the Bank of Japan and the creation of a stock purchasing organ that transpired in 1965 at the time when Yamaichi Securities collapsed. The crisis was overcome by making banks with close relations with Yamaichi, such as the Industrial Bank of Japan, provide support in terms of personnel and financing, and by getting the central bank to extend special emergency loans. Also, in the subsequent sale of government bonds, financial institutions went out of their way to cooperate in the smooth sale by organizing underwriting syndicates. It is not difficult to imagine that the experience of such success delayed the shift in the ministry's stance in financial administration.

What prompted the Ministry of Finance to realize the dead-end of traditional financial administration and the necessity for financial reform as critical issues were probably that the 'infallibility myth of banks' of the past was going to be difficult to maintain in the process of resolving the bad loans problem that worsened after the burst of the 'Bubble,' and the increasing criticism that was directed at the ministry. To be precise, it dates back to the collapse of Kizu Credit Cooperative in August 1994, and that of two more credit cooperatives in Tokyo which occurred consecutively in December of that same year, which necessitated not only full-fledged bailout loans by financial institutions, but supportive special loans from the Bank of Japan and the Deposit Insurance Organization as well. From then onwards, it became clear that the 'Convoy administration' could not be maintained. Also, much confusion ensued in providing public funds to clean up the housing loan companies in 1996, increasing mistrust in the Finance Ministry. That mistrust reached its peak with the subsequent revelation that officials of the

Finance Ministry and Bank of Japan had been entertained by the companies.

Secondly, the specialized banking system and rigid administrative structure gave rise to powerful interest groups, which acted as obstacles in promoting fundamental reforms of the financial system. As we can understand from the previously-mentioned domino effect that accompanied structural changes in corporate fund procurement, major commercial banks were eager to expand their operations. But small- and mid-sized financial institutions, whose own operational niches could be eroded, rejected such moves as the 'stronger man's logic.' As a result, Japan's financial reform had to take the shape of mutual entry into each others' business areas, making fundamental reform based on sound principles difficult.

Thirdly, the 'Bubble Economy' of the late 1980s also had its share in delaying the start of financial reform. Following the accord reached by the Japan-U.S. Yen-Dollar Commission, liberalization of the Tokyo financial markets began to show some progress, raising asset values such as stock prices, and money began to flow in from abroad. As a result, the Tokyo financial market was recognized as a global financial center on par with New York and London, and raised the presence of Japanese financial institutions in European and U.S. markets. These were likely to have led to over-confidence in global competitiveness by the Finance Ministry and the financial institutions, delaying any efforts to reform the financial system.

Due to these reasons, while the need for financial reform had been pointed out much earlier, such reform remained slow and partial up to this stage.

Ⅳ. Comprehensive Financial Reform

1. The Purpose and Structure of 'Japan's Big Bang'

In November 1996, Japanese Prime Minister Mr. Hashimoto announced plans for an acceleration in and broadening of financial reform in Japan. The purpose was to reform the state of the Tokyo market -- which had deteriorated significantly to the point that, far from being a global financial center, its status as Asia's central market was being challenged by Hong Kong and Singapore -- and to develop it into a financial market that could rival New York and London by 2001. To that end, the following principles were adopted:

① Free (a free market governed by market principles) – liberalization of entry, products, pricing;

② Fair (a transparent and reliable market) – clear and transparent rules, investor protection;

③ Global (a global market at the cutting edge) – a legal structure that responds to globalization, creation of a monitoring system, accounting system.

In response, the Financial System Research Council, the Securities and Exchange Council and the Insurance Council began their deliberations, which culminated in their reports on May 21, 1997. These reports differed considerably in terms of their zeal for reform, but laid out a time schedule for reforming the financial markets and financial services sector. With regard to the securities market, which was to undergo the most wide-ranging reforms, the Securities and Exchange Council proposed a comprehensive reform plan for the financial and securities markets based on the following recognition:

(1) It is necessary to conduct wide-ranging reforms for the securities market from a mid- to long-term viewpoint towards the 21st century;

(2) In Japan's financial and securities markets, the emphasis until now had been placed on procuring and allocating funds mainly for the core industries. However, as the population ages, its role as a place to effectively invest the 1200 trillion yen in individual financial assets will gain in importance. Also, in terms of fund procurement, the provision of financing to various new industries that require risk-taking will become an important issue.

(3) The traditional system of indirect financing centered on banks is unable to sufficiently fulfil these roles. It is necessary to strengthen the functions of the securities market, which is better fitted for carrying and distributing risk.

(4) The past framework of preventive regulation may have hindered development of innovation and self-responsibility among market participants. It is also necessary to reform market infrastructure such as accounting, taxation and legal systems into a framework that encourages product development and transactions.

