

# The Reform of the Financial System in Japan

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## 1. BACKGROUND TO THE REFORM

The Japanese economy is reputed to be one of the most highly regulated in the industrialised world, despite efforts towards deregulation. Among the most notoriously over-regulated areas in the economy is the financial market.

The Japanese financial system is currently undergoing a major reform. The gist of the reform is deregulation. In accordance with the blueprint of the reform prepared by government advisory bodies in 1997, holding companies were liberalised and laws related to financial holding companies took effect in March 1998. The amendments to the Foreign Exchange and Foreign Trade Law came into force in April. Then, in June, the Financial Systems Reform Law, which amended various laws including the Securities and Exchange Law, Banking Law, and Insurance Law, more or less finalised the reform. Measures included in the latter Law are to be implemented from December this year, but some measures, such as the full liberalisation of the brokerage fee, are to be implemented in the course of the next three years.<sup>1</sup>

The reform encompasses a broad range of issues, and indeed introduces major changes to the existing system. People in the Japanese business world (not necessarily the finance sector), as well as foreign investors have been aware of the necessity of a major change in the system for some years. In fact, some reform measures were introduced in the 1990s, including the much-publicised Law on Financial Reforms of 1992. These changes tend to be halfway measures, watered down by the compromises of various interest groups.

However, the rapid widening of the gap between foreign and Japanese financial markets finally convinced the Japanese government that more decisive measures were needed. Of particularly serious concern to the financial sector was the seeming shift of business abroad because of the highly regulated financial system in Japan. Insufficiency of disclosure by Japanese companies made foreign investors wary of the Japanese

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1 The goals of the reform are summarised in the government report published in *World Trade and Arbitration Materials*, March 1998, pp. 24-25. For a summary of the reform, see T. KATAYAMA and R. MAKOV, "Deregulation of Financial Markets in Japan", *Journal of International Banking Law*, 1998 Issue 4, pp.128-133.

market. For Japanese business companies, the Japanese financial market was too rigid and costly. On the other hand, while there are said to be 1,200 trillion yen worth of Japanese household savings, only a small percentage of this sum is invested in the securities market; around 57% are deposited in saving accounts. The lack of attractive financial products for individuals due to over-regulation is said to have fended off the general public from investment in securities and other financial products. Thus, the market was losing on both fronts; companies and individuals. It should be added that the banking sector, troubled by accumulated bad loans, and the securities companies, troubled by low share prices and the low volume of trade, badly needed some measures, namely deregulation, to boost business.

A series of financial scandals involving securities companies and banks and the questionable handling of these cases by the Ministry of Finance also made people aware of the necessity of reform. The lack of transparency in the administration and supervision of the market was thought to be a fertile ground for irregularities. The appropriateness of the dual role played by the Ministry of Finance as a guardian of the industry and at the same time, a regulator, was also questioned.

It was against this background that the reform was introduced. In the following pages, salient features of the reform will be discussed in comparison with the system which existed until this year.

## 2. REFORM OF THE SUPERVISORY MECHANISM

The Ministry of Finance was in charge of supervising banks, securities companies and insurance companies until June 1998, when a new agency – the Financial Supervisory Agency – came into operation. The Ministry controlled the business of these institutions in great detail. One example is the restriction on the opening of branches by banks. Although there was no explicit statutory basis, banks were not allowed to open branches without the tacit approval of the Ministry. Actually, the number of branches was determined by the size of the deposits entrusted to the banks. This was intended to protect smaller financial institutions and regional banks. Another example is the marketing of new financial products, where financial institutions had to “consult” the Ministry in advance.

The problem was that these regulations often lacked explicit statutory basis and were based upon the general supervisory power of the Ministry. Specific measures were implemented by administrative guidance, which usually took the form of circulars of the Ministry's bureaux, but sometimes were not given in a written form. There was a broad scope of discretion on the part of the Ministry. The effectiveness of the guidance was supported by the Ministry's power to grant licences and approvals.

This lack of transparency and accountability was highlighted in 1991 in the wake of the securities scandal. Major securities companies were found to have compensated losses suffered by favoured customers through their discretionary accounts. Compensa-

tion *per se* was not against the Securities and Exchange Law at that time, but against a circular of the Securities Bureau; promise of compensation was unlawful. The Ministry had encouraged securities companies to close these accounts earlier. Securities companies were of the view that the Ministry had tacitly allowed compensation when closing these accounts, which was denied by the Ministry. In a way, this is a good example of the problems caused by the lack of clear-cut regulations.

