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Japan's Landmark Financial Deregulation: What It Means for the United States

(name redacted)
Specialist in Industry and Trade
Foreign Affairs, Defense, and Trade Division

Summary

Major financial deregulation is underway in Japan that could have far-reaching implications for U.S.-Japan economic relations. The process has been accelerating since the so-called "Big Bang" announcement by former Prime Minister Hashimoto in November 1996 calling for the realignment of Japan's financial markets to make them comparable to those of Europe and the United States. The reform process includes allowing financial institutions to establish holding companies and enter heretofore prohibited lines of business. It also is expected to open markets to more foreign participation. Along with the Financial Services Agreement under the World Trade Organization and bilateral agreements with the United States on liberalizing Japan's insurance market, these measures are expected to open the management of approximately $10 trillion in personal assets in Japanese financial markets to U.S. banks, brokerage houses, and other financial service companies. The U.S. Treasury has been negotiating with Japan on financial deregulation under the U.S.-Japan Enhanced Initiative on Deregulation and Competition Policy. This report will be updated as events warrant.

Background

Japan's major financial deregulation began in November 1996 with the so-called "Big Bang" proposed by former Prime Minister Hashimoto. It was aimed at deregulating Japan's financial markets to make them comparable to those in Europe and the United States by the year 2000.[1] The theme of the Big Bang has been "free, fair, and global." Japan's financial markets are to become free from excessive government interference, fair in the sense that access is to be open and prices determined by market forces, and global in the sense that competition is to be international. The essence of the Big Bang is to reduce direct government intervention into the operations of financial markets; to eliminate barriers among banks, trust banks, securities companies, and insurance companies; to direct regulation more toward providing market information and reducing fraud rather than toward influencing specific activities of financial institutions, and to subject Japan's

[1] Hashimoto Announces "Big Bang" Economic Plan. Kyodo Newswire. November 11, 1996.

financial institutions to more international market pressures. The impetus for deregulation was given a boost by the Asian financial crisis in 1997-99. The crisis highlighted weaknesses of Japanese-type financial systems that had been established in other Asian countries and emphasized the need to move toward a more market-determined financial system throughout the Asian region.

Financial deregulation in Japan is of interest to the United States because it affects U.S. financial firms and investors and promises to open the management of more personal assets on Japanese financial markets to U.S. and other financial services companies. The deregulation and market opening, if carried out as planned, could make more financial opportunities available for U.S. firms. Japan has a pool of individual savings and other financial assets of around $10 trillion — larger than the gross domestic product of the United States — half of which is now invested in savings accounts that are paying interest of only 1% or 2% per year. If more of these assets were invested in U.S. stocks and other assets, both the inflow of capital from Japan and the U.S. trade deficit may rise. This deregulation combined with depressed equity values in Japan also has lowered the cost for U.S. companies to acquire or merge with Japanese companies in distress. The Asian financial crisis in 1997-99 also highlighted the need for more market-based decision making in Japan and less governance based on inter-company relationships and guidance from government bureaucrats which was successful during most of Japan's post-war period of rapid economic growth but lacked the flexibility and market discipline required for financial firms to compete in the new global economy.

Japanese financial deregulation parallels deregulation passed by the 106th Congress on November 4, 1999 (Gramm-Leach-Bliley act, P.L. 106-102) that significantly modernizes American finance by breaking down barriers among banking, brokerage services, and insurance sectors.[2] It also means that Japan is abandoning the heart of the financial policy heretofore followed by its Finance Ministry in which its banks and other financial institutions were considered to be a convoy and the stronger ones had to assist weaker members in order to keep them all moving forward together.

The U.S. Treasury along with the U.S. Trade Representative are pursuing U.S. interests in Japan's Big Bang and other financial deregulation through the U.S.-Japan Enhanced Initiative on Deregulation and Competition Policy announced by President Clinton and former Prime Minister Hashimoto in June 1997. The two sides meet periodically to negotiate and assess progress being made.