Based on this recognition, the council divided the subjects into investment instruments, markets, and market intermediaries, and proposed wide-ranging reform plans for each (Table 1). And on December 1, 1998, an omnibus 'Financial System Reform Bill' comprising 22 revisions in related regulations took effect, thus raising the curtain on the 'Big Bang.'

In the post-war era, the Japanese securities market had long remained a limited source for fund procurement under a market intermediary structure where banks enjoyed overwhelming dominance. Due to the low interest rate policy, the bond market had been kept in a condition where a free secondary market was totally underdeveloped, and because of the collateral requirement, companies that were able to issue bonds were limited to the best companies in the heavy, large-scale industries. The situation began to change as a secondary market for bonds rapidly developed following the start of mass issuance of government bonds in 1975, when financial institutions were allowed under limited conditions to sell government bonds they owned, and as newly emerged blue chip companies which were shut out of the domestic market due to the collateral requirement took the move and began issuing bonds in the Euromarket and the Swiss market, which led to the revision of the collateral requirement to allow issuance of non-collateral bonds in an effort to prevent the hollowing out of the domestic corporate bond market. Subsequently, the accord reached by the Yen-Dollar Commission prompted further liberalization in the corporate bond market, to the point that it has now become a more or less

Table 1 Schedule for Reforming the Securities Market

	FY1997	FY1998	FY1999	FY2000	FY2001
I . Investment Vehicles (Attractive investment instruments)					
(1) Diversity of the types of bonds					
(2) Diversity of derivatives products					
(3) Developing Investment Trust Products					
① Introduction of the Cash Management Account					
② OTC sales of investment trusts products by banks					
③ Private investment trusts					
④ Investment company type funds					
(4) Review of the Definition of Securities					
(5) Enhancement of corporate vitality and efficient use of capital					
Ⅱ. Markets (An efficient and trusted framework for transactions)					
(1) Improvement of transaction system in Stock Exchange					
(2) Improvement of the OTC (JASDAQ) market system					
(3) Deregulation of the solicitation by the securities firms of the unlisted, unregistered stocks					
(4) Improvement of the share lending market					
(5) Improvement of the clearing and settlement system for securities					
(6) Strengthening imspection, surveillance and enforcement system					
(7) Strengthening Disclosure					
Ⅲ. Financial Intermediaries (Diverse investment service to meet client needs)					
(1) Deregulating Brokerage Commissions					
(2) Diverse activity by intermediaries					
(3) Employing holding company structure					
(4) Strengthening asset management services					
(5) Enhancing the monitoring system of the soundness of securities companies					
(6) Entry regulations of the securities companies					
①Licensing System reform					
②Enhancing mutual entry into banking, securities and trust business					
(7) Investor protection related to exits of intermediaries from the market					
①Strict separation of client assets from securities companies' own assets					
②Enhancing the securities Deposit Compensation Fund scheme					
Review of the taxation related to securities					
Shift to the new administrative regime					

Source : Securities and Exchange Council (1997) free market.

The stock market was similarly limited by the low level of capital accumulation, where most of the issues were conducted at face value until the early 1970s, and was not a market where pricing mechanism functioned. Because of the higher costs of dividend payment involved in raising capital at face value, corporations increased their capital only when they were faced with a shortage of funds as banks tightened lending. Conditions allowing pricing mechanism to function in the stock market were finally met in the latter half of the 1970s, as stock prices began to rise on monetary easing, encouraging a move to stock issuance at market value. However, the post-war breakup of the zaibatsu and the ban against holding companies led to widespread cross-shareholding among former zaibatsu companies, which was followed shortly by commercial banks, and influenced price setting in terms of supply and demand. In other words, since stocks tied up in cross holdings did not circulate in the market unless there was a special reason, they had the effect of providing permanent support for stock prices, thus making stock issuance at market value an advantageous method of fund procurement. However, the functioning of this beneficial cycle depended on the continuous rise in stock prices. If stock prices declined, companies with weak finances were forced to sell the shares, posing a major obstacle to recovery in the stock price. This is the reason behind the latest debate concerning the need for a freeze on the dissolution of such corporate cross-shareholdings.

Putting that aside, until now the securities market had not been designated the role of a market for asset management in official documents. In that sense, this report had an epoch-making significance.

Along with the progress in comprehensive financial reform, the focus on the core business of the financial services industry has gradually been narrowed down. Namely, the change from financial intermediaries centered on the banks to increasing the role for the securities market, and a functional shift in the securities market from that of fund procurement to asset management. These are essential functions to be fulfilled by financial markets for providing financial support to new industries, upgrading industrial structures as well as for future economic development. But in an intermediary system centered on banks, there is a limit to the amount of risk that can be handled. Also, even if venture capital should taken on that role, it would be difficult for investors to take risk without at least developing an IPO and M&A markets to provide an exit. In that sense, it is extremely important to expand the boundaries and to strengthen the functions of the securities market.