Later in the 1990s, when a Japanese bank suffered loss created by its rogue trader but failed to disclose it to the US authority, the handling of this case by the Ministry was criticised. In fact, the bank had reported this to the Ministry earlier, but the Ministry failed to advise the bank in an adequate way. Then, in 1997, another series of scandals broke out. It was revealed that a major bank had financed an obscure businessman who proceeded to purchase shares of the then "Big Four" securities companies. Several of the securities companies actually compensated losses of this businessman. This further cast doubt on the capability of the Ministry in supervising the industry. Also when Yamaichi Securities collapsed, it was revealed in the report prepared by an independent body that the director of the Securities Bureau had actually suggested that debts should be transferred abroad.

These incidents also highlighted the adequacy of the dual role of the Ministry, i.e. its role as a regulator of the market and also as a promoter of the industry. In the case of the rogue dealer of the US subsidiary of the Japanese bank, and also in the Yamaichi Securities case, the Ministry seems to have performed the role of a promoter rather than a regulator

Already in the aftermath of the securities scandal of 1991, the possibility of setting up an agency for the supervision of the securities industry was discussed. There was a proposal to establish an independent administrative commission in charge of regulating financial institutions. After a heated political debate, eventually, instead of an agency overseeing the whole range of financial institutions, the Securities Surveillance Commission was set up as a watchdog over the securities and the financial futures market. This Commission has been fairly active in the past five years. According to their annual report, the Commission has initiated proceedings against cases of insider trading, unfair methods of trading etc.<sup>2</sup>

In the course of the administrative reform which started in 1995, it was proposed that the inspection and supervision of financial institutions should be separated from the Ministry of Finance. This time, the separation of the functions performed by the banking bureau, securities bureau and the insurance division from the Ministry of Finance was at issue. The above-mentioned incidents cast doubt on the appropriateness of entrusting the ensurance of fair and transparent operation of the financial market to the hands of the Ministry, particularly in the light of the forthcoming deregulation.

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2 SECURITIES SURVEILLANCE COMMISSION, *Heisei 8 nendo katsudô hôkoku (Annual Report of Activities, 1996)*, Tokyo 1997.

Again, after some political hassles, a new agency called the Financial Supervisor Agency was founded in June 1997 and started operation in June 1998.

The Agency has been set up as part of the Prime Minister's Office. It is headed by a chairman, not a minister. The chairman is appointed by the prime minister. The Securities Surveillance Commission, which hitherto had been part of the Ministry of Finance, came to be part of this Agency.

The Law on the Establishment of the Financial Supervisory Agency provides that the Agency's primary task is to supervise (including inspection) banks, securities companies and insurance companies so that these companies carry out their business in an appropriate way and are soundly managed. The Agency also carries out surveillance of trading in securities in order to ensure fairness of transactions. Such functions of the Agency are intended to protect depositors, insurance policy holders, and securities investors, and also to ensure smooth functioning of the financial system and the circulation of securities. The Agency covers, *inter alia*, banks, trust companies, insurance companies, securities companies, securities financing and securities investment trust companies, securities investment advisory companies, and companies trading in financial futures and conducts inspection of these entities. The Agency also has a Financial Intelligence Unit, which handles matters concerning the prevention of money laundering.

Banking and securities bureaux at the Ministry of Finance were abolished. Granting and withdrawal of licences, e.g. licence for financial futures trading, orders to suspend operation, to correct the methods of business, and approval of certain kinds of new financial products are now within the portfolio of the new Agency. However, as a result of a political compromise, legislative and administrative planning functions are left to the Ministry. Matters such as the improvement in the disclosure system are to be handled by the Financial Planning Bureau. It should be added that other agencies such as the Ministry of Agriculture and Ministry of Labour still maintain power over financial institutions within their portfolio.

Whether the new Agency is sufficiently independent of the Ministry is questionable. Although the Agency is empowered to order suspension of whole or part of business, or withdraw licences of securities companies, if such measures are likely to affect the circulation of securities in a significant way, prior consultation with the Minister of Finance is required. The same applies in cases where the Agency intends to apply such measures to banks if such measures are likely to affect the financial system in a significant way. In this respect, the demarcation of boundaries between the Ministry and the Agency is not clear. There may be further changes in the apportionment of roles between the Ministry of Finance and the Financial Supervisory Agency.

Another institutional development in the framework of the reform is the enactment of the new Law on the Bank of Japan.<sup>3</sup> The Law on the Bank of Japan, which was modelled after the German *Reichsbanksgesetz* of 1933, has long been considered to be outdated. The independence of the Bank of Japan of the government has been strengthened. For example, the power of the government to issue orders to the Bank was abolished, and it was made clear that the difference of views between the government and the directors of the bank does not serve as a ground for the latter's dismissal. Instead of the informal meeting of the governor and senior directors, which hitherto has been the de facto decision-making body, the new Law reconfirmed that the policy board was the supreme body of the Bank and changed its composition.

