

# Recent Banking System Reforms and Outlook for Japan's financial markets.

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## (Table of Contents)

### 1. Background of the Japanese Banking Reforms (Big Bang)

- (1) Change of environment surround in Banking business
- (2) Decline of status as the function of financial intermediaries

### 2. Recent progress of Reformation for Banking and Financial system

- (1) Revision about legislative control of financial system
- (2) Recent progress and formation of various financial markets
- (3) About safety net for investors

### 3. Critical points of Recent financial Reform

- (1) Difficulties of dealing with bad-debt problem for Banking sector
- (2) Framework for handling failure and restoring of financial institutions
- (3) Prudent behavior of investors and lack of domestic risk capital

### 4. Outlook for Japan's financial market after Reform

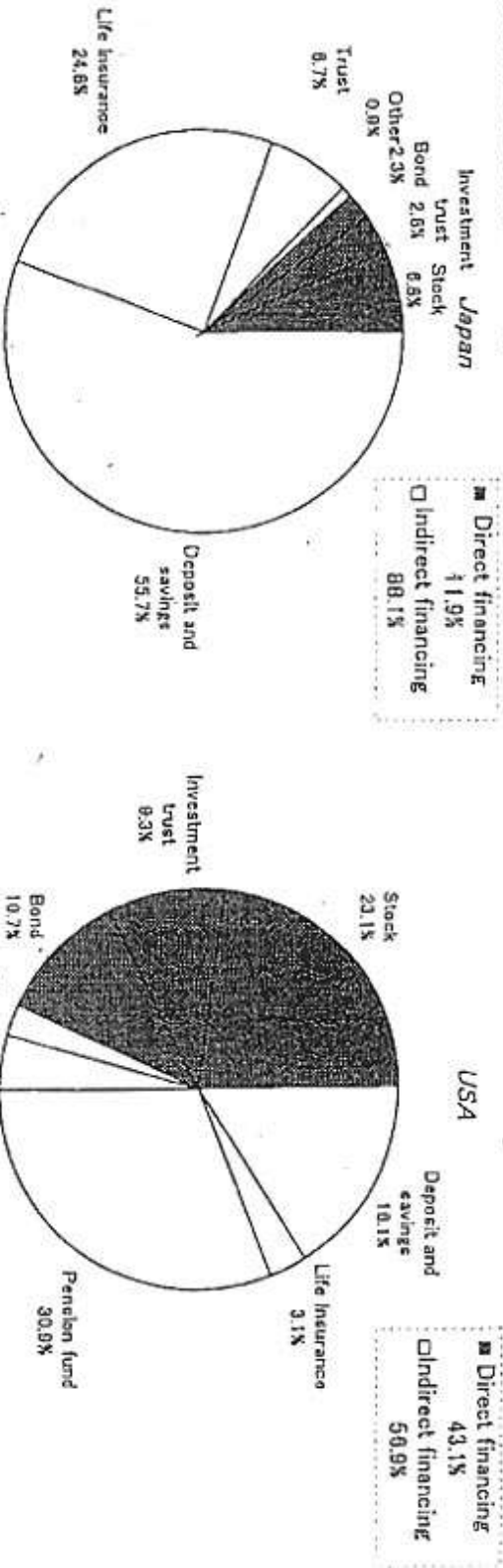
- (1) Increase of business chances in financial sector
- (2) Reorganization and cooperation through business status and nationality
- (3) Internationalization of Japanese financial and capital markets

(Figure 1)

