The monetary, regulatory and competitive implications of the restructuring of the Japanese banking industry

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1. Major changes in the banking sector in the last decade

1.1 Overview of factors contributing to the changing nature of the banking industry

In recent years, the Japanese banking industry has faced drastic and very challenging changes, including the global trend of rapid progress in financial innovations on account of technological developments, and the accumulation of non-performing loans resulting from the burst of the bubble economy.

In addition, deregulation measures recently accelerated by the "Japanese Big Bang" has provided the industry with an impetus for changes.

1.1.1 Progress in financial innovations

Financial innovations induced by the development of technology have also taken place in Japan and have enabled financial institutions to unbundle risks of conventional financial instruments (such as loans and bonds) and produce new financial instruments, such as derivatives and asset-backed-securities. Financial innovations have also induced financial institutions to provide diversified and complex financial products in terms of cash flow, risk and return profile, and have thus enabled them to cope more flexibly with the needs of their customers.

In addition, innovations have made it easier for banks to evaluate the returns earned from bearing certain risks and thus facilitated their risk management.

1.1.2 Changes in the economic environment

The Japanese economy has experienced structural changes for the last two decades. Economic growth slowed compared to 1960s and 1970s and the less capital-intensive industries, such as services, gained larger shares in the domestic economy. These changes reduced the need for fixed investments and firms began to hold more idle funds (Graph 1). As for households, personal financial assets have accumulated up to 1,200 trillion yen. This situation drove both firms and households to pursue a variety of investment opportunities in terms of risk and return profile.

1.1.3 The burst of the bubble economy and non-performing loan problems

In the bubble economy, however, financial institutions continued to put emphasis on expanding the scale of their business rather than on improving their interest rate margins. In other words, the bubble economy blew away the momentum for changes among financial institutions and gave their management the illusion that quantitative growth of traditional loan business would continue to be the best goal to pursue. It was only after the burst of the bubble economy that this illusion was eventually wiped out.

Banks have been significantly hit by the fall in asset prices, as it appeared on their accounts as accumulated non-performing loans (Graphs 2 and 3). They had to devote their energy to cope with non-performing loans while foreign competitors developed new financial services.

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1.1.4 Recent changes in banks' management

Interest rate margins turned out to be insufficient to cover losses resulting from non-performing loans, and banks' final profits declined sharply (Graph 4). Profit margins in the traditional banking business as measured by spreads between interest rates on deposits and loans at the time of contracts had been rather steady and low compared to those of US and European banks (Graph 5).

In response, banks began to introduce more sophisticated methods to set interest rates that reflected the credit risks of borrowers as accurately as possible. Banks also recognised the need to establish business lines with increasing profits, such as investment management business, in the course of restructuring their business, and have been seeking affiliation with other financial institutions to strengthen their skills (Graph 6).

1.2 The Government's policy responses

The "Japanese Big Bang" was one of the Government's principal responses to the weaknesses in the financial sector. This measure derives from the recognition that banking and securities regulations had become outdated, as the progress of technological developments in data processing and communication had enlarged the scope for market mechanisms to ensure efficiency and contain abuses. As technology progresses further, regulations have come to be seen as burdensome and as protecting existing interests.

One of the weak aspects of the Japanese financial system was said to lie in the lack of transparency due to weak disclosure. The introduction of Prompt Corrective Action and the measures taken as part of the "Japanese Big Bang", including the introduction of mark-to-market accounting and disclosure based primarily on a consolidated basis, should help market participants to more easily scrutinise financial institutions' conditions. It was necessary for Japanese banks to clarify their restructuring policies and the schedules to write off non-performing loans in order to restore the market's confidence.

A scheme to utilise public money to strengthen the capital of banks and to assist consolidation of banks is another policy response to deal with weaknesses in the financial sector (see Section 2). Public money is to be injected into large banks to strengthen their capital and to exert pressures on banks to formulate concrete plans for recovering their financial soundness. In due course, banks should endeavour to identify their comparative advantages and allocate their resources accordingly. Moreover, quite a few banks, after a thorough review of their own resources, have sought consolidation with other financial institutions rather than restructuring on a solo basis.

2. Implications for financial stability

2.1 Recent successive failures of Japanese financial institutions and their resolutions

2.1.1 Introduction

Against the general background discussed in the previous section, this section will focus on the policy responses of the Bank of Japan to the situation after successive failures of several financial institutions in autumn 1997.

Sanyo Securities Company, Hokkaido Takushoku Bank, Yamaichi Securities Company and Tokuyo City Bank all confronted difficulties in continuing their business as they began to lose market confidence, evidenced in the sharp decline in their stock prices as well as in withdrawals of deposits and investments. In effect, the cautious attitude of interbank market players made it impossible for these institutions to raise sufficient funds to fulfil their obligations to settle payments and to meet reserve requirements.

In response, the Bank of Japan has taken several measures, including the extension of special loans (based on Article 25 of the former Bank of Japan Law) to the failing financial institutions and the utilisation of various market operation means to provide the markets with sufficient liquidity.

2.1.2 The extension of special loans to failed financial institutions

In order to ensure smooth payments of failed financial institutions, the Bank of Japan extended special loans without collateral to Hokkaido Takushoku Bank, Tokuyo City Bank and Yamaichi Securities Company. The loans were aimed at providing the necessary liquidity until the liquidation (in the case of Yamaichi) or the transfer of businesses (in other cases) could be completed.

The extension of the Bank of Japan's loan to Yamaichi raised difficult issues related to the safety net. In this case, the Bank of Japan's loan was extended to an institution which was not a bank. In light of the principles that the Bank applies in extending lender-of-last-resort loans, it was a common view that the central bank's safety net was primarily prepared for depository institutions.[2] A failure of non-depository institutions is usually not likely to cause systemic repercussion since they are not in chained creditor-debtor relationships with other entities, as so determined in the case of default of the Sanyo Securities Company.

In the case of Yamaichi, however, central bank's support was judged indispensable in order to prevent worldwide systemic repercussions. Banking subsidiaries of Yamaichi overseas could have triggered difficulties in settling payments through chains of transactions. In addition, Yamaichi had entered into derivatives and other financial contracts with a number of financial institutions in Japan and abroad. If such transactions had been wound up, erosion of the credibility in the Japanese financial system could have affected the Japanese economy and caused disruptions in domestic and overseas financial markets.

The extension of the Bank's special loan to Yamaichi raised another difficult problem, as it covered for funds for domestic and overseas affiliates within the Yamaichi Group, and not only for the securities company itself. The key issue is the extent of the Bank's coverage when its loan is extended to an institution which operates within a group.

The expansion of the safety net could lead to moral hazards within the financial system. On the other hand, the changing organisational structures of financial institutions and the diversification of financial activities make it necessary to reexamine the scope and cover of the safety net.

2.1.3 The management of the Bank of Japan's monetary policy operations

The failures of large banks and securities companies made market participants extremely sensitive to credit risks. The failure of Sanyo Securities Company was the first default in non-collateral overnight call transactions, which made the evaluation of counter-party risks in the interbank markets more stringent (Graph 7). Such market circumstances not only made it difficult for transactions to come to terms, but also placed an upward pressure on market interest rates (Graph 8). The gap between the minimum/maximum overnight non-collateral rates widened reflecting the expansion of credit risk premiums.

To cope with the situation, the Bank of Japan utilised various market operations to inject ample liquidity into the markets in order to smooth market transactions and stabilise market interest rates.

The Bank of Japan's open market operations are usually meant to counter an overall shortage or excess of reserves in the market. The fund shortages of individual financial institutions are supposed to

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2 The Bank extends lender-of-last-resort loans to provide funds for the purpose of ensuring the stability of the financial system only in cases where all of the following conditions are met. First, there is a strong possibility that failure of one financial institution to settle transactions with another may trigger a chain reaction of defaults and, as a result, confidence in other sound financial institutions will be undermined or runs on deposits will occur. Second, credit extension by the Bank is indispensable, as there are no other sources of funds. Third, measures are taken to prevent moral hazard, and, fourth, the financial soundness of the Bank will not be threatened.

be covered through the market mechanism under which participants take adequate counter-party risks in exchange for due returns.

Faced with successive failures of financial institutions, the Bank of Japan has injected liquidity well beyond the level necessary for financial institutions to meet the reserve requirement in order to offset the upward pressure on interest rates (Graph 9). Reflecting the Bank's operations, the short-term rates were kept stable at their targeted level. In addition, the operations were intended to help financial institutions smoothly execute payment activities in cases where market participants became excessively cautious in providing credit to each other. Although enough funds were provided on a macro basis, financial institutions with low grading would have found it difficult to acquire the funds required to settle payments. The Bank's policy of injecting sufficient liquidity into the market had the effect of easing fears that defaults might occur.

Since rates on longer-term money market instruments remained high, the Bank also provided funds on relatively long terms through the purchase of bills and commercial papers. In particular, funds were provided on terms with the repayment due after the end of March to ease otherwise tight monetary market conditions. Operations to provide funds were usually 1-3 months long, while operations to absorb funds by issuing bills were shorter with maturity less than one month. Through such operations, the Bank has executed maturity transformation, which contributed to stabilising longer-term rates.

It should also be pointed out that the Bank's issuance of bills to banks have alleviated the impact of the so-called "Japan Premium" where, due to a decline in their creditworthiness in international markets, Japanese banks encounter extra funding costs, compared to leading US and European banks (Graph 10). Since the auction system meant that the Bank's bills were mainly sold to foreign banks, the operations helped Japanese banks obtain foreign currency funds, as they stimulated swap transactions between yen and foreign currencies. All in all, these operations led to a market expansion of the Bank's balance sheet (Graph 11).

Another part of the Bank of Japan operations was focused on the credit market, because the disposition of the large amount of non-performing loans forced banks to curtail their assets in order to meet the Basle capital standard. In addition, faced with severe competition, banks began to strengthen their risk management and attach more importance to improving profitability of their loans (Graphs 12 and 13).

In response to the resulting tight conditions in the credit market, the Bank of Japan increased its purchases of corporate commercial paper in order to smooth financing activities of corporations as well as ease monetary conditions (Graph 14). On 13th November 1998, the Bank announced the introduction of new measures for money market operations in response to the recent situation in firms' financing activities, including expansion of CP repo operations, the establishment of a temporary lending facility and the creation of a new market operation scheme utilising corporate debt obligations as eligible collateral.

It may be argued that the Bank's holding of corporate debt obligations instead of government bonds could deteriorate the financial soundness of the Bank and impair confidence in the currency. However, the Bank only holds or takes as collateral corporate debt obligations judged eligible and, in the case of holding, acquires them in repurchase agreements under which counter-party institutions are obliged to buy back the debts.

2.2 Temporary measures to stabilise the financial system until 2001

2.2.1 Financial revitalisation

In order to restore confidence in the Japanese financial system, the government of Japan decided to introduce temporary emergency measures to precipitate resolutions of failing banks while protecting deposits in full until March 2001 (deposits that exceed 10 million yen may not be protected thereafter).

New authorities to deal with failing banks were given to the newly-established Financial Revitalization Commission (FRC). First, the FRC may appoint financial administrators, who shall transfer businesses of the failing banks to other banks or, if there appeared no banks that would voluntarily assume their businesses, to public bridge banks established by the Deposit Insurance Corporation (DIC). Second, the FRC may commence special public management (temporary nationalisation) of banks which have failed or are in danger of failing. In this case, the DIC has to acquire the shares of those banks.

