Deregulation of the Japanese Financial Markets and the Role of Japanese Banks

Kenusuke Hotta

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Kenusuke Hotta is Managing Director of Sumitomo Bank, Limited

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Introduction

Thank you for that very kind introduction, Mr. Chairman.

It is indeed an honor to be invited here as part of your "Japan Distinguished Business Leader Lecture Series".

I am not at all sure I am "distinguished" but I certainly work for one of the most distinguished banking institutions in Japan and can, therefore, shed some light on a most timely and dynamic subject: Financial De-regulation in Japan and the Role of Japanese Banks in that process.

Today, I would like to review four related subjects:

First, to describe what has been the historical structure of the financial system being left behind and the role banks played within it;

Second, to identify the pressures that are bringing about liberalization;

Third, to set out what are the sometimes tentative and sometimes major steps toward deregulation which have been taken to date;
Fourth, and finally, to give you my forecast of what the future holds for our financial system and, more particularly, how the commercial banks will evolve in response to changes in that system.

**Historical Structure**

In order to understand the present, and to hazard predictions about our future, we need to appreciate the past. Even by Western standards Japan's banking system is ancient; for example, Sumitomo Bank's ancestral roots go back to the 1600's.

But for today's purposes, we need only begin with the severe conditions which existed in our country following World War II, when the Japanese economy was in a ruinous state. Industrial production was down to 28% of its level prior to the War in 1935, GNP per capita to 55%, and real wages to around 30%. Capital was extremely scarce.

In response, the Japanese authorities fashioned an industrial policy aimed at reconstructing and promoting the growth of the post-war economy.

That policy took, as an article of faith, the belief that it would be impossible to raise up the productive levels of all sectors of industry at once. Being realists, the bureaucratic institutions, therefore, resorted to a "designated industry" approach which gave priorities to certain key industries, particularly, coal, steel, chemical fertilizers and electricity.
Our regulators introduced a new financial system at this time designed to promote, through the instrumentality of our banks, the absorption of the general public's savings and the smooth transfer of these savings to industry at low cost for use as capital investment funds and working capital.

These regulations fall into three major categories:

First, interest rate restrictions, principally controls on interest rates for deposits, were established.

As a result of the 1947 Temporary Interest Rates Adjustment Law, deposit rates were pegged directly to the official discount rate, and could, therefore, not float in response to market conditions.

The second body of regulations rigidly compartmentalized the business of financial institutions, by, first, establishing three main types of banking institutions and, second, restricting each type of institution to specific product areas.

More specifically, the provision of long-term and short-term credit was divided by the Long-Term Credit Bank Law between long-term credit banks, which could fund such loans through the issuance of debentures, and commercial banks, where funding capabilities were, by regulation, more limited. Similarly, trust banking and commercial banking business activities were separated through the use of so-called "administrative guidance."
Furthermore, for the entire banking industry — commercial, long-term credit and trust — investment banking was and, with limited exceptions, is verboten.

Thus, three fences were established surrounding three banking categories.

And what was the reason for this?

At that time, it was believed that a system which enforced the strict specialization and compartmentalization of players in the industry would contribute to greater efficiency in the financial system through the development of particular expertise and the avoidance of excessive competition.

As to the walls separating commercial banking from investment banking, and commercial banking and trust banking, the authorities had another goal in mind, one that was separate from industrial strategy: that is, the protection and nurturing of the securities firms and trust banks, institutions still in their infancy, whose management was relatively weak compared with that of the banks.

Finally, we came to the third body of regulations, those which controlled capital movements between Japan and aboard: in particular, the foreign exchange regulations, and other measures, designed to isolate the domestic economy from the fluctuations in the overseas financial markets.
New Pressures

This tightly regulated -- and, it should be said, successful -- system was fully intact right up to the mid-1980s, when the winds of change began to blow.

In 1983, Professor Solomon of Stanford University, at the request of the then Chairman of Caterpillar, published a paper entitled: "The Misalignment of the U.S. Dollar and the Japanese Yen: The Problem and the Solution." The Solomon paper, taking up the complaints of major U.S. exporters, contended that the exchange controls I mentioned earlier had artificially depressed the value of the Yen to the advantage of Japanese exporters over their American rivals.

