Some Reflections on Proposals for Reinvigorating Japan's Securities Markets

Yasuyuki Fuchita

Why Do Japan's Securities Markets Need Reinvigorating?

Reinvigorating Japan's economy and industry versus reinvigorating its securities markets

The debate about how to reinvigorate Japan's securities markets, which has become increasingly heated since the stock market decline gained momentum in the autumn of 2000, took on a new note of urgency in January of this year when the Liberal Democratic Party set up a committee especially for this purpose.

The debate tends to focus on how to boost share prices, but any such action is unlikely to be successful if it does not include measures to deal directly with the macroeconomy and what companies are actually worth.

However, this does not mean that nothing needs to be done about Japan's securities markets. In fact, much of Japan's current economic and financial malaise can be attributed to the fact that the country's securities markets have not been reinvigorated. What is needed is not short-term measures to boost share prices but substantive action to reinvigorate the country's securities markets. In other words, another look needs to be taken at why (as was the aim four years ago when the then prime minister, Ryutaro Hashimoto, made his "Big Bang" speech) it is that the structure of Japan's money flow is still exactly the same. As we shall see, there is a close connection between the fact that Japan's markets and its economy are both still in the doldrums 10 years after the asset boom of the 1980s went into reverse and the fact that the promise to change the structure of the country's money flow has not been kept.

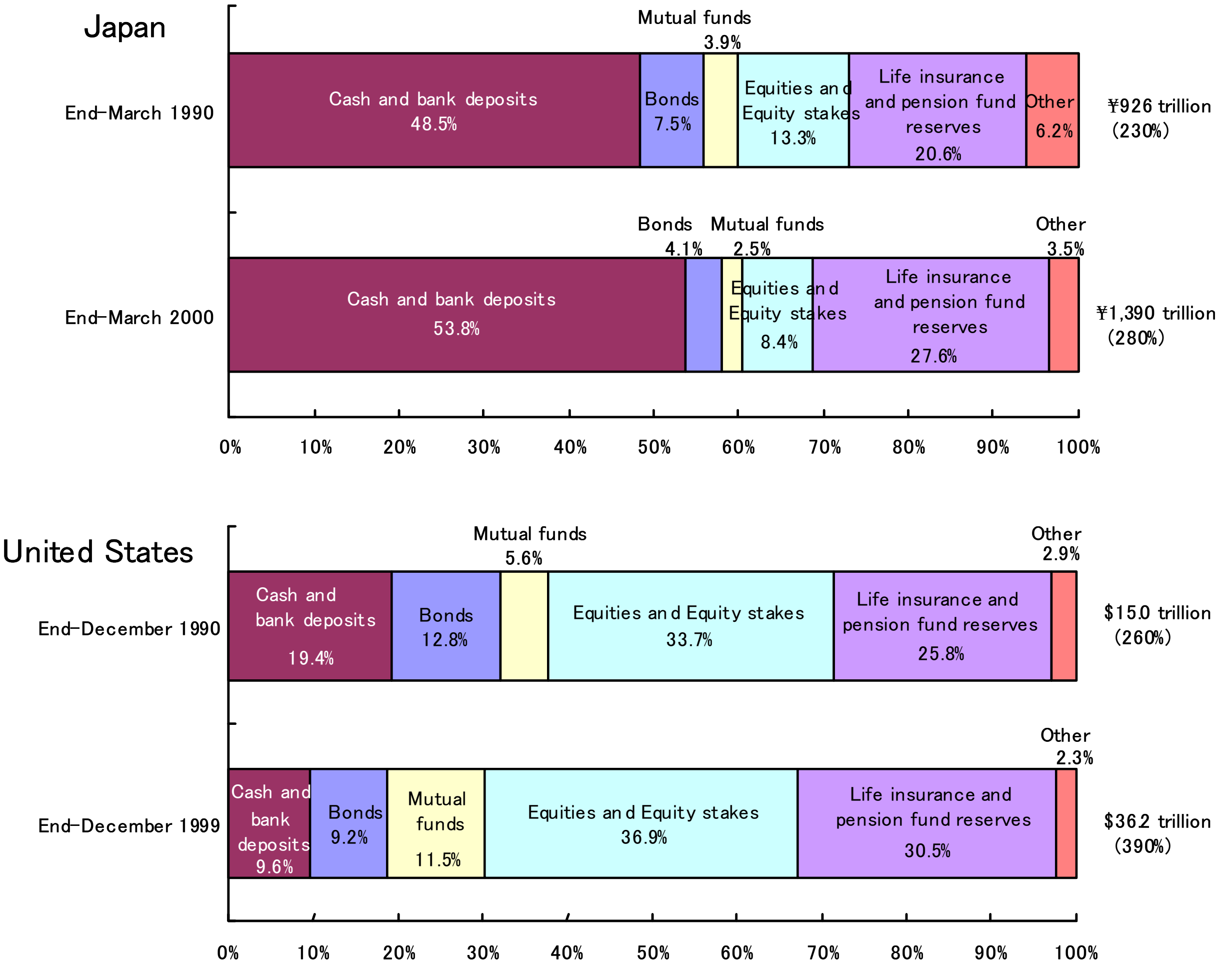
The structure of Japan's money flow

One of the main objectives of Big Bang when it was announced in November 1996 was to increase the flow of money via the country's securities markets, thereby complementing the flow of money via banks and life insurers.