2.2.2 Public funds

The Deposit Insurance Act was amended in February 1998 to provide public funds totalling 17 trillion yen, allowing the DIC to purchase assets of troubled banks and offer assistance to other banks overtaking their businesses. In October, the Government was also empowered to guarantee up to 18 trillion yen when the DIC borrows funds for the conduct of financial revitalisation activities such as the establishment of public bridge banks, special public management and the purchase of banks' assets.

Measures to strengthen the capital bases of banks to ensure early restoration of soundness were also laid down in October last year. The new Resolution and Collection Organization (RCO), founded by the merger of the Resolution and Collection Bank (RCB) and the Housing Loan Administration Corporation (HLAC), will be able to acquire the common stocks of significantly or critically undercapitalised banks, as well as preferred stocks of banks even with capital ratios of 8% or above. The DIC is given up to 25 trillion yen of government guarantees to borrow funds in order to provide funds to the RCO to acquire shares of banks.

2.2.3 Resolution of the LTCB and of the NCB

The Prime Minister, acting on behalf of the FRC until its establishment in December, placed the Long Term Credit Bank of Japan (LTCB) under special public management (temporary nationalisation) with the bank being deemed insolvent on 23rd October 1998. Market participants were concerned whether entering special public management might fall under the definition of "an event of default" listed in agreements of derivative transactions and thus cause all transactions to be wound up. While the LTCB is subject to special procedures for a bank placed under temporary nationalisation, the nationalised LTCB will continue its normal operations with necessary funds provided by the DIC. Therefore, all obligations including deposits, bank debentures, those from interbank and derivatives transactions owed by the LTCB will be settled orderly according to their due dates and in full value.

On 13th December 1998, the Prime Minister announced that the Nippon Credit Bank (NCB) was insolvent and that the NCB would be placed under special public management.

2.3 Stability of the financial system and the implementation of the "Japanese Big Bang"

2.3.1 The implementation of the "Japanese Big Bang"

The measures discussed above are aimed at restoring the stability of the financial system. In the long term, however, the financial system should be strengthened by competition among banks and by the innovation of private banks. The full-scale financial system reform, the so-called "Japanese Big Bang", is based on the understanding that restructuring of the banking industry through deregulation is essential.

It is sometimes argued that the "Japanese Big Bang" was implemented too early because it compels Japanese banks to both face tougher competition and charge off non-performing loans from their balance sheets. However, merely curtailing the size of banks' balance sheets without improving the profitability of banks would not be sufficient to provide banks with the basis to survive. It would rather stop the smooth flow of funds and seriously affect the whole Japanese economy. In addition, foreign financial institutions came into play in the restructuring of the Japanese banking industry since expectation grew that new business opportunities would expand in the Japanese market because of the deregulation measures. The move by foreign financial institutions to seek alliance with Japanese banks to reduce costs and risks for local marketing should help Japanese banks restructure their businesses.

Therefore, the implementation of the "Japanese Big Bang" should be appreciated both as a measure to facilitate the disposition of non-performing loans and as an attempt to restructure the Japanese banking industry as a whole.

2.3.2 The contents of the "Japanese Big Bang" (Table 1)

The "Japanese Big Bang" was initiated by the then Prime Minister Hashimoto in November 1996. He proposed the plan amid the growing perception that the international competitiveness of Japanese markets had declined in recent years, due to high transaction costs. It was also pointed out that the weakness of Japanese financial institutions in creating innovative products mainly derived from the old-fashioned stringent regulations.

The basic principles of the Japanese financial system reform plan are "free, fair, and global". It advances liberalisation in terms of entry, scope of activities and organisational structures and it establishes rules for fair and transparent transactions, with all measures to be completed by 2001. The aims of the reform are to expand the choice of options for investors and borrowers, to improve the intermediaries' services while promoting competition among them, and to develop a market which is easy to use.

The forerunner of the reform was the comprehensive amendment to the Foreign Exchange Law in April 1998. The amendment completed liberalisation of foreign exchange transactions so that domestic customers can make deals directly with financial institutions overseas without permissions of the government and any party can engage in the foreign exchange business. Failure to carry out a full-scale reform of the institutional framework without delay would have caused "hollowing out" of Japanese financial markets.

Most of the other specific items of the reform were laid down in the Financial System Reform Law which passed the Diet last June and was implemented on 1st December 1998. Major changes laid out in the Law, inter alia, include the liberalisation of organisational structures of banking groups, including utilisation of holding companies; the liberalisation of off-exchange transactions for listed securities; the lifting of the ban on securities derivatives; the abolition of license requirements for securities companies and diversification of their business operations; the introduction of mark-to-market accounting for financial instruments and disclosure of financial institutions on a consolidated basis; and the strengthening of the safety net to deal with failure of securities firms and insurance companies.

These deregulation measures have had several consequences for the banking industry. The liberalisation of entry into financial businesses has increased competition with firms of other financial sectors and even commercial firms. On the other hand, the expansion of the business scopes of banks, including securities operations, has enabled them to establish new profitable business lines. In addition, the liberalisation of organisational structures has made it possible for banks to enter into alliance with firms in other financial sectors to make their business operations more efficient by achieving economy of scope. These factors are expected to promote the restructuring of the banking industry.

2.3.3 The current wave of consolidation

The "Japanese Big Bang" has stimulated consolidation in the banking sector (Table 2). The implementation of the "Japanese Big Bang" has made banks realise the need to strengthen their financial and managerial bases, and quite a few Japanese banks have chosen to affiliate with other financial institutions. In addition, the liberalisation of organisational structures and the diversification of business fields have created an environment where banks easily find allying firms in other financial sectors.

In particular, banks have entered (or are seeking to enter) into alliance *with foreign financial institutions* to strengthen new business fields and to earn better evaluation in the market.

Investment management and derivatives, which Japanese banks are seeking to strengthen, require new investments and specialised skills which would take time before they could start earning profits. Consequently, banks regard alliances with institutions that already have such specialities to be an easier way to start these new businesses.

In addition, for Japanese banks which intend to maintain and develop global operations, alliance with foreign institutions graded highly by the markets is a key to earn high evaluation in global markets. Therefore, Japanese banks have made efforts to find partners, while scaling back their own activities through branches abroad in a move towards reducing business operation costs.

In turn, foreign financial institutions' view partnership with Japanese banks as a way to reduce costs and risks for local marketing in the Japanese market. The amendment of the Foreign Exchange Law and other deregulation measures of the "Big Bang" have enlarged such opportunities for foreign financial institutions.

Liberalisation of organisational structures is one of the main features of the "Big Bang" (Graph 15). Such measures include the lifting of the ban to establish bank holding companies and the expansion of the scope of activities permissible for banks' affiliates. Due to such deregulation measures, banking groups (including bank holding company groups and bank-sub groups) will be able to engage in all financially related businesses, such as those of securities companies, insurance companies, companies specialising in ancillary or peripheral business of banks. Reflecting the measures, many banks have sought consolidation with other types of financial institutions, especially securities and insurance companies (insurance companies that banks or bank holding companies can own are limited to failing institutions until 2001). Through such consolidations, banks are seeking to provide customers with a whole line-up of financial products enabling one-stop shopping. The types of consolidation include establishment of joint ventures, entering into capital relationships, and the acquiring of businesses under a single holding company.

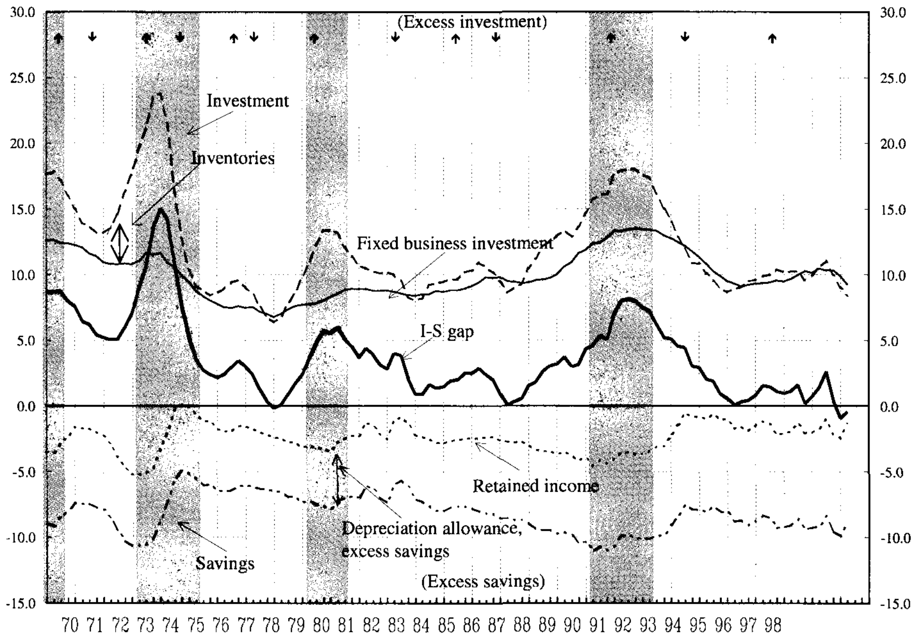
In addition, banks are seeking to make their management more efficient by specialising their business operations to areas with comparative advantages and by outsourcing or entering into alliance in other areas. The liberalisation of bank operational structures will enable banks to smoothly withdraw from particular businesses and enter into new businesses.

As banking businesses tend to be operated by a group rather than by a single entity, it becomes more important for regulatory authorities to supervise and monitor banks on a consolidated basis. Therefore, regulations to secure sound risk management of banking groups have been laid down in the Financial System Reform Law. Such regulatory measures include the application of capital adequacy rules and restrictions on large exposures (capital subscriptions and credit extensions) on a consolidated basis, and the requirement of "arm's length" transactions within the group. Financial authorities, including the Bank of Japan, need to consider concrete methods to monitor banking groups in order to check the banks' soundness.

Graph 1

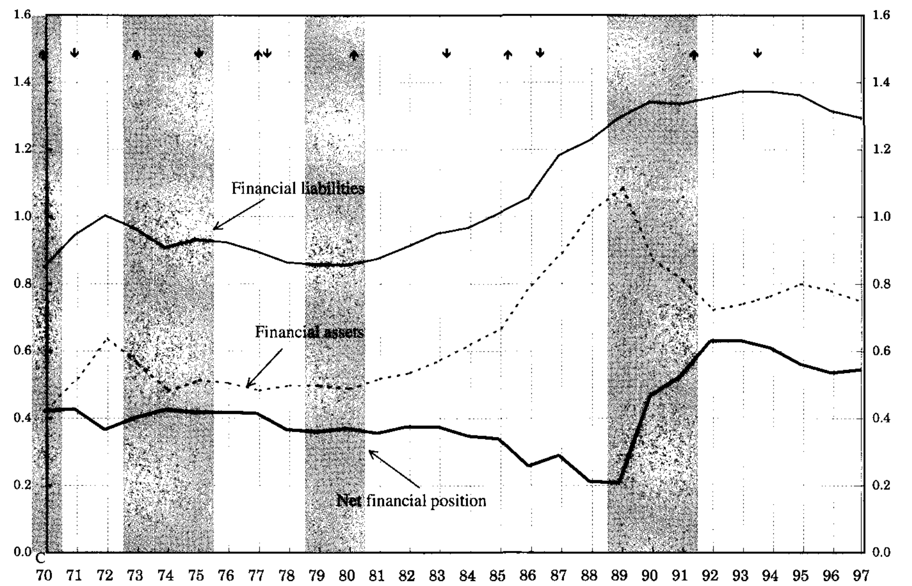
Savings-investment balance and financial position of the corporate sector

(1) Savings-investment balance of the corporate sector
As a percentage of nominal GDP, three-quarter moving averages



Notes: Based on *Corporate Business Statistics Quarterly*. Investment = newly invested fixed assets + changes in inventories; fixed business investment = newly invested fixed assets; retained income = changes in fixed provisions + special reserves and other surpluses.

