The Program for Further Financial Reform

Yasuyuki Fuchita

I. Outline of Program

1. What is the Program for Further Financial Reform?

On 24 December 2004 the Financial Services Agency announced its Program for Further Financial Reform ("the Program"). Popularly referred to as the "Ito Plan," the Program is seen as the successor program to the Program for Financial Revival (announced on 30 October 2002) and popularly referred as the "Takenaka Plan."

The Agency's decision to publish the Program before the end of 2004 was in response to a call from the Council on Economic and Fiscal Policy in its fourth set of "Basic Policies for Managing and Reforming the Economy" (published in June 2004).

This policy document (the Basic Policies) recommended that, in view of the progress that had been made in writing off nonperforming loans, the period of "intensive adjustment," in which every effort, no matter how painful, was to be made to implement structural reform, even at the cost of negative growth, should end in March 2005 and be followed by a two-year period of "concentrated consolidation" in which further structural reform would be carried out.

The aim of the Program for Further Financial Reform was to provide a blueprint for how the financial system should be regulated during this second two-year period. The Basic Policies set out five objectives for the Program, which was originally called the "Program for Concentrated Consolidation of the Financial System": (1) to create a robust yet dynamic financial system, (2) to encourage financial institutions to make continuing and voluntary efforts to put their house in order, (3) to create a regional financial services industry that would help to revitalize local communities and businesses, (4) to offer a wide range of high-quality financial services tailored to the needs of consumers, and (5) to devise practical regulations for financial transactions that users can have confidence in. According to the Basic Policies, the Program would then encourage private-sector financial institutions to use their initiative to offer high-quality financial services that could compare with those offered anywhere else and would take the Japanese economy into a new phase of growth.

The Agency started work on the Program in the summer of 2004 and held talks with other government departments as well as the private sector. When, in September 2004, Tatsuya Ito took over from Heizo Takenaka as Minister for Financial Services, he set up an advisory team of private-sector experts, which set to work on drawing up proposals for the Program.

Although the Program outlines the policies the Agency is expected to devise, the Agency itself is supposed to draw up detailed work schedules by the end of March. This is what happened after the Program for Financial Revival was published, when the Agency had about a month to prepare similar schedules.

Figure 1 Basic Concepts for Designing the Program

◇ Change of phases surrounding the financial system: from an emergency reaction phase to a forward-looking phase
From an emphasis on "financial system stability" (emergency reaction to the nonperforming loan problem) to an emphasis on "financial system vitality" (establishing a desirable financial system for the future)
◇ Desirable financial system
By the efforts of the private sector, not the public sector
Any user of financial products and services has access to options for diversified and good-quality financial products and services any time, anywhere, at an appropriate price (a convenient, attractively priced, diversified, international and reliable financial system)
→Realization of a "Financial Services Nation" (establishing attractive markets, "less savings more investment")
◇ Five points in the challenge of moving towards a "Financial Services Nation"
- Emphasis on users' needs and thorough implementation of user protection rules
- Strategic use of IT for strengthening the competitiveness of financial institutions and further developing financial infrastructure
- Further development of a financial system which is internationally open and a financial administration with an international perspective
- Contribution to regional economies
- Establishment of a reliable financial administration

Source: Financial Services Agency.

2. Comprehensive coverage of the Program (including securities and insurance industries as well as banking)

One of the distinctive features of the Program—in contrast to the Program for Financial Revival, which focused on the banking system (and especially on the big banks)—is that it covers not only banking but also the securities and insurance industries.

As far as the securities industry is concerned, the government's efforts to encourage people to save less and invest more are well known. However, this has yet to produce any obvious changes in the way money flows in the economy. The Program therefore makes clear the need not only for an investment services law but also a better system of corporate disclosure, new guidelines for determining who can be an accredited institutional investor, measures to encourage private placements, and a new formula for calculating the capital adequacy ratios of securities companies.

As far as the insurance industry is concerned, the Program calls for a greater variety of insurance products and more flexible pricing, new rules governing insurance transactions (dealing with unlicensed mutual aid associations, observing the suitability principle governing insurance policies, improving the monitoring of insurance advertising, and creating a new system for protecting policyholders), and a new formula for calculating solvency margin ratios.