However, more than four years later and not long before the deadline for achieving these objectives (March 2001), there are no signs that the flow of money via Japan's securities markets has increased. In fact, as can be seen in Figure 1, the amount of cash and bank deposits as a percentage of personal financial assets has increased more than that of securities over the past 10 years. Insofar as this runs contrary to the objectives of Big Bang, Big Bang can be said to have failed completely.

In their aversion to risk, individuals in Japan continue to hold most of their money in the form of bank deposits, while the banks, still suffering from the effects of bad loans, find themselves unable to take any risks and are therefore obliged to invest mainly in risk-free assets such as government bonds. As a result, Japanese industry and business have been deprived by the country's financial and capital markets of the growth opportunities they need, and both the economy and the markets are still in the doldrums (Figure 2). This, in turn, creates a vicious cycle whereby individual investors become even more averse to risk.

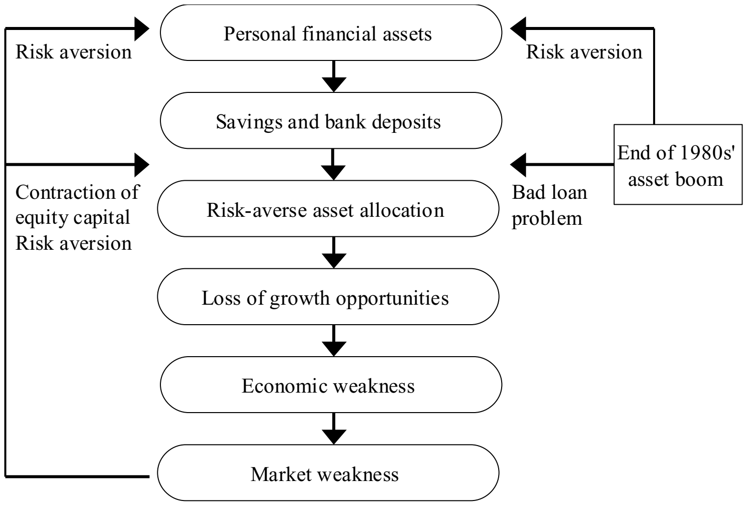
Figure 1 The Composition of Household Financial Assets in the US and Japan



Notes: 1 The percentages on the horizontal axis are the ratios of each asset class to total financial assets.
2 The percentages in parentheses are the ratio of total financial assets to nominal GDP.

Source: Bank of Japan.

Figure 2 Japan's Money Flow Structure as the Cause of a Cycle of Economic and Market Weakness



Ownership of Securities by Individuals: Current Situation and Action Needed

Extremely low degree of interest in owning securities

Japanese savers' preference for low risk and high liquidity is even stronger than it was 10 years ago, showing how the decline in share prices and the failure of a number of banks since the end of the asset boom of the late 1980s have made conservative investors even more conservative.[1]

Another characteristic of Japanese savers is their extremely low degree of interest in securities investment. This is something that goes back much further than just 10 years. As can be seen from Figure 3, the current state of affairs, where more than 70% of Japanese households do not own any securities, has existed since 1962.

During this period, the percentage of households owning securities has remained less than 30% in spite of all the changes that have occurred on Japan's securities markets: the heavy issuance of government bonds since 1975, the introduction of medium-term government bond funds in 1980, the boom in shares and mutual funds during the asset boom of the late 1980s, various reforms to Japan's mutual fund industry (including the sale of mutual funds by banks), the deregulation of brokerage commissions and the spread of the Internet in the late 1990s. Although there have been slight changes in the weightings of different types of securities as investor preferences have shifted from bonds to mutual funds, and from mutual funds to equities and foreign securities, the overall figure has remained unchanged (Figure 4).

1 M. Iwatani, "The Composition of Personal Financial Assets in the Wake of Japan's 'Big Bang'," Capital Research Journal, Spring 2001.

It is quite clear from the past 40 or so years that most Japanese households are not interested in securities investment—regardless of what happens on Japan's securities markets and whatever reforms are introduced. Unless this situation can be changed, however, there would appear to be no way of inducing any real changes in the structure of the money flow.