(2) Financial position of the corporate business sector
Times nominal GDP

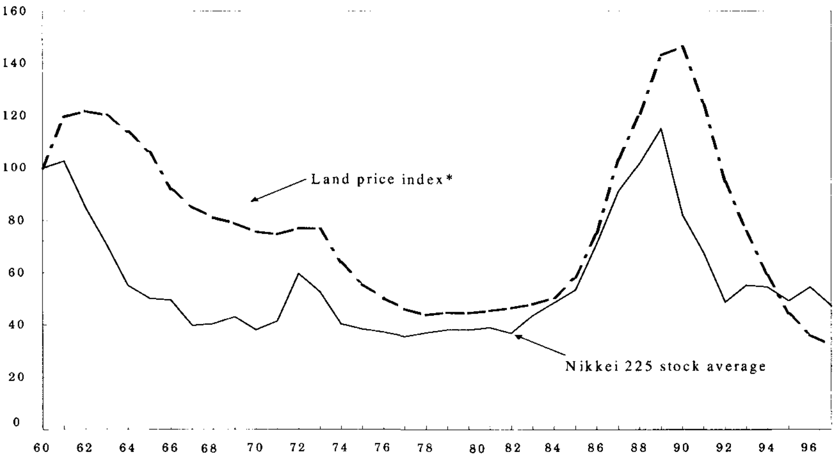


Notes: Net financial position = financial liabilities – financial assets; financial assets exclude "trade credits", "foreign claims" (foreign trade credits, foreign direct investments and other foreign claims) and "others"; financial liabilities exclude "stocks", "trade credits", "foreign debts" (foreign trade credits, foreign direct investments and other foreign debt (excludes foreign bonds)) and "others".

Source: Flow of Funds Accounts.

Graph 2
Stock and land prices

Relative to nominal GDP, 1960 = 100



* Index of land for commercial use in urban areas.

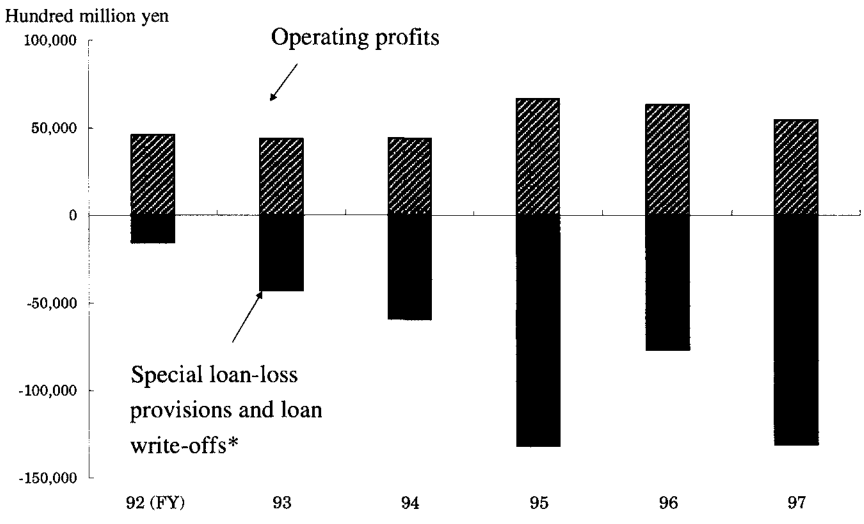
Graph 3
Non-performing loans and operating profits

(1) Non-performing loans, in billions of yen

	1992 FY	**1993**	**1994**	**1995**	**1996**	**1997**
Non-performing loans	12,774	13,575	12,546	28,504	21,789	19,530
Special loan-loss provisions and loan write-offs	1,619	4,105	5,455	13,445	7,819	13,268
Accumulated loan-loss provisions and loan write-offs	1,619	5,724	11,179	24,624	32,443	45,711

Notes: Non-performing loans comprise loans to legally bankrupt companies, overdue loans, loans with reduced or suspended interest (loans to legally bankrupt companies and overdue loans up to 1994) based on the disclosure standard of Zenginkyo (the Federation of Bankers Association of Japan). Special loan-loss provisions and loan write-offs = loan write-offs + non-performing loans to the Cooperative Credit Purchasing Company (CCPC) + other forgiveness of claims.

(2) Operating profits and loans write-offs

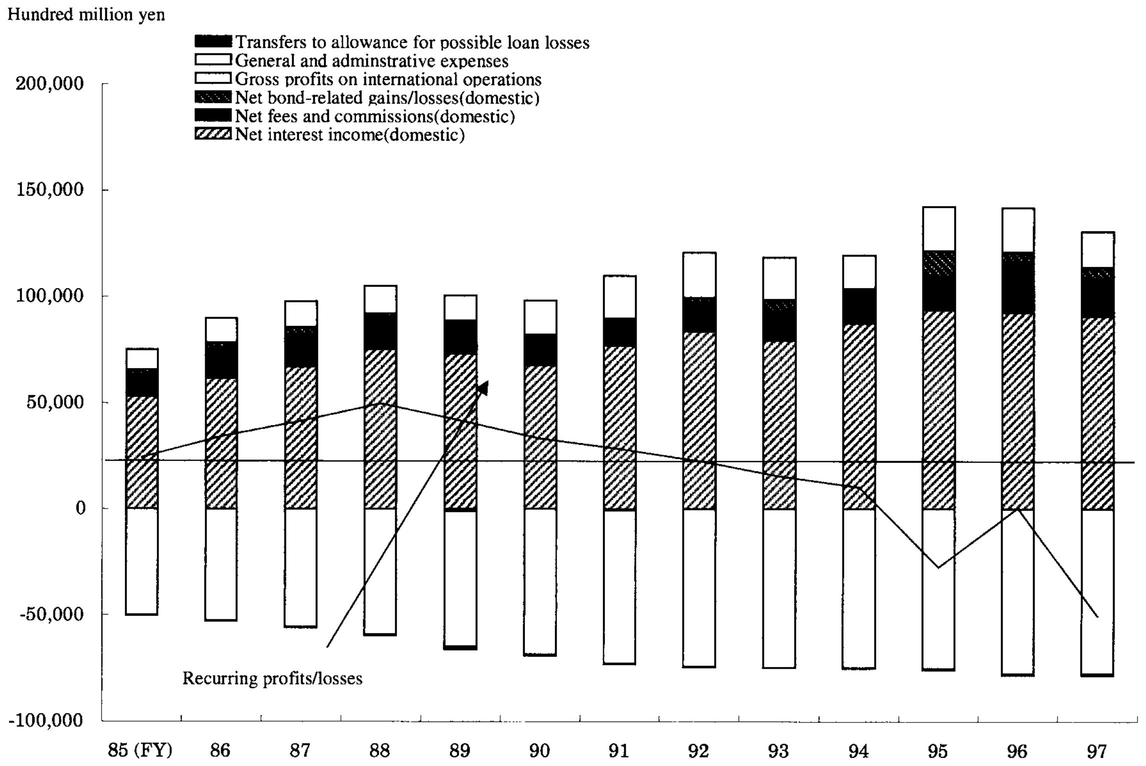


* Loan write-offs + transfers to special loan-loss provisions accounts + losses from the sales of non-performing loans to the CCPC + other forgiveness of claims.

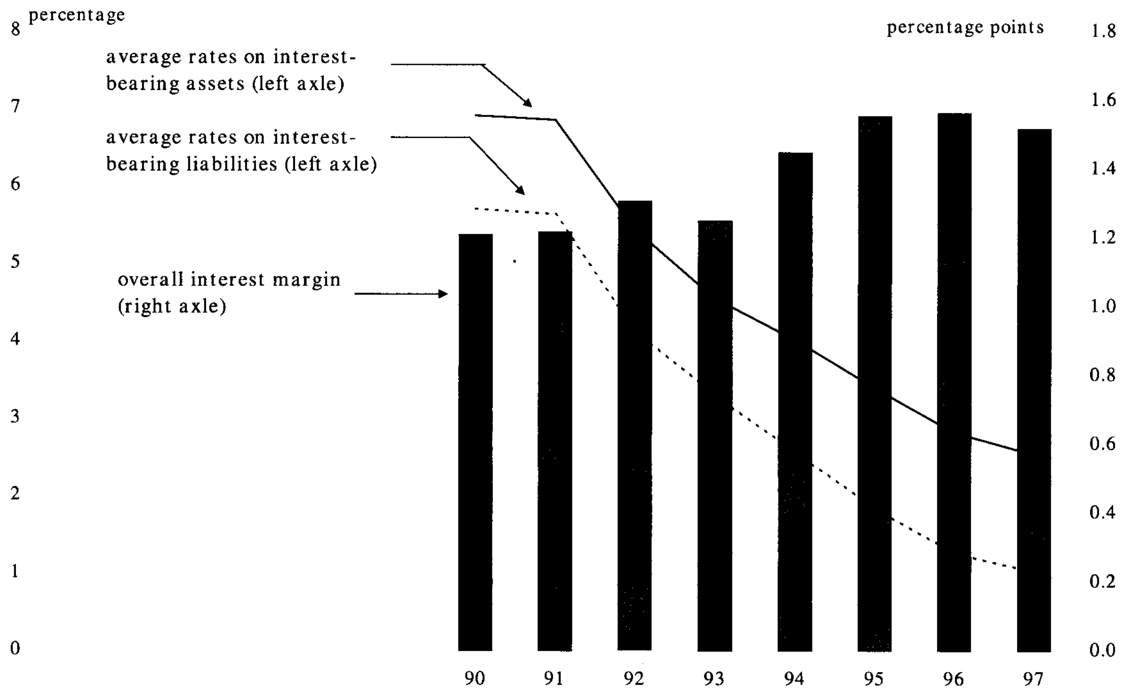
Source: Bank of Japan, *Profits and Balance-sheet Developments of Japanese Banks in Fiscal 1997.*

