JAPANESE BANKING REFORM: A LEGAL ANALYSIS OF RECENT DEVELOPMENTS*

I. INTRODUCTION

The explosive growth of the Japanese economy during the postwar period has brought about fundamental changes in the structure of Japan's financial markets.1 Japan's transition from a capital-starved, war-stricken economy to the world's largest creditor nation has brought about tremendous structural changes in Japanese financial circles.2 Financial reform, therefore, has been a longstanding topic of interest in government and economic circles.

In the summer of 1991, two advisory bodies to the Japanese Ministry of Finance (MOF) issued official reports containing their respective recommendations for reforming the nation's financial system.3 The Financial System Reform Council deliberated on the

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1. See infra notes 93-169 and accompanying text.

2. See infra notes 9-92 and accompanying text.


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subject of financial reform from the perspective of the banking system, and the Securities Council focused on the securities industry. The reports issued by the two councils formed the basis for a financial reform bill that was submitted to the Diet on April 10, 1992, and was passed into law on June 26, 1992. In addition, subsequent rulemaking by the MOF has further clarified the direction of legal and regulatory reform.

Financial reform in Japan, however, has been a gradual process. The Banking and Securities Reports discussed in this Note embody over seven years of deliberation by the Financial System Reform and Securities Councils. The results of these deliberations reflect a number of concerns: structural changes in Japan's economy, the internationalization of Japanese finance, and changing patterns of corporate finance by Japanese companies. Events occurring after the reports were issued, including financial scandals and Japan's plunge into recession, have further shaped the direction of financial reform. Examined together, the reports, the Financial System Reform Act, and the developments that surrounded their creation illustrate the issues involved in reforming the legal and administrative framework on which Japan's financial system rests.

This Note will examine recent developments in Japanese financial reform, focusing primarily on the banking industry, the Banking Report, and amendments to Japan's banking laws brought about by the Financial System Reform Act. Part II will provide a historical overview of Japan's financial system. Part III will continue this historical discussion, focusing on the issues and problems that have

should be liberalized gradually, starting with larger transactions); Shōtorishin hōkokusho: Raishun jisshi ni teikō, Nihon Keizai Shinbun, Jan. 29, 1992, at 3 (reporting that the liberalization of the securities transaction fee has been slowed by the recent stock market slump).


5. Kin'yū Seido Oyobi Shōken Torihiki Seido No Kaikaku No Tame No Kankei Hōritsu No Seibi Nado Ni Kansuru Hōritsu, Law No. 87 of 1992 [hereinafter Financial System Reform Act]. The Financial System Reform Act includes numerous amendments, many of them minor, to a variety of existing laws. The most significant changes are to the Banking Law, the Securities Transaction Law, and other primary economic statutes. See id. art. 1 (amending Banking Law), art. 15 (amending Securities Transaction Law); infra note 158. To avoid confusion, all citations to statutes in this Note refer to the preamendment version of the laws unless otherwise indicated.

6. See infra notes 287-96 and accompanying text.

7. See infra notes 93-169 and accompanying text.

8. See infra notes 298-317 and accompanying text.
emerged in recent times to create pressure for financial reform. Part IV will discuss the recommendations of the Banking Report, contrasting it with the Securities Report, and will discuss the impact of both reports. Part V will discuss developments since the reports were issued, including an overview of the contents of the Financial System Reform Act and proposed administrative regulations that have been issued since the Act’s passage. Part V will also present an analysis of financial reform to date. Part VI presents a brief conclusion.

II. HISTORICAL REVIEW

This section briefly describes the system’s pre-World War II roots and then focuses on postwar developments. It also describes the types of financial institutions and the regulatory regime to which they were subject prior to the passage of the Financial System Reform Act.

A. The Prewar Period

Japan based its first modern banking law, the National Bank Act of 1872, on the American national banking system, although Japanese banking subsequently developed into a scheme closer to the British model.\(^9\) Between 1872 and the end of World War II, the banking industry evolved into a heterogeneous system of specialized institutions catering to particular financial markets. In 1921 savings banks were segregated from commercial banks in order to limit depositors’ exposure to risk.\(^1\) In addition, a sharp distinction between commercial lending and industrial and agricultural financing led to the demarcation of long-term and short-term lending institutions.\(^1\)

While ordinary banks were, and still are, the predominant source of short-term loans, a number of specialized (and often heavily government subsidized) institutions were established to provide long-term financing for industry, agriculture, and other specialized sectors of the economy.\(^1\) The Nippon Kangyo Bank, founded in 1896, was

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9. FEDERATION OF BANKERS ASSOCIATIONS OF JAPAN (ZENGINKYO), THE BANKING SYSTEM IN JAPAN 11–12 (1989) [hereinafter BANKING SYSTEM].
10. Id. at 12. This partial segregation lasted until 1943 when, in order to promote saving as a part of the war effort, the government allowed ordinary banks to take deposits. Id. In order to reduce the number of banks, the government embarked on a policy of encouraging bank mergers. As a result, most savings banks, by this time rendered redundant, were merged out of existence; only five remained by the end of the war. Id.
11. Id. at 13.
12. Id. at 13–14.
one of these specialized institutions. The majority of these institutions eventually disappeared, however, either as a result of the government's wartime policy of encouraging mergers or through postwar occupation reforms. The presence of the Nippon Kangyo Bank, now known as Daiichi Kangyo Bank, and the segregation of long-term and short-term institutions continue to be an integral part of Japan's banking system. As shall be seen, however, changing circumstances render the division between long-term and short-term institutions increasingly anachronistic. In 1922 the trust business was established as a sector separate from ordinary banking and was an area in which only trust companies and specialized trust banks could engage.

B. The Postwar Period

Japan's defeat in World War II and the subsequent American occupation brought many changes in its financial system, in that "[t]he existing financial system was basically organized for the purpose of creating a stable supply of limited funds for each industrial sector in the post-war era when funds were short." The most significant change was the segregation of the securities business from banking in a manner similar to the United States' Glass-Steagall Act, which prohibits banks from dealing in most forms of securities. Moreover,

13. Id.
14. Id. at 14.
15. See generally infra notes 38-74 and accompanying text (discussing different types of financial institutions).
16. See infra notes 94, 131-35 and accompanying text.
17. BANKING SYSTEM, supra note 9, at 14-15.
18. BANKING REPORT, supra note 3, at 12. Writing on the separation of banking and securities, a less charitable observer has noted that the purpose of this fragmented system was "to squeeze as much money as possible from Japanese savers so it could be channelled into industry." Nigel Holloway, Tokyo's Walls Tremble, FAR E. ECON. REV., May 11, 1989, at 54, 55. Note also that most of the laws that established the specialized banks, discussed infra notes 46-65 and accompanying text, were passed between 1947 and 1954.
19. Makoto Yazawa, A Synopsis of Securities Regulation in Japan, in JAPANESE SECURITIES REGULATION 23, 29 (Louis Loss et al. eds., 1983). Prior to this, banks were permitted to engage in a variety of securities activities. BANKING SYSTEM, supra note 9, at 44. Unlike American banks under Glass-Steagall, however, Japanese banks are permitted to hold equity securities (including stock in securities companies) for their own account, provided that these holdings do not exceed 5 percent of the issuing company's total value. Compare SHITEKI DOKUSEN OYOBI KÔSEI TORIHKI NO KAKUHO NI KANSURU HÔRITSU, art. 11, Law No. 54 of 1947 [hereinafter ANTIMONOPOLY LAW] with Banking (Glass-Steagall) Act of 1933 § 16, 12 U.S.C. § 24 (1982). More recently, Japanese financial institutions have been permitted to combine banking and securities activities in foreign countries where universal banking is permitted. Richard Dale,
due to the postwar shortage of capital that was vital for economic development, the government was forced to compartmentalize the financial industry by fostering different types of institutions to cater to specific industries. At the same time, the government temporarily empowered the MOF and the Bank of Japan (BOJ) to set ceilings for deposit interest rates. Depositors had few other options, and thus banks were able to obtain capital cheaply and to loan it to industries at a significant profit.

The capital shortage rendered whole industries beholden to the banks. To cope with this deficiency, the government began the practice of overloaning: BOJ would loan more money than was economically prudent to the large banks, who would do the same to capital-starved companies. The companies in turn relied on high leverage to fund rapid growth and market share expansion. This contributed to the development of the notorious banking system. To obtain financing, a company had to cultivate a close relationship with a single, main bank. Banks primarily supplied loans which provided significant tax advantages over equity financing: loan interest payments were deductible, whereas dividends to shareholders came out of after-tax profits. As a result, many companies became highly leveraged, deriving as much as 80 percent of their capital from bank loans. In addition to loans, banks exchanged equity with their debtors and developed long-standing, close relationships. While their heavy debt load generated pressure on companies to expand their market share (though not necessarily at a profit) to service their debt, both the extent of their debt to, and close relationship with, their banks meant that the banks became

_Japan's Banking Regulation: Current Policy Issues, in JAPANESE FINANCIAL GROWTH 33, 35 (Charles Goodhart & George Sutija eds., 1990)._

20. This was accomplished by the passage of the Temporary Interest Control Law. RINJI KINRI CHOSEI HO Law No. 181 of 1947. The original purpose of this law was to prevent banks from engaging in potentially ruinous interest rate "price wars." _See BILL EMMOTT, THE SUN ALSO SETS 101 (1989)._ This provisional statute is still in force today. _Id._


23. JOHNSON, supra note 21, at 204–05.

24. _Id._ at 205.

25. _See id._ at 203–04.

26. _Id._ at 203.

27. _See ABBEGGLEN & STALK, supra note 22, at 166.

increasingly responsible for the continued financial health of the companies.29 Bank shareholdings were limited to 5 percent of a company by the Antimonopoly Law.30 Nevertheless, bank shareholdings of companies within the keiretsu groups collectively represented a significant aggregate of control.31 By providing the only viable source of finance and equity holdings, banks thus exercised a great deal of influence over the management of their corporate affiliates.32

At the same time, however, the practice of overloaning meant that all parties had an interest in ensuring that all other parties remained financially solvent. This interest was centralized at the BOJ, which traditionally has been "the ultimate guarantor of the system."33 By centralizing all loan risks at the government level, the system made the loans virtually risk free for the private sector, leaving banks and companies alike to concentrate solely on increasing their respective market shares by expanding into whatever growth industries the government was trying to foster.34 As guarantor of the whole system, the BOJ "gain[ed] complete and detailed control over the policies and lending decisions of its dependent 'private' banks,"35 just as the banks themselves had control over their own borrowers. Given that the failure of a financial institution would cause catastrophic reverberations throughout this network of debt, the government would always step in to prevent such an event from taking place.36 This whole structure is sometimes referred to as the "convoy system" (goeiseudan hoshiki).37 each participant looks out for other participants, and all

29. ABEGGLEN & STALK, supra note 22, at 166-67; JOHNSON, supra note 21, at 204-05; see also Peter Martin, Ghosts of the Decade Past, FIN. TIMES, May 29, 1992, at 16 ("The close ties between lender and borrower often lead the banks to cut interest rates for a troubled debtor.").
30. ANTIMONOPOLY LAW, art. 11, Law No. 54 of 1947.
32. See JOHNSON, supra note 21, at 205-06; see also KAREL VAN WOLFEREN, THE ENIGMA OF JAPANESE POWER 121 (1989) (describing tremendous control gained by banks over corporations because of the capital shortage after World War II).
33. JOHNSON, supra note 21, at 203.
34. Id. at 206.
35. Id. at 203.
parties arrive safely. The term "convoy" also implies that each participant must travel at the speed of the slowest member of the group.

C. The Postwar Financial System

Before discussing events that made financial reform increasingly necessary, it is important to describe the structure and operation of the financial system before reforms took place. This section provides a brief overview of the types of financial institutions and regulatory regimes that existed prior to passage of the Financial System Reform Act.

1. Types of Financial Institutions. The first type of financial institutions are the ordinary banks. These are established according to the Ginkō hō or Banking Law. Their primary activities consist of short-term financing, loans, deposits, and fund transfers. Apart from foreign banks, which are established in Japan as ordinary banks, two distinct categories of ordinary banks exist. The first category consists of the large city banks (toshi ginkō) such as banking giants Sanwa and Sumitomo. Well-known at home and abroad, these institutions play a significant role in the Japanese economy.

Second, there are the sixty-four regional banks (chihō ginkō) with at least one in each of Japan’s forty-seven prefectures. These banks have their principal offices in large-sized or medium-sized regional cities and do business primarily within the prefecture in which their principal office is located. The distinction between city banks and regional

38. GINKO HÔ [BANKING LAW], Law No. 59 of 1981.
39. BANKING SYSTEM, supra note 9, at 23–24. The banking law itself merely defines the scope of permissible activities an ordinary bank may engage in as “(1) [r]eceiving of deposit or installment savings; (2) [l]oan of fund[s] or discount of bills or notes; (3) [e]xchange transaction[s].” BANKING LAW, art. 10, Law No. 59 of 1981. Ordinary banks may also engage in a variety of other activities that are “ancillary to banking.” Id. art. 10(2).
41. In 1990, 23.8 percent of fund-raising and 30.2 percent of loans were from city banks. See BANKING SYSTEM, supra note 9, at 7.
42. Id. at 23. Note this figure does not include the new “second tier” of converted sōgo regional banks. See infra note 48 and accompanying text.
44. BANKING SYSTEM, supra note 9, at 23–24.
banks has no legal basis but arises instead from custom and administrative convenience.\textsuperscript{45}

In addition to the ordinary banks, there are several categories of more specialized banks, all of which are affected by the Financial System Reform Act.\textsuperscript{46} The first of these is the sōgo or mutual bank. These institutions, eliminated by the Financial System Reform Act,\textsuperscript{47} were established under the 1951 sōgo Bank Law and existed primarily to provide financing for small- and medium-sized businesses.\textsuperscript{48}

Second, there are three long-term credit banks\textsuperscript{49} established in accordance with the Long-Term Credit Bank Law.\textsuperscript{50} Along with several specialized banks, the long-term credit banks have traditionally had the exclusive ability to issue debentures.\textsuperscript{51} There have, however, been limits on their ability to take deposits.\textsuperscript{52} Although the Financial System Reform Act does not formally abolish the distinction, the walls

\textsuperscript{45} Id. at 23. Article 8 of the Banking Law requires a bank to obtain the MOF's approval before establishing a branch. BANKING LAW art. 8, Law No. 59 of 1981. This provides the MOF with a very significant administrative tool for preventing city banks from encroaching on the territory of smaller regional banks. The MOF has used this form of administrative guidance to limit the number of branches established by the city banks outside of Tokyo and other major cities. BANKING SYSTEM, supra note 9, at 42.

\textsuperscript{46} See infra note 268 and accompanying text.

\textsuperscript{47} FINANCIAL SYSTEM REFORM ACT, Law No. 87 of 1992.