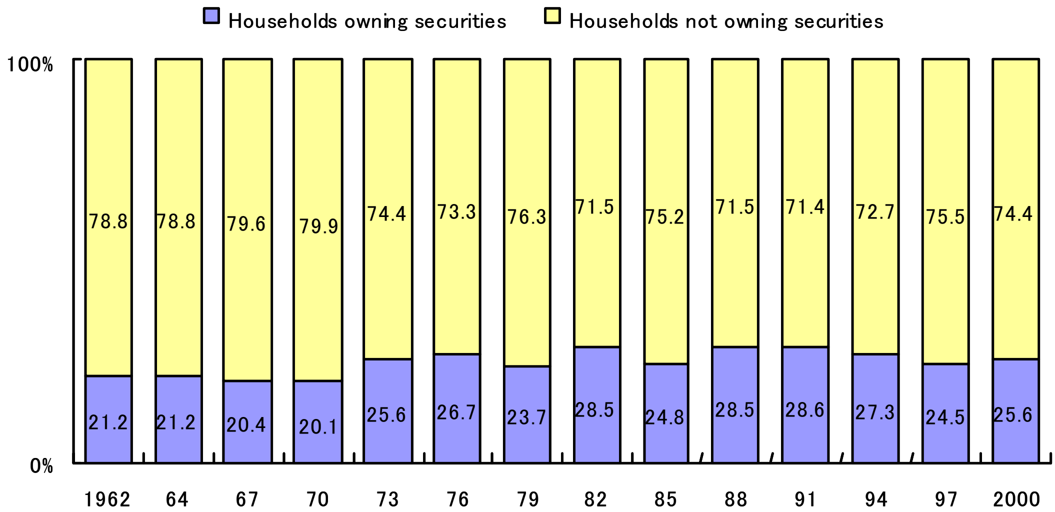
How can the uninterested majority of households be induced to change their minds?

How can the majority of households, which have no interest in owning securities, be induced to invest in equities or mutual funds? The answer is clear from Figures 5 and 6: more than 70% of households replied that they would not invest in equities or mutual funds under any circumstances. Only 15% replied that they might be persuaded if they knew more about equities and mutual funds; so more investment training for the general public, as some people have advocated, is unlikely to have much effect. Nor can much be expected from reducing transaction sizes.

Money market funds as a response to the need for safety and liquidity

The bulk of personal savings are held in a secure, liquid form, and it will not be easy to induce individuals to increase their exposure to risky assets. One way to induce this core of savers to change their minds (even if only slightly) might be to popularize money market funds as a secure and liquid form of securities investment similar to bank deposits.

Figure 3 Household Ownership of Securities (%)



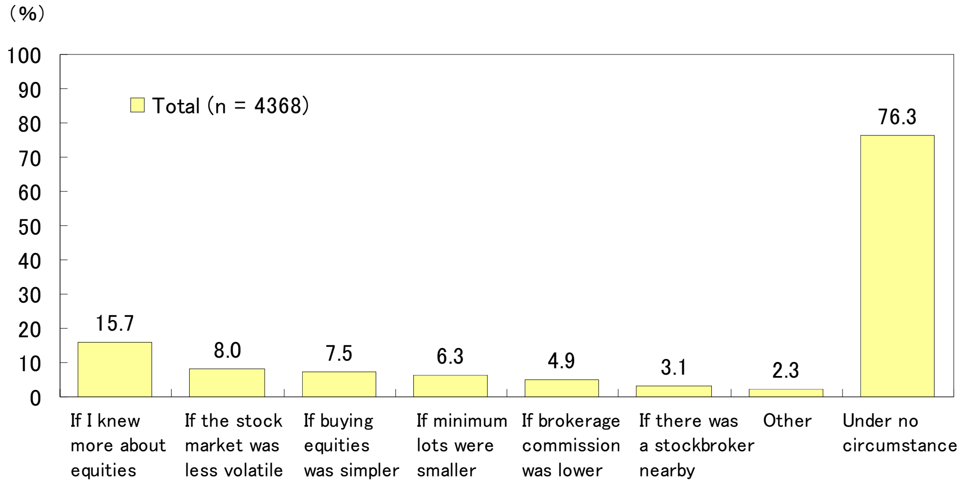
Source: Shoken Chochiku ni Kansuru Zenkoku Chosa [Nationwide Survey of Securities Saving], Japan Institute for Securities Information and Public Relations, 2000.

Figure 4 Breakdown of Household Ownership of Securities (double counting, %)

	Household ownership of securities	Equities	Mutual funds	Bonds	Foreign securities
1979	23.7	16.0	6.4	7.2	0.3
1982	28.5	18.0	8.2	10.9	0.3
1985	24.8	15.8	12.8	10.5	0.6
1988	28.5	18.5	16.7	10.8	1.0
1991	28.6	19.6	15.1	9.5	1.4
1994	27.3	20.5	12.1	7.9	1.3
1997	24.5	19.2	8.8	6.7	2.1
2000	25.6	20.8	8.8	6.8	2.5