### 3. CHANGES IN THE METHOD OF FINANCIAL ADMINISTRATION

In the past, the financial system had been administered by the Ministry of Finance in a highly detailed, but often informal and discretionary way. As is the case with public administration in Japan in general, the relationship between the Ministry and financial institutions was not unilateral. Instead, the regulator and the regulated co-operated in setting out policies and implementing them. *Milhaupt* and *Miller* characterise this system as a regulatory cartel.<sup>4</sup> It is basically for the benefit of insiders; it lacked transparency and there was no real accountability by any of the players. The state of affairs is held to be at least partly being responsible for the sorry condition of the financial system in Japan today.

This system is in the process of change in favour of more transparency and accountability.

First of all, circulars, through which the Ministry administered the system, have been either abolished, or replaced by ministerial ordinances and guidelines. Some circulars have already been „codified“ into ordinances since the securities scandals in 1991, but the latest measure is more far-reaching. There used to be 366 circulars in banking and 34 circulars in securities business which implemented administrative guidance.<sup>5</sup> For example, the opening of a new branch was regulated by one of those circulars. These circulars were abolished, and matters such as the criteria for granting of licence and permissions will be regulated by ministerial ordinances and notices. Some guidelines were also issued by the Ministry of Finance. Self-regulatory measures by bodies such as

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3 M.J.B. HALL, "Financial Reform in Japan: Redefining the Role of the Ministry of Finance", *Journal of International Banking Law*, 1998 Issue 5, pp. 171-176.

4 C.J. MILHAUPT and G.P. MILLER, "Cooperation, Conflict, and Convergence in Japanese Finance: Evidence from the 'Jusen' problem", *Law and Policy in International Business*, vol. 29, 1997 p. 12.

5 *Tsûtatsu tô no seiri ichiranhyô (Sorting List of Circulars)*, Banking Bureau of the Ministry of Finance, June 8, 1998. *Shôken-kyoku genkô tsûtatsu tô no seiri-hyô*, Securities Bureau of the Ministry of Finance, June 8, 1998.

the Securities Dealers Association are also expected to play a major role. It should be added, however, that whether or not these changes are merely a formality would depend on the actual implementation of these guidelines and self-regulatory measures.

Secondly, instead of highly discretionary ways of monitoring and supervising the soundness of financial institutions, a more transparent system of „early corrective measures“ was introduced in 1996 and came into effect in April 1998 in relation to financial institutions to which international standards are applicable. For those to which domestic standards are to be applied, the change will be implemented later by March 1999. If a certain parameter – capital adequacy ratio – is met, then pre-determined measures are automatically applied, thus excluding discretion by the regulator. Thus, if the capital adequacy ratio of a given financial institution falls below 8% for those involved in international business and 4% for those involved in domestic business, these institutions are obliged to prepare a plan to improve business. If the ratio falls under 4% and 2% respectively, a plan to increase the capital has to be prepared, limits have to be placed on the increase of net assets, existing businesses may have to be reduced, new businesses and new outlets are prohibited. If these ratios reach 0%, suspension of business will be ordered.

Naturally, in order to make these changes effective, inspections by the authority, hitherto by the Ministry and from June 1998 by the Financial Supervisory Agency, has to be improved. In the past, such inspections tended to be a formality, particularly in overseas subsidiaries and branches. Major banks were inspected on a regular basis only every four years. It should be remembered that the Ministry had failed to find irregularities involving *Yamaichi* despite repeated inspections. In this regard, financial institutions are now required to assess their capital adequacy by themselves on the pain of criminal penalties. To what extent the self-assessment can be accurate is not known. In one recent case, there was a big gap between the self-assessment by a troubled bank and the assessment by the Ministry.

Thirdly, the method of detailed prior interference by the supervising authority in the day to day business of financial institutions is to be replaced by post de facto control. Various reporting and notification requirements are now being reviewed. For example, the prior consultation system for marketing new products or commencing new businesses is said to be gradually fading out, being replaced by a post de facto notification.

Even the licensing requirement for securities companies was abolished. Under the current system, securities companies are licensed by the Ministry of Finance. This system has been criticised abroad for impeding new entries into the market. Licensing is to be replaced by a registration system by the reform, although some businesses, such as trading in OTC financial derivatives, will still be subject to licence. On the other hand, financial institutions will be held responsible for the outcome of their acts. Criminal penalties for violations of the law have been duly strengthened.

