Chapter 11

JAPAN

Japan is the world's second largest economy, its largest exporter of capital and Asia's largest financial market. The health of the Japanese economy is very important to Asia, and as Australia's largest trading partner, highly significant to Australia.

Throughout the 1990s, serious problems have burdened Japan's financial sector, compounding concerns over the economy's long term growth potential. However, a major financial sector transformation now is underway; poor profitability and serious efforts to undertake reforms and resolve non-performing loan, NPL, problems drive it. Key influences include significant corporate restructuring, growing pressures on the main bank system, greater disparities between strong and weak financial institutions, and increasing involvement of foreign financial institutions in the Japanese market. However, serious challenges remain, including needing to continue to resolve NPL problems in weaker banks and insurance companies, locking in the credibility of Japan's new supervisory arrangements and reforming the postal savings system, which absorbs about 20 per cent of Japanese household savings.

This chapter analyses recent key financial sector reforms, the scale of NPL problems and progress in resolving them. It also assesses pressures on the banking and life insurance sectors, and restructuring that is underway. Finally, it examines foreign financial institutions' prospects, and major future trends and challenges.

FINANCIAL SECTOR DEVELOPMENTS

Since the mid 1990s, the regulatory structure of Japan's financial sector has changed substantially. Patterns of savings and financing also continue to change gradually.

Regulatory Changes

Major financial sector supervisory reforms include establishing the Financial Reconstruction Commission and the Financial Supervisory Agency, focusing the Bank of Japan on implementing monetary policy and supervising the payments system, and substantially reducing the Ministry of Finance's power in financial sector supervision.[1] Since it was established in December 1998, a cabinet minister has chaired the Financial Reconstruction Commission, which now heads Japan's regulatory structure. A commission secretariat oversees public capital injections into banks and, in conjunction with the Deposit Insurance Corporation, disposes of failed institutions. The Financial Supervisory Agency, established in mid 1998, supervises banks and other financial institutions. The Ministry of Finance's Financial System

[1] The Bank of Japan law, effective since April 1998, contains a range of measures to enhance the bank's independence and transparency in running monetary policy. For example, minutes of monetary policy meetings now are published promptly. The Bank of Japan retains an ongoing responsibility for maintaining financial system order and, as such, retains the right to examine banks.

Planning Bureau retains broad policy responsibility for financial system stability. However, from 2000, the Financial Supervisory Agency will assume this responsibility also and be renamed the Financial Agency.[2]

Consolidating financial sector supervision in independent institutions separate from ministries of finance and central banks is in line with many developed economies' reforms. Separation helps overcome goal confusion and conflicts of interest, for example in implementing monetary policy, and consolidation enables more consistent supervision of universal financial institutions. (See Chapter 3 - *Prudential Reform.*)

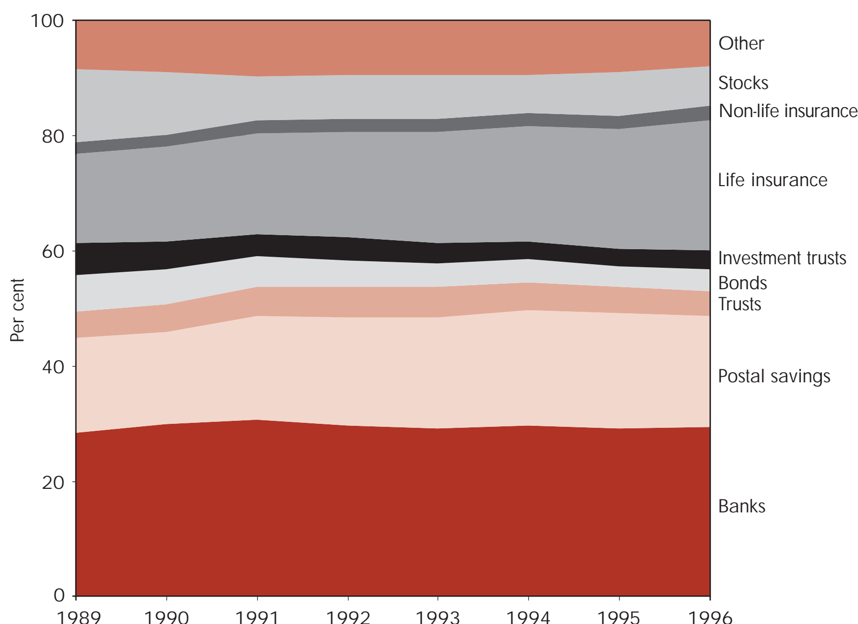
Changing Savings and Financing Patterns

Banks remain the single most important savings vehicle for Japanese households (Figure 11.1). While life insurance's importance increased from 1989 to 1996, the sector's serious problems have caused a significant exodus of funds since then. Although the importance of shares waned as a savings vehicle due to the equity market's prolonged weakness, recent equity market strength could reverse this trend. Postal savings continue to be very important; their savings' share grew in the mid 1990s due to problems in the private banking system.

Figure 11.1

Banks and Life Insurance the Major Savings Vehicles

Major Personal Savings Vehicles, Per cent



Note: Other includes deposits with credit associations and cooperatives, agricultural and fishery cooperatives, labour credit associations and personal subscriptions to local government bonds.

Source: Bank of Japan, 1996.

[2] The long term regulatory structure is not entirely clear as the Financial Reconstruction Commission will be wound up at the end of March 2001, or thereabouts.

Patterns of corporate financing also are changing. In the second half of the 1980s, eligibility requirements for bond and stock issues were relaxed, significantly increasing their importance in corporate funding. In the 1990s, equity market weakness reduced the corporate financing role of shares, with bond issues also growing more slowly (Figure 11.2). The importance of private banks was not eroded. However, in the new regulatory environment, banks will face more competition from other financial institutions; sustained equity market recovery will increase this pressure.

MAJOR FINANCIAL SECTOR REFORMS

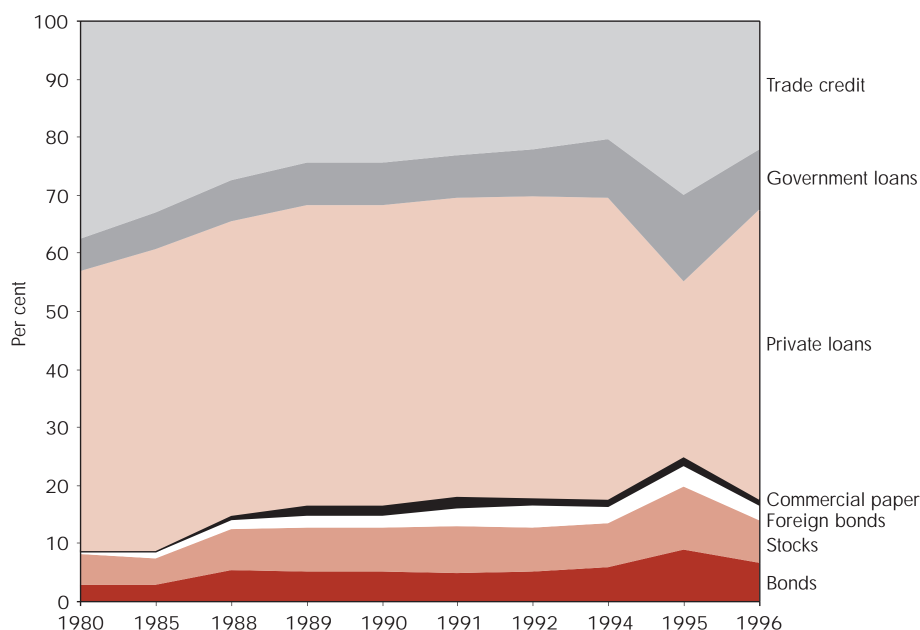
Japan has been liberalising its financial sector since the early 1980s. It:

- started to liberalise interest rates in 1985 and all rates were liberalised by 1994
- relaxed eligibility requirements for firms wishing to issue bonds and stocks during the 1980s and early 1990s
- relaxed regulations preventing banks and securities companies from entering each other's lines of business from 1992 (East Asia Analytical Unit, 1997).