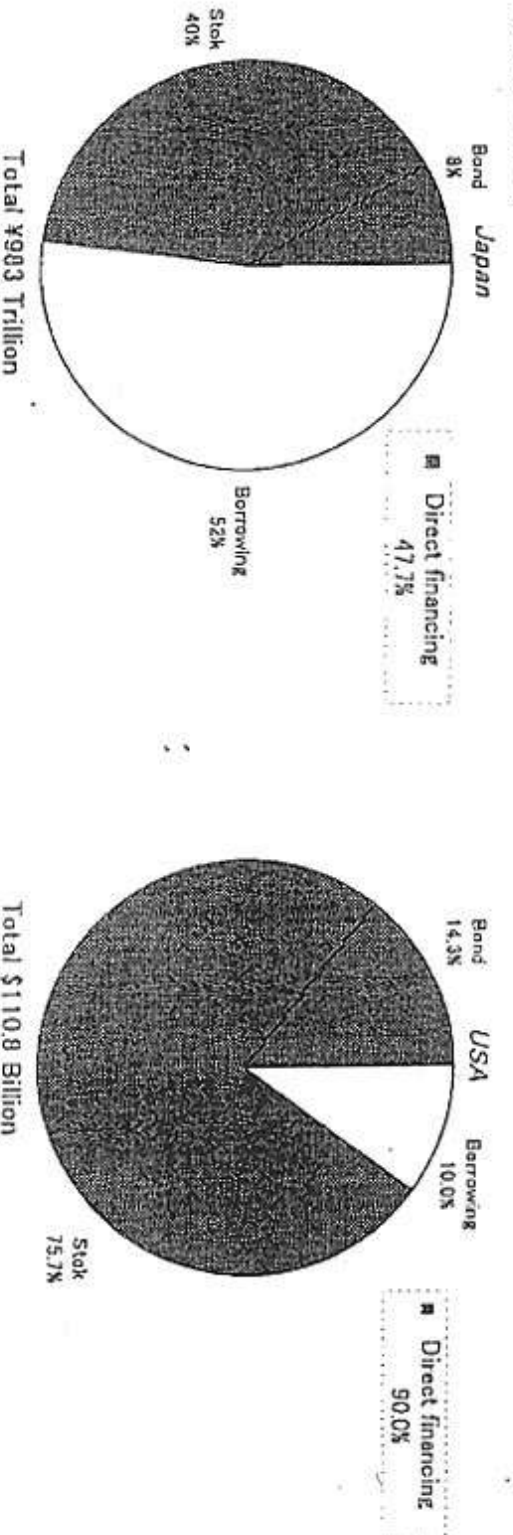
Comparison between Japan and the USA in Direct Financing and Indirect Financing

-Going forward, the expectation on Japan's securities market will grow larger and larger.

(1) Personal financial assets (end of 1995)



(2) Corporate funding (end of 1995)



(Note) Japan's Corporate funding is on the basis of end of financial year. Prepared from Bank of Japan statistics and Flow of Fund Accounts

(Figure 2)

