Globalization of Financial Markets and Financial Regulation in Japan

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I. INTRODUCTION

> "During the past 20 years financial markets have changed and developed at an astonishing pace. The markets have expanded, globalized, integrated, disintermediated, and innovated at a rate unknown to history and in doing so have escaped the bonds of control traditionally provided by government officials and regulators. Market forces and disciplines now rule the global economy."[1]

The astonishing growth of the global financial system inevitably affects, and is affected by, Japanese financial markets and Japanese financial institutions. Globalization of financial markets does not mean that there is one market on the earth. It means that many markets coexist in a multi-layer fashion, and they interact with one another. Financial transactions take place across the country borders and financial institutions and others act across the country borders in these multi-layer markets. Under this environment, a risk arisen in one market can easily be transmitted to another, but from a regulatory standpoint, it is difficult to regulate these multi-layer financial markets.

The interaction between Japanese and global financial markets, however, is not entirely clear. In December of 1989, a historical drop in stock prices on the Tokyo Stock Exchange began. Accelerated by the discovery of the "loss compensation scandal" in 1991,[2] the stock price decline led to a sixty percent drop in the market in 1995.[3] This market decline spread to real estate and other financial assets and led to the worst banking crisis in Japan's history driving the real economy into recession. Although this bursting of the stock market and real estate "bubbles" resulted in unheard damage to Japanese institutions and the national economy, it did not spread to other countries' markets.

From a Japanese perspective, however, the competitiveness of Japanese financial institutions and Japanese financial markets inevitably declined. Under these circumstances, Japan faced two fundamental issues related to its legal and regulatory systems.

First, Japan's traditional legal and regulatory systems were found to be insufficient to deal with bankrupting banks, securities companies and other financial institutions. The bankruptcy of banks or securities companies was almost unknown in Japan's history after

World War II, and there is no statutory framework, other than the general bankruptcy laws, for dealing with the failure of financial institutions. Also, the collapse of a prominent British merchant bank, Baring Brothers, in 1995 brought confusion in Japan's futures markets and triggered discussions about reforming margin requirements and related matters to deal with the possibility of a broker's bankruptcy.

Second, financial markets in Tokyo (and other locations in Japan) began to shrink and transactions began to flow to other countries, and these phenomena exacerbated concerns about the competitiveness of Japanese financial institutions. The general response in Japan has been to speed up the pace of deregulation with the hope of regaining the attractiveness of the Japanese financial markets and the competitiveness of Japanese financial institutions. Recent efforts and discussions in Japan all relate to these two issues. In particular, in November 1996, Prime Minister *Hashimoto* announced "Japan's Big Bang", and Japan embarked on a drastic reform program about its financial system with drastic deregulation and regulatory restructuring. Japan's Big Bang is expected to be completed by 2001. In May 1997, the Diet passed the laws to abolish exchange control and to allow financial (and other) holding companies. These two laws will become effective in 1998. The Diet also passed the law to move supervisory power from the Ministry of Finance to the Financial Supervisory Board, a new agency to be established in 1998. In June 1997, three councils at the Ministry of Finance – the Financial system Research Council, the Securities and Exchange Council and the Insurance Council – made public their reports on the Big Bang plan.[4] The plan is drastic and the time table was specifically shown for the implementation of the plan.

This article addresses the significance of the globalization of financial markets and Japanese responses in recent years in its financial regulation. I discuss recent trends in the Japanese financial regulation in Section 2 (concerning the banking sector) and Section 3 (concerning the securities sector), and evaluate both areas from a global perspective in Section 4. While this article is descriptive rather than analytical, Section 4 reveals first that just as market forces and disciplines rule the global economy, global standards of financial regulation, whatever they may be, have been emerging and becoming even more important. Section 5 argues then for the proposition that the movement of Japanese financial regulations toward such global standards results more from domestic problems than competitive pressures from outside Japan.