Graph 4
Operating profits and overall interest margin

(1) Operating profits

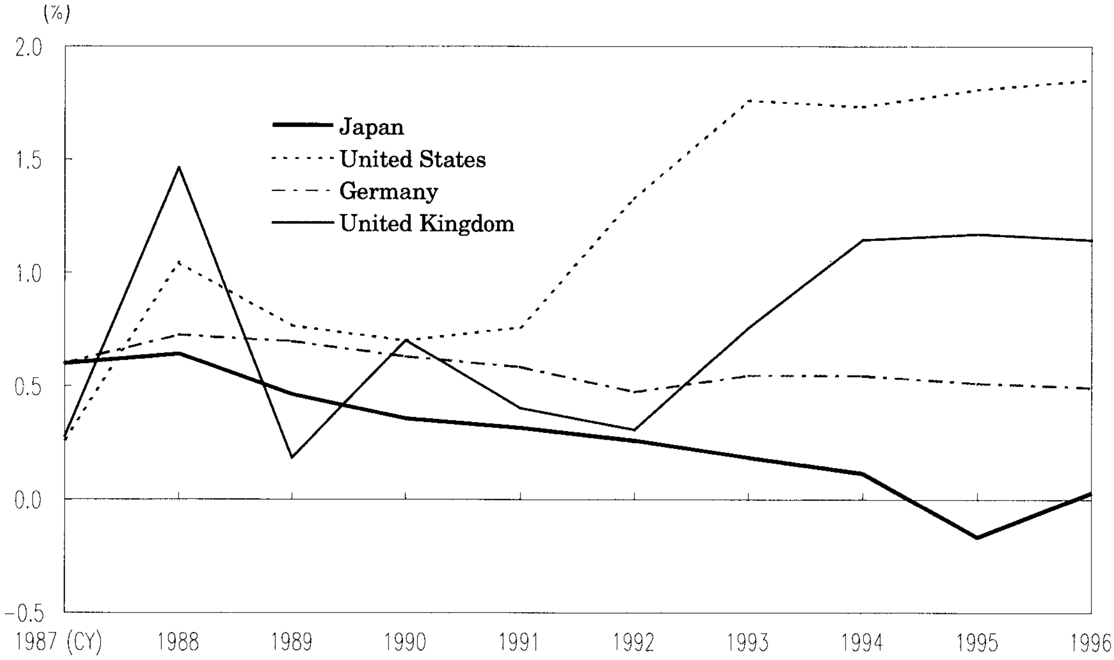


(2) Overall interest margin*



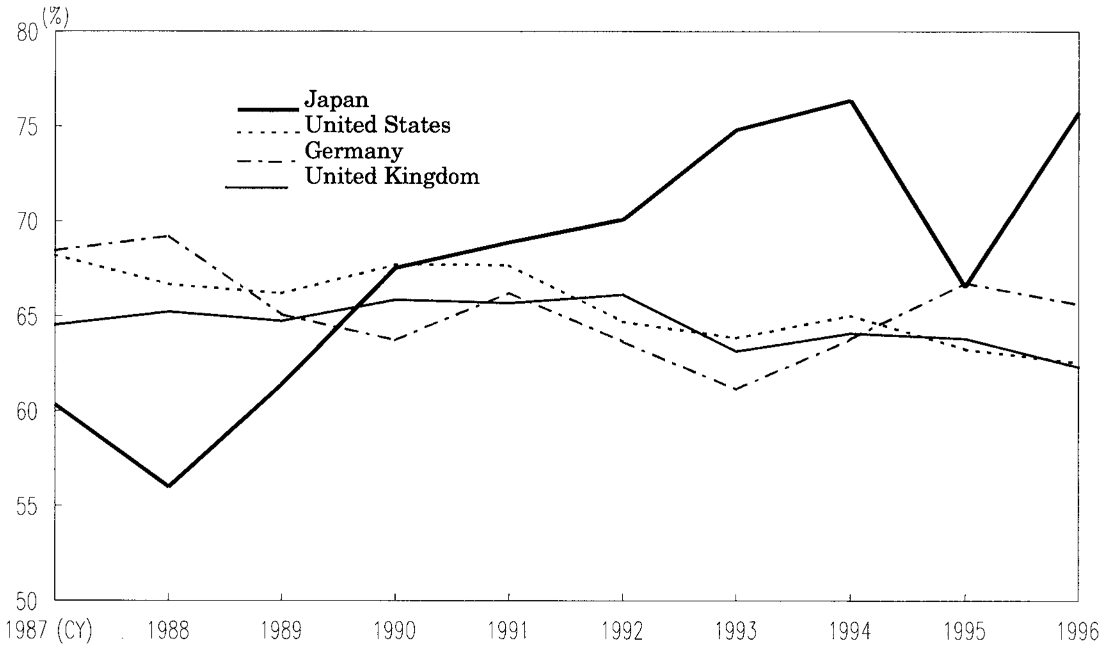
* Due to changes in the accounting method, comparable data for the period before 1990 are not available.

Graph 5
Profits of banks
(1) *ROA* of banks



Note: *ROA* = profit before tax/average asset total.

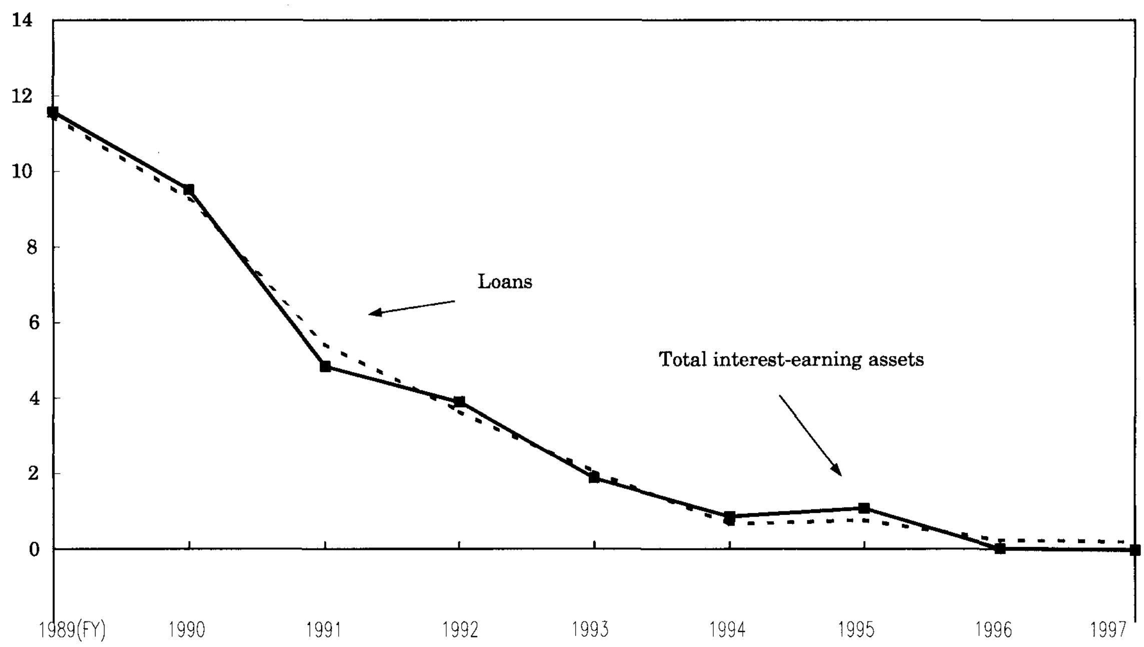
(2) Net losses/income balance



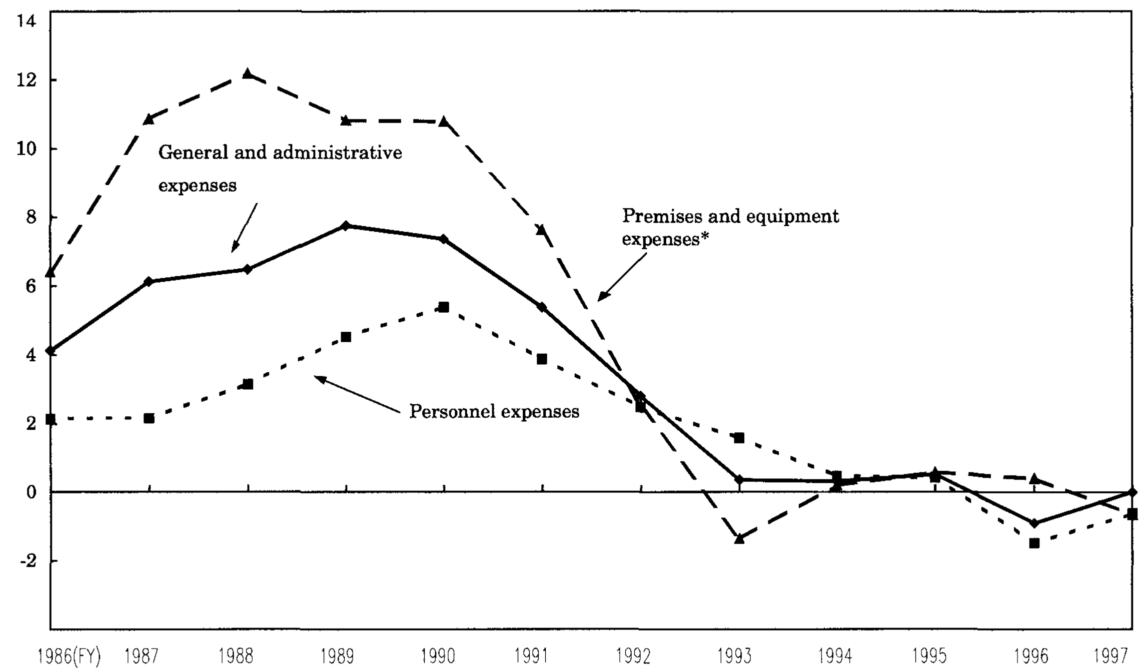
Note: Net losses/income = operating expenses / gross income.
Source: OECD, *Bank Profitability: Financial Statements of Banks* (1998).

Graph 6
Changes in balances of loans, total assets and expenses

(1) Balances of loans and total assets
Percentage changes from the previous year



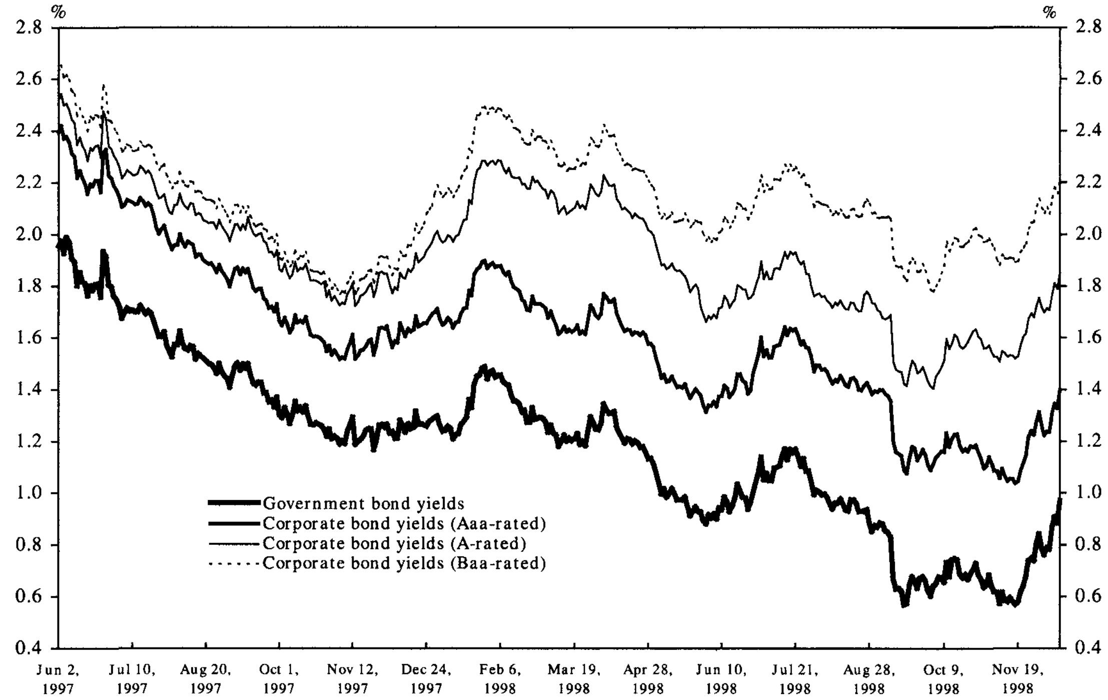
(2) General and administrative expenses
Percentage changes from the previous year