\textsuperscript{48} Sōgo Ginkō Hō [Mutual Loans and Savings Bank Law], Law No. 199 of 1951, repealed by FINANCIAL SYSTEM REFORM ACT, art. 4. Only sōgo banks were permitted to deal in mutual installment funds. FINANCIAL SYSTEM REFORM ACT, art. 4. Otherwise, they were allowed to engage in the same activities as ordinary banks, except that, with exceptions, they could only issue loans to, or receive mutual installment savings from, companies with three hundred or fewer employees or with capital of less than a designated amount. Id. art. 2(2). In practice, the sōgo banks catered to a clientele similar to that of the regional banks, except the sōgos were not subject to the same geographical branching restrictions. See generally BANKING SYSTEM, supra note 9, at 41–42 (discussing branch establishment regulation and administrative guidance). There were sixty-eight sōgo banks as of December 1988. Id. at 25. Having become increasingly like ordinary banks in their activities, many sōgo banks began converting to ordinary banks, even before the repeal of the Mutual Bank Law made conversion or merger unavoidable. See id. at 25–26. Such conversions were permitted by a 1989 amendment to the law governing bank mergers. Id. at 26; Kin'yō Kikan no Gappei Oyobi Tenkan ni kansuru Hōritsu [Law Concerning Amalgamation and Conversion of Financial Institutions], art. 3, Law No. 86 of 1988. The conversion of most of the sōgos to ordinary banks has effectively created a second tier of regional banks. See BANKING REPORT, supra note 3, at 10; BANKING SYSTEM, supra note 9, at 41–42.

\textsuperscript{49} BANKING SYSTEM, supra note 9, at 24.

\textsuperscript{50} Chōki Shin'yō Ginkō Hō [Long-Term Credit Bank Law], Law No. 187 of 1952.

\textsuperscript{51} Id. art. 4; Fumiko Fujisaki, Japan Banks Haggle over Securities Market Entry, Reuters, May 27, 1991, available in LEXIS, Nexis Library, Reuters File.

\textsuperscript{52} BANKING SYSTEM, supra note 9, at 25.
between long-term and short-term credit banking have been coming down.\textsuperscript{53}

The third major type of specialized bank is the trust bank. Along with nine foreign trust banks, there are seven Japanese-owned trust banks.\textsuperscript{54} These banks are permitted to engage in the trust business under a 1943 law granting this entitlement to ordinary banks and long-term credit banks.\textsuperscript{55} Like the long-term credit banks, the bulk of the trust banks' business is in the form of long-term funding through loan trusts and other devices.\textsuperscript{56}

In addition to the types of banks discussed above, there are a host of other specialized financial institutions which need to be mentioned briefly, both to illustrate the diversity of Japan's financial system and to show how together they represent an important conglomeration of economic and political interests. These other depository institutions include: the Bank of Tokyo,\textsuperscript{57} the Shōkō chūkin Bank,\textsuperscript{58} the Nōrin chūkin Bank,\textsuperscript{59} shinkin banks,\textsuperscript{60} credit cooperatives,\textsuperscript{61} labor

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\textsuperscript{53} See infra note 157 and accompanying text.
\textsuperscript{54} See infra note 157 and accompanying text.
\textsuperscript{55} FUTSŌ GINKÔ NO SHINTAKU GYÔMU NO KEN'EI NI KANSURU HÔRITSU [LAW CONCERNING THE CONCURRENT ENGAGEMENT OF THE ORDINARY BANK IN THE TRUST BUSINESS], art. 1, Law No. 43 of 1943. Administrative guidance appears to be at least one of the reasons why more banks have not taken advantage of this law to expand into the trust business; article 1 of the law requires the MOF's approval before a bank may become a trust bank. Id.
\textsuperscript{56} BANKING SYSTEM, supra note 9, at 25.
\textsuperscript{57} Though sometimes considered one of the city banks, the Bank of Tokyo (BOT) is chartered under a special statute, namely the Foreign Exchange Banking Law. GAIKOKU KAWASE GINKÔ HÔ [FOREIGN EXCHANGE BANK LAW] Law No. 67 of 1954; THE JAPANESE FINANCIAL SYSTEM 172 (Yoshio Suzuki ed., 1987); see also BANKING SYSTEM, supra note 9, app. 1, at 1 (listing the BOT under heading "city banks"). Originally established as the country's only foreign exchange bank, the BOT's raison d'être has effectively vanished because all banks are now able to engage in foreign exchange activities. Nevertheless, the BOT's international financial expertise and global network of branches assure its continued viability. Bank of Tokyo: Just Impediment, ECONOMIST, Mar. 7, 1992, at 88.
\textsuperscript{58} Partially financed by the government, the Shōkō chūkin Bank is a special institution established in 1936 to provide financial services for unions of small-sized and medium-sized enterprises. BANKING SYSTEM, supra note 9, at 28.
\textsuperscript{59} The Nōrin chūkin Bank and its branches function as the central bank of the farming, forestry, and fishing industries. See THE JAPANESE FINANCIAL SYSTEM, supra note 57, at 232. Like the Shōkō chūkin Bank, it also receives substantial government support. Id.
\textsuperscript{60} Shinkin banks are cooperative, not corporate, entities that may be subscribed to by individuals or medium or small enterprises. BANKING SYSTEM, supra note 9, at 26. Along with the ancillary activities permitted to ordinary banks, the shinkin banks may take deposits and engage in foreign exchange, but they may only issue loans and discount bills for subscribers. SHIN'YO KINKÔ HÔ, art. 53, Law No. 238 of 1951. The viability of these banks is increasingly in doubt. In the eyes of some observers, the shinkin, like American savings and loans, may bring down the whole banking system due to excessive involvement in bad property deals. See Anthony Rowley, Tokyo Worried About Stability of Credit Co-ops: Japan's S & L Crisis?, FAR
banks,\textsuperscript{62} agricultural cooperatives,\textsuperscript{63} fishery cooperatives,\textsuperscript{64} and several other types of cooperative institutions which may engage in financial activities.\textsuperscript{65} Many of these individual institutions are also members of institutional federations.\textsuperscript{66} The Financial System Reform Act affects all of these institutions, primarily by expanding the scope of financial activities in which they are permitted to engage.\textsuperscript{67}

There are also foreign institutions. By 1985 over one hundred branches of foreign banks and securities firms had been established in Japan.\textsuperscript{68} Foreign bank branches are chartered and regulated as branches of ordinary banks under the Banking Law,\textsuperscript{69} while foreign security branches are subject to a special legal regime.\textsuperscript{70} A number of foreign banks have also been permitted to engage in trust activities in the Japanese market.\textsuperscript{71}

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61. See Banking System, supra note 9, at 27.

62. Similar to the sōgos and the credit cooperatives, labor banks are cooperative institutions whose primary activities consist of installment savings, lending, and deposit transactions for labor unions and their members. See id. at 27–28; Rōdō Kinko Hō [Workers’ Banking Institution Law], Law No. 227 of 1953.

63. Agricultural cooperatives actually existed before the Pacific War but did not become widespread until after the passage of the Agricultural Cooperative Societies Act of 1947. Susumu Yamaji, Agriculture, in Politics and Economics in Contemporary Japan 184, 191 (Murakami Hyoe & Johannes Hirschmeier eds., 1979). These cooperative institutions cater to the financial needs of the agricultural community and engage in a variety of nonbanking businesses, including marketing agricultural products and purchasing farm equipment. Banking System, supra note 9, at 29.

64. Suisangyō Kyōdō Kumiai Hō [Fisheries Cooperatives Law], Law No. 242 of 1948. The main activities of fishery cooperatives are taking members’ savings and lending to members. Banking System, supra note 9, at 30.


66. For example, all credit cooperatives belong to the National Federation of Credit Cooperatives, which acts as a central bank for its members. Banking System, supra note 9, at 27.

67. See infra notes 268, 270 and accompanying text.

68. The Japanese Financial System, supra note 57, at 196. Although Japanese banks and their overseas securities affiliates were still prohibited from engaging in securities activities within Japan at the time, in 1986 the MOF began allowing the securities affiliates of foreign banks to establish branches in Japan. See Dale, supra note 19, at 35–36.


70. Gaijoku Shōken Gyōsha ni kansuru Horitsu [Law Concerning Foreign Securities Dealers], Law No. 5 of 1971.

71. Tatewaki, supra note 40, at 157–60.
In addition to these private and semiprivate institutions, there are two government banks, namely the Japan Development Bank and the Export-Import Bank of Japan, and a number of government financial corporations. Finally, there are the other sectors of the financial industry: the life and casualty insurance companies, various forms of nonbanks, and the banking industry's greatest rival in the current reform movement, the securities industry.

Each of these various types of financial institutions has its own prerogatives, its own customer base, and its own interest in seeing reform proceed or stagnate. This heterogeneity of interests has proven to be an obstacle to the development of new financial products and other changes in the past, and will be the most difficult hurdle for reformers to traverse in the future. In the words of the Financial Reform Council:

[In Japan, various restrictions and customs stemming from the existing vertical division system have impeded the development of new financial products and services. ... Under the existing system, even if a new product is developed involving multiple financial sectors, its offer... tends to be restrained since this gives rise to confrontation between sectors.]

2. The Regulatory Regime. Most types of depository institutions are regulated by the Ministry of Finance. Apart from controlling entry into the banking business, the MOF exercises administrative guidance over established banks in three main ways: (1) it controls the ability of banks to branch domestically and abroad; (2) it grants the appropriate licenses required for some of the activities in which banks are allowed to engage, and (3) it makes numerous decisions regarding the daily conduct of the banking business (e.g., the scope of activities permitted through associated businesses). The terms of the financial laws themselves provide the MOF with a broad range of discretionary powers. For example, the first sixteen articles of the Banking Law contain no less than twenty provisions that delegate

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72. BANKING SYSTEM, supra note 9, at 34.
73. See THE JAPANESE FINANCIAL SYSTEM, supra note 57, at 166-68.
74. BANKING REPORT, supra note 3, at 14. Such conflicts, for example, have led to a variety of restrictions being imposed on the private placement of bonds and the sales of commercial paper and housing loan mortgage trusts. Id.
75. See BANKING SYSTEM, supra note 9, at 37.
76. One increasingly important area of banking activity which requires licensing by the MOF is dealing in government securities. Id. at 64-65.
77. Id. at 43-52.
discretionary authority to the MOF or the government.\textsuperscript{78} Given its broad powers over banks, the MOF has been able to keep troubled financial institutions from going bankrupt by encouraging other banks to deposit funds with the institution or by promoting the merger of weak banks with strong ones.\textsuperscript{79}

Banks are also subject to control by the Bank of Japan. As Japan's central bank, the BOJ controls the official discount rate, sets reserve deposit requirements, and participates directly in financial markets as part of its fiscal policy.\textsuperscript{80} Unlike central banks in most countries, the BOJ is able to control directly the lending volume of major financial institutions through what is known as window guidance.\textsuperscript{81} Both the MOF and the BOJ have also been granted a variety of powers to inspect and investigate banks and other financial institutions.\textsuperscript{82}

In addition to the MOF's Banking Bureau and the BOJ, a host of other government bodies exercise some degree of regulatory authority over the financial system. The Securities Bureau of the MOF controls the securities companies and administers the Securities Transaction Law.\textsuperscript{83} The MOF also has a Finance Bureau, which is responsible for issuing government bonds,\textsuperscript{84} and an International Finance Bureau, which together with the Banking and Securities Bureaus exercises control over the foreign financial activities of Japanese companies.\textsuperscript{85}

In addition to the MOF, local government entities exercise some control over credit cooperatives and other small institutions.\textsuperscript{86} The
Ministry of Labor exercises joint control with the MOF over the labor banks, and other ministries have authority over credit cooperatives within their jurisdictions. The Ministry of Post and Telecommunications controls the vast postal savings system, the world's largest depository institution. The Ministry of International Trade and Industry regulates the nonbanks. The Fair Trade Commission (FTC) is charged with enforcing the limitations set forth by the Antimonopoly Law on the securities holdings of banks and other financial institutions. There is also a deposit insurance corporation, though the statute which brought it into being grants it few regulatory powers. Even this picture is far from complete, but it should suffice to illustrate the maze of regulation to which financial institutions are subject.

III. THE GROWING NEED FOR REFORM

If Japan's spectacular postwar economic development is an indicator, the policy of squeezing consumers in order to secure capital for industries through a compartmentalized and highly regulated financial system has been extremely successful. Many banks have also become extremely rich in the process. Times have changed, however, and Japan's financial system has now evolved into one where a plethora of inefficient and uncompetitive specialized financial sectors, subject to a heterogeneous regulatory scheme, are actually hampering

87. WORKERS' BANKING INSTITUTION LAW art. 6, Law No. 227 of 1953 (stating that a labor bank must be licensed by the Ministers of both Finance and Labor).

88. For example, the Ministry of Agriculture, Forestry, and Fisheries has regulatory authority over the trust activities of forestry cooperatives. SHINRIN KUMIAI HO [FORESTRY COOPERATIVES LAW] art. 10, Law No. 36, 1978.


90. Rowley, supra note 60, at 36.

91. ANTIMONOPOLY LAW art. 11, Law No. 540 of 1947. In addition to being able to make exceptions to these strictures, the FTC is responsible for ensuring that businesses, including financial institutions, do not engage in anticompetitive or unfair activities. Id. art. 27(2). The FTC was established under Article 27 of the Antimonopoly Law and charged with the power to control monopolistic behavior and unfair trading practices. Id.

92. Japan's Deposit Insurance Corporation has a very small staff and is charged with administering the collection of deposit premiums. See YOKIN HOKEN HO [DEPOSIT INSURANCE LAW] art. 34, Law No. 34 of 1971. The fact that until very recently not a single claim had ever been made on the deposit insurance company indicates how protective the MOF is of financial institutions. See BANKING SYSTEM, supra note 9, at 32.

Japan's development as a world financial center. This section will examine the factors which have made financial reform vital, both for the continued well-being of the economy and for the survival of the increasingly troubled banking industry.

The Financial System Research Council approached the subject of financial reform from three different perspectives: the internationalization of finance, the needs of users, and the maintenance of financial order. They also considered reform in the light of changes in Japan's financial markets, including the liberalization and securitization of finance. Each of these issues has been a significant factor in the development of the need for financial reform.

By the 1970s banks began to hit the limits of growth in traditional areas of business. The change to a floating currency exchange rate and the oil shocks of the mid-1970s brought about drastic changes in the demands on the financial system. Furthermore, as Japan's export driven economy boomed and its consistent trade surplus brought increasing amounts of foreign capital into the country, the capital shortages ceased to be a problem. As noted by the Banking Report, "[t]he structural changes and stable growth that have taken root in the Japanese economy are accompanied by a shift from a shortage of funds to a surplus of funds today." By the mid-1980s Japan had become the world's largest creditor nation, and as a result Japan's financial system had become increasingly tied to the rest of the world. These developments created four sources of pressure for financial reform: the increasing public debt; the internationalization of Japanese finance at home and abroad; the securitization and

94. See Holloway, supra note 18, at 54.
95. BANKING REPORT, supra note 3, at 16.
96. Id. at 12-13; see Zadankai: Kin'yū seido no atarashii tenkai [Round Table Discussion: New Developments in the Financial System], 966 JURISTO 12, 13 (1990) [hereinafter Round Table Discussion 2].
97. BANKING REPORT, supra note 3, at 9.
98. Rosenbluth, supra note 43, at 68.
99. See THE JAPANESE FINANCIAL SYSTEM, supra note 57, at 25.
101. BANKING REPORT, supra note 3, at 9.
102. Shinkai, supra note 100, at 249, 255-57.
diversification of Japanese finance; and the hard times recently experienced by banks.