The public attention garnered by the Solomon paper, both here and in Japan, resulted in the formation of a quasi-official body, the Japan-U.S. Yen-Dollar Ad Hoc Committee. That Committee issued a report in 1984 which, echoing the conclusions of the Solomon report, called for broad-based and rapid liberalization of Japan's financial system.

A similar advisory body, the U.S-Japan Working Committee on Financial Markets, was thereafter formed. It is still in existence and has been a continuous advocate of reform.

So why did the Japanese authorities suddenly decide to get serious about deregulation?
Two pressures were exerting themselves on our system; first, external pressure from the United States and Europe, an outgrowth of the growing trade imbalance and the resulting Western desire that the Yen appreciate; and, second, that code word "globalization" took on real meaning. By this I mean an awareness that the international financial markets are inter-related and integrated. We came to realize that we could have all the controls in the world on our financial institutions, but if our customers (unlike their banks) were free, for example, to access cheaper sources of capital in the Euromarkets, as they did with great success in the late 80s, those controls would become meaningless. These international capital flows were too powerful to be stopped by any one country's regulators.

Let me dwell on this point in more detail.

With the coming of the oil crisis in the 1970s, the Japanese economy suddenly moved from a high-growth period, averaging 10% annual growth, to a pattern of low but stable growth, in the range of 4 to 5%.

This downshifting put stress on the financial system. While the financing needs of the private sector diminished, the central government's deficit mushroomed, such that the Ministry of Finance began publicly to issue large volumes of government bonds. These investments, unlike the competing deposit obligations of the commercial banks, were free of interest rate controls.
This situation resulted in many of our industrial and individual customers seeking new types of investments with unregulated interest rates, in such places as the domestic government bond and Euro-bond markets.

Further, at about this time, economic activity became truly international, with Japanese corporations vigorously expanding overseas.

And the upshot of all this?

A huge-scale, deregulated interest-rate instrument market was born: the government bond market. What’s more, corporations’ interest-rate preferences became increasingly important.

If banks were frozen by a regulatory system that was a product of a relatively insular Japan of the 1940s, they simply could not respond to the more globalized environment of the 80s and 90s.

Reform to Date

Prodded by these developments, the Japanese government first began to free up flows of money and capital through an amendment to the Foreign Exchange and Foreign Trade Control Law. Incredible as it seems a decade later, this law had banned all international financial transactions, except for certain limited types of transactions which were specifically authorized, related, for the most part, to trade finance transactions
designed to foster Japanese exports. The Foreign Exchange Law was completely rewritten in 1980 so as to create a system under which cross-border transactions were "free in principle, but subject to emergency restrictions."

Moreover, in parallel with the prompting of the Japan-U.S. Yen-Dollar Committee Report, various measures were enacted in quick succession, beginning in 1985, to improve both the money and the capital markets.

These included: the establishment of an uncollaterized call money market and bond future market; improvements in the government bond bidding system; the deregulation of Euroyen transactions; the abolition of the real-demand principle for foreign exchange transactions; and the opening to foreign banks in Japan of the trust and securities businesses, two areas from which the Japanese commercial banks were, and to this day are, barred.

Significant progress has also been made in the area of interest rate deregulation, a process which began with the introduction of CDs in 1979 but which gathered steam in 1985, when money market certificates were introduced and interest rates on deposits with balances of one billion yen or more were freed up. Thereafter, the minimum balances required to secure deregulated interest rates were gradually lowered.

Today, interest rates on time deposits of one month or more and of three million yen or more are completely unregulated.
By 1993, interest rates on time deposits will be completely deregulated.

Demand deposits, up to now untouched by deregulation, will be completely deregulated by 1994.

The exception to all this will be checking accounts; as in the United States, they will remain non-interest bearing.

To understand interest rate deregulation one must also take into account the so-called "bubble economy" of the 1980s.

In the early 80s, the inexorable pressure on Japan to open its markets and to slow-down its expanding trade surplus culminated in the 1985 Plaza Accord, by which Japan agreed to abandon policies, which, many felt, had artificially depressed the value of the Yen for many years.