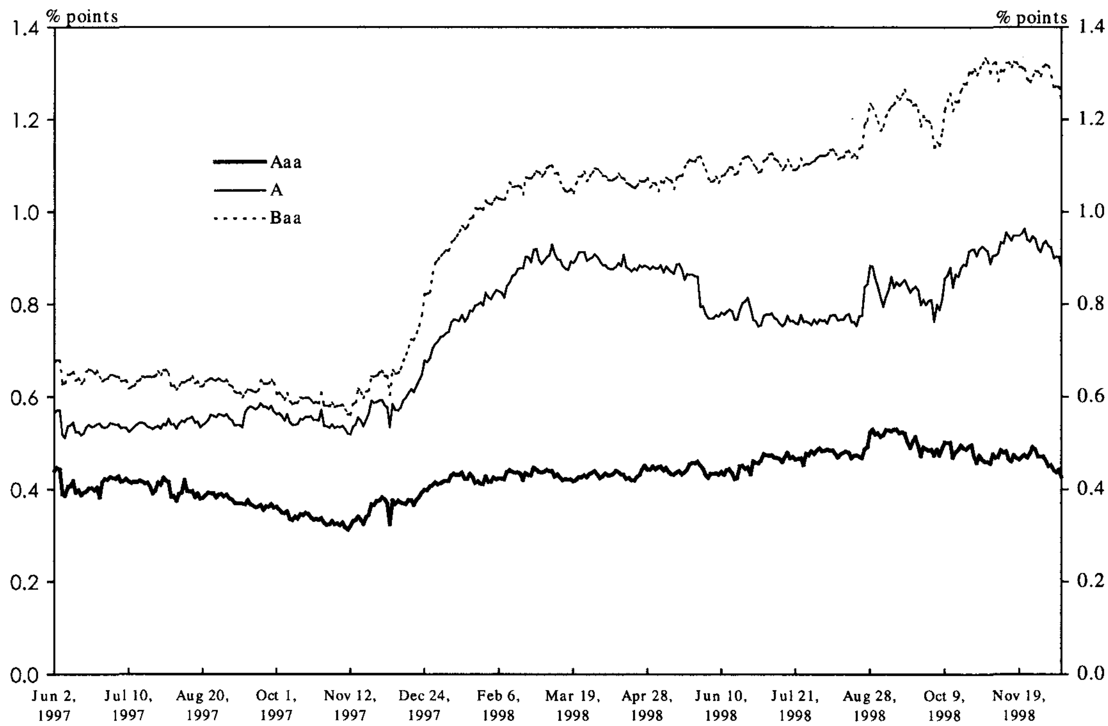
* Excludes deposit insurance and debenture issuance expenses.
Source: Bank of Japan, *Profits and Balance-sheet Developments of Japanese Banks in Fiscal 1997.*

Graph 7
Corporate bond yields

(1) Yields of Government and corporate bonds by rating[1, 2]



(2) Yield spreads of public and corporate bonds

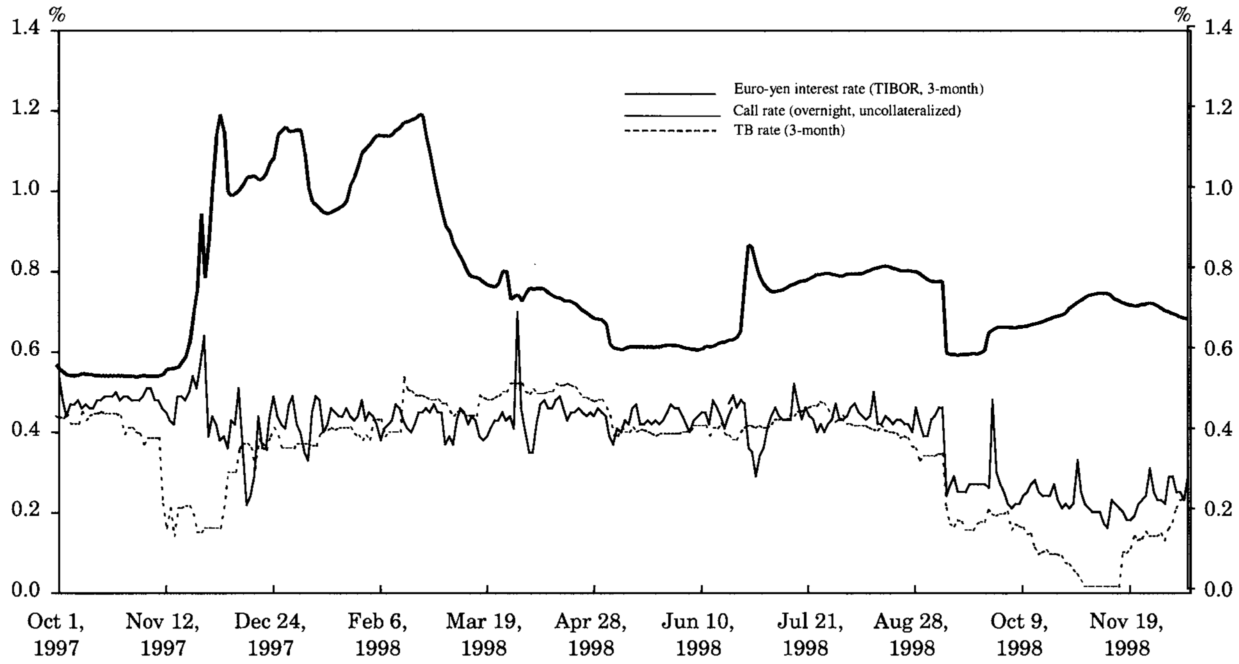


[1] Yields on bonds with 5-year maturity. [2] The indicated ratings are of Moody's Japan K. K.
Source: Securities Dealers Association of Japan, "Over-the-Counter Standard Bond Quotations".

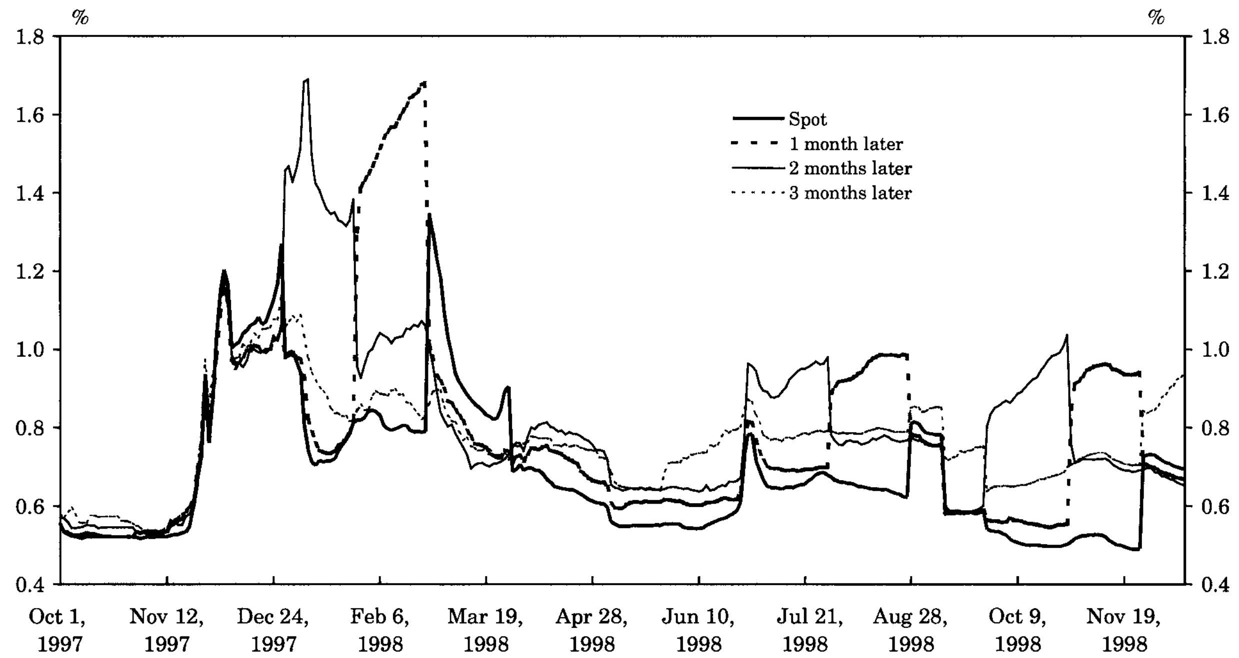
Graph 8

Short-term money market rates

(1) Interest rates on term instruments



(2) Implied forward rates*



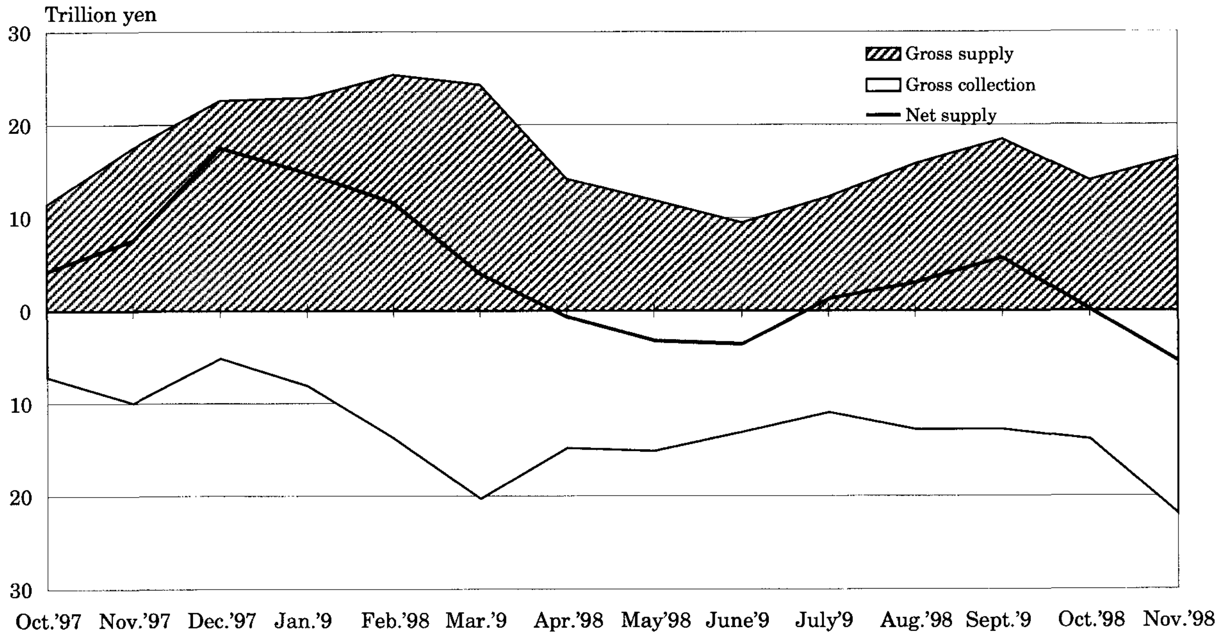
* 1-month forward rates calculated from euroyen interest rates.

Sources: Bank of Japan, "Economic Statistics Monthly" and The Nikkei Financial Daily.