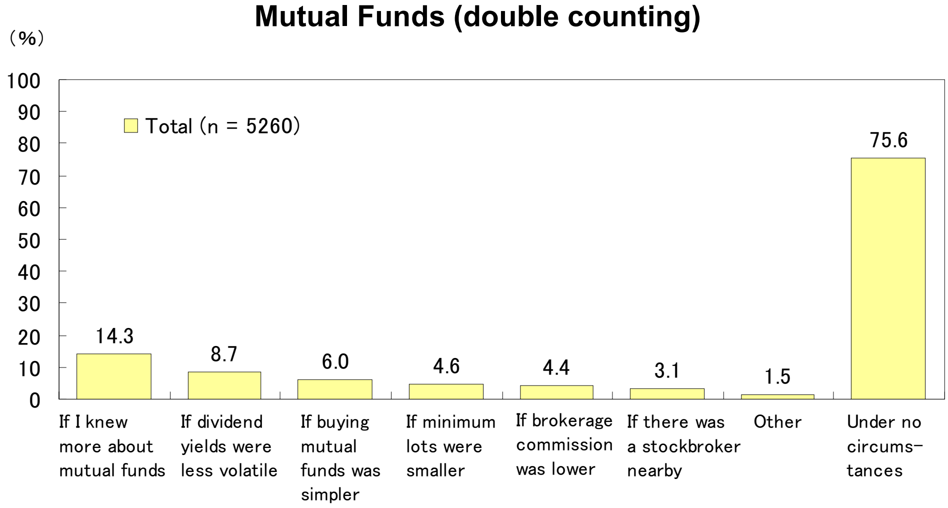
Source: Shoken Chochiku ni Kansuru Zenkoku Chosa [Nationwide Survey of Securities Saving], Japan Institute for Securities Information and Public Relations, 2000.

Figure 5 Circumstances under Which Households Would Consider Owning Equities (double counting)



Source: Shoken Chochiku ni Kansuru Zenkoku Chosa [Nationwide Survey of Securities Saving], Japan Institute for Securities Information and Public Relations, 2000.

Figure 6 Circumstances under Which Households Would Consider Owning Mutual Funds (double counting)



Source: Shoken Chochiku ni Kansuru Zenkoku Chosa [Nationwide Survey of Securities Saving], Japan Institute for Securities Information and Public Relations, 2000.

In the United States, it was the introduction of money market funds in the 1970s that helped to induce a shift in savings from bank deposits and lay the foundations for the robust money flow structure that exists today and is based largely on securities investment. These money market funds are invested mainly in commercial paper (Figure 7). As a result, not only did individual investors shift some of their savings from bank deposits to money market funds, but companies were able to reduce their dependence on bank loans for short-term funds and use commercial paper as a means of raising capital. Since then, money market funds and commercial paper have been used as a vehicle for channeling personal savings to the corporate sector—i.e., as a means of direct financing (or, as it is sometimes called, "market-type indirect financing").

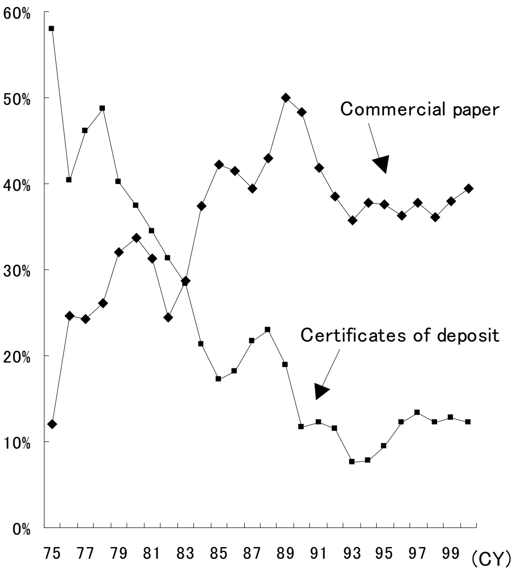
Structural problems of Japan's commercial paper market that have inhibited the development of money market funds

There has been another obstacle to the spread of money market funds in Japan: the absence of a well developed commercial paper market. In Japan, money market funds are invested mainly in bonds and bank-related instruments such as bank deposits and call loans (Table 1). So long as money market funds depend on instruments issued by banks, however, it will be impossible for them to achieve better yields than these. A plentiful supply of investment-grade commercial paper (as in the United States) would enable investors to both control their risk and achieve higher yields, while also increasing the supply of direct finance.

The main reason Japan does not have a well developed commercial paper market is that companies are able to issue commercial paper below the market rate and that banks are willing to hold such paper. Banks have been prepared to do this in order to maintain a relationship with companies that have started to raise capital on the financial markets rather than borrow it from a bank. Another factor is that the Bank of Japan has recently started to buy commercial paper as part of its open market operations. This has produced a spread of 10 or more basis points between similarly rated commercial paper, depending on whether it is eligible for use in open market operations. In other words, private-sector companies may have a different cost of short-term capital because of some decision by the central bank, regardless of how the private sector itself perceives the risk.

Commercial paper has therefore failed to become a suitable investment for money market funds in Japan—partly because its price is not determined by market forces, and partly because its supply is irregular. This has impeded the spread of money market funds in Japan. If the situation is to improve, the banking sector and the Bank of Japan will have to change their attitude.

Figure 7 Composition of Money Market Funds in the US



Source: "Mutual Fund Fact Book," Investment Company Institute.