II. Regulatory Trends in Japan: the Banking Sector

1. Dealing with the banking crisis

The banking crisis that came out since 1991 raised two issues in Japan. One was how to deal with the bad loans that already existed. The other was how to provide a better legal and regulatory framework to deal with future bank failures. As for the former, due to the Bank of Japan's low interest rate policy, banks had high operating profits in the 1995 fiscal year, and many money center banks began aggressively writing off their existing bad loans. Related issues concerning bad loans, particularly the issue of liquidating "*jûsen*" institutions, were political rather than legal ones, and the solution to most of them were agreed on in 1996. A legislative package was passed in the Diet on June 1996 ("1996 legislation"), and this legislation attempts to facilitate further write-offs of bad loans by banks suffering with *jûsen* problems.

With respect to new regulations concerning future bank failures, the 1996 legislation provides two solutions, both new to Japan. One is to introduce a special set of legal rules for bankrupting banks, including the improvement of the deposit insurance system. No "pay off" of depositors has occurred in Japan after World War II, but under the new system, Japan is "ready" to make insurance payments. The other, more important matter in the 1996 legislation is the introduction of a "prompt corrective action" system, a system similar to that adopted in the United States in 1991. Under this system, banks are classified into several categories on the basis of their soundness – primarily measured by the level of their regulatory capital – and regulators are required to act promptly when a bank faces financial problems. While the effectiveness of these two solutions awaits future experiences, it is fair to say that Japan is reaching the point the United States did several years ago.

2. *Regaining and enhancing the competitiveness of banks*

It must be noted that the banking crisis arose out of traditional lending business, whether it was the result of unwise lending or whether the bursting of the stock price and real estate bubbles was beyond anyone's expectations. The present crisis is not the result of global market activities, such as global derivatives activities. Current discussions in Japan about regaining and enhancing the competitiveness of Japanese banks focus on speeding up the pace of deregulation. And the Big Bang program accelerates this deregulation process.

Structure of banking business: The reform of the financial system in 1992 allowed banks to engage in certain types of securities business through the creation of securities subsidiaries.[5] Thus, Japanese Glass-Steagall provisions calling for the separation of banking and securities businesses were not entirely abolished, but relaxed in this way. Many banks have established securities subsidiaries since 1993. The Big Bang attempts a fundamental reform of the organizational structure of banks through the introduction of a bank holding company structure. Under the current Anti-Monopoly Law,[6] creating a "pure" holding company is prohibited, but an amendment to lift this ban was passed in the Diet in 1997. A bill for regulating bank holding companies will be introduced in the fall of 1997. It is likely that a holding company structure will be introduced in practice in 1998, and banks are at present seriously considering how they should restructure their businesses, including their securities business. While it is more important for banks to obtain a wider range of permissible securities activities, when the holding company structure is introduced, the organizational structure of Japanese banks are likely to change drastically. This would raise regulatory issues as to how bank regulations should be applied to this new form of financial conglomerate.

Derivatives business: The growth of the derivatives markets worldwide has brought further business opportunities for Japanese banks. The Japanese legal and regulatory environment in this area is not as well-developed as that of the United States and elsewhere. While there are many issues under discussion, the 1996 legislation introduced market value accounting to banks (and securities companies). Banks were complaining about traditional cost based accounting on the grounds that it was an obstacle to being able to participate in the derivatives business and thus put Japanese banks at a competitive disadvantage. The introduction of market value accounting was a major step in revising Japan's traditional accounting standards to global ones.

Exchange controls: While banks are not the beneficiaries of deregulation in this area, foreign exchange controls in Japan have for some time been considered too restrictive, and have been viewed as one of the causes for the fact that the foreign exchange market in Tokyo has been losing ground to other markets. Under current law, "foreign exchange transactions" which are subject to regulation include transactions involving foreign currencies and those involving cross border deals (the latter including the transfer of loans, for instance, between Japan and another jurisdiction). While parties can enter into transactions without obtaining regulatory permission if they act through banks (licensed to engage in a foreign exchange business), they are required to obtain permission for each transaction if they wish to do so without going through a bank. By amendments to the current law passed in the Diet in May 1997, these controls were abolished. This change will be effective in April 1998. Once this takes place, the regulatory environment for foreign exchange transactions in Japan will drastically change.