The value of the Yen, as intended by the United States, appreciated, and appreciated, and continued to appreciate beyond expectations, delivering a shock to our export industry, and causing the Bank of Japan to maintain a low interest rate policy so as to counter the so-called "En-daka Fukyo", or high-yen induced slump.
But this "easy" monetary policy fueled in 1987 and 1988 a bubbly appreciation of land and stock values in Japan unparalleled in our history and, perhaps, the history of the world.

While the Nikkei stock index was in the 13,600 range in 1985, it blasted up to an average level of 33,500 Yen in 1989. Today, of course, it has plummeted from this peak of 39,000 to about 22,000 Yen. Since the Japanese banks, under the Basle Accord, can recognize only 45% of the unrealized gains in their stock portfolios, their so-called the "hidden" reserves, their assets have become more hidden than they would like, putting capital pressure on the Japanese banking community.

More to the point, this surge in liquidity created a money supply far too vast to be subject to tight interest rate controls. Our financial institutions pushed for and obtained authority to issue deregulated instruments, such as large-lot time deposits, in order to absorb this liquidity by providing market-driven rates.

This progress, which overturns more than thirty years of absolute interest rate regulation, has drawn criticism from some U.S. government authorities as being excessively slow.

But, if we compare Japan with the United States in respect of, for example, the number of years required from the introduction of deregulated large-lot time deposits to the completion of liberalization, then in the case of the United States, it took 16 years - from 1970 to 1986 - while in Japan's case, it will have taken only 9 years to complete.
Of course, such simplistic comparisons are problematic, but, I would very much like you to appreciate the significant progress made by Japan to date, when 66% of deposits are free of control, in contrast to 1985 when only 13% were.

In comparison with interest rate deregulation, the lifting of controls on the fields in which financial institutions may operate has been progressing at a comparatively slow pace, even after 1985, when a serious examination of this problem was first launched by the Ministry of Finance.

The strict separation of ordinary banking business and long-term credit banking business, the separation of banking business and trust business, and the separation of banking business and securities business continue to form the basis of Japan’s financial system.

**Future Reforms Now Under Discussion**

Nevertheless, after about six years of discussion, two advisory bodies to our government, the Council on Financial System Research and the Securities and Exchange Council, have now made public their final reports.

Based on their recommendations, the Ministry of Finance has started preparing legislation to be presented to the current session of the Japanese Diet.
As you all well know, in this country, a bill for the most drastic reform of the financial system since the 1930s was debated in Congress over the last year, but, with the endless horse-trading among all the interested government and private-sector constituencies, a successful conclusion could not be reached, so that only the narrowly focused "FDIC Improvement Act of 1991" was passed.

In contrast, the balancing of such interests in Japan is traditionally carried out at the advisory organ discussion stage, and then through the preparation of legislation by the Ministry of Finance, so that once a bill is presented to the Diet, the odds in favor of its passage are fairly high.

The MOF-sponsored legislation should passed in the current Diet session and become effective next year.

Let me describe the reforms we anticipate.

First, a sector-by-sector subsidiary formula will be adopted with respect to entry into business fields that were previously off-bounds.

For example, in the case of banks, entry into new turf will be conducted through the establishment of securities subsidiaries and trust banking subsidiaries; and in the case of securities firms, through the creation of ordinary banking subsidiaries and trust banking subsidiaries.
Personally - and here I must declare my bias toward the interests of city banks - the model I have been championing is a European-style "universal" banking system. This would give banks free rein to go where they wished in whatever form they liked.

Therefore, I would not be completely satisfied with the sector-by-sector subsidiary formula if it were the final outcome; but, viewed as a first step toward the full-fledged liberalization of business segment controls, I feel it is acceptable.

What about particular activities allowed for these subsidiaries?

With two major exceptions, they may conduct all the types of business stipulated by the relevant industry laws covering their respective fields. As to the exceptions, commercial banks are excluded from some versions of money trust, including pension trust business and the brokering of equity securities.

When it came to the entry of banks and securities companies into each other's businesses, the discussions of the two Councils were marked by conflict to the very end, producing a divergence in the conclusions which they reached.

The Council on Financial System Reform adopted a hands-off approach, reasoning that the utilization of regulations under existing laws, the self-regulation of financial institutions, and the strengthening of disclosure requirements would be sufficient in
preventing abuses, such as conflicts of interest, arising from the entry of banks into the securities business and *vice versa*.