A. The Increasing Public Debt

According to the Banking Report, "banks are now involved in a range of securities businesses relating to public bonds."103 A combination of slow growth resulting from the oil shocks, a drop in tax revenues exacerbated by the economic slowdown,104 and a significant increase in public expenditures105 increasingly forced the government to rely on deficit financing through the issuance of long-term bonds.106 The great majority of government bonds were issued through a syndicate, of which many banks and some other financial institutions were members.107 The government used a syndicate because it enabled the government to issue debt at below-market interest rates.108 The banks acquiesced because it allowed them to preempt the government from issuing short-term debt which would have competed with their savings accounts.109

Originally, the members of the syndicate would hold onto the bonds until maturity110 or wait for the BOJ to repurchase them, which it usually did.111 Initially, nobody wanted the bonds to be sold to the general public; banks did not want to have to sell bonds which might compete with their own financial products, and the MOF did not want the market forces to raise the interest rates that the government would have to offer.112 The continual growth in the quantity of these

103. BANKING REPORT, supra note 3, at 17.
104. EMMOTT, supra note 20, at 94; TATEWAKI, supra note 40, at 28; Yukio Noguchi, Public Finance, in 1 THE POLITICAL ECONOMY OF JAPAN 186, 192 (Kozo Yamamura & Yasukichi Yasuba eds., 1987).
105. Near the end of the 1960s, the Japanese people had reached the limits of their ability to tolerate the industrial pollution, poor infrastructure, and squalid living conditions that were the by-product of industrial growth. By the beginning of the 1970s, these problems had forced the government to increase spending on public works and welfare programs. See EDWIN O. REICHAUER, JAPAN: THE STORY OF A NATION 334–38 (3d ed. 1970).
106. Shinkai, supra note 100, at 251–52. Deficit financing was not legally possible until the amendment of the Public Finance Law in 1975. Masazo Ohkawa, Government Bonds, in PUBLIC FINANCE IN JAPAN 123, 125 (Tokue Shibata ed., 2d ed. 1986); see also Noguchi, supra note 104, at 192–95 (discussing legal and economic aspects of deficit financing).
107. BANKING SYSTEM, supra note 9, at 118.
109. Id. at 69.
110. See EMMOTT, supra note 20, at 94.
111. Id. At one point the BOJ was repurchasing 90 percent of the bonds within one year of their issue. Rosenbluth, supra note 43, at 69.
bonds, however, forced the government to allow banks to resell them.\textsuperscript{113} This was necessary not only to make the bonds available to a broader market but to continue receiving the cooperation of the banks.\textsuperscript{114} Otherwise, the banks would have been burdened with an intolerable load of illiquid assets.\textsuperscript{115}

By 1975 the bond issuance had exceeded the syndicate's ability to absorb it, and a secondary market developed spontaneously.\textsuperscript{116} In 1978 the banks were still dissatisfied enough with the syndicate arrangement to boycott it altogether.\textsuperscript{117} After much negotiation between the government, the banks, and the securities industry, the new Banking Law was enacted in 1981, allowing banks to sell public bonds.\textsuperscript{118} Still, the burgeoning government debt was already causing other changes in the financial markets.\textsuperscript{119} Government debt was a significant factor both in banks' gradual expansion into new financial products and in the development of more sophisticated investment

\textsuperscript{113} See id. at 80; THE JAPANESE FINANCIAL SYSTEM, supra note 57, at 178. Initially, the sale of government bonds on the open market was prohibited. BANKING SYSTEM, supra note 9, at 17.

\textsuperscript{114} See Rosenbluth, supra note 43, at 74.

\textsuperscript{115} See id. at 70–74. In 1978, city banks lost ¥400 billion on bond holdings. Id. at 74. Banks even lost money during the one-year waiting period before the BOJ repurchased the bonds. See id. at 72–74.

\textsuperscript{116} Id. at 73.

\textsuperscript{117} Id. at 74.

\textsuperscript{118} See id. at 80; BANKING LAW art. 10(2), Law No. 59 of 1985. It was not until the end of 1982 that the MOF provided guidance on licensing banks to engage in the securities business with the GINKO TOU NO SHÔKEN GYÔMU NI KANSURU SHÔREI, Ministry of Finance Ordinance No. 62 of 1982. Actual sales of government bonds to the public by banks did not begin until April 1983, and it was not until 1984 that banks were allowed to deal in government bonds (i.e., buy and sell outstanding bonds in the marketplace). THE JAPANESE FINANCIAL SYSTEM, supra note 57, at 91–92.

\textsuperscript{119} One commentator noted:

Once a large secondary market in long-term securities (government bonds) had developed, investing institutions also wanted a larger and freer short-term money market in order to diversify their holdings and to ensure that they could raise money quickly. So the Bank of Japan eased its control of interest rates in the call money (very short-term cash) and bill discount markets, and allowed banks to issue yen certificates of deposit. On the back of the government bond market grew a market for gensaki, similar to bond repurchase agreements or repos in the United States. . . . This market thus allows institutions to borrow short-term money against their long-term bond holdings. More important still, they can invest that money in other short-term securities if the interest rates available are higher, or vice versa. Such arbitrage opportunities forced interest rates to move freely in associated markets; if the Bank of Japan tried to hold rates in one market artificially low, institutions could (and did) simply move their money elsewhere.

EMMOTT, supra note 20, at 94.
opportunities at home and abroad. Reform became necessary to reflect the shift by banks away from traditional banking activities.

B. The Internationalization of Japanese Finance at Home and Abroad

In something of an understatement, the Banking Report notes that "it is necessary to acknowledge the international position of the Japanese financial and capital markets." As Japan's industries developed in the 1960s, they began to establish plants and branches overseas. Japan's banks followed in order to provide their customers with financing and other services. The oil shock provided further opportunities for Japanese banks overseas:

In the 1970s, a large volume of "oil money" entered the Euromarkets in the wake of the rise in crude oil prices. This money was used to provide loans to the nonoil producers among the developing nations. Japanese banks participated in Euromarket syndicate loans through their overseas branches. At this time they were particularly eager to develop their international divisions because the 1973 oil shock had stunted the country's economic growth and cut private-sector demand for funds for capital spending.

Although the days of Euromarket syndicate loans were relatively short, Japanese banks had become players in the world financial markets. As the country's foreign exchange reserves swelled, Japanese capital began to flow overseas. Moreover, the meteoric rise in the value of the yen following the 1985 Group of Five Plaza Agreement was followed by a comparable surge in the value of Japanese assets. Thus, by the mid-1980s Western observers noted Japanese money

120. See id. "As of March 1988, securities accounted for 14.1% of total bank assets, and government bonds accounted for 27.4% of this." BANKING SYSTEM, supra note 9, at 64.
121. BANKING REPORT, supra note 3, at 15.
122. BANKING SYSTEM, supra note 9, at 73.
123. Id.
124. Id. at 74.
“sweep[ing] over the world.” This was accompanied by a dramatic increase in the wealth and the overseas presence of Japan’s banks, which attained major positions in the United States as a result of Japan’s comparatively low capital-adequacy requirements.

This was not an entirely positive development. As Japanese money spread around the world, complaints of Japanese economic imperialism begin to appear. At the same time, an increasing number of foreign financial institutions came to Japan seeking to participate in its financial success. When they arrived, they found the administrative maze and the numerous unwritten rules impenetrable and thus were generally unsuccessful. Although the Banking Report itself baldly states that foreign institutions “enjoy national treatment,” foreign criticism of the discriminatory nature of Japan’s financial system and the unfair advantage it gives Japanese banks abroad became increasingly harsh. This has become a source of friction between Japan, the United States, and other

129. For example, according to one survey, no Japanese banks were counted among the world’s ten largest in 1980. *World Banking: Banks Meet the Marketplace, TIME TO LEAVE* (Supp. at 3, 4), in ECONOMIST, May 2, 1992. In contrast, by 1990, six of the ten largest banks, including the top four, were Japanese. *Id.* By 1986 Japanese banks had acquired over 20 percent of the banking assets in California; in addition, 1986 marked the year that Sumitomo Bank acquired a 15 percent holding in Goldman Sachs. CLYDE V. PRESTOWITZ, JR., *TRADING PLACES: HOW AMERICA ALLOWED JAPAN TO TAKE THE LEAD* (1988). This presence has not been limited to the United States. See, e.g., Nigel Holloway, *Global Ambitions*, FAR E. ECON. REV., June 1, 1989, at 59 (reporting on a Japanese bank buying a stake in a London merchant bank). Nor has it been limited to the large city banks; by the end of the 1980s, many of the smaller regional banks had established branches in the United States. Bruce Aronson, *Regionals Are Playing Follow-the-Client*, AM. BANKER, July 27, 1990, at 16A.
130. See PRESTOWITZ, JR., *supra* note 129, at 324.
131. See EMMOTT, *supra* note 20, at 137.
133. Despite some of them having been in Japan for a decade or more, by 1986 foreign financial institutions accounted for only 3 percent of the business done in Japan. PRESTOWITZ, JR., *supra* note 129, at 12.
134. BANKING REPORT, *supra* note 3, at 28.
countries, which explains the Banking Report's expression of concern that "it is desirable that the Japanese financial system be one that is easy to use for foreign financial institutions."\footnote{136}

Once the capital shortage ended, many of the structures which had emerged in response to it began to collapse.\footnote{137} As Japan internationalized, Japanese companies discovered that, rather than cope with the outmoded regulations and expense involved in raising capital at home, it was often cheaper to raise capital in foreign markets.\footnote{138} According to one observer: "[B]eginning roughly in 1984–85, companies . . . deserted the banks. Money was cheaper elsewhere. At first, they went to the bond markets, especially offshore ones. . . . [Then] firms switched to equity."\footnote{139} As Japanese investors became increasingly sophisticated, they realized that they could get better value for their yen abroad, where interest rates were higher and they had more options.\footnote{140} As noted by the Banking Report:

In the environment of internationalization of [the] economy and advancement of financial techniques . . . corporations are now able to determine in which markets to invest and to procure capital, strictly based on such factors as profitability of the financial products offered in the world markets and the convenience of each market.\footnote{141}

This resulting capital flight has threatened to "hollow out" sectors of Japan's economy.\footnote{142} Reform was therefore necessary to make

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\begin{itemize}
  \item 136. BANKING REPORT, supra note 3, at 28.
  \item 137. See, e.g., RODNEY CLARK, THE JAPANESE COMPANY 80 (1979) (predicting that "[i]n the longer run the coherence of bank groups is further threatened by the prospect that capital will no longer be in short supply, and that other sources of capital than the domestic banks, notably the stock exchange at home and banks and underwriters from abroad, will become relatively more important") (emphasis added).
  \item 138. See Gosō-senden, supra note 37, at 7. For example, in Japan issuance fees for corporate bonds are at least 10 percent higher than those in Europe. In addition, fees charged by banks for issuance in Japan are as much as fifteen times higher than those charged by European banks. Atsushi Naoi, Bond Fees in Japan Down Yet High, NIKKEI WKLY., Aug. 3, 1991, at 14.
  \item 140. The fact that a tide of Japanese money began sweeping the world in the 1980s is itself indicative of the limited options for investment within Japan. See generally Holloway, supra note 128, at 59–61 (describing both the massive Japanese foreign investment and the inconvenience of Japan's domestic market). One scholar regards Japanese corporations' access to competitive markets overseas as "the single most important stimulus toward financial deregulation in Japan." Rosenbluth, supra note 43, at 102.
  \item 141. BANKING REPORT, supra note 3, at 9.
  \item 142. See id. at 14.
\end{itemize}
Japanese financial markets globally competitive, while at the same time making these markets more accessible to foreign investors and institutions.

C. The Securitization and Diversification of Japanese Finance

"In recent years, the fund raising of large- and medium-size corporations has shifted from bank loans to the issue of securities."143 This comment from the Banking Report reflects the fact that, within Japan, increasingly sophisticated investors and companies began turning away from the banks and seeking alternatives to the banks’ outdated products and unfavorable interest rates.144 Since the 1970s securities, over which securities companies had been granted a virtual monopoly, became an increasingly attractive alternative for firms attempting to reduce their bank debt in the post-oil-shock world.145 Japanese firms’ financial activities paralleled their dealings overseas in becoming progressively more sophisticated. Not only were they raising capital for their own purposes in foreign markets, they also started to get involved in financing as a business.146 Most of this financial activity involved securities which, despite being issued overseas, were generally purchased by Japanese investors and handled by Japanese securities firms.147 This shift greatly benefitted the securities firms.148

Furthermore, according to the Banking Report in 1991, "there is a trend among individuals toward more diversified asset investments."149 The phenomenal Japanese savings rate, another crucial

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143. Id. at 12.
144. For example, the special status of the postal savings network enables it to offer interest rates and services with which banks are incapable of competing. See Yokota, supra note 89, at 1. In the first seven months of 1991, ¥4 trillion was transferred from banks to post office accounts, a trend which bankers fear may upset the whole financial system. Id.
145. See Rosenbluth, supra note 43, at 71. Although the relationship between banks and corporations is still close, the roles have been reversed: banks often cater to a corporation in the hope that the corporation will use their services. See EMMOTT, supra note 20, 104. There are indicators that banks and corporations may become further alienated: it has been reported that at least one bank is selling its stable shares. Paul Blustein, Japanese Bank Breaks Tradition, May Sell Long-Held Shares, WASH. POST, Feb. 21, 1991, at C10. This may simply be a sign of desperation, however, rather than the beginning of any general trend. Id. at C16.
146. For example, almost 40 percent of Toyota’s pretax profits in 1988 were derived from financial activities rather than car manufacturing. EMMOTT, supra note 20, at 104.
147. Id. In order to compensate banks, the MOF allowed them to underwrite corporate securities overseas, although they are still unable to do so in Japan. Id. at 105.
148. Id. at 104.
149. BANKING REPORT, supra note 3, at 13.
factor in the formation of Japan's massive capital surplus, has gradually begun to decrease since the 1970s. Social welfare system improvements and growing confidence in the economy correspondingly reduced the incentive to save. An increasing variety of things to do with one's money, besides put it in the bank, also arose: stock and real estate investments, foreign travel, and even eating gold-flaked sushi. These systemic changes required a parallel reform in the regulation of the financial sectors.

D. Banks Experience Hard Times

As stated euphemistically by the Banking Report, "a significant change has occurred in the earnings structure of Japanese banks." The increasing public debt as well as the internationalization, securitization, and diversification of Japanese finance, forced the government gradually to deregulate interest rates and to allow banks to offer an increasing variety of financial products in order to stem the flow of capital to more attractive foreign markets. Presumably because small depositors have fewer options for investment, deregulation initially focused on large-denomination instruments. Furthermore, the walls between long-term and short-term

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150. The savings rate was as high as 25 percent in the 1960s. Kazuo Sato, Saving and Investment, in The Political Economy of Japan 1, 137, 140 (Kozo Yamamura & Yasukichi Yasuba eds., 1987). Sato asserts that "[t]he economic miracle of the 1960s owes much to the steady rise in the saving ratio as the demand for investment steadily increased." Id. at 137. The high savings rate during this period appears to have been the exception rather than the rule. See id. at 140. Therefore, it should not automatically be attributed to some unique by-product of Japanese culture and society. Id.