In addition, the Program calls for the following measures covering all three financial services: segregating the functions of creating and selling products, making it easier for companies to expand their distribution channels, giving consumers the opportunity to purchase a wide range of high-quality financial products and services in a convenient and timely manner ("one-stop shopping"), and amending and easing regulations to make them more appropriate to the needs of market participants and to encourage healthy competition and the development of new businesses.

3. Helping local economies and reforming the system of financial regulation

The Program is comprehensive not only in that it covers all three financial sectors but also in that its coverage extends to local financial services and the need to reform the system of financial regulation.

In fact, the Program is divided into three sections. While the first section ("Creating a dynamic financial system") deals with the policies that affect all three financial sectors, the second section deals with how the financial services industry can help local economies and the third section with the need to create a system of financial regulation that people can trust.

Figure 2 Concrete Measures: Creation of a Vibrant Financial System

1. Emphasis on users' needs and thorough implementation of user protection rules
- ○ Enhancement of the provision and distribution framework for financial products and services
- ○ Enactment of an "Investment Services Law" (tentative name)
- ○ Prevention of financial crimes such as card fraud
- ○ Smooth implementation of the scheduled removal of the remaining blanket guarantee on demand deposits
- ○ Expansion of financing methods that do not rely excessively on real estate collateral and guarantees
- ○ Establishment of a "Financial Services Consumer Advice Center"
- ○ Expansion of financial and economic education

2. Strategic use of IT for strengthening the competitiveness of financial institutions and further developing financial infrastructure
- ○ Groundwork for legislation on electronic fund settlement and online financial transactions
- ○ Further enhancement of the corporate disclosure system
  - ・Introduction of a rating system into inspection
- ○ Improvement in the management (governance) of financial institutions
- ○ Encouraging private placements, including reviewing the definition of accredited institutional investors, etc.
- ○ Further strengthening of market supervision and surveillance authorities
- ○ Enhancement of risk management of financial institutions
- ・ Implementation of Basel II (the new capital adequacy framework), and early recognition of and action to deal with nonperforming loans

3. Further development of a financial system which is internationally open and a financial administration with an international perspective
- ○ Groundwork for legislation on financial conglomerates
- ○ Promoting dialog among financial regulators in Asia through active participation in Economic Partnership Agreement (EPA) negotiations
- ○ Active participation in international standard-setting activities

Source: Financial Services Agency.

The Basic Policies envisage that, during the period of "concentrated consolidation" due to start in April 2005, further progress will be made in the efforts to correct the traditional overemphasis on the public rather than the private sector and on the country as a whole rather than the regions. The aim is to encourage reform from within the public sector and to revitalize the regions.

With regard to helping local economies, the Program deals directly (see below) with the contribution that local financial institutions can make to regional development. In addition, it mentions, with regard to local financial services in

general, the need to review the role of public-sector financial institutions, the need to do more to help companies recover, the need for regulations governing disclosure, and the need to provide greater access to local direct finance. However, it does not deal with any of these in detail.

In the section on the need to create a system of financial regulation that people can trust, the Program mentions the need to make the system more transparent and predictable as well as more convenient and efficient (e.g., by means of the Internet).

As regards the need to make the system more transparent and predictable, the Program lists the following needs: to establish rules of conduct for Agency staff (to ensure, amongst other things, greater transparency, written rules and clear procedures for imposing penalties); to ensure that Japanese and non-Japanese financial institutions are treated equally; to improve feedback from inspectors; to make greater use of a system of no action letters; to publish responses to general enquiries about legal interpretations; to study past cases of bank failures and to provide feedback on how this is likely to affect future regulation; to ensure greater transparency and objectivity by making greater use of the Agency's Compliance Office; and to make greater use of the Agency's network of local branches to make the public more aware of its policies.

As regards the need to make the system more convenient and efficient, the Program lists the following needs: to press ahead with e-government; to carry out inspections as efficiently as possible; to review the Agency's structure and systems; and to do more to improve the quality of the Agency's staff.

During the Financial Revival Program, the Agency was criticized for trying to exert various forms of pressure on the big banks in order to induce them to write off their nonperforming loans. Dissatisfaction was also expressed by some of the banks with the Agency's instructions and the way it carried out its inspections, which were described as opaque and arbitrary. At the same time, the number of staff increased rapidly in order to carry out follow-up checks and improve market supervision. There was also an incident last year when data submitted by a bank were lost.