There is another aspect concerning the securities market's role as a place to manage assets. Despite the fact that individual financial assets exceed 1200 trillion yen, and despite the prolonged low interest rate conditions, most of the money has remained dormant in savings and deposits. Due to the string of failures of financial institutions and the financial crisis since 1997, this trend has actually strengthened, along with a shift in the direction of safer Postal Savings. At issue is the effective investment of such an enormous amount of assets. Furthermore, along with a rapidly aging population, the collapse of the defined benefit plan of the current pension system is seen to be imminent, making a shift to a defined contribution plan inevitable.

The most important aspect of this system is that management responsibility is left to each policy holder. In other words, self-responsibility will be required of individuals. However, individuals are limited in their effort to acquire investment know-how, making support from an overall asset management service essential. Such operations require considerable investment in systems development, and will not be profitable without a certain degree of concentration in entrusted assets. And such merit of scale is fueling active moves to forge business alliances across traditional keiretsu groups.

From these we can expect that asset management will become an extremely important issue for the Japanese people in the near future. Stated from the viewpoint of the financial services industry, the asset management business is where the biggest business opportunity lies. Furthermore, if such is the case, collective investment schemes such as investment trusts offers the most promise.

In an investment trust, investment capital is collected in small lots and management entrusted to experts. This makes asset dispersion and expert management possible, which would otherwise be difficult for the individual investor. Furthermore, it allows for flexibility in creating products with varied risk profiles through a combination of investment products. For example, it enables the creation of a low risk product similar to deposits by selecting short-term investment instruments such as short-term government bonds, certificates of deposit and commercial paper. Likewise, if the goal is to achieve returns in line with the market, one can create an index fund that mimics the market portfolio. On the other hand, derivatives can be incorporated to create high-risk Bull-Bear type funds where returns increase with the rise or decline in the market. It is also possible to create sector-specific funds focused on stocks in a specific sector such as venture businesses. As shown above, the greatest attraction of investment funds lies in the ability to offer products in response to the various needs of the investor.

Considering this aspect of investment funds, it is easy to understand why banks and insurance companies have shown extraordinary interest in entering the investment trust business. Above all, adding investment trusts to the product line enables them to offer a full line of financial services. It is not an exaggeration to say that the rapid re-alignment among financial institutions in recent years have been focused on asset management services, and especially those businesses related to investment trusts.

2. Expected Effects

Aside from these moves towards re-alignment brought about by the reforms, it is true that the banks, placed under strict market scrutiny as an industry following the series of failures, and exhausted by the bad loans problem, have lacked the elbowroom needed to work on a full-scale reform for the future. Rather, a survival race involving re-alignment among banks, securities companies and insurance companies, as well as those outside the industry and foreign financial institutions, is underway at a tremendous speed. And the focus is on the asset management business, which has come to enjoy the spotlight. In addition, the securities industry, which has traditionally been highly dependent on revenue from stock trading commissions under administrative guidance from the Ministry of Finance, has found itself in an extremely serious condition ahead of full liberalization in trading commissions scheduled to take place in Oct. 1, 1999. Here again, where a break from commissions-dependent profit structure is the urgent task, most of the large and second-tier brokerages are putting in extra efforts into the asset management business, and especially into operations related to investment trusts. At the moment, these efforts have not entirely been successful, and with few exceptions, the securities industry is suffering from a prolonged downturn. For this reason, there are active moves among securities companies to form joint ventures and business alliances with banks and foreign financial institutions with which they have had close relationships in the past.

Some of the smaller securities companies have increasingly turned to becoming online brokers that aim to compete by offering discounts on commissions. As of May 1999, there are 29 brokerages that take orders via the Internet, but the number is on the rise. In America, price destruction by Internet brokers progressed at a stunning pace over the past few years, but once commissions are fully liberalized, there is a possibility that the same phenomenon will occur in Japan. To survive, it will require systems investment for continuous system upgrades, addition of varied contents as well as capital to pull through the slug match. With brokers like Charles Schwab and E*Trade, survivors of such competition in America, entering the Japanese market or having announced intentions to do so, competition in this area is also expected to increase.

In addition, following the lifting of regulations against trading of unlisted stocks and off-exchange trading, and an easing of restrictions on managing investments, specialized companies are also entering these niche markets. And the change to registration-based entry for securities companies is expected to accelerate this trend.