If these safeguards are ultimately found to be lacking, necessary firewalls could then be established, but would be kept to the bare minimum so that they would not reduce, or kill off, the essence of the financial system reforms.

In contrast, the Securities and Exchange Council Report rejects this more *laissez faire* approach, recommending that fairly high firewalls be erected.

In response, the Ministry of Finance has reportedly communicated its intention to formalize, through Cabinet Ordinances, strict firewalls, such as a ban on personnel holding posts concurrently in the parent and a subsidiary, and a prohibition against the parent bank providing funds to customers to purchase securities from its subsidiary.

For city banks, there will be a further handicap in that other types of banks and the securities industry will be given a head start in the establishment of their *de novo* operations.

The intended aim of these restrictive measures is to provide a soft landing, so that any confusion accompanying financial reform is kept to a minimum.
Perhaps these measures are inevitable in Japan, where the city banks are still viewed as having vast competitive muscle.

In any case, if these proposals fall short of the systemic reforms which were originally envisioned, many of the hoped-for benefits of reform may be lost.

We should hope that, however limited the first-stage measures are, they are not regarded as permanent solutions, but rather the foundations for further reforms.

On a more positive note, a bill permitting mergers between different categories of banks is also planned to be submitted by the Ministry of Finance during the current Diet session.

If it is enacted, the specialized foreign exchange bank, the Bank of Tokyo, and long-term credit banks will be allowed to convert into ordinary banks and merge with city banks. Moreover, the door will be open for mergers between city banks and trust banks.

By this action, the authorities are acknowledging that the specialist banking system has fulfilled its historical mission and need no longer be preserved.

Therefore, while Japanese banks generally prefer de novo expansion, it may be the case that some city banks will advance into such fields as bond issuance and trust management through mergers, rather than through the establishment of de novo
subsidaries. Given the limited number of banks in Japan, this strategy may be available only on a "first-come-first serve" basis.

Now let's turn to the longer term outlook for the 1990s.

As I have already outlined, the liberalization of Japanese financial institutions made great strides forward in the latter half of the 1980s, and I believe that this trend will continue.

In fact, as the walls between business fields are gradually removed, I expect that city banks may soon be allowed to accept long-term time deposits, that bond issuance will be liberalized, and that asset-back securities will be further deregulated.

On the negative side, banks are forced to cope with a deteriorating business environment as the economy slips into a correction phase.

Economists are welcoming this development as a means of wringing out the excesses of the bubble economy.

All that frothy growth riding on the back of low interest rates and asset inflation can be seen as distinctly unhealthy.

But for banks, this slowdown has brought about three unwelcome developments:
First, non-performing assets, particularly in the real estate sector, have been rising.

Second, the slump in the stock market has impaired their ability to reach, maintain, or build a good cushion over, the Basle-mandated capital adequacy levels.

In short, the issuance of equity and convertible bonds has grown more difficult, and controls on the rate of increase of total assets have had to be tightened to correspond to the decline in the "hidden reserves" held by the banks.

Third, the general public's trust in financial institutions has been shaken through the emergence of various financial scandals.

Some people now fear that the introduction of financial system reforms in Japan will be postponed, but for my own part, I don't think this will happen.

Certainly, the restoration of public trust in financial institutions must become a major and immediate goal of management.

Nevertheless, the need for financial liberalization should not be ignored because of a few nasty shocks to the systems.
The rapid moves toward financial liberalization in Japan in the latter half of the 1980s were not only the result of those structural changes in the 1970s and early 1980s already discussed, but were also founded on other major social transformations.

More specifically, these were:

(i) the rising demand for more sophisticated financial products in line with the growth of individual financial assets and the diversification of lifestyles;

(ii) the increasing number of corporations which are making use of more complex and wide-ranging financial strategies, such as the tapping of overseas capital markets; and

(iii) the growing need to put Japan's financial system in line with overseas markets and provide a level playing field for both foreign financial institutions and investors - an outgrowth of Japan's expanding share of the world economy and the growing presence of its corporations and financial institutions abroad.

These changes will, I believe, only accelerate in the future, and cannot be reversed.

Further, those outdated protective measures established by government to restrict competition in the financial industry can also be seen as one of the indirect causes of the recent flurry of securities scandals.
In fact, both the Council on Financial System Research and the Securities and Exchange Council have, since the autumn of last year, been investigating measures to prevent the recurrence of financial scandals and are scheduled to release their respective reports by the end of this month if things go well.