In view of this and in an attempt to correct the traditional overemphasis on the public rather than the private sector, the Program for Further Financial Reform calls on the regulator not to take market discipline for granted and to be vigilant in its role of watchdog in order to ensure that the regulatory process is transparent, predictable and efficient.

So much for the main items of the Program. Next, we will take a closer look at some conflicting views on financial conglomerates (one of the more controversial subjects of the Program) and then discuss some conflicting views on how banks (and especially regional financial institutions) should be regulated.

Figure 3 Concrete Measures: Contribution to Regional Economies

1. Revitalization and activation of regional economies, facilitation of small and medium-sized enterprise (SME) financing

○ Further promotion of region-based relationship banking by designing a new action program inheriting the existing "Action Program Concerning Enhancement of Relationship Banking Functions" with a view to promoting revitalization and activation of regional economies, facilitation of SME financing, and strengthening of management functions of regional financial institutions. The new action program will be built on the assessment of the existing one.

2. Strengthening management functions of regional and small and medium-sized financial institutions

○ Promotion of efforts to improve risk management, business assessment, profit control and governance

Source: Financial Services Agency.

Figure 4 Concrete Measures: Establishment of a Reliable Financial Administration

1. Improving the transparency and predictability of the financial administration

○ Establishment of the FSA's "Code of Conduct," reconfirmation of the equal treatment principle of domestic and foreign financial institutions

2. Promotion of a convenient and efficient financial administration through e-government, etc.

○ Implementation of an efficient and sound administration through e-government, etc.

○ Full internal check and review of FSA's organization and frameworks based on the "FSA's Full Check Project"

Source: Financial Services Agency.

II. Financial Conglomerates and the Program for Further Financial Reform

1. Removing the demarcation lines between banking, stockbroking and insurance

As we have seen, the Program for Further Financial Reform covers all three financial sectors (banking, stockbroking and insurance). In this connection, the Program's reference to the need for legislation to deal with financial conglomerates has given rise to all sorts of speculation. Although there have been press reports that the Agency wants to remove the demarcation lines between banking, stockbroking and insurance, this has not been reported officially. Nor is there anything in the Program itself to suggest this. What the Program has to say about financial conglomerates can be summarized as follows.

First, in the section on the need for a more internationally open financial system and a more international system of financial regulation, the Program talks about the need for the financial system and financial regulators to respond to structural changes resulting from international financial deregulation, including the increasing specialization of financial services, the growth of conglomerates, globalization and the emergence of a wide range of new financial services as a result of new types of transactions and products as well as the need for legislation to deal with the growth of conglomerates and the need to inspect and supervise them as well as deal with problems affecting more than one sector.

Similarly, the same section mentions the growing need (as a result of increasing globalization and the growth of financial conglomerates) to cooperate with financial regulators overseas as financial regulations and standards become increasingly similar. In view of this, it goes on to say, care must be taken to ensure that Japanese and non-Japanese financial institutions are treated equally, and that the Japanese financial system and financial markets operate according to clear principles and universal rules. At the same time, it says that Japan's regulators should play an active part in devising such rules (rather than simply adopting existing ones), alert to their strategic implications, and seek to show a lead. Finally, it talks about the need to ensure that the rules, inspection and supervisory procedures that are adopted for international conglomerates are appropriate.

Therefore, although the Program talks about the need to respond to the growth of financial conglomerates in the section on international financial developments, this is far from calling for the creation of such institutions.

In spite of that, however, some newspapers have repeatedly claimed that the aim of the Program is to go down the same road as the United States when it adopted the Gramm-Leach-Bliley (GLB) Act and abolish the demarcation lines between banking, stockbroking and insurance.

It is well known that the aim of the Gramm-Leach-Bliley Act was to end the restriction which prevented financial holding companies from using subsidiaries to cross sector demarcation lines. If that is regarded as encouraging the formation of conglomerates, then Japan, which ended this restriction even earlier, already has its own conglomerates. In addition, Japanese law now allows banks to sell investment trusts, act as agents for securities companies, and allow trust banks to sell their products and services in their branches on an agency basis, and thus engage in at least some nonbanking activities, while moves are already under way to allow banks to sell a wide range of insurance products.

The next stage (i.e., removing the demarcation lines altogether) would mean, for example, that banks would be allowed to underwrite corporate bonds, new shares and even insurance (i.e., engage in full-service banking). However, the Financial System Council has never officially discussed this possibility; nor is there any mention of it in the Program.