The rationale behind Japan's Big Bang is threefold. First, Tokyo and Osaka are falling behind other world financial centers. Operational costs are high, and new product approval has been difficult. Second, many Japanese financial institutions have been in serious difficulty. Several banks and credit unions have been restructured or forced to merge, and the banking industry has been grappling with an overhang of nonperforming loans. The 1997-99 Asian financial crisis also exacerbated Japan's financial distress and underlined the extra risks generated when non-market criteria were used to allocate financial resources

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[2] See: CRS Issue Brief IB10035, *Financial Services Modernization Legislation in the 106th Congress*, by F. Jean Wells.

Table 1 shows the major elements in Japan's Big Bang and other financial deregulation. The centerpiece of Japan's Big Bang was the Financial System Reform Law which took effect on December 1, 1998. Rather than a new law, it actually was a set of amendments to existing financial laws. Some of the major changes in Japanese law are to allow financial institutions to establish holding companies,[3] non-regulated foreign exchange transactions, new financial products (derivatives, investment trusts), unregulated brokerage commissions, stock trading by bank-owned securities companies, and insurance sales by both securities companies and banks. The Ministry of Finance has lost considerable authority. The Bank of Japan was given more independence from the Ministry and much of the Ministry's supervisory and inspection authority was transferred to the Financial Reconstruction Commission and its subsidiary, the Financial Supervisory Agency. Banks engaged in international operations now must meet the 8% capital-asset requirement of the Bank for International Settlements or undertake prompt corrective actions. For Japan's financial community, the changes have been monumental.

On a bilateral basis, the United States and Japan have long been engaged in market opening negotiations in the financial services sector. On February 13, 1995, the two nations concluded a comprehensive financial services agreement that provided for liberalization of legal and operational constraints that impede access by foreign financial services providers in the areas of asset management, corporate securities, and cross-border financial transactions. According to the U.S. Trade Representative, over the first two years of the agreement, the Japanese government implemented the vast majority of commitments within the time frames specified. In some areas, Japan had either accelerated the implementation of certain commitments or expanded their scope. At a follow-up meeting to the agreement in October 1997, however, the United States emphasized the need for further improvements in financial disclosure and transparency. These concerns were addressed in the December 1998 Financial System Reform Law.

Access to the insurance sector in Japan has long been in dispute in U.S.-Japan relations. Japan is the second largest market for insurance in the world, but foreign firms account for only 3.9% of the market (as compared to 10% to 33% in other industrialized nations).[4] In 1994, the United States and Japan concluded a bilateral insurance agreement that committed Japan to enhance regulatory transparency, strengthen antitrust enforcement, introduce a "notification system" for approval of insurance rates and products, and undertake specific liberalization measures. The 1994 agreement also contained a provision related to "mutual entry" of life insurers into non-life insurance markets and of non-life insurers into life insurance markets.

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[3] Previously, banks and securities companies were allowed to hold only a 5% stake in nonfinancial companies, while insurers were allowed a 10% stake.

[4] U.S. Trade Representative. *1998 National Trade Estimate*. On Internet at [http://www.ustr.gov/reports/nte/1998/contents.html]. p. 218-221.