151. Japan's personal savings rate dropped by 7 percent between 1975 and 1985. EMMOTT, supra note 20, at 234; see also Sato, supra note 150, at 140 (discussing the drop in the savings rate in 1970s); THE JAPANESE FINANCIAL SYSTEM, supra note 57, at 10-12. But see Time for a Reagan Tax Cut—in Japan?, BUS. WK., Mar. 1, 1993, at 22 (reporting a sharp rise in personal savings due to Japan's recent economic problems).

152. See EMMOTT, supra note 20, at 234-35. In 1988 the government also eliminated a major tax incentive for saving. Id. at 235.

153. BANKING REPORT, supra note 3, at 12.

154. See supra text accompanying notes 103-52. As of December 1991, 65 percent of deposits in city banks were in accounts with unregulated interest rates. FEDERATION OF BANKERS ASSOCIATIONS OF JAPAN, DEREGULATION OF THE FINANCIAL SYSTEM IN JAPAN 2 (1991) [hereinafter DEREGULATION] (on file with author).

155. See DEREGULATION, supra note 154, at 2.

156. For example, in 1979 interest rates were deregulated on three to six month certificates of deposit (CDs) over ¥500 million. In 1985, interest rates on money market certificates (MMCs) were introduced with a minimum amount of ¥50 million. Tatewaki, supra note 40, at 45. Total deregulation was supposed to be completed in 1993. Tomio Shida, Financial Industry Inches Nearer to Deregulation, JAPAN ECON. J., Feb. 23, 1991, at 35. Deregulation of demand deposit
banks have gradually been coming down as ordinary and long-term credit banks began to offer increasingly similar financial services.\textsuperscript{157} Similarly, the 1981 amendments to the Banking Law and to the Securities Transaction Law permit banks to trade in public bond options.\textsuperscript{158} As a result, banks have gradually become active in the securities markets. Thus, over time, the distinctions between different types of financial institutions have become increasingly irrelevant.\textsuperscript{159}

Despite having been granted these new privileges, the banks still need to offer higher (i.e., market) interest rates while trying to remain competitive in a stagnant loan market, thus creating a two-sided squeeze on the banks' interest rate spread, which has recently caused serious problems for many banks.\textsuperscript{160} Large institutions have become increasingly predatory in attracting customers, often at the expense of the smaller institutions.\textsuperscript{161} As banks expanded into each others' accounts, however, is not scheduled to take place until mid-1994. DEREGULATION, supra note 154, at 2.

157. Long-term credit banks are issuing two-year debentures, while regular banks have begun offering three-year term deposits; previously, long-term credit banks had been limited to five-year instruments, while ordinary banks were restricted to short-term financing. \textit{E.g.,} Tatsuho Itô, \textit{Japan Long-Term Banks to Launch Two-Yr Debentures}, Reuter Money Report, Oct. 24, 1991, LEXIS, Nexis Library, MONRPT File; \textit{see also} \textit{New Mid-Term Time Deposits Designed}, Japan Econ. Newswire, May 19, 1992, \textit{available in} LEXIS, Nexis Library, JEN File (noting that regional banks are designing three-year to four-year time deposits).

158. \textit{See also} BANKING LAW art. 10(2), Law No. 59 of 1981 (authorizing banks some securities-related activities); \textit{SHÔKEN TORIHIKI HÔ [SECURITIES TRANSACTION LAW]} art. 65(2)(2)(i), Law No. 25 of 1948 (exempting banks from the total ban of securities transactions, provided in the preceding subsection, for certain types of transactions); BANKING REPORT, supra note 3, at 17.

159. \textit{See, e.g.,} \textit{THE JAPANESE FINANCIAL SYSTEM}, supra note 57, at 165 ("[I]t is difficult to make very precise distinction [sic] in a functional sense among the depository institutions. ... [After 1975] each type of financial institution began to invade the turf of others.").


161. \textit{See generally} Yūichi Hiraishi, \textit{Jiyūka no naka dewa kyōdo soshiki kin'yū no genten ni modore}, EKONOMISUTO, July 15, 1991, at 48 (discussing the appropriate corporate strategies for the cooperative type of financial institution in the era of liberalization and internationalization); Masahiro Takahashi, \textit{Hokkaidō, hiroi chiki no 'sumiwake' mo yurusarenaku natta}, EKONOMISUTO, July 15, 1991, at 38 (reporting increasing competition in Hokkaido due to the liberalization of deposit rates and the new entry of larger banks to small-sized firms' corporate finance market). The \textit{shinkin} banks, for example, are in a serious dilemma. As explained by a Sanwa Bank officer, "[The \textit{shinkin}] cannot compete with us .... There is no limit to our ability to take their customers away." Henny Sender, \textit{Japan's Not-So-Mighty Banks}, INSTITUTIONAL INVESTOR, Nov. 1990, at 130.
markets, reform became increasingly necessary to protect the sectors of the financial industry which were disadvantaged by this new competition.

In the long run, excessive economic growth may have been the banks' principal downfall. According to the Banking Report, "[a]s a result of liberalization and internationalization of finance, Japanese banks and other financial institutions are confronted with a variety of risks. . . ."\(^{162}\) In the case of the larger banks, the expansion of their partners in the *keiretsu* group eventually led to a drop in profits because:

as a company in a bank group gets bigger two things happen. The group bank becomes less able and less willing, for reasons of financial prudence [there are legal restrictions as well] to provide the growing company with most of its funds. At the same time, the company becomes attractive as a potential borrower to a number of outside banks. As the company borrows more from these outside banks its relations with the group bank are attenuated. . . .

Bank groups suffer, therefore, from an inherent defect, that the more successful their member companies are, the less likely they are to remain largely under the control of the central bank.\(^{163}\)

Similarly, the dramatic rise in stock and land prices that occurred in the 1980s hurt banks and other financial institutions. Banks had invested heavily in stock and had financed stock and land speculation activities of affiliates.\(^{164}\) Most of these loans were made with property as collateral.\(^{165}\) As long as land and stock prices continued to spiral, the underlying structural problems of the banking system went largely unnoticed.\(^{166}\) When the stock and real estate markets dropped precipitously at the beginning of the 1990s, the value of banks' stockholdings fell rapidly,\(^{167}\) and they were stuck with portfo-

\(^{162}\) BANKING REPORT, *supra* note 3, at 13.

\(^{163}\) CLARK, *supra* note 137, at 78, 80.


\(^{165}\) See generally *infra* notes 300–01 and accompanying text (discussing nonperforming loans backed by devalued real estate holdings).

\(^{166}\) See, e.g., Butler, *supra* note 164, at 12 ("What Japan's economic bureaucrats have consistently failed to appreciate is the extent to which the heady years also distorted investment and consumption patterns.").

lios of bad loans secured by severely devalued land.\textsuperscript{168} These losses provided a new urgency for financial reform. As noted by one observer:

The fragmented nature of official supervision of financial institutions in Japan has not mattered too much in the past because the industry's overall asset structure was diversified enough to prevent any undue concentration of risk. But all this has changed with the massive funding of Japan's recent land and property bubble.\textsuperscript{169}

The Banking and Securities Reports, therefore, had to cover a broad variety of concerns: some long-standing and some arising from relatively new developments. The degree to which these concerns were addressed in the reports is the subject of the following section.

IV. REFORM AT LAST?

The core of the Financial System Research Council's (Council) reform proposals involved removing the legal and regulatory barriers between the following sectors of the financial industry: banking, long-term banking, securities, and trust activities. Citing the worldwide trend toward "the expanding scope of activities for financial institutions,"\textsuperscript{170} the Banking Report suggested that such changes would encourage "sufficient competition between financial institutions . . . in all financial markets"\textsuperscript{171} and enable the financial institutions to "meet the increasingly sophisticated and diverse needs of the user. . . ."\textsuperscript{172}

The Council was also concerned with "the achievement of a level playing field at the start of mutual entry and the avoidance of excessive impact on existing financial institutions."\textsuperscript{173} With these quite different objectives in mind, the Banking Report discussed five different methods by which the mutual entry of financial industries into each other's markets could be accomplished: \textsuperscript{174} (1) universal

\textsuperscript{168} See generally infra notes 300–01 and accompanying text (discussing nonperforming loans secured by devalued real estate). In addition, the larger banks had also lent excessively to fund merger and acquisitions activities in the United States during the 1980s, many of which resulted in bankruptcies. See Sherry R. Sontag, Japan's U.S. Lesson in Bankruptcy, Nat'l L. J., Apr. 30, 1990, at 3.

\textsuperscript{169} Rowley, supra note 60, at 36.

\textsuperscript{170} BANKING REPORT, supra note 3, at 16.

\textsuperscript{171} Id. at 19 (emphasis added).

\textsuperscript{172} Id. at 20.

\textsuperscript{173} Id.

\textsuperscript{174} This part of the reform proposal did not surprise anybody. The Council had, after all, been discussing the subject of financial reform for six years, and this aspect of their deliberation
banking; (2) bank holding companies; (3) multifunctional subsidiaries; (4) a piecemeal approach; and (5) mutual entry through wholly-owned subsidiaries. Each of these methods is described below and is followed by a discussion of the recommendations of the Securities Report and the public reaction to both the Banking and Securities Reports.

A. Options for Reform

The first method for reform proposed in the Banking Report was a universal banking system. This would have allowed financial institutions to engage in a broad range of activities without having to establish subsidiaries or use separate facilities. For example, banks would be allowed to deal in securities and trust instruments, and securities companies could take deposits.

Universal banking was rejected partly because it might be difficult to achieve a level playing field. This euphemistic statement reflects the reality that large banks supported the adoption of a universal banking system, but the securities industry and smaller banks vehemently opposed such a system because it would have placed them at a competitive disadvantage. Under a universal banking system, securities companies and the smaller and/or specialized banks with limited numbers of branches would have been seriously handicapped in competing with the large city banks that had branches throughout the country. Moreover, the securities industry insisted that strict firewalls be maintained between different financial operations.

From this standpoint, a universal banking system might not have

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was public knowledge at least two years before they issued their final report. See, e.g., Round Table Discussion 2, supra note 96, at 13, 25–29 (discussing the implications of the various methods of mutual entry); Holloway, supra note 18, at 54 (discussing the five possible means of mutual entry).

175. BANKING REPORT, supra note 3, at 21.
176. Id.
177. See Goso-sendan, supra note 37, at 7.
178. Round Table Discussion 2, supra note 96, at 28. The long-term credit banks appear vulnerable to any form of deregulation, and they will likely acquire regular banks in order to obtain a network of branches through which to engage in new forms of business. See Anthony Rowley, Marriages of Convenience, FAR E. ECON. REV., Jan. 30, 1992, at 43.
179. See Goso-sendan, supra note 37, at 7. One commentator has also observed that the concern with firewalls is more about equalizing competition than preventing the inappropriate exchange of information between parents and subsidiaries. Round Table Discussion 2, supra note 96, at 26.
provided sufficient safeguards against conflicts of interest and self-dealing.180

The second option for reform was to allow mutual entry through bank holding companies, similar to the system of the United States.181 This approach was not discussed at length in the Banking Report. Article 9 of Japan’s antitrust law prohibits holding companies,182 and the Council did not deem it appropriate to “seek a revision of that law for the sake of financial system review alone.”183

The third approach for reform was mutual entry through multifunctional subsidiaries.184 This plan would involve different institutions participating in each other’s fields of business through a special type of subsidiary.185 While this method would have synergistic advantages and would enhance user benefits, the Banking Report expressed some concerns about conflicts of interest and self-dealing.186 These concerns were similar to those about universal banking and made the multifunctional subsidiary approach less attractive than mutual entry through separate subsidiaries.187

The fourth method for reform was a piecemeal approach, using “desegregation in individual areas of business, while leaving intact the existing regulations that otherwise segregate different types of [financial] operations.”188 Although this approach did have the definite political merit of softening the reform’s impact on the various interests involved, the Banking Report rejected its use as an overall

180. The Banking Report gracefully concedes that “[i]n regard to the mutual entry between banks and securities companies, the universal banking system... has many problems at this point in terms of maintaining sound banking management and preventing harmful conflicts of interest.” BANKING REPORT, supra note 3, at 21.

181. Id.

182. ANTIMONOPOLY LAW art. 9, Law No. 54 of 1947.

183. BANKING REPORT, supra note 3, at 21.

184. Id. The Japanese version of the Banking Report refers to this option as the Tokureihō Hōshiki (“special legislation”) approach. KIN’YŪ SEIDO CHŌSA KAI, SEIDO MONDAI SENMON INKAI HÔKOKU, reprinted in EKONOMISUTO, July 15, 1991, at 120, 130. It is difficult to discern the reason for this discrepancy because discussion of this approach by both the Banking Report and the media was extremely limited. Presumably, the two terms—“multifunctional subsidiaries” and “special legislation”—together refer to subsidiaries established under new legislation with licensing criteria and permissible activities that differ significantly from the existing types of financial institutions.

185. Id. Foreign observers have described this form as an investment banking subsidiary limited to wholesale activities. Holloway, supra note 18, at 54.

186. BANKING REPORT, supra note 3, at 21.

187. Id. at 20-21.

188. Id. at 20. One commentator described this less generously as “[m]ore of the same.” Holloway, supra note 18, at 54.
method because it "would make it difficult to pursue a consistent and far-reaching mutual entry and would not make it possible to build an internationally acceptable system that extensively promotes users' benefits."\textsuperscript{189} However, the Council did recognize that this approach, used in combination with another method, would probably be appropriate in specific financial sectors\textsuperscript{190} such as for regional banks and smaller financial institutions.\textsuperscript{191}

The final reform alternative, which the Council recommended in its Banking Report after rejecting the other approaches, allowed mutual entry through wholly-owned specialty subsidiaries.\textsuperscript{192} A subsidiary approach was preferred because it presented the fewest problems; the separate subsidiary was preferred to the multifunctional subsidiary because it would be more effective in "prevent[ing] harmful conflicts of interest, thus maintaining financial order."\textsuperscript{193} Observers have also noted that the subsidiary method would be more effective in preserving "fair competitive conditions" (note that these terms do not necessarily carry the same meaning as they would in an American context), particularly if requirements for separate business premises are imposed.\textsuperscript{194} Thus, the playing field is not likely to experience any sudden drastic tilts.\textsuperscript{195} The separate subsidiary method became law with the passage of the Financial System Reform Act of 1992.\textsuperscript{196}

In detail, the Banking Report recommended that the subsidiaries be fully established entities. As such, the subsidiaries would be fully

\textsuperscript{189.} BANKING REPORT, supra note 3, at 20. As written, the committee's reasons are not particularly lucid. The quoted passage presumably means that partial deregulation would simply complicate matters further and perpetuate the current system which favors the interests of financial institutions at the expense of their users. Following publication, the most widespread criticism of the Banking Report was that it favored the interests of financial institutions with little regard for consumers. See Holloway, supra note 18, at 54-55; infra notes 253-54 and accompanying text. Consequently, the reference to promoting "users' benefits" would appear to be more for effect than out of any actual concern for users' convenience. See infra notes 325, 328-30 and accompanying text.