#### 4. DIMINISHING SEGREGATION

Japan has a highly segmented financial system. There are three types of segmentation; firstly, segregation of long term and short term finance, secondly, deposit banking and trust banking, and thirdly banking and securities business. Among the banks, there are ordinary banks as well as long term credit banks, trust banks, co-operative banks etc. Ordinary banks are further classified into city banks, regional banks, and secondary regional banks. There was also a foreign exchange bank.<sup>6</sup> The business of each category of financial institution was subject to license, was strictly defined in scope, and the entry into another business was extremely difficult. This worked against competition, but in favour of protecting the business of the existing players.

The system of segmentation had become less strict in recent years, but the present reform seems to have more or less dismantled this system. The liberalisation of financial holding companies made this possible.

The segregation between banking and securities business is a product of the post-War reform. Before the Second World War, banks were allowed to engage in any kind of businesses; thus, under this universal banking system, banks acted as major underwriters of securities. It was only after the War, that Japan followed the U.S. Glass-Steagall Act and strictly segregated securities business from banking business. This was intended primarily to ensure sound management of banks by distancing them from the securities market, thereby protecting the banks from fluctuation in the securities market, and also to prevent them from creating financial conglomerates. On the other hand, one of the differences between the Glass-Steagall Act and the Japanese system is that in Japan, banks are allowed to hold shares of business companies for investment purposes. In fact, in 1995, financial institutions accounted for 39.5% of the shares of listed companies.<sup>7</sup> This, in a way, weakens the argument that segregation is needed to reduce exposure of banks to the securities market. Currently, it is reported that the capital adequacy of major banks is affected by the constant fall in the prices of shares held by banks.

There has been a longstanding dispute between the banks and securities companies on the demarcation of boundaries. The wall between the two businesses had already become somewhat blurred ever since the amendment to the Securities and Exchange Law in 1981. Another amendment in 1988 made it possible for banks to engage in securities index futures and option trading in government bonds.

The system of segregation between banking and securities business became even less strict in the 1990s. There was much pressure from the banks, which, with the shift of corporate finance from indirect to direct finance in the latter half of the 1980s, found it more and more difficult to satisfy customers without dealing in securities. Furthermore,

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6 For an outline of the previous system, see Y. SUZUKI (ed.), *The Japanese Financial System*, Oxford 1987, pp. 35-40.

7 JAPAN SECURITIES RESEARCH INSTITUTE, *Securities Market in Japan 1998*, Tokyo 1998, p. 83.

profitability of banking business was in decline and new business opportunities had to be sought.

In 1992, a set of laws for financial reform was adopted. Banks and securities companies were allowed to enter into the other's business through subsidiaries. Banks were allowed to do business concerning private placement of securities. Securities companies were allowed to set up banking and trust bank subsidiaries, while securities subsidiaries were made available to banks. However, the scope of business was limited and the size of the subsidiaries was fairly small.

At the time of the 1992 reform, the adoption of the universal banking system was considered to be unsuitable, partly because of the potential conflict of interests. Japanese banks hold a substantial number of shares and bonds and therefore, the possibility of conflict of interests is particularly acute. The universal banking system also met opposition from securities companies which feared that banks might become too powerful.

With the current reform, the wall between banking and securities business has been further lowered by the amendments to the Securities and Exchange Law and Banking Law. Restrictions on the scope of business by securities subsidiaries of banks are gradually being lifted. There will be no restriction in this respect by, at the latest, March 2000.

A contentious issue between securities companies and banks was the offer and sale of beneficiary certificates for securities investment funds. They have long been an exclusive business of securities companies. However, as part of the lowering of the barriers between securities and banking business, from 1997, banks were allowed to offer their premises to the fund management companies to sell certificates. Then, from 1998, banks have come to be allowed to sell those certificates as securities business, provided that they obtain license.

Liberalisation of financial holding companies, which was one of the core measures of the current reform, is expected to deliver the final blow to the system of segregation. Since 1948, Japan has prohibited holding companies by Anti-Monopoly Law. There was dissatisfaction on the part of the business communities, which contended that it was only Japan and Korea that banned holding companies. At the time of recession, it was acutely felt that prohibition of holding companies was inhibiting efficient management of companies and stifling business. In 1997, the Anti-Monopoly Law was amended and holding companies were allowed to be set up. Only those holding companies which represent excessive concentration of economic power are prohibited.