Table 1 Composition of Money Market Funds in Japan (as of September 2000)
(¥ million, %)

Bonds	9,309,917	65.6%
Bank deposits	1,623,407	11.4%
of which, certificates of deposit	1,618,007	11.4%
Call loans	2,232,927	15.7%
Banker's acceptances	4,999	0.0%
Commercial paper	1,061,683	7.5%
Total	14,200,876	100.0%

Climate for money market funds becoming increasingly unfavorable

At one time, medium-term government bond funds enjoyed a certain popularity with individual investors because of their safety and liquidity. With the adoption of market value accounting, however, such funds will cease to be viable in their existing form. Moreover, since last year, mutual funds (including money market funds) have been obliged to provide prospectuses to all their investors—a measure the costs of which would appear to outweigh the benefits. Nor have cash management accounts, which increase the use of money market funds as a means of payment, caught on in Japan to the extent that had been hoped. Thus, in spite of the fact that it is becoming increasingly important for Japan's securities markets to respond to the strong desire of individual investors for safety and liquidity if the Japanese economy and Japanese society are to enjoy stability and prosperity, the situation is, in fact, becoming worse.

As we shall suggest, the economic and social costs and risks of establishing an instrument such as money market funds as an additional cornerstone of the financial system would surely be less than if the system were to continue to depend mainly on bank deposits, themselves dependent on bank deposit insurance, banking supervision and the Bank of Japan. It should therefore be the aim of financial policy to strike a proper balance between bank deposits and securities such as money market funds.

Need for early introduction of defined contribution pension schemes and employee stock ownership plans as a means of increasing the proportion of equities and mutual funds in personal financial assets in the medium to long term

Although money market funds have an important part to play in increasing the flow of personal savings to the securities markets in line with the needs of individual savers, their very safety and liquidity mean that they can supply only some of the risk capital required. Nevertheless, there is no way the 70%-plus of Japanese households with no interest in investing in equities or mutual funds are suddenly going to show an interest after 40 years of disinterest. Efforts to induce inexperienced investors like these to display a positive attitude towards such investments are unlikely to prove successful unless they are accompanied by adequate advice.

This means that it would be unrealistic and inappropriate in the short term to try to devise means of inducing the 70%-plus of households with no interest in securities investment to invest in equities and mutual funds of their own accord. Instead, it would be better to create conditions where equities and mutual funds could become a natural part of their financial assets in the medium to long term.

This role could be played by defined contribution pension schemes and employee stock ownership plans (ESOPs). As descriptions of the basic aims of such schemes can be found elsewhere,[2] this report will concentrate on the important role that they can play in reinvigorating Japan's securities markets.

Contribution of money market funds, defined contribution pension schemes and employee stock ownership plans to changing the structure of the money flow in the United States

Defined contribution pension schemes and ESOPs were introduced in the United States in the mid-1970s and gradually formed the foundations for the ownership of equities and mutual funds by individuals. Since then, tax incentives for defined contribution pension schemes, the fact that the baby-boom generation is now approaching retirement, and a bull market have helped to make investment in equities and mutual funds in the United States extremely popular.

In the United States, 401(k) plans have played a key role in increasing mutual fund ownership. One important aspect of these plans is the requirement that employees

[2] M. Igata, A. Nomura, and T. Kamiyama, " Employee Stock Ownership Plans in the United States and the Introduction of Such Plans in Japan”, Shihon Shijo Kuwotari, Winter 2001.

receive training in investment skills. This then enables them when they retire to choose their own investment adviser or to trade for themselves via the Internet. As a result, there is a growing number of increasingly sophisticated individual investors.

In this way, the increasing popularity of money market funds among US investors with a preference for safety and liquidity has helped to channel personal savings in the United States into the securities markets, while ESOPs and 401(k) plans have helped to increase investment in equities and mutual funds by individuals, thereby changing the structure of the money flow. Hopefully, similar trends will help to solve the structural problems of the flow of money in Japan.

Exchange-traded funds

Strenuous efforts also need to be made in other areas to encourage Japanese investors, most of whom are inexperienced, to invest in securities. How successful these efforts are will depend on whether Japan's stockbroking industry can come up with innovatory products and on how the authorities respond.

One promising such product is exchange-traded funds (ETFs), which have proved extremely popular in the United States.[3]

Most people would probably agree that basic products for inexperienced individual investors should be well diversified and passively managed index-linked products. ETFs have a zero tracking error and low charges. The fact that (like equities) they are traded continuously makes them suitable for individual investors.

In Japan, mutual funds based on the Nikkei 300 Index are a similar product. Hopefully, a wider range of ETFs will gradually be introduced to cater for the needs of different investors.

Creating a Climate in Which the Market Mechanism Can Operate

The previous section considered three options (namely, trying to popularize money market funds, introducing defined contribution pension schemes and ESOPs, and introducing ETFs) in terms of how they might help to extend securities investment to the vast majority of households in Japan that do not own any securities, because, otherwise, the money flow structure will not change.