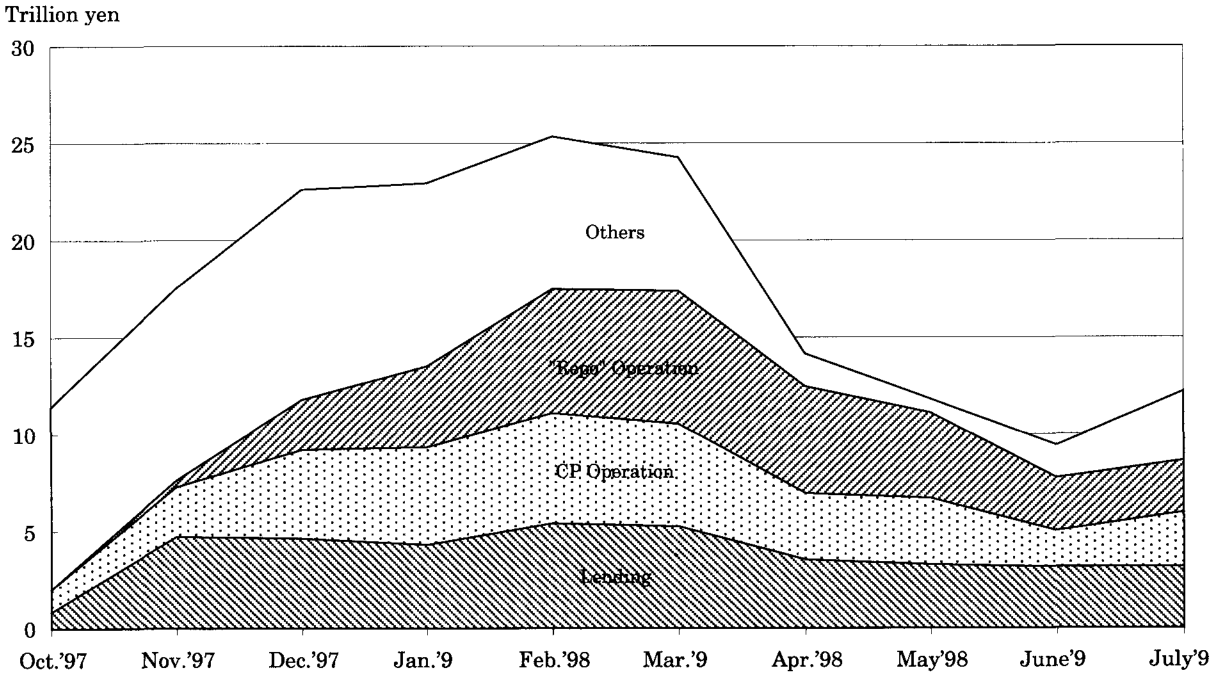
Graph 9

Supply of funds by the Bank of Japan

(1) Gross and net supply of funds

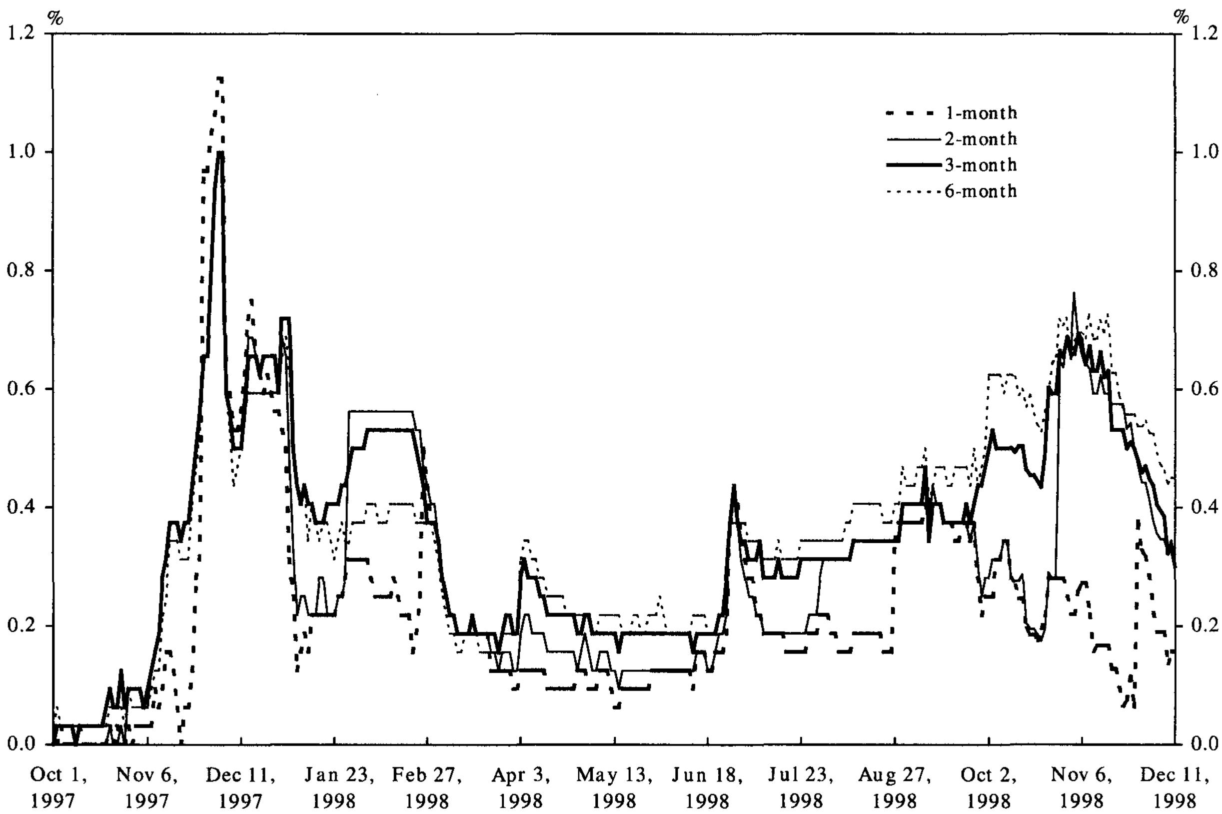


(2) Composition of gross supply of funds



Source: Bank of Japan, "Economic Statistics Monthly".

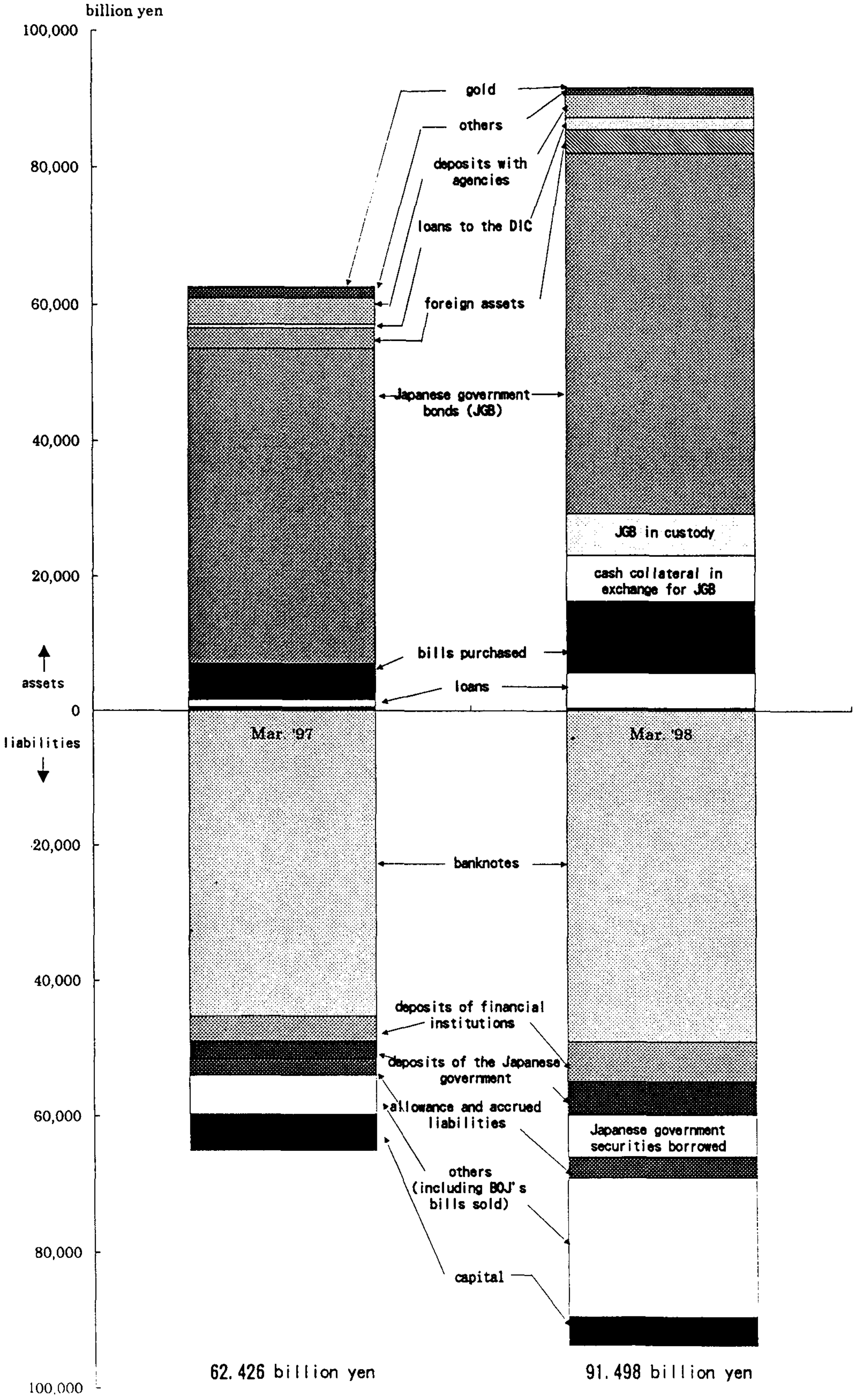
Graph 10
Japan premium in the eurodollar market



Note: The Japan premium is the extra expense Japanese banks must pay for raising funds in overseas financial markets. The premiums shown here are calculated as the interest rates quoted by Bank of Tokyo-Mitsubishi less those quoted by Barclays Bank in the eurodollar market (London).

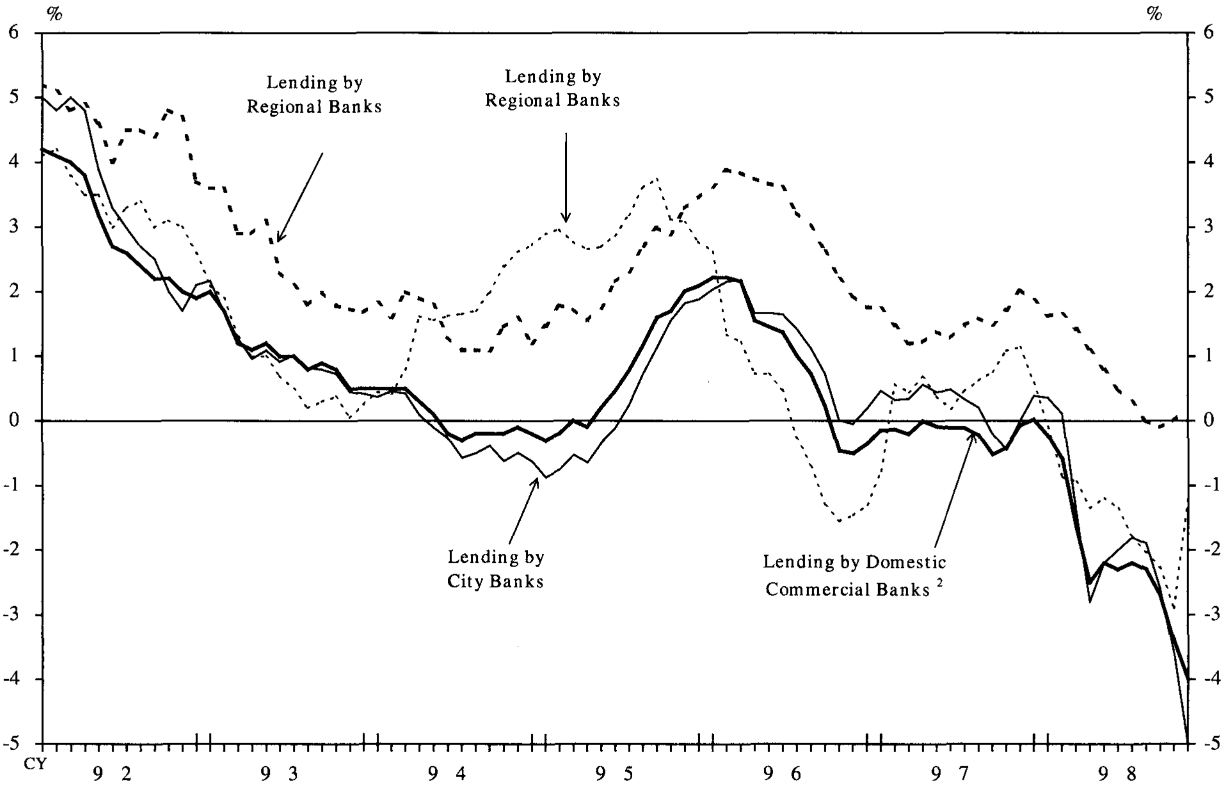
Source: British Bankers' Association.