This general liberalisation of holding companies enables financial institutions to set up a financial holding company. Relevant laws were amended in December 1997. Financial institutions may now form a group with various types of banks and a securities company under the umbrella of a holding company. Setting up of a financial holding company group by a bank or an insurance company is subject to the approval of the Minister of Finance.

It should be noted that there are restrictions as to the size of banks and securities companies which can belong to the same group. The general prohibition of setting up holding companies which represents excessive concentration of economic power also applies to financial holding companies. Basically, if a holding company group 1) has a business which is exceptionally large in size (assets over 15 trillion yen) and covers a substantial number of principal fields of business, 2) the group has a high degree of influence through financing, or 3) occupies a substantial position in each of a substantial number of principal business areas which are interrelated, it is regarded as an excessive concentration of economic power. Thus, it is not possible to have a holding company which has a major bank, securities company and insurance company within the group. A banking holding company may have a securities subsidiary, but its size will be limited.

A large scale financial company whose total assets exceed 15 trillion yen cannot have a large business company, i.e. a company whose total assets exceed 300 billion yen, as a member, except in cases where this company is engaged in financial business or businesses closely related to financial business (The Guideline of the Fair Trade Commission).<sup>8</sup> The Ministry of Finance maintains that in the latter case, even if the company's assets are under 300 billion, a holding company group set up by a bank can have a securities company and/or an insurance company, but should not have a business company as a member except for companies of limited scope of business such as leasing and business. This is intended to prevent excessive concentration of power to banks. On the other hand, holding companies set up by securities companies may have business companies as a member of the group.

It should be added that by virtue of the Anti-Monopoly Law, a holding company group, as a whole, may not hold shares of a listed company over a certain limit. In cases where the group which is set up by a bank includes a securities company, bank and insurance company, the ceiling will be 15%.

The liberalisation of financial holding companies is not necessarily the final solution to the long standing disputes among different kinds of financial businesses. There are some potential negative effects in such a system. It is known that there is a possibility of conflict of interests within the financial holding company group. Insider information may be abused within the group. The group itself may gain a dominant position and become exclusive.

The problem is that the liberalisation of financial holding companies was hurried through without much discussion as to the side effects which might accompany it and without due regard to the measures to cope with them. In the Japanese corporate culture with a close-knit network of insiders, it may not be easy to establish a firewall between banking and securities companies within the group. Thus, there is no guarantee that the information obtained by a bank through lending business will not be utilised by a

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8 See the FTC home page at <[www.admix.ftc.go.jp](http://www.admix.ftc.go.jp)>.

securities company in the same group. Customers may feel compelled to use a bank which belongs to the same group as its underwriter.

Unlike the United States, where a body of complicated regulations on financial holding companies had developed over the years, Japan had to start from scratch. Nevertheless, sufficient discussion on these matters seems to have been lacking.<sup>9</sup> Actually, even for holding companies in general, it was only in July 1998, one year after the liberalisation of holding companies, that the Ministry of Justice invited discussions on the introduction of a new set of regulations concerning the relationship between the parent company and its subsidiaries.

##### 5. REMOVAL OF FOREIGN EXCHANGE BARRIERS

The Foreign Exchange and Foreign Trade Control Law was substantially amended in 1997 (effective from April 1998) as part of the financial reform. The term „control“ was dropped from the title of the Law; it is now called Foreign Exchange and Foreign Trade Law. The overall goal of the amendment was the liberalisation of outward transactions and foreign exchange business.

In fact, the Law went through a major amendment in 1980. The amended Law declared that foreign exchange, foreign trade and capital transactions were basically free from restrictions and that only minimum necessary control and adjustments were to be exercised. However, there were actually various exceptions to this rule. For instance, special methods of settlement, such as set-off, were subject to approval by the minister. Although the 1980 amendment was claimed to be a major step towards liberalisation, it was pointed out that the amendment fell short of a total restructuring, since broad discretion was given to the ministries in creating specific exceptions to the general permissive principle. Much of its implementation was left to cabinet orders, ministerial ordinances, as well as to circulars and notices.<sup>10</sup> Capital transactions were either subject to approval, or had to be notified in advance.

Some of these exceptions were gradually lifted in recent years. For example, „netting“ between residents and non-residents was regarded as „special methods of payment“, and was subject to approval, but a general licence was made available. However, the Law was still complicated overall with various exceptions provided by sub-laws, and was regarded as highly restrictive by the business community. The over-regulated system was blamed for the Japanese market losing business against foreign markets.

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9 N. KAWAHAMA, “Kinyū mochikabu kaisha ni tsuite (On Financial Holding Companies)”, *Jurisuto* 1997 November 15, pp. 37-39.