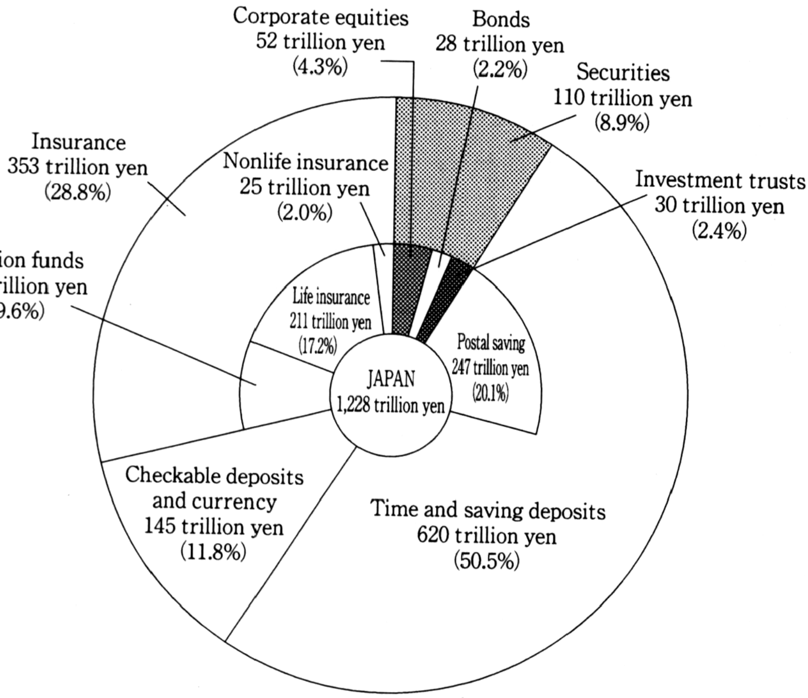
As we have seen, there is a rush to enter the securities business among companies outside the industry and new entries by foreign financial institutions, aiming to capture the enormous individual financial assets that have remained for the most part in savings and deposits throughout the long period of super low interest rates (Chart 1). At least for these newcomers, the securities business is seen as an attractive, underdeveloped business, in contrast to existing companies that are suffering under the prolonged slump.

V. Remaining Issues

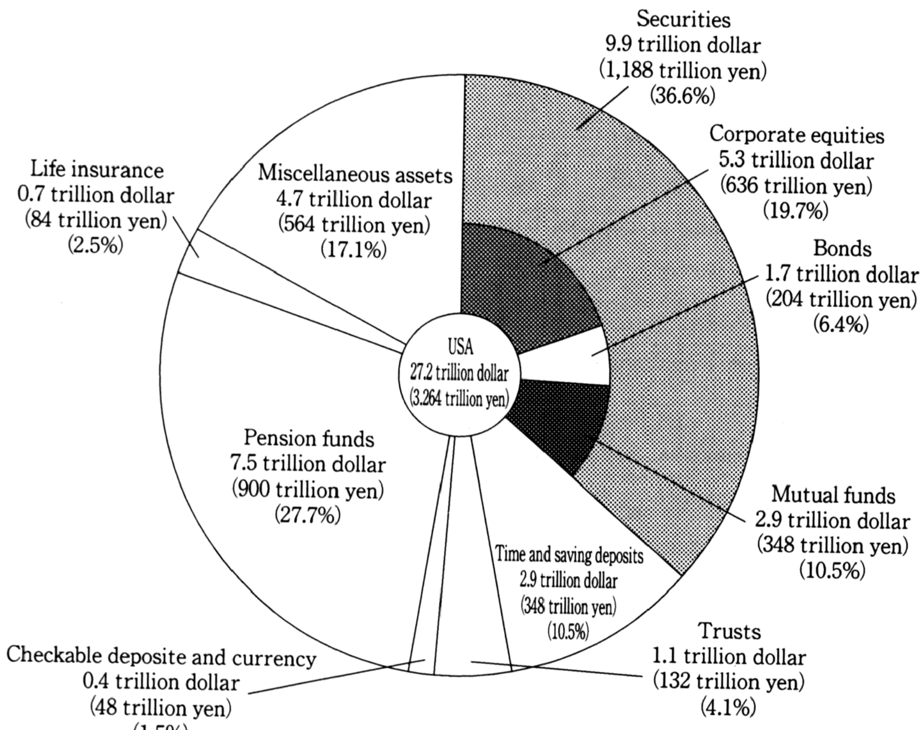
1. Incomplete Disclosure and Systemic Risk

The series of bank failures have revealed what is lacking or weak in the latest financial system

Chart 1 Composition of Individual Financial Assets, Japan VS. USA, Sep., 1998



note. 'Pension Fund' is the sum of pension trust, personal pension fund and private pension fund.