Figure 11.2

Securities Market Financing Peaked in 1995

Corporate Financing Shares, Per cent, 1980-96



Note: Private loans are loans from private financial institutions while government loans are loans from government financial institutions.

Source: Data for 1981-84 and 1986-87 are not available. Yoshino, 1995, updated by East Asia Analytical Unit.

In November 1996, then Prime Minister Hashimoto accelerated this reform agenda by announcing the 'big bang' financial sector reforms; these were designed to make Japanese financial markets internationally competitive and promote Tokyo as a world financial centre. A key element of these reforms is progressively to remove barriers between different types of financial institutions. By 2001, banks, insurance companies and securities firms all will be allowed to operate in each other's areas of business.

MAJOR BIG BANG INITIATIVES AND TIMETABLE

Fiscal year[3] 1997

- Securities houses can establish bank-type accounts for customers and handle unlisted stocks

Fiscal year 1998

- Companies and individuals can undertake foreign exchange transactions without government authorisation
- Banks can sell their own investment trust products over the counter
- Ban on financial holding companies lifted
- Firms can enter securities broking without government licences
- Securities houses can expand their asset management services
- Loans can be transformed into asset-backed securities

Fiscal year 1999

- Securities houses can set their own commissions on securities trading
- Financial assets are assessed at market rather than book value, and accounting practices are brought to international standards
- Controls on banks' securities subsidiaries are removed
- Banks can issue straight bonds[4]
- Insurance firms can establish banking and securities subsidiaries

By fiscal year 2001

- Banks and securities houses will be allowed to enter the insurance sector
- Remaining restrictions on pension fund allocation will be removed

Source: OECD, 1997.

[3] The Japanese fiscal year runs from 1 April to 31 March.

[4] A straight bond is a simple debt contract between an investor and a firm.

The big bang package is being implemented on schedule. For example, in December 1997, authorities scrapped the ban on financial holding companies and liberalised foreign exchange controls.[5] From June 1998, banks could sell investment trusts over the counter and freely enter the securities business. These far-reaching reforms and Japan's bad loan problems together are stimulating a major restructuring of Japan's financial sector.

In July 1997, in addition to the big bang reforms the Ministry of Finance revoked restrictions on new bank branch numbers and locations, and bank and ATM operating hours. In June 1998, it increased insider trading penalties, permitted off-exchange equities trading and consolidated the ordinances interpreting financial laws and providing administrative guidance (OECD, 1998). From December 1998, the brokerage and insurance sectors created investor and policy holder protection funds.

NON-PERFORMING LOANS

Japan's NPL problem developed well before the Asian financial crisis, originating in the 'bubble economy' period of the late 1980s and early 1990s. At that time, lending to real estate companies and small businesses increased rapidly, inflating asset prices (East Asia Analytical Unit, 1997). When the asset price bubble burst, the NPLs of banks, non-bank financial institutions and life insurance companies all increased significantly, but rather than writing off NPLs and attempting to collect collateral, many financial institutions rolled over loans and under-reported NPLs to shield the true extent of their problems.

Government NPL and Bank Restructuring Policies

Until the late 1990s, the Government believed the banks could grow out of their problems, so it focused on resolving the problems of politically sensitive non-bank financial institutions, like the *jusen* (mortgage companies) and agricultural cooperatives.[6] After the Government suffered a political backlash for committing public funds to the *jusen, it* remained reluctant to intervene in resolving the banks' problems or injecting public funds. However, in late 1997, as major financial institutions, such as Hokkaido Takushoku Bank and Yamaichi Securities collapsed, the Government increasingly promoted bank NPL workouts. By October 1998, it had allocated ¥60 trillion in public funds to restructure the financial sector including:

- ¥17 trillion to nationalise failed banks and protect their depositors
- ¥18 trillion to purchase preferred and ordinary shares to recapitalise undercapitalised banks[7]

[5] Liberalising foreign exchange controls saved traders an estimated ¥175 billion per year in commission fees by allowing them to net their foreign exchange transactions and put them through a wider range of institutions (OECD, 1998). This reform also allowed residents to hold foreign currency accounts abroad.

[6] For example, in 1996, the Government brokered a complex deal involving significant public funds to liquidate the *jusen* and bail out agricultural cooperatives.

[7] Preferred shares have preference over common stock in paying dividends and liquidating assets but do not carry voting rights.

- ¥25 trillion to purchase preferred shares in 'healthy' banks, with capital adequacy ratios over 8 per cent, thereby increasing their liquidity and willingness to lend.

In December 1998 and January 1999, authorities imposed conditions on major banks' access to capital injections (Financial Reconstruction Commission, 1999a). Participating banks had to reduce staff and non-staff expenses, and increase their provisioning.[8] Moreover, the Government required weaker banks to offer higher dividends on their preferred bank shares and demonstrate stronger restructuring initiatives. All but three of the 17 major banks applied for public funds and received ¥7.5 trillion.[9] In fiscal year 1999, the banks also attempted to raise about ¥2 trillion by new equity and bond issues; Bank of Tokyo-Mitsubishi is the most successful fundraiser in Japan and abroad.

The authorities also have improved significantly arrangements for purchasing NPLs. In April 1999, the Resolution and Collection Organisation took responsibility for NPL purchase and disposal from the Housing Loan Administration Corporation, established to take over the seven failed *jusen's* business, and the Resolution and Collection Bank, which managed failed bank and credit cooperative NPLs.[10] Unlike its predecessors, the Resolution and Collection Organisation purchases NPLs from both healthy and distressed institutions. This enables solvent banks to move debt off their balance sheets and recommence normal lending activities.

The predecessors of the Resolution and Collection Organisation did not perform well. From its inception in 1996 to September 1998, the Housing Loan Administration Corporation liquidated only about 20 per cent of its NPL portfolio. Similarly, despite buying its NPLs at only 20 to 30 per cent of their face value, the Resolution and Collection Organisation had sold only 19 per cent of its inventory by April 1998 (International Monetary Fund, 1998). A more transparent pricing formula based on expected future cash flows was needed to improve asset sales, increase market confidence and reduce political interference (International Monetary Fund, 1998).