2. Meaning of the Program's reference to legislation to deal with financial conglomerates

We think the reason the Program refers to the need for legislation to deal with financial conglomerates is that, since the kind of conglomerates mentioned above in connection with the Gramm-Leach-Bliley Act already exist in Japan as well as in a number of other countries and could affect Japan's financial markets and since Japanese financial conglomerates are also active on the financial markets of these countries, the question arises whether the existing legislation for each financial industry is sufficient or whether a more comprehensive response is required.

One example of this is the Financial Conglomerates Directive passed by the European Commission in December 2002. Recently a number of European Union members, including the United Kingdom, have announced their intention to incorporate the Directive in their national legislation. However, even those countries that are not members of the European Union are under pressure to respond in some shape or form. This is because a financial group operating in the European Union and whose parent is based in a non-EU country could be obliged to accept direct regulation by an EU regulator if the standard of regulation in the country in which its parent is based is considered to be lower than in the European Union.

In response, in June 2004, the US Securities and Exchange Commission adopted two rules: "Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities" and "Supervised Investment Bank Holding Companies." Although the Gramm-Leach-Bliley Act permits financial holding companies, most US securities companies (with some exceptions such as Charles Schwab) are not financial holding companies. Most financial holding companies in the United States are banking groups. This is apparently because the regulator responsible for financial holding companies is the Federal Reserve and most securities companies see no point in having to be regulated by the Federal Reserve as well as the Securities and Exchange Commission.

US securities companies operating in the European Union that are holding companies (but not financial holding companies) are therefore subject to the EU Financial Conglomerates Directive and have to demonstrate that the regulatory regime to which they are subject in the United States is of the same standard. This is why the Securities and Exchange Commission introduced the above capital adequacy rule and supervisory regime for nonbank holding companies.

The Financial Services Agency has also done its homework on this issue. For example, in June 2002 the Agency set up a Financial Conglomerates Study Group at its Financial Research and Training Center, and discussion papers have been published since September 2003. Also, on 8 November 2004, the Agency announced the establishment of two new offices (a Financial Conglomerate Office and an Office of International Affairs) within the Supervisory Coordination Division in the light of "the growing importance of regulatory responsibilities across different financial sectors and the sharp increase in international regulatory responsibilities caused by the growth of financial conglomerates." Legislation on financial conglomerates may even be necessary to ensure that bodies such as these can exercise their responsibilities properly.

3. The realities and benefits of being a financial conglomerate

As we have seen, the Program for Further Financial Reform does recognize the existence of financial conglomerates at an international level and propose the establishment of a new regulatory regime to deal with it. What it does not do, however, is recommend that the formation of such conglomerates should be fostered.

Indeed, the views expressed in the above-mentioned discussion papers are, if anything, on the cautious side:[1]

1 Takahiro Nagata, "Kin'yu Konguromaritto no Keizaigaku" [The Economics of Financial Conglomerates], Akusesu FSA [Access FSA], April 2004.

- Japanese banks are hardly rushing head over heals to form financial conglomerates.
- In fact, during the past couple of years no major financial conglomerates have been formed anywhere in the world.
- The tendency is for financial markets to take a dim view of financial groups that decide to form conglomerates that only complicate their operations.
- Recently there has been a significant increase in the number of financial institutions seeking to obtain the benefits of being a financial conglomerate (e.g., synergies and risk diversification) by other means (e.g., forming alliances or transferring risk).

It has not been unusual for financial groups that did not include a bank to transfer some of the risk from a bank outside the group to an insurance company within the group. It is likely that the Financial Services Agency's calls for a regulatory regime that can deal with financial conglomerates were intended to address cutting-edge issues such as this.

Although it is clear from the above that the Program never had any intention of fostering the development of financial conglomerates, we still need to establish whether or not it favors the formation of financial conglomerates along the lines of European full-service banks rather than the kind of financial conglomerates that can already be formed in Japan and the United States by means of subsidiaries.

For a start, we need to take a closer look at what exactly those full-service bank-type financial conglomerates are really like.[2] The financial services group that has probably gone furthest towards removing the demarcation lines between its various operations is the ING Group. Although the group sells its insurance products via its banking outlets and its banking services via its insurance outlets, it is still divided into two intermediate holding companies: ING Bank NV, which deals with all of the group's banking and financial service companies, and ING Verzekeringen NV, which controls the group's insurance operations. This is because Dutch law does not allow a single legal entity to offer both banking and insurance services. The group's investment banking arm, ING Barings, is a division of ING Bank NV.