10 A.D. SMITH, “The Japanese Foreign Exchange and Foreign Trade Control Law and Administrative Guidance; the Labyrinth and the Castle”, *Law and Policy in International Business*, 1984, p. 418.

The latest amendment to the foreign exchange system has introduced significant changes.<sup>11</sup> Formerly, foreign exchange business had to be handled exclusively by licensed foreign exchange banks. Currencies could be exchanged only by licensed foreign currency exchangers. Prior notification was required in various transactions, but if the transaction was to be effected through designated securities companies, the requirement did not apply. By the amendment, the requirement of license for foreign exchange business and foreign currency exchange was dropped. The system of designated securities companies was totally abolished. It is expected that there will be some new entries, mainly by securities companies, into the foreign exchange business, which, previously, had been dominated by foreign exchange banks.

Cross border payment *per se* was not subject to approval even before the amendment. However, as an exception, "special methods of settlement" required approval. These included credit and debit entries between the accounts of residents and non-residents, deferred payment after more than 2 years of shipment and set-off. Thus, even if a Japanese importer had a claim against a foreign exporter, there was no possibility of set-off, and therefore, the importer had to pay for the product and the exporter had to repay debts by two separate transactions through foreign exchange banks. Netting transactions including multiple netting (netting involving parties other than the parent company and its subsidiaries, or group companies) have been largely liberalised by March 1997. In fact, by the latest amendment, the entire concept of „special methods of settlement“ has been abolished. Except in cases of contingencies, payments are not subject to license or prior approval. This will naturally save the cost of transactions, but will reduce the revenue of banks.

Instead of prior notification, there is a reporting requirement in various transactions. A post de facto report is required in cases where a resident or non-resident effected payment from Japan to a foreign country or received payments from overseas, and where a resident effects payment or receives payment from a non-resident in Japan or overseas. Payment of under 5 million yen, or payment directly related to export-import transactions are exempted from this requirement.

On the other hand, banks etc. are now under obligation to confirm that the payment is made with appropriate approval if it is required. In cases where a customer intends to make payment overseas above 5 million yen, banks, postal offices, and foreign currency exchangers are required to confirm the identity of the customer by asking the customer to present necessary documents. They are obliged to submit a report on the implementation of this requirement to the Minister of Finance every six months.

Capital transactions have also been liberalised. These include transactions involving the emergence, transfer, or termination of claims based upon deposit or trust agreements, transactions concerning the emergence of claims based upon loan agreements

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11 For an outline of the new system, see A. TAKATSUKI, *Kaisei gaitame-hô (The Amended Foreign Exchange Law)*, Tokyo 1998.

and guarantee agreements, and transactions related to obligations emerging from the sale of instruments of payment or claims between residents and non-residents. Capital transaction is not limited to transactions between residents and non-residents. If the transaction is effected in foreign currency, transactions between residents are also regarded as a capital transaction. Thus, if a resident company effects payment in foreign currency with another resident company, this is a capital transaction. Furthermore, purchase of securities by a resident from a non-resident, transfer of securities by a resident to non-residents, issuing or offer of securities overseas as well as issuing or offer of securities denominated in foreign currency in Japan by residents, and issuing or offer of securities in Japan by non-residents are also capital transactions.

Before the latest amendments, some of these transactions were subject to approval by the Minister of Finance. Thus, if a resident intended to open an account abroad, such approval was needed, not only for the opening of the account, but also for the actual transfer to and withdrawal from the account. Settlement by foreign currency as well as foreign currency transactions based upon financial index futures contracts between residents were subject to approval. Therefore, in cases where a manufacturer exported machinery through a trading house, the trading house had to convert the foreign currency payment into yen before making payment to the manufacturer.

One of the problems with the regulation on capital transactions before the 1997 amendment was that the issuing or offering of securities abroad by Japanese companies was subject to prior notification. The same applied to issuing of foreign currency denominated securities in Japan. Companies were not allowed to proceed within 20 days of the notification, while the Minister reviewed the application. The Minister was empowered to recommend changes or suspension of the issuing or offering on various grounds. This deprived the issuer of the opportunity of issuing securities in a timely manner.

Another problem with the previous system was that a loan transaction between residents and non-residents was also made subject to prior notification. This meant that, for instance, if a company in Japan intended to transfer funds to a foreign subsidiary, or if the parent company needed foreign currency held by a foreign subsidiary and wanted the fund to be transferred, prior notification to the Minister of Finance was required. Again, a 20 days waiting period was applicable.