note. 1 dollar = 120yen
source. Bank of Japan, FRB

reform (Table 2). Above all, its failure to incorporate the strengthening of disclosure has disabled effective action against growing mistrust within the markets. Published figures on the amount of bad loans changed each time they were disclosed, damaging credibility, and by the time the Ministry of Finance and the Bank of Japan announced that the worst was over with the bad loans problem, the markets met them with complete mistrust. Once bad news surfaced at a specific financial institution, other financial institutions in the same industry were often forced into the corner as their stocks were also sold on 'imagined connections.' For example, Industrial Bank of Japan stocks were sold in the aftermath of the collapse of the Long-Term Credit Bank and the Nippon Credit Bank, simply on the fact that it was also a long-term credit bank stock. This is a classic example of the manifestation of systemic risk, but if we are to part from the traditional 'Convoy administration' and aim to achieve financial administration governed by market principles, accurate and timely disclosure of information remains the only effective strategy.

The disclosure of bad loans at banks began in March 1993, but at the time the definition only covered 'bankrupt loans' and 'past due loans." Broader figures that take 'restructured loans' into account were not disclosed until March 1996. These figures showed that the amount of bad loans had decreased at an even pace, making it difficult to understand why banks continued to face a serious crisis since autumn 1997. This led to criticism that the definition under which bad loans had been disclosed in the past were too narrow, and national banks began disclosing their more broadly-defined risk-controlled loans from March 1998. These risk-controlled loans included past due loans for which repayment was delayed by six months or more as well as those delayed by three months or more, and not only restructured loans but loans extended by the banks to support companies under operating stress. This definition more or less matches the definition of bad loans adopted in America. These figures showed that bad loans (risk-controlled loans) at 19 major banks and nationwide banks totaled about 22 trillion yen and 30 trillion yen, respectively, in March 1998, a considerably larger figure compared with those defined by the former criteria.

However, even after bad loans figures based on the stricter definitions were disclosed, confidence once lost proved difficult to restore. So the Ministry of Finance, faced with criticism that self-assessment conducted by the banks were too lenient, compiled and disclosed figures on categorized loans based on the banks' self-assessment submitted in response to the ministry's inspections. These consisted of four categories. The first category comprised assets with sound value; the second category, assets which require a certain level of risk control; the third category, assets for which loan recovery was extremely questionable; and the fourth category, assets deemed irrecoverable or valueless. Of these, assets that fell into the second through fourth categories covered all loans for which recovery was questionable to a certain extent, and the total amount reached about 50 trillion yen for the major banks and about 72 trillion yen for nationwide banks as of March 1998. These included assets such as

Table 2 Chronology of the Emergence of Troubled Financial Institutions : 1992-99

Troubled financial institution	Date troubles annouced by authorities	Resolution policy adopted
Taiheiyo Bank	May. 1992	Low-interest loan made to the bank over next 10 years
Kamaishi Shinkin Bank	Oct. 1993	
Osaka Fumin Credit Co-operative	Nov. 1993	
Gifu Shogin Credit Co-operative	1994	
Kizu Credit Co-operative	Aug. 1994	Business suspended in Aug. 1995. Performing assets eventually transferred to the Resolution and Collection Bank.
Nippon Trust Bank	Oct. 1994	MOF approved merger by Mitsubishi Bank Nov. 1994.
Tokyo Kyowa Credit Co-operative	Dec. 1994	Liquidated and performing assets transferred to the newly established Tokyo Kyodo Bank in Mar. 1995 (This Bank was reorganized into the Resolution and Collection Bank in Sep. 1996)
Yuai Credit Co-operative	July. 1995	
Cosmo Credit Co-operative	July. 1995	
Hyogo Bank	Aug. 1995	Business suspended in Aug. 1995. Subsequently liquidated and performing assets transferred to the newly established Midori Bank Jan. 1996.
Fukuiken Daiichi Credit Co-operative	Dec. 1995	
Ibaraki Chuo Credit Co-operative	Dec. 1995	
Osaka Credit Co-operative	Dec. 1995	
Taiheiyo Bank	Mar. 1996	Liquidated and performing assets transferred to the newly established Wakashio Bank
Musashino Shinkin Bank	Sep. 1996	
Hanwa Bank	Nov. 1996	Business suspended in Nov. 1996. Bank liquidated. A New 'bridge bank' was established for the purpose of paying out depositors, recovering performing loans and disposing of collateral. Irrecoverable nonperforming loans transferred to the Resolution and Collection Bank.
Nippon Credit Bank	Apr. 1997	MOF reassured the markets by announcing a restructuring plan.
Hokkaido Takushoku Bank	Apr. 1997	Planned to merge with Hokkaido Bank for April 1998.
Naniwa Bank ; Fukutoku Bank	Oct. 1997	MOF approved to merge at the end of Oct. 1997.
Kyoto Kyoei Bank	Oct. 1997	Assisted takeover by Koufuku Bank.
Hokkaido Takushoku Bank	Nov. 1997	Business in Hokkaido region to be transferred to Hokuyo Bank. Business in the Honshu area to be Transferred to other finacial institutions.
Tokuyo City Bank	Nov. 1997	Closed. Bank of Japan to provide assistance as necessary until the final resolution of the bank.
Long-term Credit Bank	Oct. 1998	Temporarily nationalized.
Nippon Credit Bank	Dec. 1998	Temporarily nationalized.
Kokumin Bank	Apl. 1999	Closed.
Koufuku Bank	May. 1999	Closed.
Tokyo Sowa Bank	June. 1999	Closed.
Namihaya Bank	Aug. 1999	Closed.