III. Regulatory Trends in Japan: the Securities Sector

For securities companies, major problems arose from the loss compensation scandal in 1991 and the drastic stock price declines which occurred on the stock markets. Securities companies did not suffer directly from the banking crisis. Current discussions taking place regarding the reform of securities regulations in Japan are directed at more fundamental and structural issues.

1. Fundamental dilemma in securities regulation

In securities regulation, there is a historical dilemma: how to respond to the phenomenon of investor institutionalization.[7]

While capital markets are both well-developed and well-functioning markets when compared with product and other markets, they operate in a highly regulated environment. Highly organized securities markets of stock exchanges also operate in a highly regulated environment. This puzzle of why there is more rather than less regulation in the capital markets than in other markets stems from the historical aim of securities regulation: the protection of public investors against manipulative and deceptive activities by securities brokers. Thus, securities regulation in most jurisdictions emerged and is centered upon the idea of retail investor protection.[8] And two fundamental ways of protecting investors are found in the mandatory disclosure and anti-fraud rules.

Subsequent developments in the capital markets, however, resulted in the emergence and growth of institutional investors, typically mutual funds and pension funds, who can "fend for themselves," and this led to the need for an adjustment on the part of the traditional regulatory structure. The initial response to this institutionalization was to allow exemptions from the disclosure requirements in the primary markets. Private placement exemptions were thus recognized in most jurisdictions.[9] The next stage was to push exemptions a step further into the secondary markets, and allow sophisticated investors to trade in less or non-regulated markets. Rule 144A in the United States was an ambitious step in this direction.[10] Here, the exemption approach has faced a policy issue: whether we can live simultaneously with two markets, one for retail investors and the other for institutional investors. No satisfactory answer has been presented on this issue anywhere in the world.

Investor institutionalization led to the flowering of the asset management business, and also had an impact on the structure of both capital markets and industrial organization. Although the stock markets established on stock exchanges used to be the only places available for stock trading, investor institutionalization, coupled with advanced computer technologies, changed the way in which stock is traded. Stock exchanges have had to face direct competition with various (off-exchange) electronic trading systems, and the structure of the stock markets has become more complicated. This has raised the difficult regulatory issue of whether and how to regulate these electronic trading systems.[11]

Also, the ownership structure of public firms has been affected. The traditional model of separation of ownership and control, by which shares of public firms are anonymously held by many dispersed public investors does not reflect present realities. Instead, the shares of public firms have commonly come to be held by a relatively small number of institutional investors (as well as public investors).[12]

As a result, dual governance problems have come to public attention. First, we now observe an increased level of discussion on when and how institutional investors exercise their stockholder rights in the firm whose shares they own, and whether increased activism by institutional stockholders is a good thing for a national economy. Second, governance within these institutions themselves became an important issue. The key question is in what manner management of these institutions should be held accountable to their public beneficiaries, and whether some form of regulation should be installed to secure their accountability.

As briefly noted above, investor institutionalization created a new and very important area of business: pooling and asset management. This also created a new area for regulation: regulation of the asset management business. Actual developments in this area, however, were not as straightforward as described above. The United States enacted a federal investment company law as early as 1940. This law has worked well, and further regulatory refinement is currently underway. Note, however, that the Glass-Steagall Act prohibits commercial banks from "sponsoring" mutual funds, and also, that there has developed a separate area of pooling and management by commercial banks known as common and collective trusts.

In Japan, although investment trusts (the counterpart of mutual funds) have achieved rapid growth in recent years, they have for the most part been considered an additional source of funds and brokerage revenues by the securities companies. A fairly fundamental reform program to modernize the Japanese mutual fund industry took place recently, and further reform is expected as a part of the Big Bang.[13] Note, however, that Japanese investment trusts have been regulated separately from other asset management areas such as pension funds, commercial trusts, and funds managed by investment advisors, and it has proved difficult to restructure this fragmented regulatory environment into a more "functional" regulatory framework.

In 1986, the United Kingdom introduced a comprehensive regulatory framework into this area by enacting its Financial Services Act. A variety of pooling and management schemes are grasped as "collective investment schemes" and are subject to "functional" regulation under the Act.