By the amendment, the requirement of prior notification or approval for capital transactions was abolished. The opening of accounts abroad by residents was dropped from the list of capital transactions, and thus was fully liberalised. Residents may now effect securities transactions abroad without prior notification. Issuing or offering of securities abroad, and loan transactions between residents and non-residents do not require prior notification either. On the other hand, these transactions are subject to post de facto reporting.

Obviously, the latest amendment is a major step towards deregulation of foreign exchange control, although many of the restrictions had been gradually liberalised

before the amendment. However, it is pointed out that whether the burden of reporting and notification is really alleviated or not depends on actual implementation of the post de facto reporting system.

#### 6. BROADENING OF THE INVESTOR'S CHOICE

Because of rigid regulations and the segregated system, Japanese investors have hitherto not been given sufficient choices for investment. Financial products handled by each category of business, e.g. securities companies, were standardised but limited in scope due to regulations, and channels for marketing were limited. There was a prior "consultation" system with the Ministry of Finance for marketing new products. As has been discussed above, with the liberalisation of foreign exchange control, Japanese residents may now transfer funds abroad and invest in overseas securities. Liberalisation also took place in relation to products marketed in Japan.

In stark contrast to the United States, a majority of household savings which amounts to 1,200 trillion yen, goes into saving accounts, and is not invested. An example is the investment trust funds (mutual funds). Only a small portion of the household savings has been invested in these funds. The over-regulated system was blamed for this state of affairs.

Only investment trusts of a contractual type had been in operation before 1998. Under this system, the trust property is invested in securities in accordance with the instruction of the fund management company; the right of the beneficiary is shared by an unspecified number of people. Trustees had to be either a trust company or a bank engaged in trust business. Assets which the funds could invest in were strictly regulated by the Ministry of Finance.

Since the 1980s, as investors became selective and yield conscious, the investment trust industry devised various types of investment trusts, such as intermediate-term government bond funds. This was followed by domestic and foreign bond funds (1984), long-term government bond funds (1986), and money management funds (MMF) (1992).

The collapse of the „bubble economy“ hit investment funds heavily. The total amount of assets held by investment funds has been in decrease. A reform took place in 1994; various restrictions on the management of assets were lifted and the disclosure system was improved.<sup>12</sup>

With the growing needs for diversification of assets management, as part of latest the reform, a company type investment trust fund was introduced this year. The name of the Law was accordingly changed to the Law on Securities Investment Funds and Securities Investment Juridical Persons. The amendment has also introduced private investment funds, whose beneficiaries are less than 50 in number. It is now possible for

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12 T. TAMURA, *Tôshi shintaku; kiso to jitsumu (Investment Trusts; Basics and Practise)*, Tokyo 1998, pp. 67-70.

the funds to invest in unlisted shares as well as unregistered shares. Thus, the investment may be more attractive, although it may be risky. The underlying idea of the reform is “self responsibility”, i.e. investors will be given choices, but have to bear responsibility.

A measure which is designed to facilitate investment is the liberalisation of cash management accounts with securities companies. Customers can settle various payments through this account with money reserve funds (MRF), which is a type of money market funds.

Another novelty in this context is the proposed liberalisation of wrap accounts. Since 1991, discretionary accounts were banned by the Securities and Exchange Law.

The ban was introduced because of the securities scandals which involved de facto discretionary accounts managed by securities companies. However, in the course of the current reform, it was proposed that wrap accounts, which are of a similar nature to discretionary accounts, should be introduced. In the light of recurring scandals involving these types of accounts in Japan, there is some scepticism as to the appropriateness of such liberalisation.

## 7. ENSURING FAIRNESS AND TRANSPARENCY

In a deregulated environment, investors are required to act at their own risk. This presupposes that they are provided with sufficient information to make their decision and that financial institutions act in accordance with established rules of behaviour.

There has to be an appropriate means by which a fair and sound operation of the market is ensured. Unfortunately, in the past, the Japanese financial markets could hardly be characterised as fair or transparent.

The disclosure system under the Securities and Exchange Law has been constantly improving in the last decade. The latest amendment to the Securities and Exchange Law expanded the disclosure requirement to cover issuing and offering of securities under 500 million, but above 100 million yen. Until 1998, the disclosure requirement did not apply when the amount of offer or sale was less than 50 million yen. Merely a notification was needed. In the light of the liberalisation of soliciting purchase of unlisted or unregistered shares by securities companies and the possibility of soliciting on a broader basis such as through the Internet, disclosure was thought to be needed for offer and sale on a smaller scale.

With the diversification of securities, information which requires disclosure have come to vary. For asset-based securities, the Law has introduced the concept of „specific securities“ which are subject to a different system of disclosure.<sup>13</sup>

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13 A very good analysis of the current disclosure system is found in KOMOTO and OKUMA, *Shôken torihiki-hô tokuhon (Securities and Exchange Law, Special Edition)*, Tokyo 1998, pp. 46-47.