Table 1. Major Provisions of Japan's Financial Deregulation

Date	Measure
1996	Prime Minister Hashimoto announces the Big Bang economic program
1997	Trading of options on individual stocks allowed at stock exchanges Stricter penalties are imposed on improper acts by financial institutions Restrictions eased on management of investment trusts, pension funds, etc. Financial institutions allowed to establish holding companies
1998	Foreign exchange transactions allowed without government authorization Securities companies free to set commissions on trades over ¥50 million Bank of Japan given more independence from the Ministry of Finance Japan's Financial Supervisory Agency began operations Prompt Corrective Action (PCA) measures are implemented requiring financial institutions to disclose bad assets, loan-loss writeoffs, and capital adequacy ratios Finance Ministry abolished the use of Ministry circulars (tsuutatsu) and administrative notices (imu-renraku) to exercise its supervisory powers Member insurance companies allowed to set own premium rates Securitization of assets via special purpose companies allowed New corporate-type and privately placed investment trusts allowed Full liberalization of securities derivatives Restrictions eliminated on scope of business activities for securities companies Switch from licensing to registration system for securities companies Introduction of proprietary trading systems Improvement of fair trading rules in the Securities and Exchange Law Banks allowed to sell investment trust certificates Bank subsidiaries allowed to provide all financial services Entry of Insurance companies into securities business and securities companies into insurance business Securities Investor Protection Funds and Policy Holder Protection Corp. created Financial Reconstruction Commission begins supervision and inspection of financial institutions which it delegates to the Financial Supervisory Agency
1999	Strict separation of customer and proprietary accounts of securities companies Public comment procedure implemented for financial services regulations Beginning of phase-in of consolidated basis disclosure of non-performing assets Restrictions to be eliminated on scope of business activities for securities operating subsidiaries of banks and trust banks and trust bank operating subsidiaries of banks and securities companies (bank-owned securities companies to trade in stocks) Full liberalization of brokerage commissions Entry of insurance companies into the banking business allowed Banks allowed to issue straight bonds Tokyo Stock Exchange begins Market of High Growth and Emerging Stocks Measures passed to insure bank deposits to March 2002 Securities transaction and bourse taxes eliminated Tax exemption for foreign holders of Japanese government bonds
2000	Establish a NASDAQ Japan stock market in Osaka Bill to allow an electronic disclosure system for securities transactions reports Bills to set new rules for collective investment schemes Banks and securities companies to be allowed to enter the insurance sector (Oct 1)

Note: Additional financial system reform measures are in: Japan. Ministry of Finance. Schedule for Financial System Reform. April 2000. On Internet at [http://www.mof.go.jp/english/big-bang/big-bang.htm] and U.S. Trade Representative. Second Joint Status Report Under the U.S.-Japan Enhanced Initiative on Deregulation and Competition Policy. May 3, 1999. On Internet at [http://www.ustr.gov].

Under a 1996 Insurance Business Law, life and non-life insurance firms (first and second sectors) are allowed to do business in Japan in their counterpart sectors if done through subsidiaries. Japan also agreed to avoid "radical change" in the third sector (e.g., policies covering cancer, hospitalization, nursing care, and personal accidents) until foreign, small, and mid-sized insurers have had a reasonable period to compete in significantly deregulated primary life and non-life sectors. In December 1996, the United States and Japan agreed to supplementary measures which defined the extent and timing of primary sector insurance deregulation by the Ministry of Finance. These measures also defined the scope of business activities of Japanese insurance subsidiaries in the third sector — consistent with Japan's commitment to avoid radical change. Beginning in July 1998, a two-and-one-half year clock began in which Japan is to open this third sector of Japan's insurance market.

In April 1999, during bilateral consultations, the United States raised several concerns about Japan's administration of its insurance sector. These included a lack of transparency with respect to government actions potential "radical change" occurring in the third sector. The U.S. side recognized, however, that the deregulatory steps taken have yielded important results with more foreign firms in the market and an increase in rate and product competition.[5]

The continuing banking crisis in Japan also has induced the Japanese government to take action to resolve the problem of non-performing loans of banks. Under the Prompt Correction Action (April 1, 1998) financial institutions are categorized by reference to their capital-asset ratios and must take certain corrective action when necessary. Under the Early Stabilization of Functions of the Financial System Law (October 23, 1998), financial institutions can request government capital injections by having the government's Deposit Insurance Corporation subscribe to their preferred or ordinary shares. Under the Financial Revitalization Law (October 23, 1998), the government instituted procedures to deal with failed financial institutions and to purchase their assets. The government is financing these activities through loan guarantees for the Deposit Insurance Corporation. It also plans to increase the amount of funds appropriated for protection of bank deposits from 17 to 23 trillion yen (about $209 billion) and extended the special measures to full protect deposits until the end of March 2002.[6]