It is difficult to evaluate which country's regulation is most desirable. Fragmented regulation in the United States and Japan has produced continuous disputes among participants regarding jurisdictional and related issues. It may also have hindered the development of new schemes, and thereby unnecessarily increased costs to the national economy. Various industries, however, may compete with one another while being subject to different sets of regulations, and this may be better than a world where all industries are subject to the same uniform, functional regulation. The Japan's Big Bang shows a suggestion toward a uniform, functional regulation, but it may take years to accomplish this comprehensive change.

2. *Deregulation of anti-competitive measures*

In Japan, securities companies still enjoy fixed commissions for their brokerage activities.[14] The report by the Securities and Exchange Council on June 1997 established an agenda for abolishing the fixed commission system. Another issue taken up in the report is to change the licensing system for the securities business to a registration system. The report also announced that the concentration principle by stock exchanges, which do not allow member firms to trade outside the exchange, will be abolished. Yet another important issue is whether to repeal Japanese Glass-Steagall. While a complete repeal is not expected in the near future, the report announced that banks will be admitted the business of marketing mutual funds.

3. *Other trends*

There are several other trends that can be viewed as evidencing a trend in Japanese regulation toward a more global standard. First, as noted above, the 1996 legislation permits securities companies to use market value accounting for their derivatives business. Second, the collapse of Baring Brothers brought confusion to the futures markets in Japan regarding its margin requirements. The current unique margin system in Japan was criticized, and in October 1997, a new system will be adopted by Tokyo Stock Exchange and others. The new system offers protection to customers in a similar way that the United States system does. At the same time, the inadequacy of current legal and regulatory rules for dealing with insolvent securities companies drew much attention. While the failure of a securities company probably raises less need for concern than if a bank fails, in such an event, customers' assets would not be satisfactorily protected under current laws, and therefore new legislation is needed to address this issue. The 1997 report by the Securities Exchange Council announced the reform on this point, too.

IV. GLOBALIZATION OF FINANCIAL MARKETS AND THE JAPANESE RESPONSE

1. Global standards for financial regulation?

The astonishing growth of global financial markets has produced increased risks and volatility in the marketplace. It has made the exercise of regulatory control more and more difficult. Indeed, it may not be wise to try to control today's global financial markets. Markets control and manage themselves. Increased risks and volatility in the marketplace can be best dealt with by market participants, and not by regulators. This phenomenon, however, does not mean the death of regulation. Markets as a whole survive, but particular investors may suffer.[15] In fact, global standards of financial regulation seem to be emerging and gaining support in the international financial community.[16] Such standards are comprised of three primary measures: capital adequacy requirements, increased disclosure of information, and increased cooperation among regulators.

First, since the Basle Committee on Banking Supervision adopted an agreement on capital adequacy for banks which operate internationally, all such banks in major countries have been subject to this minimum capital adequacy standard. These banks are required to assess the credit risk of all on and off balance sheet assets and to provide capital to back the risks involved with such assets. Beginning 1998, this agreement will require that banks maintain additional capital for market risk exposure as well. The International Organization of Securities Commissioners ("IOSCO") has been formulating a similar capital adequacy agreement for securities companies.

Second, banks and securities companies are being required to disclose an increasing amount of information concerning their holdings of derivatives and other volatile securities. These disclosures are becoming more and more important.

Third, information exchanges and other forms of cooperation among regulators are also becoming important. As a symbolic event, in 1995, the delay in reporting an employee's fraud to United States regulators by *Daiwa Bank*, a major bank in Japan, resulted in it being forced to shut down (or transfer to another institution) all of its operations in the United States.

2. Evaluating recent trends in Japan

How can the recent trends in Japanese regulation described in Sections 2 and 3 be evaluated against the global standards described above? They can be analyzed in two steps. First, recent trends show that Japanese regulation is moving from a position of industry protection to that of market protection. Second, this market protection is not achieved by directly regulating risks and volatility, but rather by introducing indirect regulation, which is consistent with emerging global standards of financial regulation. Note, however, that the Japanese style of rulemaking tends to be preserved when Japan adopts such changes.