SCALE OF NPLS

While still subject to some risks, major banks' NPLs now are well on the way to resolution.[11] However, smaller regional banks and life insurance companies still have major problems; the Government recognises it must resolve these to restore confidence in the financial sector.

[8] Banks must provision 100 per cent of the unsecured portion of loans to bankrupt borrowers, 70 per cent of the unsecured portion of high risk loans and 15 per cent of loans deemed potentially at risk. This is double or triple previous provisioning.

[9] Bank of Tokyo-Mitsubishi and Nippon Trust and Banking did not apply for funds, while Yasuda Trust and Banking will receive funds through Fuji Bank.

[10] Originally the Resolution Collection Bank and its predecessor, the Tokyo Kyodo Bank, were established to manage the assets of failed credit cooperatives such as Cosmo and Kizu.

[11] Japan has 17 major banks. One is a long term credit bank; the rest are either trust or city banks.

Major Banks

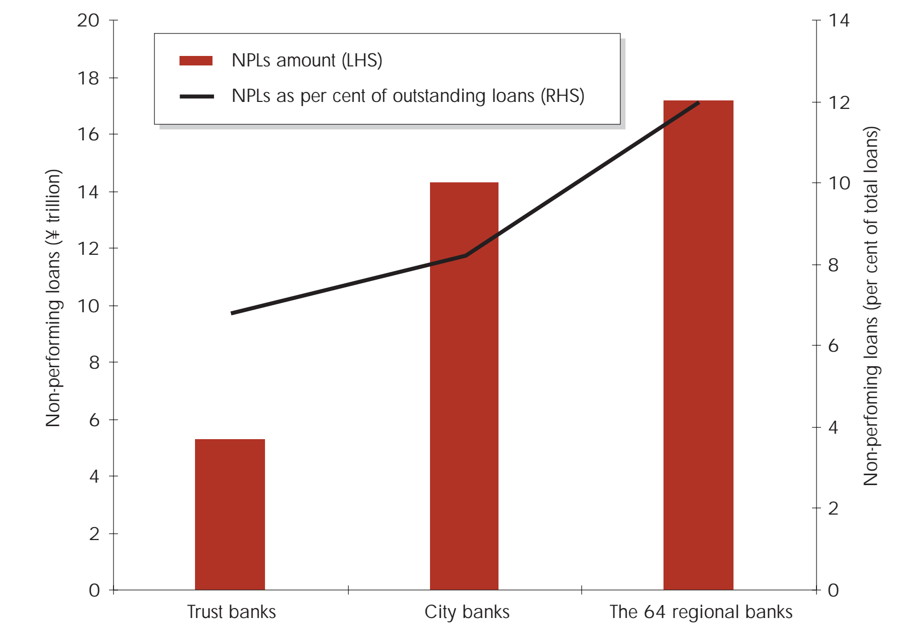
As at 31 March 1999, according to official figures, the 17 largest city and trust banks still had ¥21.4 trillion (US$194 billion) in NPLs, almost 7 per cent of outstanding loans (Figure 11.3). Against these NPLs, the banks hold ¥7.5 trillion in public capital, ¥10.4 trillion in loan loss reserves and a substantial level of realisable collateral. Consequently, the Minister for Financial Reconstruction considers the current stock of NPLs resolved, and many analysts broadly agree with this assessment.

However, concerns remain about whether banks have fully disclosed their NPLs. For example, in March 1999, major banks applying for public funds from the Financial Reconstruction Commission revealed they rated as 'normal' around 40 per cent of their loans to bankrupt companies (HSBC Securities, 1999).[12] Moreover, NPL problems could increase further if share and real estate prices fall, economic activity

Figure 11.3

Regional Bank NPLs Are Highest

Banks' Non-performing Loans, March 1999



Source: HSBC Securities, 1999; and Financial Supervisory Agency, 1999a.

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12 Another concern with the NPL figures is that of the ¥21.4 trillion, the amount of loans classified as 'at risk' (3.9 per cent) is greater than the amount classified as 'requiring special attention' (1.4 per cent), a lower risk category. This is most unusual; the value of loans 'requiring special attention' should be greater than the value of loans 'at risk' (HSBC Securities, 1999, p. 16).

remains weak or Japanese banks incur more losses in Asia.[13] To date, most banks have provisioned against expected losses from NPLs rather than liquidating them and removing them from their balance sheets; this practice exacerbates the risk of future NPL problems. However, enabling the Resolution and Collection Organisation to purchase NPLs from both healthy and failed institutions should encourage NPL liquidation. Tax incentives to write off loans, and since 1998, the capacity to move loans off balance sheets via securitisation also should speed this process.[14] (See Chapter 4 - *Banking*.)

Regional Banks

In December 1998, after auditing Japan's major city banks, the Financial Supervisory Agency focused its attention on Japan's 64 regional banks and 60 secondary regional banks. In the three months to June 1999, the Financial Supervisory Agency declared three secondary regional banks insolvent. In March 1999, a self assessment by the 64 regional banks put NPLs at ¥22.7 trillion, 11.8 per cent of total credits (Figure 11.3). While these figures surpass major banks' NPLs, they still may be an underestimate; June 1999 audits for fiscal year 1997 of the 64 regional banks showed NPLs were ¥2 trillion higher than these banks declared in March 1998 (Financial Supervisory Agency, 1999b).[15] Furthermore, the regional banks are less well provisioned to write off these NPLs; their 1997 bad debt reserve ratio averaged only 40 per cent, compared to 52 per cent for the major city banks (*Nikkei Weekly*, 28 June 1998, p. 12).

Government policies on bank recapitalisation of regional banks are broadly similar to those applied to the 15 major banks (Financial Reconstruction Commission, 1999b). The ratings agency, Moody's, believes many small, severely undercapitalised regional banks ultimately risk liquidation; larger regional banks are likely to receive government support because of their perceived importance to local economies (*Australian*, 27 August 1999, p. 23).

Life Insurance

After bank deposits, life insurance is Japan's second most important savings vehicle (Figure 11.1). The life insurance sector also has extensive NPL problems but in late 1999, their true size was unknown. Official data on the state of insurers is scarce but in May 1999, the Financial Supervisory Agency began the first stage of a comprehensive audit of the sector, starting with the five largest life insurers.

[13] As at the end of June 1998, Japanese banks had ¥27 trillion in outstanding loans to Asia, representing around 7.5 per cent of major banks' total loans. A significant proportion were experiencing difficulties, particularly those which lent to Indonesia and Thailand.

[14] In 1998, taxes were adjusted to permit deductions for losses incurred from debt write-off arrangements and legislation passed to encourage securitisation of assets, including bad loans (International Monetary Fund, 1998).