\textsuperscript{190.} BANKING REPORT, supra note 3, at 20.

\textsuperscript{191.} Id. at 24.

\textsuperscript{192.} Id. at 20-22. This method was also the only possibility mentioned by the Security Council. See SECURITIES REPORT, supra note 3, at 162.

\textsuperscript{193.} BANKING REPORT, supra note 3, at 21.

\textsuperscript{194.} Round Table Discussion 2, supra note 96, at 26-28. Several observers have pointed out the need for a more thorough discussion of firewalls. Id.

\textsuperscript{195.} Although the regulation of foreign financial institutions in Japan is a subject beyond the scope of this paper, it must be noted at this juncture that, prior to the change in law, foreign banks were permitted to own up to 50 percent of a Japanese securities company. Foreign Banks to Benefit from MOF Ruling, NIKKEI WKLY., June 29, 1991, at 12.

\textsuperscript{196.} See infra notes 270-75 and accompanying text.
functional entities, licensed, and entitled to complete privileges under the appropriate laws. Banks should be allowed to have securities subsidiaries and trust banking subsidiaries, securities companies should be able to create banking and/or trust banking subsidiaries, and so on. Neither foreign exchange nor long-term banking subsidiaries were discussed, having been dismissed as largely redundant. Still, the Banking Report left open the subject of long-term credit banking subsidiaries "for reasons such as achieving continuity with the existing system." At the same time, the Banking Report recognized that there was a need to maintain an orderly deregulation, and for this reason it suggested placing certain provisional restrictions on the scope of activities permitted to some types of subsidiaries. Specifically, while banking subsidiaries ought to be fully empowered, trust subsidiaries should be excluded from doing some types of trust business and possibly be limited to conducting real estate trust activities. Securities subsidiaries should be given all the powers allowed under the Securities Transaction Law, but should be temporarily excluded from brokering and other activities in the secondary market. The Council saw little merit in embodying these limitations in law because doing so "could result in creating new types of financial sectors, which would run counter to the objectives of the system review."

The Council also recognized that it might be economically impossible for regional financial institutions to set up subsidiaries.

197. BANKING REPORT, supra note 3, at 22.
198. Id. In reality, mutual entry is likely to be fairly one-sided; that is, banks going into the securities business. The banking subsidiary of a securities firm would be hindered by the difficulty of establishing the network of branches that would be necessary to take deposits successfully. Shōtorishin saishū hōkoku an: Kankeisha wa kō miru, ASAHI SHINBUN, May 16, 1991, at 8. Similar economic considerations would restrict securities firms from entering the trust business as well. See Özume kin'yū seido kaikaku 3: Danko hantai no uragawa, shōkenkai ni tadayō kyodatsukan, YOMIU SHINBUN, May 11, 1991, at 7 (describing the fear in the securities industry of facing banks' new entry into the securities business).
199. BANKING REPORT, supra note 3, at 22.
200. Id. Some view the breakdown of the distinction between long-term and short-term financing as a threat to the continued existence of the long-term credit bank system. Özume kin'yū seido kaikaku 3: Danko hantai no uragawa, shōkenkai ni tadayō kyodatsukan, supra note 198, at 7.
201. BANKING REPORT, supra note 3, at 23.
202. Id.
203. Id.
204. Id. at 22.
205. Id. at 24. In addition to the regional banks, other "regional financial institutions" include the numerous smaller institutions such as credit associations, farm cooperatives, etc. Id.
For this reason and to benefit local users, the Banking Report suggested that regional financial institutions be allowed to choose between establishing subsidiaries and expanding the scope of some of their own activities on a more limited basis. The Banking Report clearly deferred the difficult question of what special dispensation should be granted to regional institutions. It stated that the activities allowed to regional institutions should "be those which are necessary for meeting the needs of local users and for supporting the development of the region, and which pose virtually no problems in maintaining financial order when undertaken by regional financial institutions themselves." This rather nebulous statement is followed by two examples of such activities: land trusts and charitable trusts. But again, the Banking Report did not make any definite recommendations.

In addition to proposing the basic format by which mutual entry should be accomplished, the Banking Report made several other recommendations. First, it proposed broadening the scope of activities in which banks could engage without being required to establish a subsidiary, focusing primarily on loosening the restrictions on banks' involvement in private bond placements and various "securitization-related" products. Second, the Banking Report hinted at possibly allowing banks to deal in domestic corporate bonds and freeing them to issue bonds of their own. Third, the Banking Report recommended an immediate review of many regulations and practices which it did not specifically address.

The Council recognized that any form of major change in the financial system was likely to be traumatic for all the parties involved. The Banking Report concluded, however, that the combination of the

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206. Id.
207. Id.
208. Id. Doubtless, the functions in which regional financial institutions eventually will be allowed to participate will not be those that the users need, but rather those that other types of institutions are willing to concede.
209. Id. at 20–21.
210. Id. at 23.
211. See id. at 24. The report also equivocated on the question of allowing securities companies to engage directly in foreign exchange activities. Id. at 23–24. It is conceivable that several questions such as these were deliberately brought up, then left unanswered, in order to provide bargaining chips for future disputes between the various industries.
212. Id. at 25. Examples of recommended regulations include further liberalization of interest rates and the diversification of trust products and bank debentures. Id.
subsidiary format, existing laws, and institutional self-regulation would suffice to prevent "harmful side effects of mutual entry." 213

To supplement the existing regime, the Council proposed four additional areas of reform. 214 First, it proposed instituting higher capitalization levels in order to "attain sound management." 215 Adherence to the Bank for International Settlements (BIS) capitalization standards had been discussed in Japan for several years, 216 and the Banking Report formally proposed "further studies" regarding making it the legal standard. 217 In the case of subsidiaries, the Banking Report suggested examining the feasibility of consolidating the capital-adequacy requirements of parents and subsidiaries, 218 as is the practice in other countries. 219 Second, the Banking Report mentioned the need to reinforce the disclosure system, although it did not provide any details. 220 Third, it suggested that the monitoring function of supervisory authorities should be improved, particularly with regard to risk management, given the various transactions in which banks may become involved after liberalization. 221 Fourth, the Banking Report briefly recommended improving the deposit insurance system. 222 Finally, the Banking Report made some brief observations and suggestions regarding foreign financial institutions, the insurance industry, nonbanks, governmental financial institutions, and cooperative financial institutions. 223 The extent to which the Banking

213. Id. at 26.
214. Id. at 26–27.
215. Id. at 27.
217. BANKING REPORT, supra note 3, at 27. To date, capital-adequacy requirements have been set by the government. BANKING SYSTEM, supra note 9, at 40–41; Finance Ministry May Push for Rule on Bank Ratio, NIKKEI WKLY., July 27, 1991, at 3. Since the Report was issued, however, the MOF proposed making BIS’s capital-adequacy standards a statutory requirement. See Capital Adequacy Standards Proposed as Law, NIKKEI WKLY., Nov. 30, 1991, at 4.
218. BANKING REPORT, supra note 3, at 27.
219. Id.
220. Id.
221. Id.
222. Id. at 28.
223. Id. at 28–30.
Council's recommendations were reflected in the Financial System Reform Act is discussed in Part V.

B. The Securities Report

In contrast to the Banking Report, the Securities Report was shorter and much less equivocating in its demands. Unlike the Banking Report, which had to reflect the delicate balance of interests of various types of banks, the Securities Report was primarily concerned with limiting the encroachment of banks into securities companies' domain to a bearable minimum.

Described briefly, the Securities Report contained three main ideas on the subject of financial reform. First, the Securities Report advocated that the term "security" be given an all-encompassing, American-style definition in order to bring a broader range of financial products under the ambit of the Securities Transaction Law. The Securities Report suggested that new "securitization products" should be classified as securities in order to protect investors and enhance the distribution of securities. Securities could only be sold by licensed dealers, and banks were prohibited from direct dealings in most securities. Consequently, broadening the ambit of what constituted a security would have given the securities industry a comparative advantage over banks by expanding the role of securities in Japan's capital markets. Although banks would have been able to deal in securities through subsidiaries, a broad definition of securities still would have benefitted the securities industry in three ways. It would have completely blocked smaller banks, which could not afford the expense of establishing a subsidiary for securities dealings, with the possible exception of participation in private placements. Furthermore, banks' securities subsidiaries would have been temporarily limited in the scope of their securities activities, and therefore be less competitive. Finally, through the redefinition of "security," it would have been possible to shut banks out of existing

225. See SECURITIES REPORT, supra note 3, at 155-56.
226. See id.
227. See supra note 118 and accompanying text.
228. See SECURITIES REPORT, supra note 3, at 155.
229. See infra notes 263-348 and accompanying text.
product markets in which they were already involved, such as the burgeoning commercial paper market.230

Second, the Securities Report called for a revision of the concept of what constitutes a public offering.231 The classification of a transaction as a public offering triggers disclosure obligations.232 Under the preamendment definition, any invitation to acquire securities made to a number of unspecified persons on equal terms was regarded as a public offering.233 The Securities Report argued that a variety of transactions made with informed investors should not be considered public offerings and hence excluded from disclosure requirements and other protective regulations.234 While this proposal did not have direct relevance to banking reform, it appears to have represented an effort by the securities industry to make securities, and thus securities companies, more accessible to investors.

Third, the Securities Report discussed the entry of banks into the securities business in a section euphemistically titled “Deliberations on Market Intermediaries.”235 Given the increasing variety of securities-related products, the Report conceded that “it is possible that, in certain exceptions, depending upon the type of securitization product, cases may develop where it may be appropriate to allow persons not engaged in the securities business to act as a market intermediary.”236 It also conceded that banks should be allowed to participate in private placements.237 The Securities Report even bowed to the inevitability of banks entering the securities market through subsidiaries.238

At this point, however, the Securities Report became less accommodating. It listed a number of specific concerns regarding the increased involvement of banks in the securities industry. These include: banks’ safety and soundness, conflicts of interest, self-dealing, and the possibility of banks acquiring undue influence over companies

230. See Round Table Discussion 2, supra note 96, at 23. The Securities Report does indicate that it would be appropriate to allow banks to continue dealing in commercial paper and certificates of deposit, even if they are reclassified as securities. SECURITIES REPORT, supra note 3, at 161. However, this issue clearly provides the leverage for future bartering with the banks over the details of the reform.
231. SECURITIES REPORT, supra note 3, at 158.
232. Id.
233. Id.
234. Id. An example of transactions which should be exempted from disclosure requirements are offerings made to less than fifty persons. Id.
235. Id. at 161.
236. Id. (author’s translation).
237. Id.
238. See id. at 163.
and the marketplace.\footnote{239} In order to prevent such negative side effects, the Securities Report made two proposals. First, it advised that mutual entry be a gradual process to prevent market confusion.\footnote{240} In particular, it recommended the creation of a legal prohibition on banks engaging in brokerage activities.\footnote{241} Second, although it did not use the term directly, the Securities Report called for an extremely strict system of firewalls to compartmentalize risk and prevent self-dealing.\footnote{242} If fully implemented, this network of firewalls would have negated much of the benefit which banks or other financial institutions might have hoped to derive from establishing a securities subsidiary.\footnote{243}

C. The Impact of the Reports

Both the Banking Report and the Securities Report were highly criticized. This criticism can be divided into three issues: (1) that the Reports failed to advocate true, meaningful reform; (2) that the substance of the Reports ignored some of the supposed goals of reform; and (3) that those proposals the Reports did make were too vague with respect to the details of reform.\footnote{244} Although both

\footnote{239} Id.
\footnote{240} Id.
\footnote{241} Id. at 164. This is one area where the recommendations of the Securities Report diverge from those of the Banking Report, which advocates only informal restrictions. Compare id. with \textit{BANKING REPORT}, supra note 3, at 18–19. The intent of the Securities Report is clear: once in place, a statutory prohibition on brokering by banks would be both harder to circumvent and far more difficult to remove than a mere regulatory understanding. \textit{See generally Round Table Discussion 1, supra note 3, at 87} (commentators agreeing it will take a long time before the restriction on brokering by banks is finally lifted).

\footnote{242} \textit{See SECURITIES REPORT, supra note 3, at 163.} The call for firewalls is not addressed solely to banks but to any parent subsidiary relationship where one entity is a securities company. \textit{See, e.g., Round Table Discussion 1, supra note 3, at 90–92} (discussing the firewall issue in general).

\footnote{243} \textit{See Round Table Discussion 1, supra note 3, at 90–92.} Doubtless this is precisely what the securities industry wanted. \textit{See Özume kin'yū seido kaikaku 3: Danko hantai no uragawa, shōkenkai ni tadayou kyodatsukan, supra note 198, at 7.} Some of the proposed firewalls reflect legitimate concerns, such as a parent making imprudent investments in order to prop up a failing securities subsidiary. Other firewalls, however, appear more concerned with making securities subsidiaries as unattractive as possible to prospective entrants into the securities business. For example, some firewalls would prevent parent companies from granting favorable terms (e.g., for loans) to their securities subsidiaries or their customers, parents and subsidiaries doing business on the same premises, and interlocking directorships. \textit{Round Table Discussion 1, supra note 3, at 90–92; see also Round Table Discussion 2, supra note 96, at 27–28} (discussing firewalls in connection with market competition).

\footnote{244} Criticism of the Reports began even before they were officially released because their contents were known beforehand. \textit{See, e.g., Kinseichō hōkoku an: Gyōkai e no hairyo yūsen,
Reports repeatedly stressed the need for more competitive financial markets, neither provided a clear guideline, as observers had hoped, regarding what kind of competition should be engendered on the road to reform. Should there be completely free competition sacrificing weak and inefficient institutions? Should competition be encouraged only to the extent that such institutions would not be eradicated, or should there be some intermediate alternative?\footnote{245} Although the Banking Report briefly refers to the need for competition, stating that "to support the present system is rather to protect the vested interests of existing financial institutions of each sector,"\footnote{246} nothing within the Report suggests that these vested interests either could or should be seriously endangered by the proposed reforms. It is not surprising, therefore, that some observers regarded the proposed reforms as a continuation of the convoy system.\footnote{247} While the media generally recognized the need to avoid excessive confusion in the process of reform,\footnote{248} at least one commentator felt that the MOF's concern for \textit{kin'yū chitsujo} (financial stability) was misplaced.\footnote{249} Such criticism was hardly new; it had been made over ten years earlier, when the Banking Law was amended in 1981,\footnote{250} and perhaps indicated how little things had really changed.\footnote{251}
A second related and common complaint was that by focusing too much on the continued well-being of all sectors of the financial industry the Reports neglected the two other themes supposedly underlying the reform proposals: user needs and the internationalization of finance. Criticism that the convenience of financial consumers had been neglected was particularly widespread. Only a short section of the Banking Report was devoted exclusively to user benefits, and, while the Securities Report purports to be greatly with the opportunity to render the proposed reforms meaningless by refusing to grant licenses to subsidiaries when, in its view, doing so might threaten the stability of other institutions or the economy in general.