In Germany, a single legal entity may engage in both commercial and investment banking. However, a bank may only engage in insurance underwriting via an insurance subsidiary.

---

2 The following remarks on particular financial conglomerates are based on Takahiro Nagata, Tsutomu Sano, Hiroaki Kondo and Ren Ryo, "Obei Shuyo Kin'yu Konguromaritto" [The Leading Western Financial Conglomerates], mimeo, 15 August 2003.

Therefore, even in Europe, a single legal entity may not engage in the complete range of financial operations.

4. One-stop shopping and the segregation of production and sales

However, even if a single legal entity is not allowed to engage in the complete range of business operations, there are examples in many countries of one-stop shopping or cross-selling. In the United Kingdom, for example, Lloyds TSB sells life insurance, pension plans and investment products created by its insurance subsidiary, Scottish Widows. In the United States, the JP Morgan Chase Manhattan Group has apparently been able to increase its investment banking presence by marketing loans and investment banking services across the board to its corporate clients via both its investment banking and commercial banking subsidiaries. The Federal Reserve and the Justice Department have adopted a lenient attitude towards such tying.

Once regulators allow financial groups to offer one-stop shopping and cross-selling, it would seem almost inevitable that they will eventually be able to offer their customers a full range of financial services regardless of the seller's legal status and whether any regulatory demarcation lines exist. However, as the discussion papers of the Financial Services Agency's study group indicate, opinion is divided over the merits of such a business strategy.

Even within financial groups themselves opinion is probably divided about whether one-stop shopping is in customers' best interests. In the case of the Lloyds TSB Group, for example, Lloyds TSB Bank sells Scottish Widows' life insurance, pension plans and investment products. However, Scottish Widows' most important outlet is via independent financial advisers (IFAs). These nontied advisers provide outlets for the investment and insurance products of many different providers—not just Lloyds TSB—and are a key channel of distribution to the retail market.

What this means is that, although financial conglomerates tend to favor one-stop shopping, where customers can choose from a complete range of services at one outlet, there is no need for one company to perform all the different services from product creation to sales if the ultimate goal is one-stop shopping. In that case, it might just as well become a vendor of services provided by a different company in each sector. Nor would it need to belong to the same group as the company or companies whose services it was selling. In fact, if the aim is to offer customers the best service, it might be better to segregate product creation from sales than form a conglomerate.

5. The outlook for financial conglomerates and the segregation of production and sales in Japan

As we have seen, it would be reading too much into the references to financial conglomerates in the Program for Further Financial Reform to say that the Financial Services Agency was advocating the creation of financial services companies that engage in every financial service under the sun. Although there are countries where a single financial services company may call itself a full-service bank and engage in both banking and stockbroking, there is as yet no industrialized country where a financial conglomerate may also engage in insurance.

This is not to say, however, that the demarcation lines between different financial sectors will never become blurred and that further deregulation of one-stop shopping and cross-selling will never take place. Indeed, a more direct approach to removing demarcation lines might be preferable to the indirect approach of allowing subsidiaries to cross them, and the very existence of such barriers may well be increasingly questioned.

As we have seen, the Program does strongly advocate one-stop shopping as a way of improving customer service. Some may say that customers do not necessarily want this. However, this is something for consumers to decide—not financial service professionals with a vested interest to protect. Others may say that, if a financial service provider wants to have a go, why stop it. Similarly, those who point out possible pitfalls such as conflicts of interest are likely to be reminded that conflicts of interest are not peculiar to banking and stockbroking (or banking and insurance) and can be found in many walks of life, including securities analysis and investment banking. Where such conflicts exist, they will say, they can be dealt with by erecting firewalls. Why prohibit such activities right from the start?

The pursuit of one-stop shopping and the gradual erosion of the provisions of the Securities and Exchange Law as a result of the enactment of an investment services law may lead to a further easing of intra-industry barriers. A representative of one of the major Japanese banking groups recently commented that the easing and eventual removal of such barriers (e.g., firewalls) would be a practical step towards servicing the multiple needs of corporate clients. Unless such barriers (and especially restrictions on cross-marketing and dual employees) were soon lowered and eventually removed, he said, it would be impossible to provide the range of services clients need.[3]

---

[3] Harumi Yano and Shohei Ishisaka, "Kigyo no Fukugoteki Kin'yu Nizu e no Taio no tame Faiaworu Kisei no Soki Mianoshi o" [Need for Firewalls to Be Reconsidered in the Light of Companies' Multiple Needs], Kin'yu Zaisei Jijo [Financial and Fiscal Affairs], Kinzai Institute for Financial Affairs, 13 December 2004.