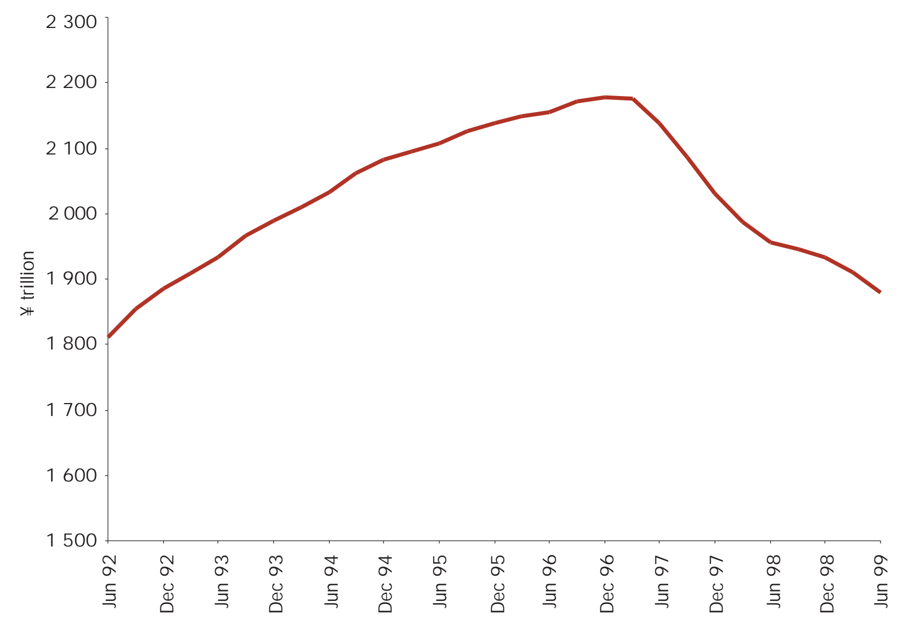
[15] According to the banks, NPLs were ¥15.2 trillion, compared to the Financial Supervisory Agency's figure of ¥17.2 trillion (Financial Supervisory Agency, 1999b). Similarly, secondary regional banks self assessed NPLs as of September 1998 were ¥5.4 trillion, compared to the Financial Supervisory Agency's figure of ¥6.6 trillion (Financial Supervisory Agency, 1999c).

For fiscal year 1998, the seven main life insurance companies officially admitted to NPLs of ¥978 billion (US$10 billion) (*Nikkei Weekly*, 14 June 1999, p. 8). However, one analysis estimates life insurers' investment losses are as high as 10 to 18 per cent of assets, or ¥19 trillion to ¥34 trillion (US$172 billion to US$309 billion), up to 50 per cent more than the banks (*Economist*, 19 April 1999, p. 88). Low asset quality compounds problems caused by the gap between guaranteed returns and actual yields; low equity prices and interest rates often reduce yields on market instruments to levels below minimum yields guaranteed to policy holders.[16] In fiscal year 1998, for the seven major life insurers this negative yield gap reached ¥1.3 trillion (*Nikkei Weekly*, 14 June 1999, p. 8). In the two years to December 1998, low returns and increased risk perceptions caused life insurance policy holders to cash in 11 per cent of contracts by value (Figure 11.4).

Figure 11.4

Life Insurance Contracts Drop Dramatically

Outstanding Japanese Life Insurance Contracts, 1992-98



Source: CEIC, 1999.

[16] For example, in fiscal year 1998, the yield on Nippon Life's investments was 1.6 per cent while its average guaranteed payout was 4.1 per cent. In April 1996, the requirement that life insurers guarantee a minimum return of 4.5 per cent per year was lowered to 2.5 per cent per year (East Asia Analytical Unit, 1997). However, a large proportion of insurance policies still carry guaranteed returns of around 5 per cent (International Monetary Fund, 1998).

Since 1997, two life insurance companies, Nissan Mutual Life and Toho Mutual Life have collapsed. Many commentators believe more failures are likely as the Financial Supervisory Agency proceeds to audit and act against companies found to be below the statutory minimum 200 per cent solvency margin.[17] These failures could exhaust the industry's safety net, and some combination of public funds and reductions in guaranteed yields will be needed to rescue the industry (*Nikkei Weekly*, 7 June 1999, p. 12).[18]

STRUCTURAL CHANGE IN BANKING AND INSURANCE

Continued poor profitability, NPL problems and financial market desegmentation combine to drive far reaching structural change in Japan's banking and insurance industries. Consequently, downsizing, mergers, alliances and a growing role for foreign financial institutions are occurring and more can be expected.

Banking

Staff downsizing has been underway for several years. However, previously staff often were merely transferred to subsidiaries. Since 1998, the conditionality attached to public fund injections has boosted downsizing. Major banks receiving public funds agreed to reduce staff by 122 800 (13.9 per cent) between March 1999 and March 2003 (Financial Supervisory Agency, 1999d). Branch network rationalisation also is ongoing, with examples including Fuji, Sumitomo and Sakura Bank announcements in late 1998 (*Daily Yomiuri*, 30 October and 4 November 1998).

Banks also are consolidating their operations by withdrawing from international business. Weaker banks like Mitsui Trust and Banking and Daiwa Bank have abandoned their international operations altogether to avoid the higher required capital adequacy standards and to focus on domestic activities (*Nikkei Weekly*, 2 November 1998, p. 12).[19] However, Bank of Tokyo-Mitsubishi is maintaining all its overseas branches while Fuji, Sanwa and Sakura Banks have substantially reduced overseas operations but are still maintaining a global presence (*Nikkei Weekly*, 14 December 1998, p. 13).

Mergers and alliances also can enhance efficiency. The 1996 merger of Bank of Tokyo and Mitsubishi Bank was the first major merger.[20] The resulting Tokyo-Mitsubishi Bank now is one of Japan's strongest banks; it was one of only two banks which did not seek public capital injections in 1999. The conditionality attached to banks accessing public funds gave further impetus to mergers. After a series of relatively small scale alliances, such as that between Toyo Trust and Sanwa

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[17] The solvency margin is the ratio of capital and unrealised profit to a weighted measure of risky assets. Since April 1999, life insurers have had to disclose this ratio, and if it falls below 200 per cent, the Financial Supervisory Agency may order them to close.

[18] An industry funded safety net was set up in December 1998 and has ¥400 billion in assets. However, Toho's liabilities alone exceeded its assets by ¥200 billion (*Nikkei Weekly*, 7 June 1999, p. 12).

[19] Purely domestic banks require capital adequacy ratios of only 4 per cent: those with international networks require 8 per cent capital adequacy ratios.

[20] The merged bank capitalised on the two institutions' complementary expertise. Before the merger, the Bank of Tokyo had a good reputation in international financial transactions, while Mitsubishi Bank was strong in domestic lending (East Asia Analytical Unit, 1997).

Bank in early 1999, Japan's next major merger, of Dai-Ichi Kangyo Bank, Fuji Bank and Industrial Bank of Japan, was announced in August 1999.[21] The proposed merger, to be completed by 2002, would create the world's largest financial institution. More importantly, it targets major cost areas. For example, within five years the merger will reduce joint domestic branch numbers by around 150 and the joint workforce by 6 000 people.[22] The merger also will enable the new bank to make major new information technology investments (Fuji Bank, 1999). In October 1999, a further large merger was announced between Sumitomo and Sakura Banks, to be completed by April 2002.

However, public funds could be wasted if mergers lack a sound commercial rationale. For example, some analysts question the commercial rationale of merging two weak trust banks, Mitsui Trust and Banking and Chuo Trust and Banking, believing trust banks and commercial banks have more synergies (*Nikkei Weekly*, 25 January 1999, p. 1).