Source. Hall (1998), pp. 160-65 and various press reports.

lending to companies that are paying interest but are nevertheless reporting losses, which came under the second category, leading some to point out that the definition was too broad to signify bad loans. However, others pointed out even forcefully that the actual size of bad loans could be even larger because the figures were based on the banks' own assessment. In fact, an examination of cases such as the Long-Term Credit Bank and Nippon Credit Bank, which have been handed over to state-control, reveals that their bad loans far exceeded the total amount reported under the second to fourth categories.

As we have seen, while there has been a significant improvement in the disclosure of bad loans compared to the past, it has come about through a passive gesture on the part of the Ministry of Finance, which was forced to do so in response to the heightened mistrust against its stance, and so far has not been sufficient to restore credibility. Especially because in March 1998, public funds were extended to the major banks as the worsening bad loans problem led to the problem of inadequate capital. This was done on the premise that none of the banks had liabilities exceeding assets, but eight months' later, when the Nippon Credit Bank was placed under state control, it was revealed that the bank's liabilities had already been in excess of its assets at the time public funds were extended, heightening mistrust in the regulatory authorities. Furthermore, in 1999 there was to be a second infusion of public funds, based on the recognition that the economic slump was being made worse by the banks' loan recovery activities and tighter lending policies, which were caused by their inadequate capital levels. However, there has not been a sufficient effort on the part of the banks towards drastically improving their operations, which should be the premise of any extension of funds.

It is certain that the bad loans problem in the banking sector has posed a major obstacle in pursuing financial reform. Its basic principle is to place greater importance on the market and to force speedy exit of banks with unsound operations, and to that end, prompt corrective action has already been adopted. Here, the basic idea is that a bailout of a financial institution and protection of depositors should be treated as separate issues. In other words, the financial system and the depositor are what needs to be protected, and that a shakeup of unhealthy financial institutions should rather be welcomed. Based on this idea, deposits are to be fully protected for the time being. However, as seen from the serious impact left on the regional economy by the collapse of the Hokkaido Takushoku Bank, in reality an extremely critical situation could arise in the real economy, depending on the process of debt takeover. It is also true that prompt corrective action accelerated the tightening of lending by banks, leaving no way out but a further extension of public funds. For this reason, a view has recently emerged in some quarters suggesting the postponement of the pay-off system originally scheduled to take effect from April 2001, for the reason that the withdrawal of large deposits would significantly affect the banks. There is certainly concern that proceeding with the original reform schedule could further worsen the economic slump. However, the confusion and mishandling of the bad loans issue in the past several years, beginning with the problem of the housing loan companies, were not caused by the reform itself, but may be attributed to the way they were handled and in the moral decline at the regulatory authorities. Therefore, although one cannot rule out the possibility that some need may arise for slowing down the pace of reform, it is necessary to proceed with financial reform while pursuing policies for recovering the economy, which is at the root of the bad loans problem.

2. Strengthening Depositor and Investor Protection

Another important weakness in Japan's financial reform is the lack of sufficient consideration for the infrastructure of financial transactions. For example, in order to ask the investor to exercise self-responsibility, it is necessary for trustworthy information to be disclosed in a timely manner in order to enable the investor to make the decisions. But we have already seen the situation concerning disclosure of information on the banks' bad loans, and in general, corporate disclosure in Japan has not been sufficient. This is what led to the situation where stocks of targeted companies were sold en masse in the market on speculation borne of uncertainty. To repeat, as long as we are to proceed with financial reform in the direction of respecting market principles, thorough disclosure of information is the only method for avoiding such situations.