Foreign financial institutions in Japan also complain that Japanese regulations governing dual employees (i.e., those who work in both the banking and securities operations of a financial services group) and the joint use of data and systems by banking and securities subsidiaries are more restrictive than those in the United States.

The important thing, however, as the Program points out time and time again, is that any regulations that make it more difficult for consumers to receive the financial products and services they want should be abolished—not whether that leads to the creation of financial conglomerates. Nor is the Financial Services Agency advocating that financial groups should become conglomerates that incorporate an ever greater number of different functions. In fact, the Program's message is more precise: product creation and sales should be segregated, and any restrictions on sales channels should be lifted. Indeed, as we have seen, many of the restrictions on selling products that used to be the preserve of other financial sectors have in recent years been removed.

Finally, this discussion is also likely to have implications for the privatization of Japan Post. Under the initial privatization plan for 2007, the postal savings and postal insurance businesses were due to become separate subsidiaries of a holding company. Now, however, they may have the option to become more closely integrated, depending on the outcome to the current round of private-sector financial deregulation. Similarly, by becoming a nationwide sales network for financial products from other providers besides Japan Postal Savings Bank and Japan Postal Insurance, local post offices may contribute to the segregation of product creation and sales throughout Japan's financial services industry.

III. Policies for the Banking Sector and the Contribution to Local Economies

1. Need to improve governance and risk management

Although the principal goal of the Financial Revival Program (namely, to reduce the nonperforming loan ratios of the main banks by 50% by March 2005) has been achieved, this does not mean that all of the banking sector's problems have been solved. The reduction in the nonperforming loan ratio was largely the result of exogenous factors such as the recovery in the economy and the stock market. With the corporate sector still showing little demand for funds and competition among banks as fierce as ever, making it impossible for banks to achieve adequate lending margins, the structural situation remains the same.

Policies are therefore needed to ensure that there is not another nonperforming loan problem. Building on the Financial Revival Program's success in halving the

nonperforming loans of the main banks, the Program for Further Financial Reform calls on banks to ensure that their nonperforming loan ratios remain below their levels of end-March 2005. In addition, the Program expresses the hope that individual institutions' indicators of profitability and financial soundness will improve significantly along with their credit ratings.

For the same reason, the Program calls on private-sector financial institutions to improve their governance and risk management. For their part, the authorities are keen on (1) introducing a rating system for their inspections that measures a range of features (rather than just a bank's financial condition), (2) implementing offsite monitoring in order to improve banks' internal auditing, and (3) making greater use of an early warning system.

Basel II is due to be introduced at the start of 2007. The remaining two years are a kind of dress rehearsal. The Program therefore also mentions the need for financial institutions to use this as an opportunity to ensure that they have the necessary risk management rules and systems up and running in time and for the regulatory authorities to ensure that their systems are also ready. It therefore requires the main banks to draw up plans explaining how they intend to improve their risk management systems.

However, banks also need to improve their profitability and customer service. In this connection, the Program states the Financial Services Agency's intention to introduce legislation on electronic banking in order to make the most of the technological advances in this area and enable banks to improve their systems and cost competitiveness as well as allow financial institutions to enter the banking sector in various shapes and forms.

2. Contributing to local economies

One of the main items the Basic Policies said should be included in the Program was the need for financial institutions to help revitalize local economies and businesses. One of the original objectives for the period of "concentrated consolidation" was to continue the program of structural reform in order to correct the overemphasis on the public sector and the country as a whole in favor of the private sector and the regions and to enlist the support of the financial services industry in revitalizing local economies.

The Financial Revival Program was aimed at the main banks. The following year, in March 2003, the Financial System Council's Working Group on Relationship Banking published a report on regulating regional financial institutions, and the

Financial Services Agency implemented an action program for the regional financial services industry.