Life Insurance

The same factors, NPL problems, poor profitability and removal of barriers between financial sectors also are driving structural change in the life insurance industry. From fiscal year 1999, insurers can enter the banking and securities sector; from 2001, banks and securities companies should be able to offer insurance products.[23]

These pressures are increasing alliances with foreign financial institutions and between Japanese insurers.[24] The most notable example of the latter is the comprehensive alliance between Taiyo Mutual Life Insurance and Daido Mutual Life Insurance, to enhance their life insurance business; many previous alliances targeted non-core businesses.[25]

The Government will submit a bill to permit demutualisation to the Diet in the first half of 2000. This reform should generate further structural change in life insurance, as companies switch from unlisted mutual organisations to listed companies which must supply information to shareholders. Listing also allows insurers to raise fresh equity capital and facilitates mergers.[26]

[21] The Toyo-Sanwa alliance, which includes the merger of Sanwa Trust and Banking, a wholly-owned subsidiary of Sanwa and Toyo, is seen as commercially astute, as major commercial banks like Sanwa have difficulty establishing trust banking subsidiaries because they lack experience in global portfolio management (*Nikkei Weekly*, 25 January 1999, p. 1)

[22] However most of these job cuts already had been pledged as part of the conditionality for public fund injections (*Far Eastern Economic Review*, 2 September 1999, p. 38).

[23] While it is part of the scheduled 'big bang' reforms, no final decision has been made on whether banks will be able to sell insurance products.

[24] These alliances are discussed later in the chapter.

[25] Life insurers typically team up with banks and other non-insurance financial institutions in pension and investment trusts (*Nikkei Weekly*, 25 January 1999, p. 3).

[26] As a result of their problems, life insurers also are becoming more active holders of corporate shares. Previously, they gave unconditional discretionary power to company chairmen of companies in which they held shares, but now Nippon Life, Dai-Ichi Mutual Life and Sumitomo Life have guidelines for exercising their voting rights at annual general meetings (*Nikkei Weekly*, 14 June 1999, p. 12). However, it remains to be seen how much actual practice will change.

Mergers and Alliances

Ongoing big bang reforms will maintain the pressure for mergers across the financial services industry. Progressive dismantling of financial sector barriers is producing a spate of mergers and alliances (Table 11.1). For example, declining distinctions between commercial and investment banking reduces the rationale for separate institutions in these business areas.[27] In August 1999, the Diet passed a bill permitting the exchange of shares between merging companies, further encouraging mergers.

Table 11.1

Alliances Gather Pace

Major Financial Institution Alliances and Mergers, 1998-99

	Participating firms	Joint activity
May 1998	Industrial Bank of Japan and Nomura Securities	Two joint ventures in derivatives and asset management
	Fuji Bank, Yasuda Trust and Banking, Yasuda Fire and Marine Insurance and Yasuda Mutual Life Insurance	Investment trust fund joint venture
June 1998	Nikko Securities Company and Travelers Group	Wholesale securities service joint venture
July 1998	Mitsui Trust and Banking and Prudential Insurance	Investment trust fund joint venture
	Sumitomo Bank and Daiwa Securities	Comprehensive alliance in wholesale securities, derivatives and asset management
September 1998	Bank of Tokyo-Mitsubishi, Mitsubishi Trust and Banking, Meiji Life Insurance and Tokio Marine and Fire Insurance	Comprehensive alliance in investment trusts, securities, insurance and pension fund management
	Tokai Bank and Asahi Bank	Comprehensive alliance to focus on domestic retail service
October 1998	Dai-Ichi Kangyo Bank and JP Morgan	Investment trust joint venture
	Sumitomo Trust, Sumitomo Bank and Daiwa Securities	Comprehensive alliances in wholesale capital markets
	Industrial Bank of Japan and Dai-ichi Mutual Life Insurance Company	Comprehensive alliance in all financial services
January 1999	Mitsui Trust and Banking and Chuo Trust and Banking	Merger of two trust banks
	Sanwa Bank and Toyo Trust and Banking	Strategic alliance including forming a fixed contribution pension fund
August 1999	Industrial Bank of Japan, Fuji Bank and Dai-Ichi Kangyo Bank	Full merger by mid 2002 via a holding company structure
	Sanwa Bank and Morgan Stanley Dean Witter	Comprehensive alliance for sale of investment trusts
October 1999	Sumitomo and Sakura Banks	Merger by April 2002

Source: *Nihon Keizai Shimbun*, 5 October 1998; *Nikkei Weekly*, 25 January 1999, p. 1; *Nikkei Weekly*, 6 September 1999, p. 1; and Fuji Bank, 1999.

[27] For example, from 1999, commercial banks can issue corporate debt more freely.

THE GROWING FOREIGN PRESENCE

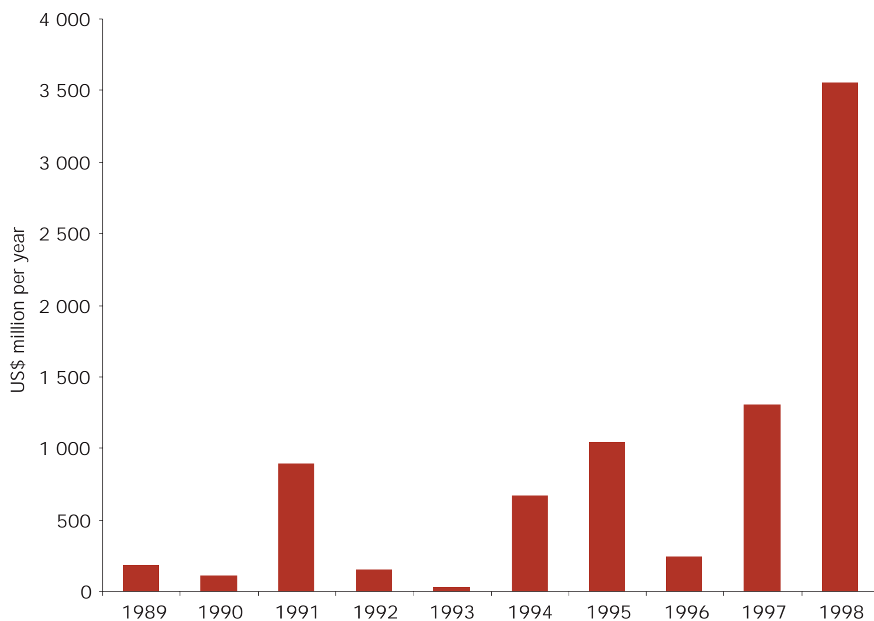
Since 1994, approvals for foreign direct investment in Japan's banking and insurance industry have increased approximately five fold (Figure 11.5). Despite Japan's poor economic performance, approvals particularly surged in 1998 when they were worth more than in the six previous years combined. This surge reflected the weak yen, new opportunities emerging from big bang reforms and financial sector weakness. Approvals growth also reflects increasing government recognition of foreign financial institutions' valuable role in upgrading practices and products.