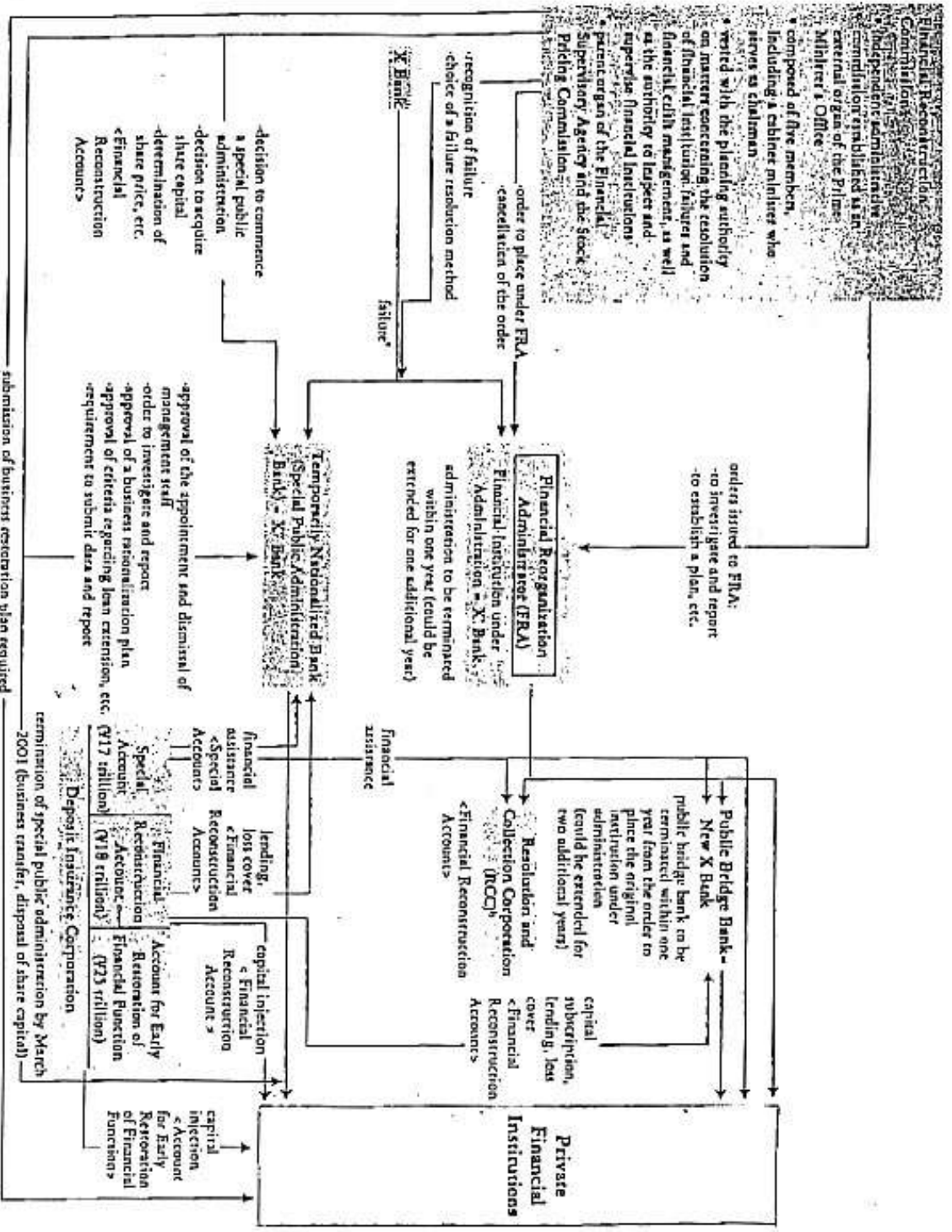
## Schedule of Japanese &lt;Big Bang&gt;