Effects and Responses

The Big Bang and other financial deregulation in Japan are providing opportunities for foreign firms to expand into the Japanese financial services market, acquire existing Japanese companies, and obtain faster approval for new products. On a macroeconomic level, the deregulation is likely to encourage net outflows of Japanese capital as Japanese investors, pension fund managers, and other capital account managers diversify more of their holdings into foreign assets and as foreign firms take over more of the management of financial assets in Japan. Such net outflows of capital are likely to weaken the yen and increase Japan's current account surplus (trade in goods and services plus unilateral

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[5] U.S. Trade Representative. *2000 National Trade Estimate Report on Foreign Trade Barriers*. p. 219-222. On Internet at [http://www.ustr.gov/reports/nte/2000/contents.html].

[6] Japan. Ministry of Finance. *Japanese Big Bang*. January 2000. On Internet at [http://www.mof.go.jp].

transfers), including that with the United States. Over the longer term, Japan's financial deregulation is likely to strengthen its financial sector and stimulate economic growth which might induce more imports into Japan and reduce its trade surplus.

At the microeconomic level, the Big Bang and other financial deregulation are producing numerous responses by Japanese and international financial service providers to prepare for future competition or to move into heretofore prohibited lines of business. Among Japanese financial institutions, the combination of the overhang of non-performing loans, financial deregulation, and stricter performance standards is causing major bank restructuring.

The major Japanese banks have responded by merging into four large groups. Mizuho Financial Group includes Dai-Ichi Kangyo and Fuji banks as well as the Industrial Bank of Japan to form the world's largest financial holding company (with assets of $1.3 trillion). Sumitomo and Sakura banks are forming another group (assets of $900 billion) as are the Bank of Tokyo and Mitsubishi Bank (assets of $635 billion) who in 2001 plan to add three trust companies to their group. The fourth large group is being formed by a merger of the Tokai, Asahi, and Sanwa banks (assets of $970 billion). These mergers are reportedly aimed at competing with global banking giants and indicate that Japan's financial industry is following a wave of financial institution consolidation occurring in the United States and Europe.[7] Japanese financial authorities seem to be aiming for a new banking structure with three levels of banking institutions: mega-banks (or money center banks), super-regional banks, and niche-playing boutique banks.

Foreign firms are taking advantage of the liberalized financial market to establish or increase their presence in Japan. For example, in asset management, T. Rowe Price, Goldman, Sachs & Co., Putman Investments, Prudential Insurance, J.P. Morgan & Co., Alliance Capital, Brown Brothers, Smith Barney, GE Life Insurance, Bankers Trust, American Express, and other U.S.-based companies are actively pursuing the huge amounts of Japanese savings now just sitting in bank savings accounts. Merrill Lynch has taken over most of the operations of Yamaichi Securities Co., and the Traveler's Group has purchased a large stake in Nikko Securities. The Fidelity Group became the first discount broker in Japan, and DLJdirect, Inc. is in a joint venture to establish an Internet brokerage service. GE Capital has become one of the largest players in leasing and it, along with companies such as the Associates Corporation, are active in consumer finance. Citicorp is helping firms process foreign exchange paperwork, and dozens of U.S. companies have been looking to Japan for deals in their depressed property market.[8] Ripplewood Holdings has bought the Long-Term Credit Bank of Japan and relaunched it as the Shinsei Bank. Financial deregulation in Japan, while aimed at solving certain domestic problems, is having the effect of opening the financial market to more participation by U.S. and other foreign companies.

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[7] Spindle, Bill and Peter Landers. Japan's Bank Megamerger Puts Entire Sector in Play — DKB, Fuji Bank, Industrial Bank Spell Out Plan. *Wall Street Journal*, August 23, 1999. P. A10.

[8] Sapsford, Jathon. U.S. Financial Firms Delve Deeper Into Japan. *Wall Street Journal*, January 26, 1999. P. A13.