Graph 11
The balance sheet of the Bank of Japan



Source: Bank of Japan, *Financial Statements*.

Graph 12
Lending by domestic commercial banks[1]



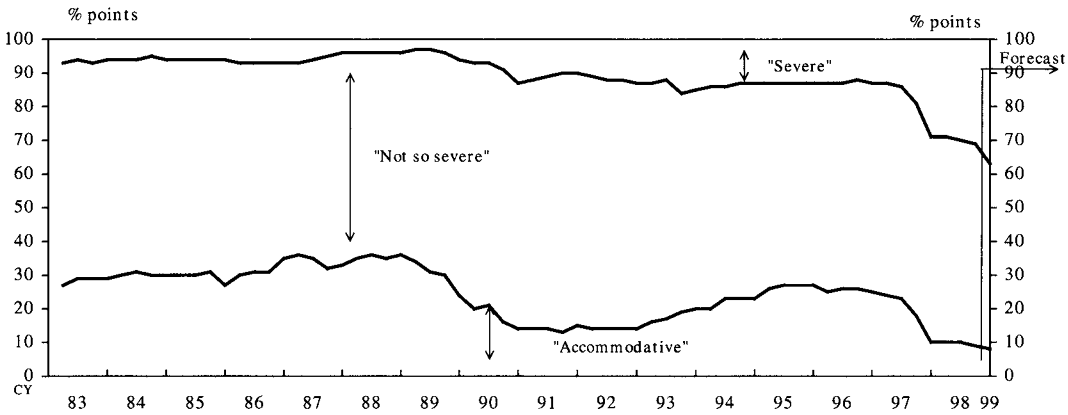
[1] Annual percentage changes in average amounts outstanding. [2] Domestic Commercial Banks refers to member banks of the Federation of Bankers Associations of Japan which consists of City Banks, Long-term Credit Banks, Trust Banks (excluding foreign-owned trust banks and trust banks that started business after October 1993), the member banks of the Regional Banks Association of Japan (Regional Banks) and the member banks of the Second Association of Regional Banks (Regional Banks II).

Source: Bank of Japan "Principal Figures of Financial Institutions".

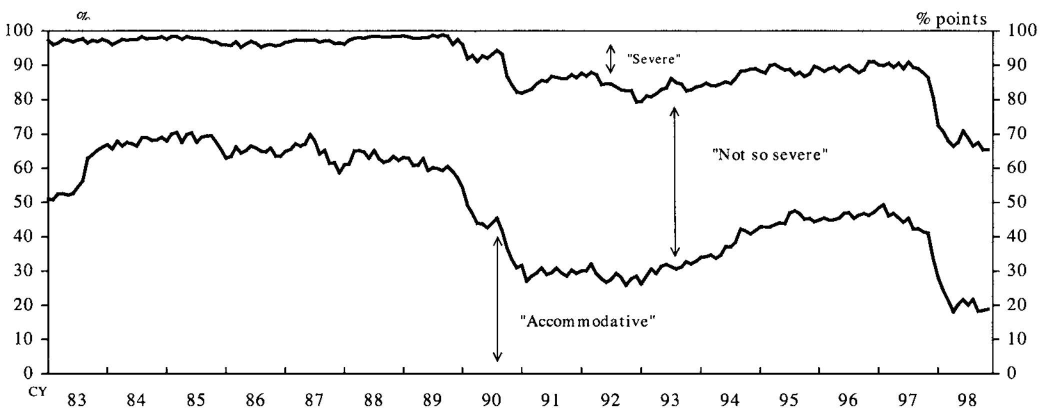
Graph 13

Lending attitude of financial institutions as perceived by small enterprises

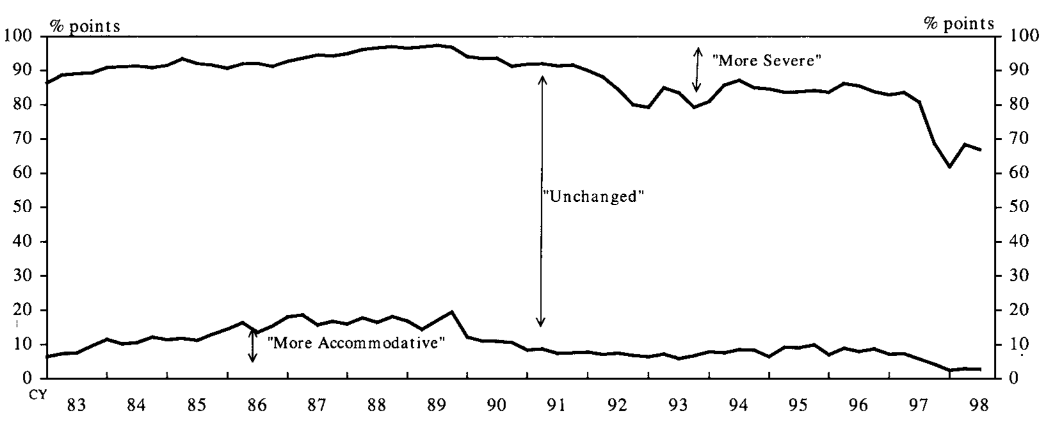
(1) "*Tankan* – Short-term Economic Survey of Enterprises in Japan" (December 1998)



(2) "Monthly Survey on Trends of Small Businesses" (Mid-November 1998)

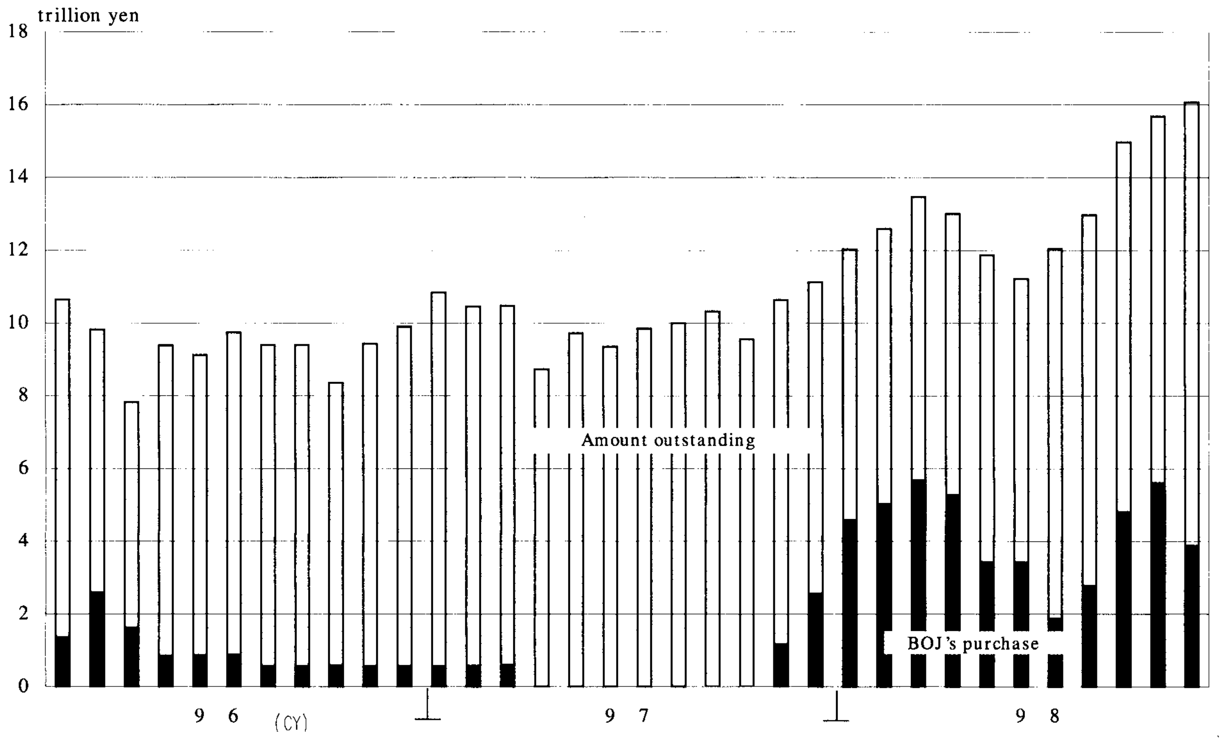


(3) "Quarterly Survey of Small Businesses in Japan" (Mid-September 1998)



Sources: Bank of Japan, (1); Japan Finance Corporation for Small Business, (2); and People's Finance Corporation, (3).

Graph 14
CP market



Source: Bank of Japan "Economic Statistics Monthly".

Table 1
Schedules of the "Japanese Big Bang"

Item of reform	1997 (Fiscal Year)	1998 (Fiscal Year)	1999 (Fiscal Year)	2000 (FY)	2001 (FY)
1. To diversify financial products and services					
• Assuring the validity of securities derivatives transactions	● introduction of trading of options on individual stocks (July)	⊙ authorisation of OTC trading of securities derivatives (Banking Law, Securities and Exchange Law)			
• Introduction of proprietary trading systems		⊙ defined as a securities business (Securities and Exchange Law)			
• Introduction of cash management account	● (October)				
• Introduction of investment companies and privately placed investment trusts		⊙ (Securities Investment Trust Law)			
• Authorisation for banks to lease office space to investment trust management companies for direct sale of investment trust certificates	● (December)				
• Authorisation for banks to sell investment trusts		⊙ (Securities and Exchange Law)			
• Authorisation for banks to sell insurance				Δ Long-term fire insurance and credit life insurance related to housing loans	
• Promoting securitisation of assets by use of asset-backed securities (ABS)		⊙ legislation for special purpose companies (SPCs) (September) (SPC Law)			
2. To improve the quality of intermediaries' services, to promote competition among them					
• Utilisation of holding companies	● bills to establish bank holding companies passed the Diet (December)	⊙ requirements for sound risk management of and within a group (Banking Law), downstream holding companies (Insurance Business Law)			
• Clarification of the range of subsidiaries of banks and insurance companies		⊙ clarification of the boundary of a financial group, requirements for sound risk management of and within a group (Banking Law, Insurance Business Law)			
• Abolition of license requirement for securities' companies (only registration will be required)		⊙ (Securities and Exchange Law)			
• Diversifying the business range of securities companies		⊙ abolishment of obligatory specialisation, introduction of rap accounts (Securities and Exchange Law)			
• Expansion of the business scope of separate subsidiaries			⊙ abolish the remaining restrictions (by end-1999 FY) (Financial System Reform Law)		
(1) securities business / trust business	Δ all businesses excluding dealing in equities and joint money trust business (October)				
(2) insurance business ⇔ banking business and other financial businesses		⊙ insurance → securities (Insurance Business Law)	⊙ insurance → banking (by end-1999 FY) (Insurance Business Law)	⊙ banking → insurance (by 2001) (Banking Law)	
• Liberalising issuance of ordinary bonds by ordinary banks			O (2nd half of 1999)		
• Liberalising brokerage commissions for stock trading		Δ liberalising commissions for transactions value over 50 million yen (April)	⊙ Complete liberalisation (by end-1999) (Securities and Exchange Law)		
• Authorisation of sub-contracting of fund-management businesses		⊙ (Securities Investment Trust Law, Law for Regulating Securities Investment Advisory Business)			
• Electronic money and electronic payment (clarifying legal uncertainties, eligibility for new entries, protection of individual users)			O (bill will be submitted to the 1999 Diet)		
• Diversifying borrowing instruments of non-bank financial firms		⊙ authorisation to issue bonds (Non-bank Bond Financing Law)			
• Abolishment of the compulsory use of rating organisation rates for non-life insurance		⊙ (July) (Law Concerning Non-life Insurance Rating Organisations)			