With regard to securities trading, the past rule of concentrating orders for listed stocks to existing stock exchanges has been abolished to allow for off-exchange trades. However, as several exchanges come into existence, without a system for distributing pricing information and orders integrating those exchanges, it could lead to a situation where these exchanges remain mutually separated. This issue of "market fragmentation' has been a recurrent issue in America ever since order concentration rules were abolished in 1975. In America, through reforms in the securities industry undertaken since 1975, the National Market System was created, which consists of integrated bid and offer information and transaction information, and an order distribution system between markets. Unless these conditions are met, any 'competition among markets' will only cause confusion and reduce the fairness and transparency of trading. However, Japan has opted for setting certain pricing limits on off-exchange trades, for the reason that the creation of such a system would be costly. As a result, there arises the possibility that a price of a stock listed on an exchange could differ between the price set at the exchange and the price at which it is traded among brokers. Was it necessary to lift regulations against off-exchange trades at the cost of inviting such a situation?

In the issue of setting up infrastructure, ensuring depositor protection and investor protection is probably the most important. That is because as the abolishment or easing of financial regulations increase competition among financial institutions and lead to more closures, one cannot hope for stability in the financial system without a sure-proof safety net. The revised deposit insurance law of 1996 stipulated that deposits will be protected to the full amount until March 2001, that a Resolution and Collection Bank will be established as a receptacle for the failed credit cooperatives, to which the

Deposit Insurance Corporation will extend financial support. Furthermore, following the collapse in November 1997 of Hokkaido Takushoku Bank, one of the commercial banks, the law was revised again in February 1998, making it possible for the Deposit Insurance Corporation to take out a maximum loan of 10 trillion yen from the Bank of Japan with government guarantee. With the revision of the deposit insurance system, the framework for depositor protection in the case of a bank failure has more or less been completed. Interest has now shifted to the impact of the pay-off, which is to take effect in April 2001.

In contrast, the issue of securities investor protection has had its twists and turns. In Japan a fund for protecting investors had existed since the establishment of the Compensation Fund for Safekeeping Securities in 1969. However, the upper limit for compensation was 2 billion yen per securities company, which meant that if a securities company with 10,000 customer accounts collapsed, the amount that could be compensated was a mere 200,000 yen for each account. But under the 'Convoy administration,' there were no cases of failure among securities companies until 1996, so the weakness of this system was not especially a problem. However, in 1997 Ogawa Securities, Echigo Securities, Sanyo Securities and Yamaichi Securities collapsed one after the other (Table 3), turning under-funding of the Compensation Fund into a serious issue. Furthermore, since more securities companies were expected to close as financial reform progressed, it became necessary to strengthen and expand the securities version of the safety net.

Thus in December 1998 the Investor Protection Fund was established, and securities companies were obligated to join. The upper limit for compensation was raised to 10 million yen per investor. However, here separate management of client assets surfaced as a major problem. Under the Securities and Exchange Act, separate management was limited to securities entrusted by customers such as stocks, leaving cash from a customer's sale of securities, margin accounts, or substitute securities to be used as operating funds by securities companies. Due to this practice, in the case of the collapse of Maruso Securities, it was unable to return customers' assets, and required the Compensation Fund for Safekeeping Securities to provide funding instead. Seeing this situation, foreign securities companies demanded complete separation of customer assets as a prerequisite for the establishment of a new investor protection fund, and discussions between domestic and foreign securities companies yielded no compromise. In the end it led to an extraordinary situation where two separate investor protection funds were created. Meanwhile, separate management of client assets was set to start from April 1999.

It is necessary to note here that depositor protection and investor protection differ in substance. While in the former case the subject of insurance is the deposited principal at the time of a bank failure, in the latter case the subject of insurance is in substance the trading of price fluctuating products, and therefore compensation for losses incurred in the course of the transaction is excluded. In other words,

Table 3 A List of Insolvent and Newly Licensed Securities Companies : 1997-99

A. Insolvent Securities Companies	
July 1997	Ogawa Securities Co.
Nov.	Sanyo Securities Co.
	Yamaichi Securities Co.
Dec.	Maruso Securities Co.
Jan. 1998	Echigo Securities Co.
April	Matsuhico Securities Co.
June	Nakamura Securities Co.
July	Nisshin Securities Co.
Aug.	Toho Securities Co.
Sep.	Ishizuka Securities Co.
Oct.	Showa Securities Co.
	Yamakichi Securities Co.
Nov.	Tokyo Flower Securities Co.
	Kyosai Securities Co.
Jan. 1999	Nakai Securities Co.
	Wakayama Securities co.

B. Newly Licensed Securities Companies	
July 1997	Tokyo Folex Securities Co.
	Nittan Brokers Securities Co.
Aug.	D-brain Securities Co.
Oct.	Ueda Tanshi Securities Co.
Feb. 1998	Angel Securities Co.
	Akushies Japan Securities Co.
	Yagi International Securities Co.
July	Nisshoiwai Securities Co.
	Sparks Securities Co.
Nov.	Mirai Securities Co.
	Yamane Prebon Securities Co.
	Nakaizumi Securities Co.
Dec.	Twenty Twenty Securities Co.
	Privier Zurich Securities Co.
	Nippon Denshi Keisan Securities Co.
	Rabo Asia Securities Co.
	Itochu Capital Securities Co.
Feb. 1999	Mitsubishi Shouji Securities Co.