Their recommendations will not only include such obvious proposals as the tightening of disclosure requirements and codifying capital adequacy requirements, but will also incorporate ideas for:

(1) the promotion of mutual entry between the banking and securities industries into each other’s domains in order to encourage competition, and

(2) the deregulation of commissions on stock brokerage, the rigid brokerage commission tables having been cited as the root cause of the loss compensation abuses engaged in by certain of the securities companies.

Thus, it may be said that financial deregulation has actually received an impetus from the recent scandals in Japan.

As the unstoppable process of liberalization unfolds, it is inevitable that the forms and roles of Japanese financial institutions will undergo dramatic change.
Conclusion

So, what does this all mean? Let's face it: much of any discussion of financial deregulation, whether in the United States, Japan or Europe, is dull as dishwater.

What is truly important is how changes in the regulatory context will ultimately force change in the business sphere. Here, the consequences will be, I believe, quite startling.

The Japanese are, by nature, group oriented; contrary to Western norms, conformity is a virtue. The Japanese banking community is no exception, having operated for many years in accordance with a "herd mentality".

If one city bank opened a New York Branch, the others would quickly follow suit. If another city bank became involved in LDC lending, the rest of the pack would follow closely behind.

This group behavior was reinforced by our regulators, who, on the positive side, created a protected, volume-oriented system where, the more assets we piled on and the more deposits we took, the more profits we made; but, on the negative side, our lines of business were very circumscribed.

With deregulation, this pack mentality will break down. For example, city banks will take the opportunity to transform, and diversify themselves into combinations of trust banks, investment banks, long-term credit banks, and commercial banks.
When this process of re-combination is completed, the end products will be very individualized as each institution is forced to make decisions and to select the strategy that makes the most sense for the institution.

Right now, the major city banks are almost fungible; they are in pretty much the same businesses in the same world markets. Differences are at the margin, relating only to relative size and profitability.

With deregulation some will come to the realization that resources are limited, such that very, very few banks have the where-with-al to remain global supermarkets, that is, institutions which have the capability and capacity to offer on a world-wide basis the full range of wholesale banking products, from corporate finance, to public finance, to project finance, to leasing, to derivative products, to whatever else may be in demand at the time.

In other words, deprived of the protection of regulated interest rates, and at the same time forced to maintain the capital levels mandated by the Basle Accord, certain of the Japanese banks will probably shrink themselves and pursue more modest goals. For example, some of the city banks are likely to withdraw somewhat from the global markets, to concentrate on being regional or super-regional banks in Japan, if not boutiques or convenience stores, or whatever.
Other banks may withdraw almost entirely from commercial banking to concentrate an investment banking, following the model, in this country, of Bankers Trust or Morgan Guaranty.

The point, I believe, is that, with deregulation, the Japanese banks will be entering a new period of maturity, you might say their adulthood, where important strategic decisions will have to be made, where successes will be achieved, and where some major league mistakes will be made.

In time, as with all deregulated economic systems, there will be winners and losers. Whether as a result of mergers or credit downgradings, the losers will disappear, or contract. However, the winners among the eleven or so city banks will, through deregulation become endowed with enhanced powers and greater flexibility in order to respond to the dynamics of global finance. Five or so of them will almost certainly number among the fifteen or so world-class banks that will emerge as the true global players of the 90s.

What will be the major role to be played by these winners?

No one can know for sure, but I expect that the major role, the paramount responsibility, of this decade will be to recycle into the world economy the balance of payments surplus of Japan.
Those capital flows will be directed, I believe, to the public sectors of the world. Here, in the U.S., the Japanese banks, through credit enhancement and direct loans, are major providers of capital to states, municipalities, schools and hospitals authorities, and other public sector institutions. My guess is that these already significant capital flows will expand in the years ahead, as this country draws upon the Japanese banking community to meet the vast infrastructural needs that lie ahead.

The dual challenges of living in a freer regulatory climate, and of fulfilling the responsibility of efficiently recycling a major portion of the world’s capital, shall make for interesting times indeed.

I trust that my remarks today will give you food for thought.

Thank you.