Whether or not such options are successful will depend on whether conditions can be created in which Japan's securities markets can function fairly and efficiently. Otherwise, they will not be able to accommodate the general investor. In the

[3] For further information about ETFs, see M. Iwatani, "The Growing Interest in Exchange-Traded Funds", Shihon Shijo Kuwotari, Summer 2000

following, three different aspects of this issue are considered. The first is the need to make it easier in Japan for treasury stock and takeover bids to be used as a means of adjusting share prices in cases where shares are undervalued. The second is the need to remedy the current situation, where banks are preventing the pricing mechanism from functioning properly on Japan's securities markets. And the third is the need for tax incentives.

Cases where shares are undervalued

Figure 8 shows the abnormal state of affairs (as of March 2000) where more than half of the non-financial companies listed on the First Section of the Tokyo Stock Exchange had a price-book value ratio of less than 1. In other words, the market value of these companies was less than their accounting value. In fact, one listed company, which decided to go into liquidation in 1999, is reported to have distributed its residual assets to its shareholders at a value per share considerably in excess of its market value immediately prior to being delisted.

A situation where most of Japan's leading companies have a price-book value ratio of less than 1 means that Japan's equity markets can hardly be said to be functioning normally. Two means of trying to remedy this which work in other countries but have failed to work properly in Japan are share buybacks and takeover bids.

Use of treasury stock

It is often said that announcements by companies that they are going to buy back some of their shares for use as treasury stock tend to boost their share prices by demonstrating confidence in their performance and drawing attention to the fact that the shares are undervalued.

In Japan, share buybacks are currently only permitted for a few particular reasons (e.g., in order to retire shares or to issue share options). However, there would appear to be a case for lifting the ban on treasury stock in order to make it easier for companies to acquire their own stock.[4]

Advantages of takeover bids

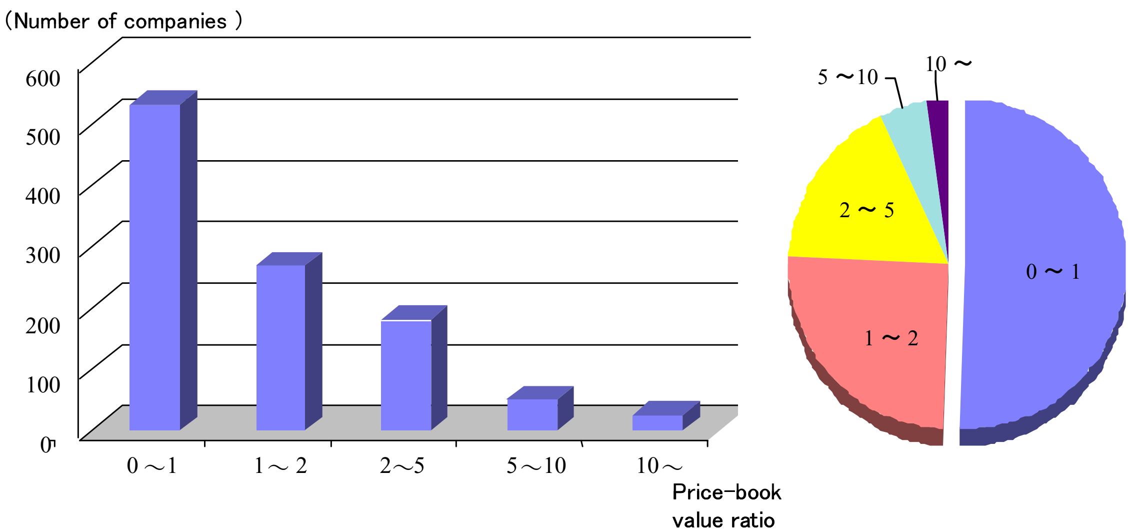
Takeover bids are used not only to correct the way in which the markets perceive individual companies but also to increase enterprise value by changing the way in which companies do business. Although a rarity in Japan, they are more common in other countries.

---

4 M. Hashimoto, "Lifting the Ban on Treasury Stock in Japan," Shihon Shijo Kuwotari, Winter 2001.

Although some commentators have said that takeover bids like those in the United States, where shares are normally issued to finance a deal, would be complicated and difficult to carry out because of the need to issue new shares and take an equity stake in the target company, these procedures could be simplified. Similarly, allowing

Figure 8 Price-Book Value Ratio of Listed Japanese (Non-financial) Companies



Notes: 1 The companies covered are non-financial companies listed on the First Section of the TSE with a fiscal year ending in March 2000.
2 Net assets are the consolidated figures for the year ending March 2000; share prices are as of end-March 2000.
Source: Nomura Securities

Japanese companies to hold treasury stock would make it easier for them to finance a takeover bid.

Naturally, financial and non-financial companies with shares in companies that are the target of a takeover bid should explain properly to their own shareholders and their agents why in each case they have decided to accept or reject an attractive offer.

Outmoded behavior by Japanese banks as an obstacle to reinvigorating the country's securities markets

The fact that the flow of money via the securities markets has failed to increase in Japan in spite of the fact that the country's securities markets have carried out wide-ranging reforms may be partly the responsibility of the country's financial institutions. Unless something is done to remedy this situation, the benefits of any further action to reinvigorate the country's securities markets are unlikely to be felt in full.