A problem related to disclosure is the accounting system. In this area, the Japanese system is not compatible with international standards. Firstly, accounting in Japan is still not conducted on a fully-consolidated basis. Consolidated accounts are available, but these are merely supplementary. Besides, the scope of consolidated companies is narrower, since Japan relies solely on the shareholding proportion – 50% – as criteria for consolidation. Therefore, some companies conceal their losses in affiliated companies, which are not covered by the consolidated accounts.

Secondly, the Commercial Code allows companies to enter the assets in the books of account at the purchase value. Until the collapse of the “bubble economy”, companies had large unrealised profits which served as a safeguard for contingencies. After the fall in the securities and real estate market, these unrealised profits were more or less wiped out, and now there are unrealised losses. In any case, because of this system, the real financial state of the company was not reflected on the balance sheet.

These problems have been addressed in the course of the reform. Harmonisation with international standards is needed, if the Japanese market is to remain competitive with foreign markets. Consolidated accounts will fully replace the current system by 1999. Valuation by current value is expected to replace the valuation at the acquisition price by the year 2000. Valuation by current value has already been introduced for derivatives held for trading purposes by banks and securities companies by the 1996 amendment to the Banking Law and the Securities and Exchange Law. As for business companies, they are required to disclose information on their derivatives transactions, from 1997 in the form of connotation with the balance sheets.<sup>14</sup>

Deregulation does not always mean that everything should be left to the market. Minimum rules to ensure fair trading are naturally required. There are already various rules which are designed to ensure fair trading in the market. Securities and Exchange Law has a set of such rules, including provisions against unfair soliciting, insider trading, and market manipulation. Laws governing other financial businesses have some rules as well. Thus, the rules did exist, but they were not necessarily implemented in an appropriate way. Besides, since the finance business was compartmentalised, the rules were also segmented and lacked consistency.

By the latest amendment to the laws, the criminal penalty for the violation of these rules has been increased. Furthermore, it is now planned to enact a law which is similar to the UK Financial Services Act which encompasses the whole range of financial business.

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14 K. ITO and T. UEMURA (eds.), *Kinyū Big Bang; kaikei seido tō hō (Financial Big Bang; Accounting System and the Law)*, Tokyo 1998, pp. 36-43.

## CONCLUDING REMARKS

In stark contrast to the highly regulated and segmented system which existed until this year, a new system with a more competitive environment is gradually taking shape in Japan. Overall, the current reform is indeed a breakthrough, and a radical change from the “ancien regime”, although there are some problems which have been left unsolved or delayed, such as the problem of taxation of securities transactions and the full liberalisation of brokerage fees.

For financial institutions, there is no doubt that there will be more business opportunities, hitherto unavailable to them because of compartmentalisation and regulation. On the other hand, there is likely to be more competition due to the removal of walls between different businesses and the lifting of foreign exchange barriers. There are already some new entries into the previously protected market, including foreign companies. Full standardisation of the brokerage fee which is expected in the year 2000 will certainly enhance competition among the securities companies. While customers are expected to benefit from competition, for financial institutions, there is no “minimal right of survival”, which used to be guaranteed to them, any more.

Previously, in addition to formal regulations, the financial system was administered by informal methods which could only be effective between informed insiders. This resulted in failures to detect and sort out various irregularities by major players in the market. Reorganisation of the supervisory mechanism may improve the system. It is hoped that the shift from detailed prior interference to post de facto control combined with increased responsibility for the players will bring some positive results. However, a long standing habit may be difficult to change. Judging from the approaches to the recent problems of failing banks, it seems that the government has not fully abandoned the paternalistic approach. Whether key players are ready to accept the changes is also questionable. Repeated scandals despite successive changes to the law create doubts as to the effectiveness of self-discipline by financial institutions.

The reform can be characterised by a shift from the paternalistic “convoy system” to a system ruled by the market. However, as is the case with deregulation in other areas, deregulation is not just about shedding regulations. Some new rules to ensure fairness and sound operation of the market mechanism have to be introduced, and moreover, enforced in an appropriate way. Unfortunately, the current reform, at least part of it, was introduced in a rather hasty way, and therefore, in some areas, means to safeguard the abuse of the system are insufficient. A good example is the liberalisation of financial holding companies without sufficient measures to cope with conflict of interests.

Now that excessive rules and regulations have been more or less removed, it is time to work out appropriate framework which create a solid basis for fair and transparent market.