The Agency's attitude towards relationship banking was that it would be inappropriate—in view of the close ties between regional financial institutions and local economies as well as the shortage of local expertise and experience in turning companies around—to expect regional financial institutions to reduce their nonperforming loan ratios by a fixed percentage in the same way as it had expected the main banks to do. Its idea was that, instead of allowing themselves to be taken advantage of because of their traditionally close local ties, regional financial institutions should turn these ties to their advantage to generate added value and to reduce their nonperforming loan ratios by helping local economies to recover.

The fact that there has been some progress in implementing the various policies for financial institutions incorporated in the Action Program (e.g., the need for a basic willingness to develop local ties, business matching and scoring models, greater use of restrictive financial covenants when lending, debt-equity swaps and origination and participation in corporate recovery funds) can be seen in the progress report for fiscal 2003 and the first half of fiscal 2004 published by the Agency on 27 December 2004.

Regional financial institutions have also succeeded in reducing their nonperforming loan ratios, albeit more slowly than their bigger brethren. However, ratios are generally higher for regional financial institutions, some of which have made remarkably little progress in reducing them. Some of those involved in the Program therefore felt strongly that, like their bigger brethren, the regional financial institutions should be set a target for reducing their nonperforming loan ratios. However, the institutions themselves rejected this on the grounds that it would have a very negative impact on local economies.

The action program for relationship banking has been based on the principle that regional financial institutions should not adopt the same policies as those adopted by the main banks. It has also, as we have seen, enjoyed some success. Therefore there is no pressing reason to change this principle at the moment. However, the Agency is far from satisfied with the progress regional financial institutions have made in putting their own house in order and has indicated that it will take further action, beginning in April 2005.

What this means is that the action program for relationship banking, which was scheduled to be completed by the end of the period of "intensive improvement" in March 2005, will be followed in April 2005 by a new action program based on an assessment of its results.

Although the Agency does not intend to apply the same set of standards to each institution, it has made clear its intention to introduce an incentive-backed scheme that will use the discipline of disclosure to induce institutions to improve their governance, their risk management, their business assessment, their profit control and, as a result, their financial soundness and profitability. What this will hopefully be (in addition to legal disclosure requirements) is a system of enabling local users (not the Financial Services Agency) to exert pressure (in the best sense of the term) by publishing information, especially for local users, on (1) goals that institutions set themselves for improving their own operations and contributing to the local economy, and (2) the extent to which they achieve those goals.

3. The outlook for banking regulation

The above was a brief introduction to those policies in the Program that deal with the banking sector—in particular, how the banks need to improve their governance and risk management, and how they (and especially regional financial institutions) can contribute to regional development.

In order to ensure that Japan is not hit by another bad debt problem, action needs to be taken to improve the flow of money in the Japanese economy by reducing the overconcentration of risk in the banking system. This means that, in addition to implementing the kinds of policies described above, it will also be necessary to implement policies such as improving the working and reliability of the markets and encouraging the use of loan sales and securitization as mentioned elsewhere in the Program.

Nor will simply reducing nonperforming loan ratios solve the problem once and for all if banks continue to increase their tax-deferred assets or allow their capital bases to be eroded. They will also need to try to reduce their tax-deferred assets. One of the Financial System Council's working groups studied the issue how tax-deferred assets should be regulated as part of its work on the Financial Revival Program and published a report on the subject in June 2004, in which it pointed out that a majority of the members of the group felt that the way in which the capital adequacy rules treated tax-deferred assets needed to be reviewed to take account of the impact on the financial system and the taxation system, and so as not to conflict with either economic policies or targets for writing off nonperforming loans. With regard to this issue the Program for Further Financial Reform takes the matter one step nearer implementation by mentioning the need to review the rule on how tax-deferred assets are included in shareholders' equity.

As far as banking issues are concerned, one issue that is not mentioned in the Program is the need to reconsider the role of transaction deposits. Although several

members of the Financial System Council proposed this while the Program was being drawn up, the timing of the Program's publication (shortly before the blanket guarantee on demand deposits was due to end) probably made its inclusion difficult.

As far as small and regional financial institutions are concerned, it is debatable whether the kind of measures proposed in the action programs will suffice. For example, one option that might be considered at some point in the future is abolishing the traditional distinction between regional banks, second-tier regional banks, shinkin banks, credit cooperatives, labor banks and agricultural cooperatives, and beefing up their central organizations.