Item of reform	1997 (Fiscal Year)	1998 (Fiscal Year)	1999 (Fiscal Year)	2000 (FY)	2001 (FY)
3. To develop a market with further utility					
• authorisation of off-exchange transactions for listed securities		⊙ (Securities and Exchange Law)			
• promoting trades in OTC registered stocks	● introduction of stock lending (July), introduction of institutionalised stock lending (October)	⊙ (Securities and Exchange Law)			
• lifting the ban on transactions of unlisted or unregistered stocks by securities companies	● (July)	⊙ revision of deposit rates (Securities and Exchange Law)			
• originating the stock lending market		O implementation of sales practices rules (Stock-Exchange Rules, Japan Securities Association Rules)			
• real-time gross settlement (RTGS) on the BOJ-Net				O (by 2001)	
4. To establish a reliable framework and rule for fair and transparent transactions					
• revision of consolidated financial statements			⊙ (April) (Securities and Exchange Law)		
• establishment of accounting standards for financial instruments		⊙ public release of exposure draft on accounting standards for financial instruments	--------------------------	------------------	----------------→
• strengthening fair trade rules of the Securities and Exchange Law	● strengthen penal regulations over insider transactions (December) (Securities and Exchange Law)	⊙ confiscation of unlawful profits (Securities and Exchange Law)			
• establishing a system to settle civil disputes in securities transactions		⊙ legislation of mediation system (Securities and Exchange Law)			
• introduction of Prompt Corrective Action		⊙ securities companies and insurance companies (Securities and Exchange Law, Insurance Business Law)			
• strengthening disclosure requirements		⊙ (Banking Law, Securities and Exchange Law)			
• assuring the legal validity of netting for derivatives contracts		⊙ (Netting Law)			
• protection of users of financial institutions	● sales practice rules for banks in selling investment trusts (December)	⊙ imposing banks the duty to explain to customers (Banking Law)	O (bill will be submitted to the 1999 Diet) (Consumer Credit Protection Law)		
• requirement of separate asset management for client assets by securities companies	● separate management of futures and option transactions (October)	⊙ (Securities and Exchange Law)			
• enhancing functions of the Securities Deposit Compensation Fund scheme		⊙ (Securities and Exchange Law)			
• establishment of the Policyholders Protection Corporation		⊙ (Insurance Business Law)			
• expansion of the definition of securities	● include trust certificates of loan assets as securities (June)	⊙ include DRs, covered warrants, ABS issued by SPCs as securities (Securities and Exchange Law)			
5. Review of taxation on Financial Transaction and Activities					
• abolition of securities transaction tax and exchange tax		⊙ reduction of tax rates (tax reform of 1998 FY)	O planned to be abolished concurrent with the reform of taxation on incomes from selling securities (by end-1999)		
• tax for stock options, holding companies, SPCs		⊙ exceptional treatment (tax reform of 1998 FY)			
• others (taxation on a total income basis, revision of the withholding tax system)		———————	———————	Study at the Government's Tax Commission ———	———→
6. Financial Services Law		———————	———————	———————	———→

●: already carried out, ⊙: carried out from December 1998, O: planned to be carried out, Δ: partly (or partly planned to be) carried out.

Table 2
Recent cases of affiliation in the financial industry

Name of institution	Press release date	Contents
Yasuda Trust & Banking and Fuyo Group	November 1997	• Transfer businesses of 4 subsidiaries of Yasuda Trust & Banking to other Fuyo Group companies (Fuji Bank, Yasuda Fire & Marine, Yasuda Mutual Life).
Yamaichi Asset Management and Société Générale Asset Management	January 1998	• Société Générale acquired 85% of Yamaichi Asset Management's stocks (the new company's name is SG-Yamaichi Asset Management).
Chuo Trust & Banking and Hokkaido Takushoku Bank	February 1998	• Chuo Trust & Banking will succeed Hokakaido Takushoku Bank's Honshu branches in the last half of 1998.
Merill Lynch and Yamaichi Securities	February 1998	• Merill Lynch succeeds branches and employees of Yamaichi Securities to establish a securities subsidiary in Japan (Merill Lynch Japan Securities).
Toho Mutual Life and GE Financial Assurance	February 1998	• Establish a joint insurance company (GE Capital Edison Life Insurance). • Toho Mutual Life will only deal with maintaining existing contracts.
Sanwa Bank and Yamaichi Investment Trust Management	February 1998	• Sanwa Bank acquired 49.3% of the stocks of Yamaichi Investment Trust Management's stocks to strengthen mutual fund businesses (the new company's name is Partners Asset Management).
Nikko Securities and Salomon Smith Barney	March 1998	• Establish two joint ventures to provide wrap services (the companies' names are Global Wrap Consulting Group, Global Wrap Services).
Sanyo Investment Advisers and Fiduciary Trust Company International	March 1998	• Fiduciary Trust Company International purchased all of Sanyo Investment Management Adviser's stocks to conduct business in Japan (the new company's name is Fiduciary Trust International Investment Advisers).
Meiji Mutual Life and Dresner Bank	March 1998	• Merge investment adviser companies in Japan, be affiliated to strengthen mutual fund businesses, etc.
Orix (consumer loan) and Yamaichi Trust & Banking	March 1998	• Orix purchased all of Yamaichi Trust & Banking's stocks from Yamaichi Securities. • This becomes the first 100% subsidiary bank of a commercial firm.
Industrial Bank of Japan and Nomura Securities	May 1998	• Establish two joint ventures to provide new financial services such as derivatives and total asset management (the companies' names are IBJ Nomura Financial Products, Nomura IBJ Investment Services).
Chuo Trust & Banking and HSBC Group	May 1998	• Cooperate in areas of asset management, mutual funds and new product developments.
Fuji Bank, Yasuda Trust & Banking, Yasuda Fire & Marine, Yasuda Mutual Insurance	June 1998	• Establish a joint investment trust management company.
Mitsui Trust & Banking and Prudential Insurance Company of America	July 1998	• Establish a joint investment trust management company named Prudential Mitsui Trust Investment Management by autumn 1998.
Sumitomo Bank and Daiwa Securities	July 1998	• Daiwa Securities will transform into a holding company which holds subsidiaries specialising in retail business, wholesale business, derivative business, asset management business, etc. Sumitomo Bank will purchase newly issued stocks of Daiwa's subsidiaries relating to investment banking.
Lake (consumer loan) and GE Capital	July 1998	• Lake will transfer its business license to GE Capital Consumer Loan in November.
Tokyo Mitsubishi Bank, Mitsubishi Trust & Banking, Meiji Mutual Life, Tokyo Marine and Fire	September 1998	• Establish joint ventures in investment trust fields by the end of 1998, and develop joint customer management systems related to the "Japanese 401K Plan", etc. • A joint company evaluating investment trusts will be established on 25th December 1998 (the name of the newly established company will be Mitsubishi Asset Brains).
Sumitomo Mutual Life and Taiheiyo Securities	September 1998	• Sumitomo Mutual Life Group will acquire more than 50% of Taiheiyo Investment Trust Management's stocks to strengthen mutual fund businesses and investment advisor businesses, etc.
Tokai Bank and Asahi Bank	September 1998	• Merge outlets and ATMs, reorganise overseas operations, raise cross-shareholdings, etc. • Establish a multi-regional holding company after non-performing assets are written off.
Daiichi Kangyo Bank and JP Morgan	October 1998	• Establish a joint investment trust company by the end of 1998.
Sumitomo Bank, Daiwa Securities and Sumitomo Trust Bank	October 1998	• Sumitomo Trust Bank will join the affiliation relationship between Sumitomo Bank and Daiwa Securities.
Investment Bank of Japan and Daiichi Mutual Life	October 1998	• Strengthen capital relationships. • Merge investment advisor subsidiaries. • Cooperate in developing new financial products.

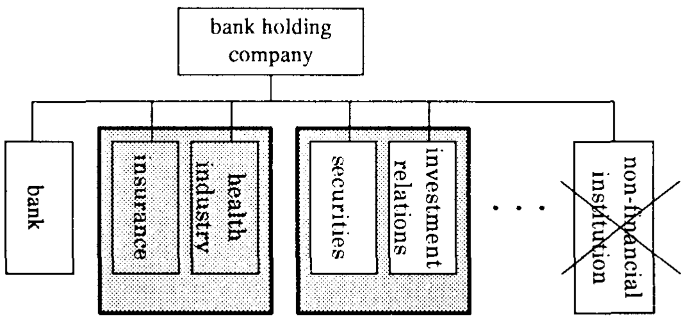
Table 2 (cont.)

Name of institution	Press release date	Contents
Daiwa Securities and 4 Sumitomo Financial Group Companies	November 1998	• Establish a joint securities company specialising in electronic finance (i.e. intermediating securities and investment trusts transactions through the internet) with a US financial holding company (DLJ).
Fuji Bank and Daiichi Kangyo Bank	November 1998	• Merge trust bank subsidiaries (the name of the newly established bank will be Daiichi Kangyo Fuji Trust Bank). • Wholesale trust operations (i.e. corporate pension fund related businesses, fund management businesses) of Yasuda Trust Bank will be transferred to Daiichi Kangyo Fuji Trust Bank.
Nihon Mutual Life and Deutsche Bank	November 1998	• Establish a joint investment advisory company in London (the name of the newly established company will be Nissei Deutsche Asset Management Europe). • Develop new investment trust products together and sell them at Nihon Mutual Life's counters. • Nihon Mutual Life's affiliated investment trust company will provide investment trusts to Deutsche Bank to sell in Europe. • Cooperate in private banking business.
Daihyaku Mutual Life and Manulife Financial	November 1998	• Establish a joint life insurance subsidiary by the end of 1998 and transfer new life insurance policies of Daihyaku Mutual Life to the new subsidiary.

Graph 15
The range of businesses of a banking group

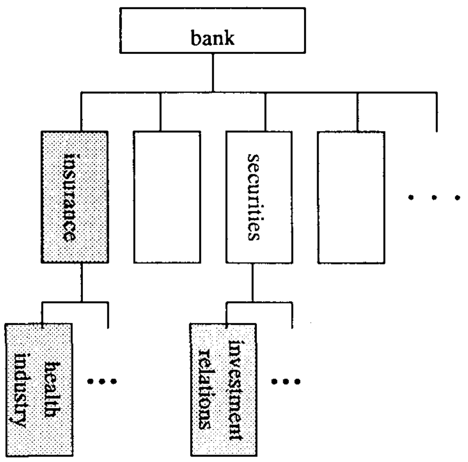
[ ] indicates the business scope newly permitted under the Financial System Reform Law (implmented from December 1998).

① **bank holding company groups**



• Bank holding companies can hold companies that operate businesses related to securities or insurance companies only when it holds a securities or insurance company as its subsidiary.

② **banking group with the bank on top**



• Banks can hold companies that operate businesses related to securities or insurance companies under its securities subsidiary or insurance subsidiary.