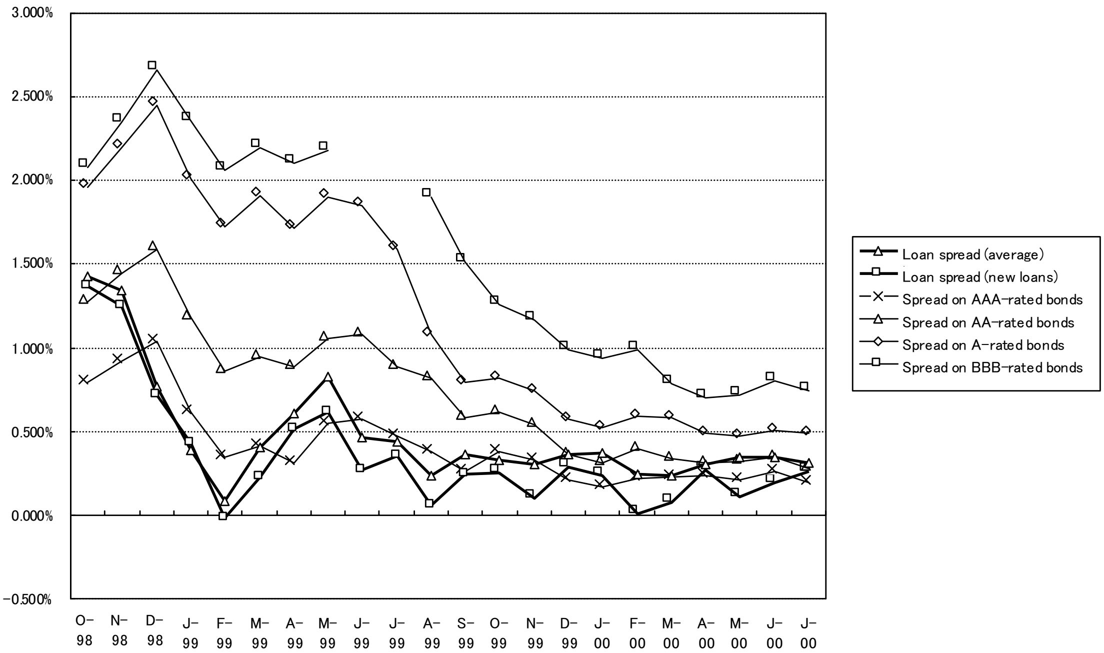
As we saw above, one of the reasons for the failure of efforts to use money market funds to foster the development of a commercial paper market and thereby increase the share of market-type indirect finance in the flow of short-term money has been a lack of commercial paper issued at market rates. This, in turn, reflects the fact that banks have generally been reluctant to put pressure on their corporate clients to issue commercial paper at market rates.

The problem is that even bank loans are often made at rates that fail to reflect the full risk involved. The spread on such loans, which are often to smaller companies that would fail to satisfy the criteria for issuing bonds, is often even narrower than that on AAA-rated corporate bonds (Figure 9).

So long as companies are able to borrow at such low rates, the prospects for Japan's commercial paper and corporate bond markets will remain poor. Although the corporate sector might appear at first sight to be benefiting from this situation, in fact it is having to share the cost in the form of weak economic growth and weak financial markets as banks continue to be unprofitable and unable to write off all their bad loans.

So long as banks continue to follow outmoded practices and fail to act according to market principles, there is little prospect of the takeover bid developing in Japan as an effective tool of corporate finance. Any bank that refuses without good reason to accept an attractive offer for its shares in a bid target is not only possibly preventing those shares realizing their full market value, but also failing to pursue a legitimate profit.

Figure 9 Spreads on Loans and Corporate Bonds



Source: Bank of Japan, Rating and Investment Information, Inc.

Financial policy remains biased in favor of indirect financing

The banking system in Japan is currently being supported by taxpayers' money. Even the Bank of Japan's commercial paper operations are aimed at supporting the banking system. However, unless the authorities take such action as an opportunity to reform banking practices, the markets will be unable to perform their role as pricing mechanisms properly and money will continue to flow mainly via the banking system.

Far from expanding the flow of money via the financial markets, financial policy in Japan—whether it be the use of taxpayers' money, the Bank of Japan's commercial paper operations, pressure on the banks to lend to smaller companies, the delay in the introduction of a pay-off system, or a deposit insurance system that fails to reflect the true risk to banks—is clearly aimed at maintaining the dominance of indirect financing.

Need for tax reforms to stimulate reform of the money flow structure

In view of the need for policies aimed at increasing the proportion of money that flows through the securities markets, consideration should be given to measures such as tax exemptions for small investors and capital gains tax exemptions or reductions for long-term equity investors.