|   | FY1997 | FY1998 | FY1999 | FY2000 | FY2001 |
|---|--------|--------|--------|--------|--------|
| (1) To expand the choice of options for investors and borrowers   |        |        |        |        |        |
| The complete lifting of the ban on securities derivatives   |        |        |        |        |        |
| Handling of securities privately by the banks   |        |        |        |        |        |
| Introduction of the Cash Management Account   |        |        |        |        |        |
| Authorization for banks to sell investment trusts   |        |        |        |        |        |
| Gradual authorization for banks to sell insurance   |        |        |        |        |        |
| Increasing the liquidity of assets by use of ABS  |        |        |        |        |        |
| Liberalization of cross-border capital transactions   |        |        |        |        |        |
| (2) To improve the quality of intermediaries' services, and to promote competition among them   |        |        |        |        |        |
| Introduction of holding companies   |        |        |        |        |        |
| Shift from the licensing system to the registration system for securities firms (but approval is required for OTC derivatives, U/W business, etc.)                                    |        |        |        |        |        |
| Abolishment of restriction on business scope of financial subsidiaries  |        |        |        |        |        |
| Abolishment of operational regulations to ordinary banks dividing the short-term and the long-term finance  |        |        |        |        |        |
| Abolishment of the specialization obligation of securities firms / Diversification of their business operations   |        |        |        |        |        |
| Liberalization of brokerage commissions for stock trading   |        |        |        |        |        |
| Electronic money / electronic payment   |        |        |        |        |        |
| Diversification of the borrowing instruments of non-bank firms  |        |        |        |        |        |
| Reform of the casualties insurance premium calculating agency   |        |        |        |        |        |
| Liberalization of the foreign exchange business   |        |        |        |        |        |
| (3) To develop a market which is easy to use  |        |        |        |        |        |
| Improvement of on-exchange trading / Abolishment of the restriction of off-exchange trading for listed securities   |        |        |        |        |        |
| Improvement of the liquidity of the OTC registered stock market   |        |        |        |        |        |
| Lifting of the ban on the trading and intermediating of unlisted or unregistered stocks by securities companies   |        |        |        |        |        |
| Measures for trading of financial futures   |        |        |        |        |        |
| Development of the short-term money market (e.g. RTGS)  |        |        |        |        |        |
| Liberalization of cross-border capital transactions   |        |        |        |        |        |
| (4) To establish a reliable framework and rules for fair and transparent transactions   |        |        |        |        |        |
| Review of the accounting system (Consolidated financial statements, Mark-to-market method, Enhancement of audits by accountants)  |        |        |        |        |        |
| Expansion of definition of securities   |        |        |        |        |        |
| Enhancement of fair trading rules of securities   |        |        |        |        |        |
| Enhancement of the system of inspection, surveillance and punishment in the securities market and establishment of the civil disruption settlements system in securities transactions |        |        |        |        |        |
| Improvement of checking of the soundness of financial institutions (ex. Introduction of Prompt Corrective Action for the banks, review of capital requirement of securities firms)    |        |        |        |        |        |
| Strengthening of measures to reduce settlement risk   |        |        |        |        |        |
| Protection of users of financial institutions   |        |        |        |        |        |
| Strengthening of the system to settle failure of securities firms / Strict enforcement of separate asset management / Increase of the Securities Deposit Compensation Fund            |        |        |        |        |        |
| Response to international requirements for economic sanctions and prevention of money laundering  |        |        |        |        |        |
| Development of an ex-post facto reporting system  |        |        |        |        |        |

Source : JCIF

(Figure 3)

# The Framework of the Financial Reconstruction Law and the Financial Function Early Restoration Law



Temporary nationalization (special public administration) can be applied to a financial institution in danger of failure. RCC is authorized to purchase assets from financial institutions under administration, bridge banks, special public administration banks, and other financial institutions.

Sauce: the Bank of Japan

(Report for Hong Kong)

## Recent Banking System Reforms and Outlook for Japan's financial markets.

### Preface

Main object of financial system reform(so called Big Bang) is Banking System Reform in Japan, because Bank achieve the major role in financial intermediary. It is different from Anglo-Saxon countries, compare with the Reform of financial system in US and Great Britain, where reform of security market is main object.

Now our Japanese financial institutions are taking off from serious crisis in 1998 after a explosion of bubble economy and make efforts for revitalization of financial function with creation of framework for securitization of financial assets.

I should like to explain this situation from now, if you permit me to summarize conclusion, major reforms to deal with the country's financial system problem were undertaken, and these became trigger the restructuring of banking system through merger and tie-ups that transcend business categories and capital affiliations. But it needs at least 2 or 3 years for improvement of fully function.

### 1. Background of the Japanese Banking Reforms (Big Bang)

The major reason behind the Japanese Banking System Reforms is already cited from Japanese Government and Economists, so it need not explain fully for you. Only I want to stress on 2 points:

#### (1)Change of environment surround in Banking business

and needs for invigorating the function of the money and capital markets, under the new environment that Japanese economy caught up with US and west European countries and that economic internationalization is progressing day by day.

I think most major reason of Banking reform necessity is to correct the disproportionate emphasis on deposits and on indirect finance of Japan's 1,300 trillion yen of personal financial assets(Figure 1 of papers).