From industry protection to market protection: In 50 years after World War II, no Japanese bank or securities company has failed. These are licensed entities, and a bankruptcy would have meant a failure of regulation and the regulator. Thus, when a bank or securities company was facing trouble, it was always rescued by fellow institutions in the form of a merger or otherwise dealt with under the leadership of the Ministry of Finance. The stock market crash and the banking crisis, however, made this "no failure" policy impossible to maintain. Today, rescuing an institution is sometimes too costly to society. Japan must (sometimes, though not always) accept failure of these institutions. What is happening today is the formulation of appropriate legal and regulatory rules to protect markets in the event of the bankruptcy of such an institution by minimizing the effects of such a failure on the marketplace.

From direct to indirect market protection: One feature of traditional financial regulation in Japan was to directly control risky activities and other market risks. Thus, portfolio regulation and other regulations restricted banks and other institutions from engaging in "risky" transactions or financial products. Today's globalized financial markets reveal that restricting certain "risky" transactions or financial products will make institutions even riskier because such restrictions deprive the institutions of the opportunity to optimally diversify the risks they face. And such restrictions have become almost impossible to enforce outside the country. Moreover, theory shows that markets regulate themselves better than governmental regulations. The fact that "indirect" regulation in the form of capital adequacy requirements, increased levels of information disclosure, and increased cooperation among regulators is becoming a global standard shows that this is the only direction for Japan to choose.

Though not described specifically above, while accelerating the pace of deregulation, Japan is clearly moving in this direction. First, Japan has been actively participating in international discussions on capital adequacy both for banks and securities companies. Second, increased information disclosure has been required of Japanese banks and securities companies regarding their holdings of derivatives and other volatile securities. Third, despite the problems revealed in the *Daiwa Bank* case, Japanese regulators have been active in promoting information exchanges and other forms of cooperation with other countries' regulators. For instance, when Barings Brothers failed, the Ministry of Finance was quite active in exchanging the necessary information with other regulators.

Style of rulemaking: As discussed elsewhere, the traditional style of formulating Japanese financial regulations is somewhat unique to Japan.[17] In short, most parties concerned participate in the rulemaking process. This process tends to be complicated, lengthy and time-consuming, but once the rule is finalized, it is unlikely that the rule will be challenged judicially or otherwise thereafter. While there is no space in this article to analyze the advantages and disadvantages of this method of rulemaking,[18] it is important to note that when Japan moves to a more global standard, it will be able to do so without changing the style of its rulemaking processes. Japan may, however, change the style of its rulemaking as well. If Japan does not drastically change its traditional style of rulemaking when adapting global standards, this should mean that this style of rulemaking has advantages in Japan.

V. CONCLUSION

The emergence of global financial markets has produced increased risks and volatility in the marketplace. It has forced changes in regulation. Increased risks and volatility in the marketplace are best controlled by market participants. Governments and regulators have had to give up direct regulation of these risks and volatility. Instead, a global standard of financial regulation has emerged in the form of indirect regulation of risks and volatility: capital adequacy, increased disclosure, and increased cooperation among regulators. While we may observe that all major industrial country's regulations are moving toward these global standards, Japanese market history shows that forces causing the adoption of these global standards primarily arise from domestic concerns rather than competitive pressures from outside Japan. This suggests that a country which suffers from scandals, market crashes or unfavorable economic conditions within the country has a stronger stimulation to move toward global standards. The speed of a particular country's move toward these standards depends on its domestic situation. It is also important to note that what is happening is not that everything is moving toward these global standards. As briefly suggested above, the Japanese experience shows that Japan tends to keep its traditional style of rulemaking while adopting the global regulatory standards discussed. From a legal and regulatory perspective, each country continues to maintain (and benefit from) many of the distinctive features it is endowed with and it developed within its own historical experiences.

Footnotes

* An early version of this paper was presented at the symposion „Das Recht vor der Herausforderung eines neuen Jahrhunderts: Erwartungen in Japan und Deutschland" on 25-27, July 1996, in Tübingen. I thank Professor *K.J. Hopt* for moderating the panel, and Professor *H.-D. Assmann* for his presentation from a German perspective at the panel. I also thank Dr. *H. Baum* for his insightful suggestions and encouragement.