252. Kinseichō hōkoku an: Gyoikai e no hairyo yūsen, supra note 244, at 7; Sumiko Takahara, Tanka wo kitto to iwaretomo, ECONOMISUTO, July 15, 1991, at 92; Shinichiro Ohta, Ryoōsha Fuzai, Gyoikai ego ni shūshi shita kakine ronsō, ECONOMISUTO, July 15, 1991, at 95.

253. See, e.g., Kinseichō hōkoku an: Gyoikai e no hairyo yūsen, supra note 244, at 7 (criticizing the Report for excessive concentration on industry interests at the expense of users and other interests); Interview with Kii Nakamura [Vice President of Housewives’ Association]: Riyōsha mo shiken shōbu no toki, YOMIURI SHINBUN, June 15, 1991 at 7 (stating that the Reports’ focus on efficient competition will only benefit rich investors). At least some politicians apparently view this as an excellent opportunity to score some political points without doing much else about the problem. The chairman of the Liberal Democratic Party’s (LDP) own Financial Problem Research Council is critical of the report for its failure to deal with consumer needs. See, e.g., Tetsuo Kondo, Kin’ya seido kaikaku wa dare no tame ni okonawareru no ka, EKONOMISUTO, July 15, 1991, at 66. The LDP also sought to gain political recognition by proposing a more user-friendly, European-style banking system after it was already too late to actually alter the direction of reform. Emiko Terazono, Call for Japan Banking to Adopt European Style, FIN. TIMES, May 20, 1991, at 17.

254. See BANKING REPORT, supra note 3, at 16. It is perhaps illustrative that the English translation of the Report states that “[u]sers’ benefits to be brought about by this revision of the financial system are discussed ... in the addendum.” Id. This addendum, however, was apparently so unimportant that it was not included in the translation. Examples of user benefits promised in this addendum include such basic ideas as improved service and varieties of products through increased competition and more assertive handling of housing loans by ordinary banks once they are able to acquire long-term capital. See, e.g., id. at 9 (advocating increased competition as a means to providing better service and more products). There was criticism that such matters should have been included directly in the body of the Report. See Ginkō, Shōkengai-sha ga kawaru: Yokin kakumei-shinshōhin kaikin de kakine kuzushi, YOMIURI SHINBUN, June 6, 1991, at 1; Kin’yū kaikaku no riten kyōchō, YOMIURI SHINBUN, May 26, 1991, at 1. It is also hardly surprising that the criticism that the institutions which have expressed the greatest concern for the needs of the user are also those which would be most disadvantaged by the reform: the long-term credit banks and the securities companies. See, e.g., Yoshio Matsumoto, Baransu kaku fugin no saiken hakkō gyōmu sannyū, EKONOMISUTO, July 15, 1991, at 88 (noting criticism of both the Banking and Securities Reports by a representative of the long-term banking industry). With respect to consumer protection, a senior BOJ official commented that excessive concern for consumer protection would create a counterproductive “moral hazard,” particularly if consumers and institutions knew that they would always be aided by the government “whatever risk they take.” Financial Regulators Split on Benefits of Japanese Financial Restructuring Plan, Banking Report (BNA) No. 22, at 969 (June 1, 1992). Why this would be different from the current system—in which institutions, rather than consumers, know that the government will step in to
concerned with protecting investors, the sincerity of this concern appears to be questionable.

Similarly, the internationalization of the financial system was addressed only in very general terms, despite being one of the primary reasons why reform had become necessary. The Banking Report made two extremely nebulous recommendations regarding the subject, namely that "consideration should be given to ensuring smooth entry of foreign financial institutions . . ." and that "the process of liberalization and internationalization needs to be furthered by reviewing the existing vertically divided system and customs stemming from it." In addition, one observer noted that the various conditions and stipulations exhorted by both Reports, if implemented, would only make the system even more opaque to outsiders. Certainly, there was scant praise from foreign observers for the proposed reforms.

Another grievance with the Reports was that they made few concrete proposals and were often in disagreement when they did. As one foreign commentator noted, the Reports had "a long way to go before agreeing on the basics, let alone the details." In addition, language in some crucial places was deliberately ambiguous, sparking renewed skirmishes over interpretation.

Finally, observers also acknowledged that the Financial System Reform Council and the Securities and Exchange Council left most of the difficult problems for the MOF bureaucrats to solve. To some,
this outcome may seem unusual, considering that the Reports were issued by advisory bodies attached to the same ministry. In fact, the discrepancies between the Reports are symbolic of the frequent criticism that the MOF is “all bureaus and no ministry.”

V. WHAT, IF ANYTHING, HAS BEEN ACCOMPLISHED?

A. The Financial System Reform Act of 1992

Nearly a year after the release of the Banking and Securities Reports, the Japanese cabinet finally agreed upon a proposed financial reform bill. It was submitted to the Diet on March 17, 1992 and passed into law largely unamended two months later. The Financial System Reform Act is comprehensive, containing amendments to sixteen existing statutes, including the laws governing most types of financial institutions, with the notable exception of insurance companies. The Financial System Reform Act does not contain anything that should surprise anyone familiar with the deliberations of the two reform councils. Nevertheless, it diverges from the Securities and Banking Reports in several small but significant respects. Consequently, it is worthwhile to review the main provisions of the new law that pertain to the banking and securities industries and to compare them to the recommendations contained in the Banking Report and Securities Report.

1. Impact on Banking Industry. First, the Financial System Reform Act expands the definition of a bank’s primary activities from “acceptance of term deposits” (teiki tsumikin no ukeire) to “acceptance of term deposits, etc.” (teiki tsumikin nado no ukeire). Second, the accommodation of the two Reports would probably be difficult; Ohta, supra note 252; Kin’yu kaikaku okura an: Shōtorishin to nao zure mo, YOMIRI SHINBUN, Apr. 26, 1991, at 7 (describing the difficulty of reconciling the Banking and Securities Reports because the parties involved had conflicting interests).

262. See Kin’yu kaikaku okura an: Shōtorishin to nao zure mo, supra note 261, at 7.


264. FINANCIAL SYSTEM REFORM BILL, supra note 4.

265. See supra notes 4-5 and accompanying text.


267. BANKING LAW art. 10(1)(i), Law No. 59 of 1981, amended by FINANCIAL SYSTEM REFORM ACT, Law No. 87 of 1992. The term “nado” is equivalent to “etcetera” in English. Although there has been virtually no comment on this apparently minor semantic change, it seems clear that the addition of “nado” to the list of banks’ primary activities opens the door to
Financial System Reform Act amends the Banking Law to permit all types of banks to participate in the private placement of securities in the secondary market. Third, the Financial System Reform Act adds a provision to the Banking Law granting the MOF the authority to establish capital-adequacy requirements and other standards for judging the financial health of banks. Fourth, and most significantly, the Financial System Reform Act enables banks and other depository institutions to establish securities and trust banking subsidiaries subject to the condition that they hold at least 50 percent of the shares of such entities. However, a rider to the Act stipu-

a vastly expanded interpretation of what those activities are.

268. Id. art. 10(2)(vi), amended by FINANCIAL SYSTEM REFORM ACT. Other types of financial institutions are granted the same permission. See SHINYÔ KINKO HÔ [CREDIT ASSOCIATION LAW] art. 53(3)(vi), Law No. 238 of 1951, amended by FINANCIAL SYSTEM REFORM ACT; WORKERS' BANKING INSTITUTION LAW art. 58(2)(xii), Law No. 227 of 1953, amended by FINANCIAL SYSTEM REFORM ACT; CHÛSHO KIGYÔ KYÔDÔ KUMIAI HÔ [LAW FOR SMALL BUSINESS COOPERATIVES] art. 9-8(2)(xi), Law No. 181 of 1949, amended by FINANCIAL SYSTEM REFORM ACT; NOGÔ KÔ KUMIAI HÔ [AGRICULTURAL COOPERATIVE LAW], art. 10(6)(vii), Law No. 139 of 1948, amended by FINANCIAL SYSTEM REFORM ACT; NÔRIN CHÔ KINKO HÔ [NÔRIN CHÔKIN BANK LAW] art. 13(1)(ix-ii), Law No. 42 of 1923, amended by FINANCIAL SYSTEM REFORM ACT; SHÔKÔ KUMIAI CHÔÔ KINKO HÔ [SHÔKÔ CHÔKIN BANK LAW] art. 28(1)(xii), Law No. 14 of 1936, amended by FINANCIAL SYSTEM REFORM ACT. Long-term credit banks also benefit from the change by article 17 of the Long-Term Credit Bank Law which makes the relevant sections of the Banking Law applicable to them. LONG-TERM CREDIT BANK LAW, art. 17, Law No. 187 of 1952.

269. BANKING LAW art. 14(2), Law No. 58 of 1981, amended by FINANCIAL SYSTEM REFORM ACT. The Banking Report recommended that in order to achieve a balance with other countries, and for administrative transparency, capital adequacy requirements should be specified by statute. See supra note 217 and accompanying text. It has been suggested by some that it is inappropriate to require banks only engaged in domestic banking to meet an international standard and that the flexibility granted by allowing the MOF to set standards was necessary. E.g., Yamashita Tomonobu, Kin'yû seido ni kansuru horitsu no seibi, SHÔI HÔMU, Aug. 15, 1992, 17, 18. This argument does not explain, however, why the rationales for a statutory capital-adequacy requirement are no longer operative.

270. BANKING LAW art. 16(2), amended by FINANCIAL SYSTEM REFORM ACT; FOREIGN EXCHANGE BANK LAW art. 9(8), Law No. 67 of 1954, amended by FINANCIAL SYSTEM REFORM ACT; WORKERS' BANKING INSTITUTION LAW art. 58(3), Law No. 227 of 1953, amended by FINANCIAL SYSTEM REFORM ACT; LONG-TERM CREDIT BANK LAW art. 13(2), Law No. 187 of 1952, amended by FINANCIAL SYSTEM REFORM ACT; CREDIT ASSOCIATION LAW arts. 54(15)-(16), Law No. 238 of 1951, amended by FINANCIAL SYSTEM REFORM ACT; LAW CONCERNING THE FINANCIAL ACTIVITIES OF COOPERATIVE ORGANIZATIONS art. 4, Law No. 183 of 1949, amended by FINANCIAL SYSTEM REFORM ACT; AGRICULTURAL COOPERATIVE LAW art. 11(16), amended by FINANCIAL SYSTEM REFORM ACT; NÔRIN CHÔKIN BANK LAW arts. 22(2)-(4), Law No. 42 of 1923, amended by FINANCIAL SYSTEM REFORM ACT. Note that in the case of shinkin banks, labor banks, agricultural and other cooperatives, only federations of these entities rather than individual institutions are permitted to acquire and own securities or trust subsidiaries. See sources cited supra. Because trust banks are ordinary banks empowered to engage in trust activities by a separate statute, authority for the acquisition of subsidiaries by trust banks is
lates that, for "the time being," licensing of bank securities subsidiaries will be conditioned on their not engaging in securities brokering.\textsuperscript{271} The same section of the Act also clarifies the rules governing bank ownership of foreign-incorporated trust and securities subsidiaries.\textsuperscript{272}

In addition, the Financial System Reform Act establishes that certain transactions between parent banks and their subsidiaries will be restricted or prohibited,\textsuperscript{273} although the creation of specific firewalls is left largely to administrative discretion.\textsuperscript{274} The Financial System Reform Act also allows smaller institutions, which are generally too small to establish full subsidiaries, to engage in certain trust and securities-related activities by themselves.\textsuperscript{275} Similarly, the Financial System Reform Act expands the scope of other activities in which the smaller banks and depository institutions are permitted to engage.\textsuperscript{276} Finally, as a possible indicator of the troubles experienced throughout the banking industry, the Financial System Reform Act amends the 1968 Law Concerning Amalgamation and Conversion of Financial Institutions by making it possible for all types of depository institutions to merge or convert to a more viable format.\textsuperscript{277} This will

\begin{itemize}
\item derived from the Financial System Reform Act's amendments to the Banking Law. See supra note 55 and accompanying text. The Act does not alter the Antimonopoly Law's basic prohibition on ownership of greater than 5 percent of a company's shares by a financial institution. Compare \textit{Antimonopoly Law} art. 11, Law No. 54 of 1947 with \textit{Financial System Reform Act} passim (containing no amendments in this area). This means that not only will subsidiaries have to be licensed by the MOF, but the parent companies will have to apply to the FTC for an exemption from the Antimonopoly Law's prohibition. \textit{Antimonopoly Law} art. 11, Law No. 54 of 1947; see Naka & Nakamura, supra note 266, at 4.
\item \textsuperscript{271}\textit{Financial System Reform Bill}, supra note 4, app., art. 19.
\item \textsuperscript{272}\textit{Banking Law} art. 16(4), Law No. 58 of 1981, amended by \textit{Financial System Reform Act}.
\item \textsuperscript{273} Id. art. 16(3), amended by \textit{Financial System Reform Act}.
\item \textsuperscript{275} E.g., \textit{Agricultural Cooperative Law} art. 10(7), (8), amended by \textit{Financial System Reform Act}.
\item \textsuperscript{276} Although a detailed discussion of the full extent of changes wrought by the Financial System Reform Act is beyond the scope of this Note, some examples of activities opened up to smaller institutions such as \textit{shinkins} and labor banks include dealings in local government and certain corporate bonds, safekeeping of valuables, and guaranteeing of debts. See, e.g., \textit{Labor Bank Law} art. 58(2)(vii), Law No. 227 of 1953, amended by \textit{Financial System Reform Act} (guarantee of liabilities); \textit{Credit Association Law} art. 53(8)(i), Law No. 238 of 1951, amended by \textit{Financial System Reform Act} (dealing with local government bonds); \textit{Law for Small Business Cooperatives} art. 9(8)(2)(xvii), Law No. 181 of 1949, amended by \textit{Financial System Reform Act} (safekeeping deposit of valuables). Note again that the Act repeals the \textit{sōgo} Bank Law. See supra notes 47–48 and accompanying text.
\item \textsuperscript{277} \textit{Law Concerning Amalgamation and Conversion of Financial Institutions} arts. 3, 4, Law. No. 86 of 1968, amended by \textit{Financial System Reform Act}. Under the
presumably make it easier for the MOF to save troubled institutions by encouraging them to merge with healthy ones.

2. Impact on Securities Industry. With respect to the securities industry, the Financial System Reform Act makes substantial changes which are largely outside the scope of this Note. Briefly, the Financial System Reform Act permits securities companies to establish trust and banking subsidiaries,\(^278\) gives a more complete definition to the term "private placement,"\(^279\) and expands the definition of "security," although without providing a thorough American-style statutory definition as recommended by the Securities Report.\(^280\) The Financial System Reform Act also establishes new and more stringent disclosure rules and generally establishes a more well-defined legal structure for securities transactions.\(^281\) Under its amendments to the Securities Transaction Law, the Financial System Reform Act permits banks to act as intermediaries for some of the instruments that the Act newly designates as securities.\(^282\)

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\(^{278}\) Securities Transaction Law art. 43(2), Law No. 25 of 1948, amended by Financial System Reform Act.