Many foreign and domestic institutions find alliances mutually beneficial. While Japanese firms have well established marketing networks and corporate clientele, they often lack product variety, state-of-the-art technology and risk management skills that major foreign players can provide. The unpopularity of full takeovers also may be due to concerns about undisclosed NPLs.

Figure 11.5

Foreign Investment in Banking and Insurance Surges

Foreign Direct Investment Approvals in Banking and Insurance (US$ million)



Source: Ministry of Finance, 1999.

INDUSTRY LEVEL FOREIGN PARTICIPATION TRENDS

Foreign financial institutions are increasingly prominent in the securities industry, pension funds management, life insurance and banking.

The Securities Industry

In August 1997, the 21 foreign securities firms on the Tokyo Stock Exchange together had a larger share of securities trade than Japan's four largest securities firms together (Suzuki, 1998). Japanese securities companies have been hit hard by deregulated brokerage commissions and banks' capacity to underwrite various bonds and sell mutual funds and increasingly accept foreign partners.[28] In July 1998, Merrill Lynch commenced retail business with 33 branches and 2 000 employees taken over from the defunct Yamaichi Securities. In June 1998, the Travelers Group effectively took over Nikko Securities' investment banking and international operations. Nikko's corporate business and research operations will become a joint venture with Salomon Smith Barney, a unit of Travelers.[29]

Pension Fund Management

Foreign firms also are increasingly active in pension fund management. To boost returns and asset security, pension funds are moving funds out of life insurance into investment adviser managed funds; many of these are foreign owned. Foreign firms offer superior risk management systems and a consequent ability to obtain greater returns. Foreign companies now manage around 8 per cent of Japanese pension fund assets (OECD, 1998). Future prospects for investment advisory companies are very strong; in April 1999, regulations restricting to 50 per cent the proportion of funds that could be placed with investment advisory firms were abolished. From 2001, pension funds will not need to invest 50 per cent of their funds in government bonds and other safe assets (OECD, 1998; and Takahara and Tanaka, 1996).

Foreign companies are even making inroads into managing public pension funds. For example, in fiscal year 1997, the Ministry of Health and Welfare's pension fund manager, one of the world's largest, Pension Service Public Welfare Corporation, increased funds under foreign management by about 6 per cent to ¥3.2 trillion (US$29 billion). This increase in foreign funds management represented around half of its new business that year.

[28] Like banks, securities firms also are reducing staff numbers and closing overseas branches. For example, in mid 1998, Nomura Securities announced a worldwide staff cut of between 1 000 and 2 000 people, and closure of 20 overseas offices. Nomura, Daiwa and Nikko Securities, the three biggest securities houses, also are shifting their business emphasis from commissions to asset accumulation (*Nikkei Weekly*, 25 January 1999, p. 16).

[29] While Nikko will hold 51 per cent of the venture, Salomon Smith Barney will run it. Travelers also will take over up to 25 per cent in Nikko. In October 1998, Travelers Group merged with Citicorp to form Citigroup, the world's largest financial group.

Life Insurance

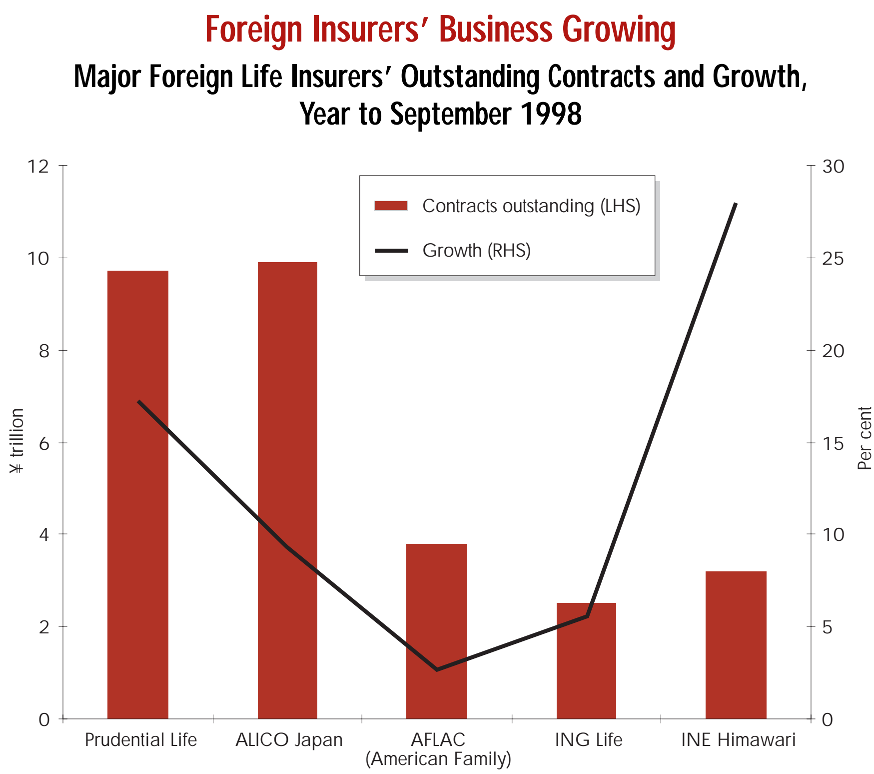
In the life insurance sector, foreign companies also benefit from domestic insurers' profitability and NPL problems. In the year to September 1998, the value of outstanding policies at Japan's seven big life insurers fell 4 per cent to ¥1 149 trillion, while from a small base, the five biggest foreign insurers expanded contracts by 10 per cent (Figure 11.6).[30] Foreign life insurers are succeeding by:

- emphasising specialised niche products rather than generic products
- offering a consulting style approach with well trained sales people rather than untrained 'insurance ladies'
- marketing actively and directly (Austrade, 1999).[31]

Figure 11.6

Foreign Insurers' Business Growing

Major Foreign Life Insurers' Outstanding Contracts and Growth, Year to September 1998



Note: INA Himawari is a foreign insurance company. (INA stands for Insurance Company of North America.)
Source: *Diamond Weekly*, 1999.

[30] The big seven Japanese insurance companies are Nippon Life, Dai-ichi Life, Sumitomo Life, Meiji Life, Asahi Life, Yasuda Life and Mitsui Life.

[31] Some newer Japanese life insurers, such as Sony Life Insurance, also use similar strategies to expand market share from low bases.