Private banks which main resource is deposit with fixed interest rates cannot take large scale of financial risk just like interest or exchange changing risk. And If massive personal financial assets are not provided with a place for efficient investment, also vigor of individual investors is not revived,it will not be possible to achieve the long-term development of the Japanese capital market.

So securitization and liquidization of bank's asset is necessary for revitalization of financial intermediaries by deregulation.

## (2) Decline of status as the function of financial intermediaries

and necessity to enhance the international competitiveness of Japanese financial institution.

According to grow worse of bank's profits, banking business reform for new fields became negative. And international competitiveness of banking business is declining, especially derivatives trading just like swap and option.

This weakened financial activities caused decline of Tokyo's status as an international financial center. For example ① fall in number of foreign companies listed in Tokyo, ② decrease in trading of foreign exchanges and Japanese shares.

As the economy was integrated into global system, adjustment policy to global rule and system should have been devised earlier. Segmentation into banks, long-term credit banks, trust banks, smaller financial institutions securities firms life-insurance companies, and non-life-insurance companies should have been ended earlier.

Takatoshi ITO, former adviser to Thailand Government said that the 'Big Bang' should have taken place 10 years earlier, 'Gradualism' allowed rent-seeking financial institution to make crucial mistakes during the bubble years. I agree quit with his opinion.

## 2. Recent progress of Reformation for Banking and Financial system

### (1) Revision about legislative control of financial system

As you know deregulation of interest rate and financial products began gradually from 1985. But it didn't sufficiently effects I mentioned above. So The 'Big Bang' policy, a comprehensive deregulation of financial market is required. This policy meant reformation of banking system, because Banking system achieve most important role in financial function.

The first step was taken in April 1998 by deregulating the foreign Exchange law and regulation. Now anyone can trade and transact foreign exchanges, without being brokered by authorized banks. And 'Big Bang' policy classify 4 groups:

- ① to expand the choice of options for investors and borrowers.
- ② to improve the quality of intermediary's services, and to promote competition among them.
- ③ to develop a market which is easy to use.
- ④ to establish a reliable framework and rules for fair and transparent transactions.

About each schedule of 'Big Bang' plan, you can see on Figure 2.

## (2) Recent progress and formation of various financial markets

Accompany with deregulation of financial system, various securities markets were born, in which Structured Financing Product and Repo (Bond loan & borrow) market became large scale, they perform important role in financial market.

Concerning financial products, with a competition from abroad, for example, financial institution(Japanese and Foreign) in Japan also became aggressive in pursuing Y1,300tri.,of personal financial assets. The Mutual Fund, Investment Trust Fund and foreign bonds, which offer higher yields than yen deposits, became popular.

(3)About safety net for investors→ I'll touch after next part.

## 3. Critical points of Recent financial Reform

### (1) Difficulties of dealing with bad-debt problem for Banking sector

Under Capital Adequacy Requirements, burden of non-performing loan limit positive banking activities(loan business etc.). So each bank hesitate to dealing with non-performing loan ,wait and see the situation.

Let me mention a conclusion in advance, Financial deregulation should have been accompanied by strengthened supervision and legal framework for handling failures of financial institutions and for restoring confidence in financial system. But these positive actions delayed for bad-debt problem by political reason. So the costs on non-performing-loan disposal became a massive amount as follow.

Cumulative losses from the disposal of nonperforming-loans by Japanese banks between fiscal 1991 and 1998,in the wake of the bursting of the economic 'bubble' reached Y56.6 trillion. This massive loss on nonperforming-loan disposal far exceeded Japanese bank's operating profits from core business of YJ37.0 trillion during this period. The excess was financed by net bond-related gains of Y 3.2tri.,net stock-related gains of Y12.4tri.,and gains on sales of real estate of Y1.7tri., as well as a decrease in capital accounts of Y17.4tr.