\(^{279}\) Id. art. 2(8)(vi). The amendments clarify that private placements are "securities activities" for legal purposes, but that banks may, with the MOF's permission, participate in private placements. Id.

\(^{280}\) Securities Transaction Law art. 2(1), (2), Law No. 25 of 1948, amended by Financial System Reform Act; Securities Report, supra note 3, at 155–57. In fact, apart from a few specific instruments such as commercial paper, the definition of security is expanded only to the extent that the Act lists a number of instruments that may be designated as securities by administrative order some time in the future. Financial System Reform Act, amending Securities Transaction Law art. 2(1), (2). An example of such a provision is as follows: "[t]he term 'securities' in this law shall mean those as mentioned in the following: . . . (viii) Those promissory notes issued by a judicial person in order to procure necessary funds for its business as may be designated [as securities] by Ministry of Finance Order." Financial System Reform Act, amending Securities Transaction Law art. 2(1)(viii) (author's translation)(emphasis designates amendment). Some industry insiders have voiced dissatisfaction over the legislation's disregard for the recommendations of the Securities Council in this regard. Tokumei Zadanka: Tōshō no kaikaku no rinen to kairi shite inai ka?, Kin'yū Zaisei Jūō, Apr. 20, 1992, at 18 [hereinafter Round Table Discussion 4].


\(^{282}\) Id. art. 65, 65(2), amended by Financial System Reform Act.
B. New Factors Affecting Reform

Three important factors must be kept in mind when looking at the Financial System Reform Act as the end product of the reform process: (1) the manner in which the Financial System Reform Act is to be implemented; (2) the effects of changing economic conditions within the financial industry; and (3) the role of recent financial scandals in shaping the reform process.

1. Implementation: The MOF Tightens its Grip. Financial "reform" has not been in any way synonymous with "deregulation" or "liberalization" as some originally thought. Amended Articles 16–2 and 16–3 of the Banking Law make this perfectly clear. These articles leave a great deal of discretion to the MOF, either directly through the grant of rulemaking authority or indirectly through the MOF's ability to interpret the etceteras and ambiguous language. These two provisions also set the tone for the entire Financial System Reform Act. For every new sphere of activity the Financial System Reform Act makes available to the different types of financial institutions, the more the MOF is granted the gatekeeping power to regulate entry into the sphere and the authority to fine tune activities within this sphere. In effect, the Financial System

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283. See Sender, supra note 161, at 131 ("To MOF officials the very term deregulation sounds ... too messy ...; they prefer 'rationalization' or 'consolidation' or even 'reregulation'.").

284. The text of the law reads as follows:

ARTICLE 16-2 (OWNERSHIP OF STOCK IN SECURITIES COMPANIES, ETC.)
A bank may, with the permission of the Minister of Finance, acquire and own a number of stocks (limited to those with voting rights) greater than 50 percent of the total number of outstanding shares in a securities company, trust bank, or other bank (limited to those designated by Ministry of Finance ordinances) . . .

ARTICLE 16-3 (TRANSACTION, ETC., WITH SUBSIDIARIES) A Bank may not engage in the following conduct with its subsidiaries, etc. . . . or customers (provided this may not be applicable in situations where the performance of the transaction in question is necessary for the public interest and permission has been received from the Minister of Finance):

1) Transactions with the subsidiary, etc., where its conditions are determined to be disadvantageous to the [parent] bank when compared to the bank's normal conditions for such a transaction.

2) [T]ransactions or activities [between a parent bank and its subsidiary or the subsidiary's customer] that are designated by Ministry of Finance Ordinances as potentially hindering the [parent] bank's sound and proper operations.

SECURITIES TRANSACTION LAW arts. 16(2), (3), amended by FINANCIAL SYSTEM REFORM ACT (author's translation) (emphasizes highlight discretionary elements left to the MOF).

285. As mentioned previously, the amendments to the definitional article of the Securities and Exchange Law leave the process of defining new types of securities almost entirely to MOF or Cabinet ordinances. See supra note 280 and accompanying text. The Act also adds a new requirement for a bank to obtain authorization from the MOF when it tries to establish a
Reform Act greatly expands the authority of the MOF to regulate financial institutions. This is an interesting result considering that the liberalization of finance was a primary motivation for the reform process.\textsuperscript{286}

On December 17, 1992, the MOF filled many of the gaps left in the Financial System Reform Act when it issued its blueprint for reform, titled "Concerning the Outline for the Implementation of Financial System Reform" (Outline).\textsuperscript{287} Projecting that implementation of the Financial System Reform Act will commence in April 1993, the Outline summarizes some of the regulations that the MOF intended to establish in order to implement the Financial System Reform Act.\textsuperscript{288} First, securities subsidiaries of banks will not be permitted to engage in the issue, distribution, or brokering of most forms of equity securities.\textsuperscript{289} Similarly, trust bank subsidiaries will be

\textsuperscript{286} See Kazumi Akiyama & Akio Nakamura, Kin'yū seido oyobi shaken torihiki seido no kaikaku no tame no kankei hōritsu no seibi nado ni kansuru hōritsu ni tsuite, JURISUTO, Sept. 1, 1992, 129, at 131.

\textsuperscript{287} Reform Outline, supra note 274, at 107. Immediately before publication of this Note, a number of MOF and cabinet ordinances implementing the details of the Financial System Reform Act were issued. Due to the timing, quantity, and scope of these ordinances a detailed analysis of their content is impossible. A preliminary examination, however, indicates that they are largely consistent with the proposals contained in the Reform Outline: minimum capitalization of securities companies was raised to ¥10 billion; minimum capitalization requirements of most other types of financial institutions were doubled or significantly raised; detailed rules pertaining to firewalls, securities transactions, etc., were also established. See generally KANPO, Mar. 3, 1993 (Special Edition), at 1-127.

\textsuperscript{288} Id.

\textsuperscript{289} Id. Specifically, securities subsidiaries of banks will not be permitted to deal or broker convertible bonds, warrant bonds, and warrant securities. Id. They are prohibited from all dealings, including underwriting, in stocks, stock index futures, and stock index options. Id. This effectively limits banks' securities subsidiaries to dealing in bonds, investment securities, and primary market transactions involving convertible bonds and warrants. Id. A question that remains unanswered is what will happen if, instead of establishing a securities subsidiary, a bank acquires a majority interest in an existing brokerage house. The MOF has indicated that, with very limited exceptions, the FTC would deem such a transaction anticompetitive and refuse to grant an Antimonopoly Law Article 11 exemption. See Naka & Nakamura, supra note 266, at 4. This approach avoids a specific answer to the difficult question of whether a securities house acquired by a bank in this manner would be allowed to continue its brokerage activities. The MOF has held out the possibility of participating in the full range of securities activities through an acquired subsidiary as a carrot to enlist the aid of banks in bailing out Japan's many troubled smaller securities firms. See Bankers' Embrace, ECONOMIST, Nov. 28, 1992, at 88. But see David Sneider, Financial Services Reform in Japan, INT'L SEC. REG. REP., Feb. 9, 1993, at 6 ("MOF has made it clear that acquisitions [of existing securities firms] will not be approved except in a 'rescue' context."). Because the Act only requires a majority interest, another question that remains is whether the MOF will permit banks to establish jointly-owned subsidiaries, with a
restricted in the scope of trust activities in which they may engage.  

The MOF will, however, in two or three years, reconsider the scope of activities in which subsidiaries are permitted to engage.

The Outline also establishes a large number of firewalls. These include restrictions on personnel exchanges between parent and subsidiary, dealings with common clients, transactions between parent and subsidiary, and the shared use of facilities.

As for the timing of mutual entry, the Outline will allow long-term credit banks, trust banks, and central cooperatives, such as the Nōrin chūkin Bank, to establish securities subsidiaries first. Securities companies, long-term credit banks, the Bank of Tokyo, and the national federations of specialized financial institutions will have priority in establishing trust subsidiaries. One year after these institutions have established subsidiaries, the MOF will consider allowing other banks (i.e., city banks) to set up their own subsidiaries. Finally, the Outline eliminates the “three bureaus guidance” controls on foreign bond issues and raises the minimum capitalization requirements for banks and securities companies to ¥20 billion and ¥100 billion respectively.

Although the Outline substantially clarifies the content of the Financial System Reform Act, it nevertheless leaves several details undefined, particularly concerning the question of firewalls. Thus,
the Outline itself will have to be further clarified before anyone can begin to consider establishing a subsidiary.

2. More Bad Times. Times have changed since Japan’s financial industries first began developing new products and expanding into new fields of activity. Many of the economic factors that originally stimulated reform are no longer operative. The bursting of the bubble economy and consequent plummeting of share and land prices have had serious consequences throughout the Japanese economy.\(^{298}\) The financial industry has been hit particularly hard by “Japan’s monetary implosion.”\(^{299}\)

The magnitude of banks’ bad debt problems came to light at the peak of the reform process. Many banks are saddled with a huge portfolio of nonperforming loans,\(^{300}\) collateralized primarily with illiquid real estate whose value has sunk drastically.\(^{301}\) The drop in

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298. See, e.g., Corporate Japan Attempts Another Rebirth, ECONOMIST, Nov. 21, 1992, at 75. (“[F]or the third time since the second world war, Japanese business is facing massive and painful readjustment.”); Japanese Banks: From Bad to Worse, ECONOMIST, Nov. 7, 1992, at 99 (“Japanese firms now face their third year of declining profits. . . . Businesses with net debts totalling 5.2 trillion yen went bust in the first nine months of 1992.”).


300. Estimates of the extent of these loans vary greatly. See, e.g., Martin, supra note 29, at 16 (citing MOF estimates that Japan’s top twenty-one banks hold ¥7-8 trillion in loans); Japan’s Monetary Implosion, supra note 299, at 75 (estimating bad loans held by banks at up to ¥60 trillion yen).

301. See Martin, supra note 29, at 16. See generally Bad-Debt Troubles, ECONOMIST, Sept. 14, 1991, at 97, 98 (explaining that banks used non-banks to bypass official restrictions on loans to property companies); Deep in Bad Debt, ECONOMIST, Nov. 2, 1991, at 70, 72 (noting problems arising from property lending). When property prices were booming in the 1980s, in order to circumvent restrictions on bank lending to real estate companies, banks lent money to nonbank affiliates which in turn lent heavily to real estate speculators. Once land prices fell, the banks were left holding the bag. See Japan’s Non-banks: What a Mess, ECONOMIST, Oct. 26, 1991, at 96, 98; Martin, supra note 29, at 16. The bad debt problem has reached such a magnitude that in January 1993, under government auspices, the banking industry established the Cooperative Credit Purchasing Company (CCPC). See Robert Thomson, Restoring Faith in a Banking System—Japan’s CCPC will Tackle the Industry’s Problems, FIN. TIMES, Jan. 28, 1993, at 20. Similar in function to the United States Resolution Trust Corporation, the CCPC will buy up property used as collateral for bad loans. See Much Ado About Nothing, ECONOMIST, Nov. 7, 1992, at 99. While it was originally envisioned that the government would help fund this corporation, it ultimately did not, thus rendering the whole operation little more than an accounting artifact. See id. The nonbanks and MITI are reportedly discussing the establishment of a similar institution to buy up the bad loans of nonbanks. Agency Proposed to Protect Investors in Leases and Credits, Comline Daily News-Tokyo Financial Wire, Dec. 11, 1992, available in LEXIS, Nexis Library, COMLIN File.
share prices has similarly had direct, negative effects on banks.\textsuperscript{302} Furthermore, the overall economic climate has seriously affected the ability of banks to make a profit. Troubled companies are drawing down their deposits\textsuperscript{303} and stagnant loan growth means that it will be difficult for banks to increase lending, which has been their traditional technique for offsetting bad debts.\textsuperscript{304} Securities companies have similarly been battered by the collapse of stock prices, and all but the largest are currently operating at a loss.\textsuperscript{305}

As a result of these economic woes, banks and other financial companies are going bankrupt,\textsuperscript{306} restructuring,\textsuperscript{307} cutting personnel,\textsuperscript{308} and reducing the scope of their overseas activities.\textsuperscript{309} Given the present economic climate and the substantial barriers to, and limitations on, the establishment of subsidiaries, few financial institutions have any interest in taking such action.\textsuperscript{310} Most are

\textsuperscript{302} See supra note 167 and accompanying text. Apart from the obvious economic loss caused by the drop in share prices, and because banks are allowed to count up to 45 percent of unrealized capital gains (hidden assets) towards meeting the new international capital adequacy requirements, any drop in the stock market hinders a bank's ability to fulfill these requirements. See Japan's Banks Count Their Capital, ECONOMIST, Feb. 8, 1992, at 82; Japanese Shares: Not What They Used to Be, ECONOMIST, Jan. 25, 1992, at 79, 80.

\textsuperscript{303} Japan's Monetary Implosion, supra note 299, at 75.

\textsuperscript{304} Bad-Debt Troubles, supra note 301, at 98. See generally Lending by Japan's Banks Grows 2.0\% in Jan., Japan Econ. Newswire, Feb. 9, 1993, available in LEXIS, Nexis Library, JEN File (loan growth continued to be slow and the limited growth that did occur was attributable to relief loans to troubled companies rather than loans for capital investment). The requirement that banks meet the BIS 8 percent capital-adequacy requirements that are scheduled to come into force in March 1993 have also restrained banks' ability to expand lending. See BIS Rule Restained Bank Lending in FY '91, Sources Say, Japan Econ. Newswire, June 4, 1992, available in LEXIS, Nexis Library, JEN file; Japan's Banks Count Their Capital, supra note 302, at 82.

\textsuperscript{305} Japanese Shares: Not What They Used to Be, supra note 302, at 80; see also Bankers' Embrace, supra note 289, at 88.

\textsuperscript{306} In 1991 Japan's Deposit Insurance Corporation was, for the first time since its inception in 1971, called on to bail out a troubled bank by financing its merger with another bank. See Japanese Banks: More Pain, ECONOMIST, May 9, 1992, at 105. A second bailout took place in spring of 1992. Id. Because the MOF has previously been able to "encourage" banks to assist troubled comrades without relying on the Deposit Insurance Corporation, these events indicate a breakdown of the traditional informal safety net. See, e.g., Sender, supra note 161, at 135.

\textsuperscript{307} See, e.g., Emiko Terazono, Leading Japanese Bank to Restructure, FIN. TIMES, Sept. 4, 1992, at 21. Some of the smaller securities companies are reported to be considering mergers in order to survive. Bankers' Embrace, supra note 289, at 88.