Japan's savings movement originated as an attempt to stimulate economic growth. At that time, "savings" were equated with bank deposits, and the system of tax exemptions for small investors that was introduced did not extend to other forms of saving. In other words, policymakers used preferential tax treatment as a means of encouraging people to put their money in the bank, and this money was then recycled by the banks. In the days when regulation and monitoring were able to ensure the soundness of the banking system, such encouragement did succeed in ensuring a steady supply of risk capital. Now that the banks are no longer able to take such risks, the taxpayer is having to support them.

What is needed now is to correct the imbalance in favor of bank deposits and ensure a more equitable supply of risk capital by encouraging investment in securities. While this may raise concerns about a fall in tax receipts, the recognition that preferential tax treatment of bank deposits has helped to create a distorted money flow structure at considerable economic and social cost to Japan and the fact that the private sector, unaided, has found it extremely difficult to increase the general public's interest in securities investment suggest that consideration should be given to reducing taxes on securities investment.

Need for a Better Balanced Money Flow Structure

Increasing need for a solution to a global problem

While the need to strike a better balance between the flow of money through the banking system and the flow through the securities markets is particularly pressing in Japan, it is by no means unique to Japan. Nor should a solution be sought simply as a quick fix to current stockmarket weakness. An international effort needs to be made that reflects the lessons learnt from the last century. The current debate in Japan about how to reinvigorate the country's securities markets should be seen as our first contribution to finding a solution to a problem that faces every leading country at the beginning of the 21st century.

Striking a balance between the banking system and the securities markets

In order for a country's securities markets to function as a channel for the flow of money, that country needs not only institutions such as stock exchanges and clearing houses as well as legal and other systems to protect investors, but also professional issuers, stockbrokers and investors.

However, it takes time for securities markets to develop, and the process is one of trial and error—hence the rapid development of banking systems in modern societies. By enabling the general public to invest its savings securely and employing specialists trained in assessing risks versus returns to lend those savings to business, these banking systems (which also function as payments systems) have become universally indispensable.

The banking system (i.e., the business of collecting deposits by guaranteeing principal and interest and investing those deposits in risky businesses and assets) is inherently highly risky. However, the fact that this mechanism benefits both lenders and borrowers (not to mention the economy as a whole) has enabled it to work—albeit by having as a counterbalance a vigilant regulator and a central bank ready to act as lender of last resort.

In fact, however, all the major economies (including Japan, the United States and Europe) experienced banking crises at both the beginning and the end of the last century. Indeed, such has been the shock to Japan, which is particularly dependent on its banking system, that it is still trying to recover as it starts a new century.

A banking system as intermediary between lenders and borrowers is clearly essential if society and the economy are to function properly. This is also why banks enjoy certain privileges while being subject to strict supervision and regulation. This will remain the case even in the new century. What needs to be rectified, however, is the balance between the two. The lessons of the last century—namely, that it is all too easy for companies and individuals to become overdependent on the banking system and for bankers and their regulators to become careless—must not be forgotten.

Structural changes in US financial institutions induce shift from money market funds to bank deposits

Japan is not the only country confronted by the need to strike a balance between its banking system and its securities markets. This issue is also likely to be the subject of an increasingly heated debate in the United States now that the Glass-Steagall Act prohibiting investment and commercial banking within the same organization has been repealed. In the wake of this, investment banks such as Merrill Lynch and Salomon Smith Barney are increasingly shifting customer assets from money market funds to deposits held by their commercial banking subsidiaries.

This will apparently enable them to save costs by not having to produce the kind of prospectuses necessary for new securities and to lower their risks by sheltering under the deposit insurance scheme.

In Japan, this balance would appear to be lacking. Since last year, mutual funds have been required to distribute prospectuses even for products as secure and liquid as money market funds—but not for bank deposits, which can be invested in assets such as property and equities.

How should banks and stockbrokers differentiate their products?

It has often been said that, with the disappearance of regulatory barriers between different types of financial services companies and the spread of securitization, the distinctions between banking and other financial products have been blurred. Recently, however, the fundamental differences between lending/deposit-taking and stockbroking have become, if anything, clearer.

It has been proposed that a narrow banking system should be introduced to deal with the risks inherent in the existing payments system, which itself depends on the banking system. In our view, there is no need to introduce a new type of bank in a financial system such as that which has existed in the United States. This is because the spread of money market funds, which themselves function as a limited payments system, has enabled the system as a whole to function like a narrow banking system and helped to reduce the risk of it becoming overdependent on the banking system. However, the major change of direction in the money flow (from money markets funds to bank deposits) which is occurring now in the United States could invalidate this argument. At the moment, the debate is focused on how to reform the deposit insurance system, and it remains to be seen whether it will develop into a discussion of issues that arise from the fundamental differences between bank deposits and securities.

Vision of a new money flow structure for the 21st century

However, the fact that the banking system in the United States plays a far less important role than it does in Japan means that the problem there is also less serious.

Japan's need to strike a healthy balance between its banking system and its securities markets is greater than that of any other country. Its need for a framework that will enable a new money flow structure to develop that is different from the banking and securities systems of the last century is therefore also that much more urgent.