Several foreign financial institutions are taking over or forming alliances with Japan's troubled life insurers. Most notably, in early 1998, GE Capital bought Toho Mutual Life's offices, sales and marketing functions, giving GE access to Toho's customers and its workforce of 7 000 (*Far Eastern Economic Review*, 6 May 1999, p. 11).[32] Although Toho Life subsequently went bankrupt, GE Capital has not been adversely affected because it bought only selected parts of the company.[33]

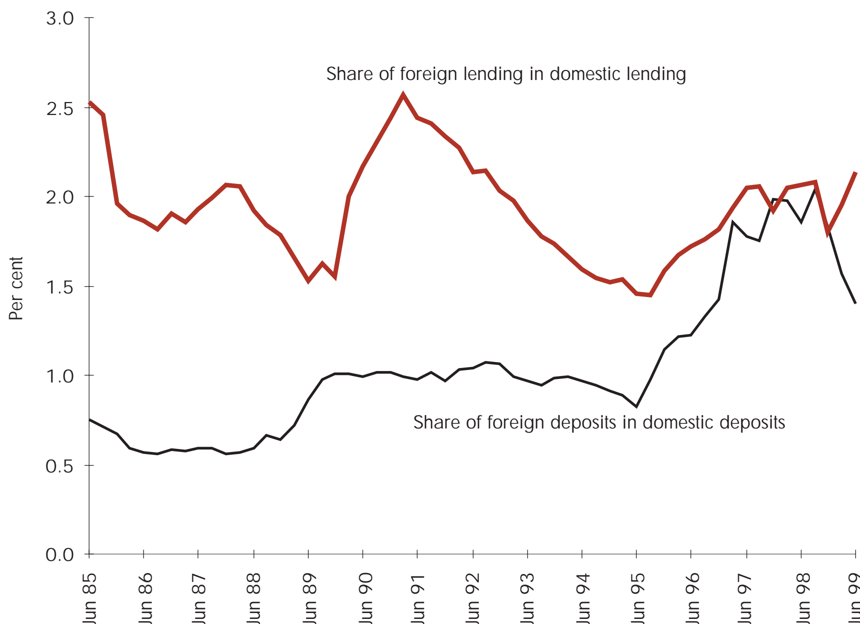
Banking

While Japanese banks dominate retail and commercial banking, from a low base foreign banks gradually are increasing their presence. Over the two years to late 1998, domestic banking system problems raised foreign banks' deposit share to 2 per cent or almost ¥10 trillion (US$90 billion). However, by June 1999, increasing confidence in the solvency of major domestic banks caused foreign banks' deposit share to contract to 1.4 per cent (Figure 11.7). Since mid 1997, foreign banks' share of domestic lending has been more stable at around 2 per cent (Figure 11.7).

Figure 11.7

Growth in Foreign Banks' Deposit Share

Share of Foreign Banks in Domestic Lending and Deposits, 1985-98



Source: CEIC, 1999.

32 Toho kept its existing insurance policies and received cash and a 10 per cent stake in the new firm, GE Edison Life.

33 In another deal, Meiji Life allied itself with Dresdner Bank (OECD, 1998).

Domestic and foreign banks are forming alliances too.[34] Although no formal foreign ownership restrictions exist, foreign banks are yet to acquire domestic banks partly due to concerns about possible undisclosed NPLs. However, in late 1999, a US investment company, Ripplewood Investment Holdings, obtained priority rights to negotiate with the Government to purchase the nationalised Long Term Credit Bank of Japan. If the purchase proceeds, several major foreign banks are expected to take a stake in Ripplewood's investment and cooperate with the Long Term Credit Bank to boost earnings (*Nikkei Weekly*, 27 September, p. 12).

AUSTRALIA'S PRESENCE IN JAPAN'S FINANCIAL SECTOR

While Australian financial institutions have not participated in any large, high profile mergers and alliances, they increasingly are active in Japan's financial sector.[35] In May 1999, Macquarie Bank announced a joint venture with Industrial Bank of Japan to undertake derivatives trading. In September 1999, the Commonwealth Bank took advantage of falling financial market barriers and established a registered securities company, Commonwealth Securities. By diversifying its Japanese operations from banking to securities, the Commonwealth Bank will help develop its financial market business (Commonwealth Securities, 1999).[36] Both AMP and Sydney Reinsurance, a subsidiary of QBE, set up offices in Tokyo in 1998-99. According to Austrade, good opportunities exist for Australian firms in asset management and financial information technology.

FACTORS PROMOTING FOREIGN FINANCIAL INSTITUTIONS

Desegmentation of financial markets and growing strains on the main bank system help foreign financial institutions penetrate Japanese financial markets.

Desegmentation of Financial Markets

Financial market desegmentation, the removal of regulatory barriers between financial sectors like banking, securities and insurance, increases the opportunities available to foreign financial institutions entering the market. For example, some Japanese banks have met the lifting of restrictions on their trading in trusts in 1998 and 1999 by negotiating with foreign service providers, who often are more experienced in managing new trust-related products. Dai-ichi Kangyo Bank and an affiliate of JP Morgan established a company to market investment trusts, while Mitsui Trust and Banking established a joint venture with Prudential Insurance to develop and manage investment trusts (Kamata et al, 1999).

34 For example, Fuji Bank and Goldman Sachs are selling mutual funds jointly, while Sakura Trust and Banking and Chase Manhattan Bank have allied their custody and overseas securities trading operations (OECD, 1998; and Kamata et al, 1999). Chase Manhattan will conduct Sakura Trust's overseas securities transactions and settlements.

35 The four major Australian banks have been in Japan for over 20 years. They focus on niche capital and financial market business, particularly Japanese capital flows into Australian and New Zealand debt products.

36 For more detail on Commonwealth Securities' operation, see Chapter 4 - *Banking*.

MACQUARIE BANK IN EQUITY DERIVATIVES ALLIANCE WITH INDUSTRIAL BANK OF JAPAN

In May 1999, Macquarie Bank entered an alliance with the Industrial Bank of Japan, IBJ, to take advantage of the October 1999 full deregulation of Japan's equity derivatives markets.

Macquarie has successfully entered derivatives markets in Australia, Hong Kong and South Africa. IBJ Securities Company Limited, IBJS, a wholly-owned subsidiary of IBJ, was one of the first Japanese securities companies granted an over-the-counter derivatives licence and is establishing a full service equities brokering operation. The 50-50 joint venture will trade and issue products including listed and over-the-counter options, convertible bonds, equity swaps, warrants and other tailored equity products for wholesale and retail clients in Japan, Europe and other markets.

Macquarie provides derivative pricing models and risk management systems to the business. Initially, it will manage the market risk component of equity derivative products issued and traded by the alliance on its balance sheet.

This alliance allows Macquarie to use its equity derivatives expertise to develop a business with one of Japan's leading banks. The Industrial Bank of Japan's announced merger with Fuji Bank and Dai-Ichi Kangyo Bank has not distracted it from its joint venture with Macquarie and ultimately the merger should positively affect Macquarie's operation.

Source: Macquarie Bank, 1999.

The 'Main Bank' System's Decline

Under Japan's traditional 'main bank system', a firm's 'main bank' would meet most of the firm's financial needs, take an equity stake in the firm, participate in its management, and organise debt workouts if necessary. This role inhibited foreign banks from penetrating the local market. However, the current decline of the main bank system should help foreign financial institutions expand their business with Japanese companies.[37]

In the past, major firms' increasing use of the corporate bond market was the chief cause of the main bank system's gradual decline (East Asia Analytical Unit, 1997).[38] One new driver is more stringent supervision, which forces banks to resolve NPLs, sell collateral on bad loans and reassess risk more generally. This new tougher approach is likely to reduce the benefits of firm loyalty to one bank. The Financial Supervisory Agency also wants banks to reduce their corporate shareholdings to reduce the riskiness of bank assets (Hale, 1999).

[37] The main bank system (Aoki et al, 1994) contrasts with the western system of corporate governance where shareholder discipline is more important.