As far as government financial institutions are concerned, concern for the possible impact on the economy meant that the Program does not recommend any drastic action to reform public corporations (other than the Government Housing Loan Corporation)—in spite of the reform program drawn up in fiscal 2001. The Council on Economic and Fiscal Policy has now resumed its discussions on this matter and will hopefully report its findings in the months to come.

IV. Conclusion

Although the Program for Further Financial Reform followed on from the Program for Financial Revival, it is, as we have seen, a more comprehensive document (dealing with more than just the nonperforming loans of the main banks) and therefore perhaps more on a par with the program of financial system reform initiated by the then Prime Minister, Ryutaro Hashimoto, in 1997 ("Big Bang").

The Program also resembles Big Bang, the aim of which was to put Tokyo back on the international financial map alongside New York and London by 2001, in that it sets itself a similar goal in its subtitle—"Japan’s Challenge: Moving toward a Financial Services Nation."

However, there is an important difference in that, whereas Big Bang emphasized national needs (e.g., the need to put personal financial assets to better use in order to boost the economy, and the need to prevent Japan's financial markets from being sidelined), the Program emphasizes consumer needs and consumer protection. In this regard, the Program more closely resembles its predecessor, the Program for Financial Revival.

At the very outset, the Program for Financial Revival emphasized the need for the financial regulators to safeguard the interests of the general public (i.e., depositors, investors and borrowers, whether individuals or companies). Although that may seem obvious, the Ministry of Finance and the Financial Services Agency at that time appeared to be more concerned about maintaining the status quo of the financial services industry. The Ministry and the Agency were frequently criticized (e.g., for colluding with the banking industry to cover up the bad debt problem and for trying to solve problems behind closed doors). This was the context in which the Program for Financial Revival reemphasized the need for the regulators to safeguard the interests of the general public.

In fact, however, the Program for Financial Revival tends to be remembered as a stick with which the regulators tried to beat the banks, and there is no doubt that it was a volte-face from the previous preoccupation with safeguarding the interests of the banking industry. However, its emphasis on the need to safeguard the general public appears not to have had much response, and it was heavily criticized for its negative knock-on effects on the general public as well as on small businesses and local economies.

In contrast to the Program for Financial Revival, which, given its prime objective of resolving the bad debt problem, had little choice but to focus on the banking industry, the Program for Further Financial Reform spells out the need for the regulators to safeguard the interests of the consumer more clearly. This reflects the Financial Services Agency's desire to make customer service and customer protection a top priority.

Hence, the Program's emphasis on one-stop shopping and electronic banking. Hence, also the proposal for a "financial services consumer advice center" that would help to improve consumer protection for all financial services—in addition to proposals for an investment services law, greater disclosure and measures to prevent financial fraud (e.g., card fraud).

The financial services industry also finds itself obliged to pay more attention to customer service and consumer protection. The kind of self-serving argument that advocates or opposes deregulation out of self-interest rather than the interests of customers is unacceptable.

The Program is a worthy successor to Big Bang in that it stresses the importance of a bottom-up effort to reform. In its report "Comprehensive Reform of the Securities Market: For a Rich and Diverse 21st Century" published at the time of Big Bang (13 June 1997), the General Committee of the Securities and Exchange Council

concluded as follows: "However, it must be said that the most fundamental factor in reviving the market is the ability of Japan's intermediaries, firms and investors to use this new found freedom. Whether a free and efficient market framework will indeed lead to a revitalized market in its true sense rests squarely on the actions of market participants. Intermediaries must show creativity and dynamism and lead the market in the new environment. Freedom requires discipline and responsibility. Market participants should all make maximum use of the freedom given them, and act with integrity and discipline backed by a high ethical standard."

However, the actual situation since then has been that, instead of market participants making good use of the freedom given them, politicians and regulators have intervened directly and very conspicuously in the markets as the threat of a financial crisis has turned to reality and various compliance violations have come to light at a large number of financial institutions.

What the Program for Further Financial Reform calls for, now that Japan's financial system is gradually returning to normal, is that the general public, supported by the civil servants, should once again realize the importance of good customer service and take the initiative in creating a new financial system. Although the "financial services nation" of the Program's subtitle may suggest an image of a country that earns its living from financial services or that financial services should be Japan's number one industry, it should perhaps be understood to mean, first and foremost, that, instead of hindering it, Japan's financial services industry should seek to contribute in at least some small measure to the success of the corporate and national economy.