\textsuperscript{310} See Japanese Savings: Safe as Post Offices, ECONOMIST, Dec. 26, 1992, at 100. ("Banks . . . are no longer in a hurry to enter the securities business, which is conspicuously unprofitable
concerned with mere survival. In fact, insiders from each financial sector have indicated that they would prefer to see the reform process frozen for the next one or two years.311

3. Scandals. Recent financial scandals have been an important factor in the process of financial reform. During the summer of 1991, when the Financial System Reform Council issued its Banking Report, a number of scandals within the financial industry came to light. Scandals involving large securities houses were perhaps the most egregious. Nomura Securities was eventually punished for financing the securities transactions of organized crime leaders, compensating favored clients for losses, and manipulating the market.312 Several prominent banks were also involved in a highly publicized scandal in which bank employees issued forged certificates of deposit to a restaurant owner who used them as collateral to borrow ¥240 billion worth of loans, which she spent on stock speculation before going bankrupt.313 These highly publicized scandals called into doubt the ability of the MOF to control the financial industries through informal
The scandals also brought the FTC, until recently dubbed "the watchdog that never bites," into the field of administrative financial regulation, and thus into the MOF's territory. The scandals highlighted the lack of transparency in the MOF's administration of financial markets. As stated by David Mulford, United States Treasury Undersecretary for International Affairs, the difference between recent financial scandals in Japan and the United States is that rules were clearly broken in the United States, whereas there were no clear rules in Japan. Finally, the scandals hurt the securities companies economically, especially through the loss of customers who had begun to doubt the integrity of the stock market.

C. Analysis

It is still too early to pass final judgment on the Financial System Reform Act. At the time of this writing, implementation of the Financial System Reform Act has just begun. Many issues remain to be worked out, and in the coming months, new and unforeseen developments will undoubtedly arise. In addition, financial reform will not be complete until other sectors of the financial system are addressed. Although the Financial System Reform Act will have a significant impact on the trust banks, it does not significantly alter the pre-World War II Trust Business Law and Trust Law which need to be updated to reflect a host of new trust-related products. The insurance industry is also suffering from its own economic problems that need to be addressed, as do those of the nonbanks.
form of the postal savings network will also be crucial if the Financial System Reform Act is to have any meaningful impact.\textsuperscript{321} True change, therefore, is projected to take several years. Nevertheless, this examination of the progress of financial reform to date merits some comments, albeit from an outsider's point of view.

Compared to England's "Big Bang" financial reform\textsuperscript{322} of several years ago, the Financial System Reform Act is a dull thud at best. Yet, given the recent turn of events this is hardly surprising. The almost exclusive delegation of authority to the MOF to implement the Financial System Reform Act and to define its terms reflects the concerns of the Act's drafters, the MOF officials.\textsuperscript{323} Accordingly, it is possible to interpret the final shape of the Financial System Reform Act in two different ways. The more charitable interpretation is that MOF officials, faced with a financial crisis of historic magnitude, felt that the only way to reform the financial system without causing an economic calamity was to retain firm control over the speed and

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320. See Japan's Non-banks: What a Mess, supra note 301, at 96. A MOF advisory panel was set up in October 1991 to discuss reform in the nonbank industry, and numerous new rules regulating nonbanks were passed contemporaneously with the Financial System Reform Act. Japan Still Shies From Embracing ABS, MORTGAGE-BACKED SECURITIES LETTER, July 6, 1992, available in LEXIS, Nexis Library, IDD File; Yoko Kobayashi, Japan Panel Proposes Tighter Rules for Non-banks, Reuters, June 15, 1992, available in LEXIS, Nexis Library, OMNI File; Neil Weinberg, Nonbank Institutions in Japan to be Supervised Although the Heavy Damage is Already Done, 2 THOMSON'S INT'L BANKING REGULATOR, July 6, 1992, at 3, available in LEXIS, Nexis Library, INTREG File. It was also reported that the MOF was planning to establish a section within its Banking Bureau to monitor nonbanks. Japan MOF to Set up Section to Monitor Non-banks, Reuters, June 29, 1992, available in LEXIS, Nexis Library, OMNI File.

321. Because of its status as a government controlled institution, the postal saving network is able to offer interest rates and terms to individual depositors with which banks cannot compete. See Japanese Monetary Growth: Slow, However You Slice It, ECONOMIST, Oct. 19, 1991, at 96. In addition to their competitive advantage postal accounts are reliable. Thus, as a result of the financial scandals and rising concern about the health of many financial institutions, money has been flowing into postal coffers at a phenomenal rate: ¥10 trillion during the period of June 1991 to April 1992. See A Better Deal for Customers?, ECONOMIST, Apr. 4, 1992, at 100. The existence of the postal savings network distorts the financial marketplace by rewarding risk-adverse behavior. See generally Japanese Savings: Safe as Post Offices, supra note 310, at 100 (noting the advantages of deposits in the postal savings system over private banks).

322. In October 1986, the British government carried out a sweeping reform, the "Big Bang" of the British financial system, including the complete removal of the wall between banking and securities activities. DEREK F. CHANNON, GLOBAL BANKING STRATEGY 238–40 (1988).

323. In Japan, "most legislation is drafted and sponsored by the concerned ministries. . . ." 2 DOING BUSINESS IN JAPAN § 3.02[2][c] (Zentaro Kitagawa ed., 1992). The Prime Minister of Japan is empowered to represent the cabinet and thus the Ministries in submitting bills to the Diet. KENPO [Constitution] art. 72 (Japan).
direction of change. Under this view, the MOF's concern for the continued health of existing financial institutions and the economy in general has resulted in the MOF's slow and cautious implementation of the Financial System Reform Act.

A less generous interpretation of the Financial System Reform Act is that deregulation of some aspects of the financial system such as interest rates, the globalization of Japanese financial markets, the spontaneous expansion of the activities of Japanese banks at home and abroad, and the damage caused to the MOF's prestige by the scandals of 1991, together constitute a serious threat to the MOF's dominance in the field of financial regulation. The Financial System Reform Act may be seen as a brilliant maneuver by the MOF to regain control. By granting privileges to engage in new areas of business to each type of financial institution with one hand and tightening its grip on the whole system with the other the MOF is subjecting these privileges to its own administration. Similarly, the MOF had to ensure that its constituents, the financial institutions, remained stable throughout the reform in order to prevent a challenge to its authority to administer them.

Both of these interpretations are probably correct to a certain extent. Financial reform, however, was not supposed to be about protecting the authority of the MOF. Furthermore, when the Financial System Reform Act is viewed together with the Banking and Securities Reports, several problems become apparent. First, many of the buzzwords repeatedly used by the reformers—"financial liberalization," "internationalization," and "user convenience"—were nothing more than that, buzzwords. As noted previously, given the amount of control the MOF will have over the reform process, "liberalization" is not the best description of the Financial System Reform Act. Similarly, nothing about the Financial System Reform Act makes it readily apparent that its drafters were concerned with the increasingly international nature of Japan's financial markets. The only significant proposal in the Banking Report that had a specific international orientation, the statutory imposition of the BIS capital-adequacy standards, was ignored.

324. See Kinseicho hōkoku an: Gyōkai e no hairyo yūsen, supra note 244, at 7. Participants in the discussion wished that the legislators had kept the original objectives of reform in mind during the process of enactment. See Round Table Discussion 4, supra note 280, at 21.
325. See supra notes 283–86 and accompanying text.
326. See supra note 217 and accompanying text.
Furthermore, "user convenience" must have a hollow ring to many in Japanese financial circles. After all, under the Financial System Reform Act, consumers may soon hypothetically walk into the local branch of the Industrial Bank of Japan Securities Co. to purchase one hundred shares of NEC, only to be told politely that as a long-term credit bank securities subsidiary, it is not currently permitted to engage in brokering. In the business context, it also remains to be seen whether companies will actually be interested in doing business with a securities company that can underwrite bonds but not securities, can participate in private placements but not actually sell stocks, and so on. If not, it is difficult to see how subsidiaries can develop a customer base while they wait to be allowed to expand into other spheres of activity.

The only consistent desire on the part of the reformers appears to have been that reform be gradual and that no institutions be sacrificed in the process. A comparison of the Banking Report, the Financial System Reform Act, and the Outline best illustrates this aspiration. As noted above, the Banking Report discusses internationalization, financial liberalization, securitization, and user needs at great length. However, it only makes a few proposals of secondary importance. The Statement of Reasons at the end of the Financial System Reform Bill also explains the need to expand the activities of financial institutions and reform the securities laws to protect investors and depositors by ensuring the sound management of financial institutions, encouraging efficient competition, and establishing a financial system that can interact with those of other countries. In contrast, the Outline makes little mention of protecting either investors or foreign markets. It does, however, frequently refer to "the soundness of securities companies," "the healthy development of capital markets," and "disciplined entry" into new spheres of business.

This is not to suggest that the stability of institutions is not a legitimate concern or that the MOF has completely ignored other

327. See generally Kukyō no shōken makikaeshi kenmei, ASAHI SHINBUN, Dec. 13, 1992, at 3 (citing fears that true reform leading to financial liberalization from the point of view of user convenience will be effectively stymied by the turf battles of the banks and securities companies).
328. See FINANCIAL SYSTEM REFORM ACT, supra note 5, app., art. 19.
330. See generally supra notes 248–51 and accompanying text.
331. See FINANCIAL SYSTEM REFORM BILL, supra note 4, at 68.
332. Reform Outline, supra note 274, at 107.
333. Id.
334. Id. at 109.
aspects of reform. From across the Pacific, it is easy to suggest that troubled institutions should be allowed to fail. Yet, as noted by one observer, “Japan lacks the safety net of a sturdy deposit insurance system. . . . To allow banks to fail in this environment would be to risk panic.”335 A wave of bank failures in 1927 and the resulting economic and political chaos were factors in both the pre-World War II rise of the militarists and the concentration of financial resources under the control of a few large banks which came to serve their cause.336

Nevertheless, by focusing on protecting financial institutions, the MOF may have inadvertently destroyed the spirit of financial reform. As we have seen, the cost and inconvenience to financial users of raising capital at home was one factor in the flight of Japanese money overseas. It is debatable whether the MOF has done much to alleviate this situation. Similarly, Japan's financial system has become a very important part of the world economy. Accordingly, just as the current economic problems of Japan’s banks are having an impact worldwide, failure to adequately address the international aspects of financial reform is also likely to have global repercussions.337

Additionally, insofar as reform was inevitable, the securities industry may have lost the battle but appears to have won the war. From the terms of the Financial System Reform Act, the securities companies would appear to have been the biggest losers. One of the securities industry's most important proposals, a unified definition of security, was not included in the Financial System Reform Act. In addition, the securities scandals, coming at the peak of reform activities, forced the MOF to shift the focus of reform more onto cleaning up the securities industry.338

335. Rosenbluth, supra note 43, at 100.
338. One securities industry insider has noted that due to the scandals, both the MOF and the industry have shunned the close communication which previously existed between them, resulting in disadvantageous treatment of the industry in the final stages of drafting the Act. See Shôichirô Shimamura, Kannenron ni ikkoku no shôrai wo yudanete yoi no ka, KIN’YÛ ZAISEI JIJÔ, Dec. 7, 1992, at 32; Kukyô no shôken makikaashi kenmei, supra note 327; see also Round Table Discussion 4, supra note 280, at 18 (noting that the timing of the scandals was “unfortunate”). Further evidence of the security industry’s downfall is found in news that shortly after the Act was passed, the MOF announced a radical reorganization of its Securities Bureau, with many high
Yet by virtue of its very weakness, the securities industry appears to have won the war at the implementation stage. As described above, the MOF has structured the details of the Financial System Reform Act so as to protect the battered securities companies as much as possible. The activities of bank securities subsidiaries are to be severely restricted for the foreseeable future, and strict firewall requirements and extremely high minimum capitalization requirements ensure that entry into the securities business will be an unattractive prospect for most. Trust subsidiaries have been similarly hobbled. The city banks, the only banks that still have the capability and motivation to establish subsidiaries, are being prevented from doing so for the time being. This is being done precisely because the city banks presented the most serious competitive threat to existing securities companies.

VI. CONCLUSION

Reform has thus become a tool for protecting sectors of the industry in distress. Some banking industry analysts have adjudged the Financial System Reform Act as merely being “aimed at rescuing troubled banks and brokerages by encouraging them to merge.” This itself is clearly a worthwhile goal and is a continuation of a trend that was being encouraged by the MOF before passage of the Act.
Looking back at the Banking and Securities Reports, however, one is reminded that financial reform was supposed to do more. By using the Financial System Reform Act almost exclusively as a means of accomplishing immediate, utilitarian goals, the MOF has rendered the reform process legally incoherent. Instead of lowering walls between different segments, the MOF has created whole new categories, albeit temporary, of mutant trust banks and emasculated securities companies, each subject to their own new rules. Rather than making the financial system more transparent by clarifying the regulatory structure, the Financial System Reform Act has rendered it opaque with its vague provisions that delegate substantive implementation to the MOF. And while banks that do want to expand into other fields of business are rebuffed, securities companies that have no desire to establish subsidiaries are faced with the prospect of being forced to do so.

In effect, the subsidiary approach as implemented by the MOF has essentially become the piecemeal approach that was rejected by the Banking Report because it "would make it difficult to pursue a consistent and far-reaching mutual entry and would not make it possible to build an internationally acceptable system that extensively promotes users' benefits." Recall that these are precisely the criticisms currently being leveled at the Financial System Reform Act and its implementation by the MOF.

Even if several years down the road, with the wave of mergers completed and the financial industry stabilized, subsidiaries are eventually permitted to engage in the full range of activities, it seems unlikely that the subsidiary approach will ever be more than a transitional device. Leaving politics and the self-interests of the parties aside, the ultimate goal of the reform, after all, is to allow banks and securities companies to participate in each other's markets. With this simple truth in mind it is difficult to rationalize, in jurisprudential terms, why a bank that is forbidden from engaging in certain activities can overcome this prohibition merely by establishing a wholly owned subsidiary. Furthermore, logic suggests that if the raison d'etre behind the adoption of the subsidiary approach was, as the evidence

emergence of "super" regional banks as a result); Tomio Shiba, Financial Industry Inches Near Deregulation, JAPAN ECON. J., Feb. 23, 1991, at 35 (table of expected financial liberalization in 1991 indicates the planned merger of over one hundred agricultural cooperatives).

346. Supra note 310 and accompanying text.
347. BANKING REPORT, supra note 3, at 20.
348. See Shimamura, supra note 338, at 33.
suggests, protection of existing institutions from the harmful side effects of mutual entry, then once mutual entry has been successfully achieved and the financial industry has reached a new equilibrium, subsidiaries should theoretically no longer be necessary. If this state of affairs does come to pass, the system of financial laws and regulations may again come to hamper the proper development of Japan’s capital markets, necessitating a new round of reforms.

Given the above, it seems that the Financial System Reform Act can only be the first step on the road to a universal banking system.349 If so, the current round of legal reforms is merely a beginning, a slow, tortuous detour planned by the MOF to ensure that everyone arrives safely one way or another. Reports of the demise of the convoy system, therefore, seem quite premature.350

Colin P.A. Jones

349. See, e.g., Bankers’ Embrace, supra note 289, at 90 (“The finance ministry has said that it is not yet ready for German-style universal banking in Japan, but this is what it may have to settle for.”).

350. E.g., The Convoy Scatters, A SURVEY OF WORLD BANKING (Supp.), in ECONOMIST, May 2, 1992, at 44, 47 (predicting the break-up of the “convoy system” due to the current financial crisis and ongoing financial reform).