[38] The gradual weakening of the main bank system also significantly affects corporate governance (see East Asia Analytical Unit, 1997).

The growing importance of market forces, including new mergers, also strains main bank arrangements. When Nikko Securities established an alliance with Citigroup, this tested relations with its main bank Tokyo-Mitsubishi.[39] Moreover, due to their size, mega banks emerging from the recent major mergers may attract customers from other corporate groups, further loosening main bank ties. Even mergers outside the financial sector can undermine main bank relationships. For example, in the strategic capital alliance between Nissan Motor Company and Renault, Nikko Salomon Smith Barney was appointed financial adviser in preference to Nissan's two main banks, Industrial Bank of Japan and Fuji Bank (*Nikkei Weekly*, 21 June 1999, p. 8).

LIKELY FUTURE TRENDS

The growing role of market forces in Japan's financial sector is increasing disparities between strong and weak financial institutions, making further consolidation likely. Strong financial institutions can enter new markets as desegmentation permits, offer new financial products, invest in new technology and use securitisation to free up their capital. These advantages increasingly should allow them to undercut smaller, weaker competitors. Domestic and foreign financial institutions also will continue to form alliances and joint ventures. Hence merger and acquisition activity is likely to increase. Recent legislation allowing the exchange of shares between merging companies will make holding companies more attractive and accelerate merger activity.[40]

Fewer cross-shareholdings, increasingly vocal institutional investors and a realisation asset prices will not rise continually should drive an increasing focus on profitability and shareholder value. This trend will favour foreign financial institutions accustomed to this market discipline, encourage further merger and acquisition activity, and improve customer focus, efficiency and financial product availability.

Use of corporate bond markets probably will become more important as economic recovery continues and large corporations search for cheaper funding sources. Ministry of Finance efforts to increase the range of maturities at which government bonds are issued will increase the government bond yield curve's usefulness as a pricing benchmark, stimulating the corporate bond market.[41]

Like the United States and Australia in the last decade, Japan's financial institutions increasingly will emphasise best practice risk assessment and credit allocation.

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[39] These problems were evident before June 1998 when Nikko Securities agreed to merge with Travelers Group. The strains increased when Travelers merged with Citicorp to form Citigroup in October (*Nikkei Weekly*, 14 December 1998, p. 1). Contrary to initial expectations, Bank of Tokyo-Mitsubishi formed its strengthened investment banking arm without Nikko (*Nikkei Weekly*, 14 December 1998, p. 1).

[40] While holding companies have been permitted since fiscal year 1998, an outstanding restraining factor is the inability of subsidiaries to consolidate their tax liability.

[41] At present, ten year bonds dominate government bond issues. In early 1999, an advisory body to the Ministry of Finance recommended issuing five year government bonds; the Ministry of Finance apparently supports such a move (*Nikkei Weekly*, 26 April 1999, p. 15).

FUTURE CHALLENGES

To ensure future financial sector health, Japan's priorities include maintaining a firm and efficient supervisory regime, reforming the postal savings system and pursuing a broad based microeconomic reform program. The latter is required to restore growth to a sustainable level consistent with financial sector health.

Maintaining Vigilant Supervision

Japan has significantly improved its supervisory regime with consolidated supervision, tightened provisioning guidelines and a new procedure to improve inspection systems. The Financial Supervisory Agency's audits also increase confidence in the tighter supervisory regime, and after the next budget, the agency will be fully independent.[42]

Nonetheless, to ensure long term financial system stability, regulators must continue to build credibility and keep pace with the expanding range of financial products, rapidly changing financial sector practices and complex organisational structures. A culture recognising the need for ongoing reform is important.

Reforming the Postal Savings System

Reform of Japan's rather anachronistic postal savings system is very slow. The system was established to encourage savings and fund development projects in the post war reconstruction phase, and could have been phased out as Japan's economy matured. However, in the 1990s, the system's share of savings increased because it provided a 'safe haven' during the private bank crisis (Figure 11.1). In addition, the postal savings system does not impose many of the deposit fees incurred by private bank depositors, such as deposit insurance premiums. Preferential treatment for the postal savings system discourages growth of an efficient profit oriented private banking system.[43]

Funds deposited in the postal savings system are channelled into government investment projects and provide a subsidised finance source for government corporations.[44] The rate of return on postal saving funds is low; the difference between average returns and funding costs was only 0.14 per cent in fiscal year 1997 (Ministry of Finance, 1998). If Japan is to increase the rate of return on its savings and have a competitive financial sector, market forces should play a greater role in allocating this vast pool of assets more efficiently.

[42] A June 1999 audit of 64 regional banks found ¥2 trillion worth of loans misclassified as fully performing, while a December 1998 audit of 17 major banks found ¥5.4 trillion worth of loans misclassified as fully performing (Financial Supervisory Agency, 1998).

[43] Depositors will indicate the popularity of postal savings in 2000 and 2001 as ¥62.9 trillion in postal term savings mature. These deposits, worth more than ¥100 trillion including principal and interest payments due at maturity, were invested for ten years in 1990 and 1991 when interest rates peaked at 6.3 per cent (*Nikkei Weekly*, 24 May 1999, p. 13).

[44] Approximately 53 per cent of assets go to government related institutions or local public organisations (Ministry of Finance, 1998).

Improving Economic Growth

Financial sector recovery requires improvement in Japan's macroeconomic performance. While bank recapitalisation should assist economic recovery by improving confidence and expanding bank lending, financial sector restructuring and reform alone will not restore sustainable economic growth.[45] Indeed, the fiscal costs of recapitalisation and recent stimulus packages may drive up long term bond rates and generate an expectation of future tax liabilities, restraining consumption and credit demand (McKibbin, 1997).[46]

The OECD estimates that without further structural reform, Japan's potential rate of sustainable output growth could fall from 1.5 per cent per year to 1 per cent over the next decade, then to 0.5 to 0.75 per cent (OECD, 1998).[47] Such projections underline the importance of further broad based microeconomic reform. Key areas in need of reform include land use laws, agriculture and the electricity and telecommunications industries (OECD, 1998).

CONCLUSIONS

Japan finally is making significant progress in eliminating banks' NPLs, although problems remain among the regional banks and life insurance companies. Japan's financial markets are changing rapidly, driven by poor profitability, NPL resolution efforts, ongoing reform and foreign participation. These changes present foreign financial firms with opportunities to expand and develop in the Japanese market.

However, even after NPL problems are resolved, financial sector reforms must continue to ensure long term economic health and vigour. Furthermore, to achieve Japan's long term growth potential and a solid base for further financial sector development, accelerated structural reforms also are needed in other sectors.

45 Given the risks associated with lending to the Japanese corporate sector in an environment of weak economic growth and widespread restructuring, banks may be slow to increase lending to companies, even after they recapitalise.

46 The increase in long term bond rates from 0.9 per cent in October 1998 to 2.1 per cent in February 1999 was attributed largely to increased market realisation of the fiscal costs of bank recapitalisation.

47 The main factors driving this decline in potential output growth are the labour force reduction flowing from population aging, the deceleration in capital stock growth and a slowing trend in total factor productivity growth (OECD, 1998).

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