1 R.C. SMITH, Risk and Volatility, The Washington Quarterly, Vol. 18, No. 4, 117 (1995).

2 For the details of the loss compensation scandal, see C.J. MILHAUPT, Managing the Market: The Ministry of Finance and Securities Regulation in Japan, 30 Stanford Journal of International Law 423 (1994).

3 In the 10 years preceding 1989, stock prices rose sixfold.

4 All reports by the relevant Councils at the Ministry of Finance are available in English at the web site of the Ministry <http://www.mof.go.jp>. Excerpts of two reports are reprinted in this volume, cf. infra Dokumentation.

5 For instance, dealing or brokerage in equity securities is not permitted for banks' securities subsidiaries. Note also that securities companies are permitted to set up subsidiaries to engage in the banking business. A "fire wall" must be established between a parent and its subsidiary.

6 SHITEKI DOKUSEN NO KINSHI OYOBI KÔSEI TORIHIKI NO KAKUHO NI KANSURU HÔRITSU, Gesetz Nr. 59/1047 i.d.F.d. Ges. Nr. 89/1993.

7 This section draws in part on H. KANDA, Changing Investors, Capital Markets, and Regulatory Responses (draft presented at the IOSCO meeting in Tokyo in 1994).

8 In theory, protection of public investors alone does not justify regulation. This fundamental question of why we need regulation in the capital markets is not discussed in this article.

9 The scope of private placement exemptions tends to have been expanded in most jurisdictions. In Japan, for instance, the scope was expanded by the 1992 amendments to the Securities and Exchange Law: when a firm issues securities, disclosure is not required if the offer is made to certain qualified institutions, irrespective of the number of offerees.

10 Japanese law has not yet gone that far.

11 See, for example, R. LEE, What is an Exchange?, in: S. REVELL (ed.), Capital Markets Forum Yearbook Volume 1, 70 (1994).

12 The ownership structure of public firms varies from country to country, reflecting a variety of historical and regulatory factors. In the United States, a strong policy limiting stockholdings by banks and other financial institutions shaped its unique market structure. See M.J. ROE, Strong Managers, Weak Owners: The Political Roots of the Separation of Ownership from Control (1994). Mutual stockholdings known as *keiretsu* in Japan may or may not be related to the institutionalization of investors. See R.J. GILSON & M.J. ROE, Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization, 102 Yale Law Journal 871 (1993).

13 See a report by the Investment Trusts Study Group, Securities Bureau, the Ministry of Finance (1994). As a result, the following reform was made. First, disclosure and anti-fraud rules were improved and, correspondingly, the process of authorizing a fund was simplified. Second, investment regulations were liberalized: for instance, borrowings by a fund are now permitted under certain conditions, and the use of derivatives by a fund, which had been too restrictive, was liberalized. Third, closed-end funds were introduced (using the trust form). The 1997 report by the Securities and Exchange Council announced the following reforms. First, private funds will be permitted under certain conditions. Second, delegation by the management company to outside institutions will be permitted under certain conditions. Third, company-type funds (somewhat similar to open-ended investment companies that were introduced in the United Kingdom in January 1997) will be introduced.

14 The fixed commission system was abolished for very large trades in 1994. Specifically it was abolished for the portion of a stock trade for which the contract price is above one billion yen. This did not affect most trades.

15 See, for example, SMITH, *supra* note 1.

16 In what manner one country recognizes the activities of another country's financial institutions is an important issue. As is well-known, the fundamental thinking within the European Union is

comprised of three principles: mutual recognition, minimum standards, and home country control. This is not taken up in this article. Rather, this article emphasizes the minimum standards being developed throughout major developed countries.

17 See H. KANDA, Politics, Formalism, and the Elusive Goal of Investor Protection: Regulation of Structured Investment Funds in Japan, 12 University of Pennsylvania Journal of International Business Law 569 (1991).

18 See KANDA, *supra* note 17.