### (2) Framework for handling failure and for restoring of financial institutions

After the failure of a big bank like Long-term Credit Bank(LTCB), which had an international presence, Japanese Monetary Authorities established a major framework in which a bank failure could be handled in a flexible way with minimum negative impact on stability of the financial system(see Figure3).

At the same time, they maintain the framework of capital injection using public funds. Bank of Japan has argued that the core of Japan's financial system problem is the undercapitalization of many Japanese banks. As bank's profitability and access to

private capital markets were limited, public fund were almost the only source.

As the condition of public capital injection, the FRC required explicit plans to improve profitability that included, in some cases, withdrawal of all overseas offices. The management improvement plan was submitted to

Undoubtedly, the capital injection is an important step in the right direction. But it is not the ultimate measure to achieve the final goal of overcoming the banking problem. Bank remove bad loan from their balance sheets to improve their cash flow. This is an important step toward restoring their financial intermediary function, which turn would contribute to an economic recovery. Also, further consolidation is necessary. By promoting consolidation in an effective way, the banking system will gain efficiency and profitability.

(About safety net for depositors and investors)

Government decided a new regulatory regime from April 2002 on which I wrote paper. Please look at attached paper.

(3) Prudent behavior of investors and lack of domestic risk capital

Critical factors about 'Big bang' plan are, I suppose, 2 points.

1<sup>st</sup> is a prudent behavior of investor(depositor) and lack of domestic risk capital. White paper by Economic Planning Agency pointed out this point last year. It is caused not only by national character, but by experience of bubble economy. It takes so much time to change behavior.

Another is a delay of legislative actions, which due to bureaucracy's negative stance.

#### **4. Outlook for Japan's financial market after Reform**

(1) Increase of business chances in financial sector

In addition to increase various financial products mentioned above, important measures have taken in the removal of bad-loan from bank's balance sheets. They include the creation of RCC(the Resolution and Collection Corporation) which can purchase bad loan not only from failed banks but also from solvent banks, a legal framework for securitization of bad loans.

(2) Reorganization and cooperation through business status and nationality

Now we are starting to see good sign in form of merger and alliances in the context of capital injection, with the announcement by some banks of explicit plans. A restructuring forced by the pressures in global capital market and the revolution in banking work by Internet accelerate this consolidation. Consolidation plan among Daiichi-kangyo Bank, Fuji Bank, Industrial bank of Japan, merger between Sumitomo Bank and Sakura Bank are this typical sample. Banks are expected to identify the

business areas of relative advantage from a deregulated wider choice of financial business and seek further profitability and efficiency through consolidation in the broader context of the Japanese Big Bang.

Japanese bank recognize International situation where, as collaboration of Deutsche Bank and Dresdner Bank, the radical restructuring happen under way across countries.

### (3) Internationalization of Japanese financial and capital markets

As a result of the progressive internationalization of the yen, demand for yen would increase both domestically, and overseas, and business opportunities for Japanese corporation, particularly financial institutions, would increase. In addition for monetary authority and companies overseas, the internationalization of the yen would offer the advantage of enabling to diversify exchange risk. Japanese government is trying to effort for Yen's internationalization, by deregulation of the Foreign Exchange Law and offering short term Treasury Bonds. But the effect is limited in this area, bad performance of Japanese economy and zero interest-rate are one of this reason.

## Conclusion

The weak banking system is limiting the option of monetary and fiscal policy. Also the weakened banking system cannot provide financing for viable industries, so restoring a robust financial sector is a most important policy for Japanese economy.

Now this process is starting, but it needs at least 2~3 years for stabilization and inherent in Japanese financial system. At the same time, various financial market and products are made gradually by Big Bang.

Our Norinchukin Bank, which have Y50tri. in assets, work hard to strengthen our position in financial business and deal with the dramatic changes sweeping through the financial industry, we are also seeking to build new business structure.

I expect your supports for us to accomplish our business. Thank you.

Main object of financial system reform(so called Big Bang) is Banking System Reform

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