Source. JASD

the subject of investor protection is limited to any losses caused by accident. In which case the complete separation of clients' assets is the essential issue in investor protection, and the maximum limit of insurance can be said to constitute a secondary issue. Because even if a securities company collapses, investors will be protected as long as customers' assets are managed under a separate account and not used for other purposes. To understand this, it would be helpful to consider the system for investment trusts. Customers who purchase investment trusts from a securities company will not incur losses other than those due to price fluctuation in case that securities company fails, because their assets are managed under separate accounts by trust banks. This is the reason why there is no need to set up investor protection funds for investment trusts.

3. Strengthening of the System of Supervision

Finally, there is the issue concerning the system of supervision. The Japanese financial system differs from that in America, so we must exercise caution in offering simple comparisons between the two. For example, while both countries adopt a licensing system, the number of commercial banks in America, despite having greatly been reduced in recent years due to mergers, still amount to about 10,000. And in the case of the registration system adopted for securities companies, there are more than 5,000 registered members of the National Association of Securities Dealers.

There is therefore an enormous cost involved in supervising such a great number of companies. While the American supervisory system for commercial banks overlap in a complicated manner, there was a total of about 6,000 inspectors at the OCC, FRB and FDIC as of 1992. The SEC and CFTC supervise securities trading, with a combined total of about 4,500 employees.

In contrast, Japan abolished the Securities Bureau and the Banking Bureau at the Ministry of Finance in 1998, and their supervisory authority was transferred to the Financial Supervisory Agency, which was newly created as an external organ of the Prime Minister's Office. The Financial Supervisory Agency took on the responsibility of inspecting and supervising financial institutions. Seeing only this aspect gives the impression that there has been an improvement in the transparency and independence of financial supervision. However, when we turn to personnel, we find that the Financial Supervisory Agency has 165 officials in its inspection division and 68 in the supervisory division. There were also 98 officials at the Securities and Exchange Surveillance Commission, whose organization moved to the Agency intact, and adding inspectors at the regional finance bureaus would only amount to about 300 officials in all. In general, it is hard to deny that it compares unfavorably with the American financial supervision system.

Certainly, regulatory costs can be kept low through prior regulation under a licensing system, which enables the exclusion of inappropriate companies from the start. The Ministry of Finance has pointed to the effectiveness of Japanese financial administration whenever the number of personnel was mentioned. However, that view is no longer persuasive with regard to the securities industry, which has moved to a registration-based system. Having declared its shift towards retrospective regulation in financial administration, the Finance Ministry needs to set up a supervisory system in line with that stance.

Why then, has Japan's financial reform proceeded in general without making preparations for infrastructure? The reason seems to be related to the ministry's motive in promoting deregulation. In fact, in an environment where fiscal restructuring became the priority following the burst of the 'Bubble,' it was unable to depend on fiscal spending to bolster the economy, and further reduction in interest rates did not offer much hope in terms of effectiveness either, in the long period of low interest rates. With no other way out, it gave deregulatory policies the status of the only economic policy that was available.

Since financial reform was placed in the context of deregulation based on such a motive, an increase in regulatory costs was not to be tolerated. It is nothing but ironic that as a result, public funds had to be extended in an even more limitless manner in response to the consecutive collapse of financial institutions.

VI. Summary and Conclusion

The Japanese financial system is experiencing a major turning point amid an unprecedented financial crisis. Though one of the causes for the worsening financial crisis may have been the way the shift in financial administration was handled. At least, the strengthening of the depositor protection system and investor protection fund were never given high priority in discussions concerning financial reform. It is difficult to deny that this amplified concern among depositors and investors, and thus led to the manifestation of systemic risk.

Japan is currently experiencing a brief respite due to the government's frantic use of fiscal spending in its plans to resolve the bad loans problem and to bolster the economy. However, unless banks push ahead with drastic restructuring, no end will be in sight for the bad loans problem. Also, as separate management of assets begins in April, there is growing concern that a large number of securities companies will face financial difficulty and be forced to close. Therefore, moves towards re-alignment in the financial services sector is set to become even more pronounced, and to proceed by involving companies across a wide array of business sectors.

At this point, it is next to impossible to foresee the new financial system that will emerge in the aftermath. Financial reform became inevitable as the system became incompatible with the real economy against the backdrop of globalization, and we can only proceed by experimenting with new financial systems along the way. What should be clear is that there is no return to the old ways, and that such a course would only worsen the crisis.

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