Reconstruction of Functions of Financial Intermediaries in Japan

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1. Full-scale financial reconstruction gets underway

After the bursting of Japan's economic bubble, two tasks emerged for Japan's financial sector. The first task is to find a solution to the bad debt problem which affects almost all financial institutions including not only banks and their affiliated firms but also the financial subsidiaries of insurance companies and securities companies, etc. The second task is to break away from a lack of competition and the "convoy" system in which all firms act in unison, which were part of the background to the present state of Japan's financial sector.

Some people blame macro policy failures. However, nobody can deny that Japan's "convoy" system in which the financial institutions all operate in the same way and expanded their lending for real estate speculation without fully realizing the risks involved which had the effect of inflating the financial bubble still further and exacerbating the bad debt problem to the extent it has reached today. Consequently, these two tasks can be seen as the need to deal with the problems which have occurred and prevention of a reoccurrence of these problems, thus neither of them can be postponed to a later date.

Regarding the second task, Japan chose to introduce the concept of competition to the Japanese market at one fell swoop by engaging in a Big Bang policy starting from November 1996. Regarding the first task, that is the resolutions of bad debts problems, it cannot be denied that until recently Japan has put off the implementation of thoroughgoing drastic measures while engaging in repeated economic stimulation measures and just hoping for a recovery in stock prices and land prices. After a considerable amount of meandering, in October 1998, the Financial Reconstruction Law and the Early Normalization Law were put into force. [*1]

The subsequently stance of the Financial Reconstruction Commission indicates that Japan has reached the stage of thoroughgoing solutions in the form of a Big Bang type of movement to deal with this task.

On January 20, 1999, the Financial Reconstruction Commission announced a basic operational policy reflecting its thinking on financial reconstruction. This displayed an extraordinary determination to seek to achieve a basic completion of the solution of the bad debt problem by the March 31st term as far as the major banks are concerned. It is also committed to the reconstruction of a financial system with unshakably powerful competitiveness by the end of March 2001 when the postponement of payoff is to be over. (Table 1)

If the financial institutions give serious consideration to the message of the Financial

*1 For details, see "Financial Reconstruction and Early Normalization Laws",Shinichi Iimura, *Capital Research Journal*, Spring 1999

Reconstruction Commission and succeed in reforming themselves, or if they are more or less forced to reform, only then will progress be made in solving the problem of bad debts. Alliances and mergers among the financial institution are already actively taking place. However, the real problem is to what extent the dissolution of bad debts problem, cost reductions and an increase in revenues will be realized. Expectations are placed on the Financial Reconstruction Commission to adopt a stance of using the act of injecting funds into financial institutions as a quid pro quo lever to get results.

The Financial System Reform law was enforced in December 1998, and a full-scale start was made to implement drastic reforms in the spirit of Big Bang to deal with the second task. In October 1999, it is expected that stock brokerage commissions will be deregulated and the ban on engaging in equities related operations by subsidiaries of banks will be lifted. In addition, from this April long outstanding changes will be made including the elimination of the transaction tax on securities and the exchange tax, and public offering of Financial Bills (Table 2). In Japan's financial market, the final approach to solving the two tasks which have remained outstanding for ten years since the bursting of the economic bubble is emerging. During 1999, it is expected that preparations will be completed to bring a predawn ray of sunshine down on Japan's economy.

Table 1 Basic Operational Policy for Implementation of Measures by the Financial Reconstruction Commission

Objectives	Term to March 1999: Completion of dissolution of bad debts held by major banks. By the end of March 2001: Reconstruction of a stable financial system with a strong competitive edge by the time payoff could begin.
1. Ensuring soundness of the financial status of financial institution	• Strict evaluation of assets and formation of reserves. • Appropriate and timely disclosure. • Clarification of the bad debt situation and early completion of measures to dispose of the problem.
2. Early normalization of financial functions (capital enhancement system)	• When self procurement is difficult, major increase in capital utilizing government guarantees. • Prerequisite conditions to increase in capital are reconstruction of operations, restructuring and efforts to reorganize. • If financial institution engage in far reaching reconstruction and rationalization of operations, preferential treatment in terms of scale and conditions for capital increase will be offered. • Even when the lending claim is cancelled, capital increase is permitted on the condition that the borrowing companies' management takes proper responsibilities.
3. Procedures to deal with failure of financial institution	• When it is judged that it would be difficult to maintain the soundness of management operations based on an objective inspection, the financial institution will not be allowed to continue to operate. • Appropriate measures with a high degree of transparency. • Protection of depositors and bona-fide and sound debtors. • Effect a smooth transfer of the financial functions and corporate value of a failed financial institution to some other sound financial institution using financial advisers, etc. • Strict accountability for responsibility on the part of the management of the failed financial institution and dishonest borrowers.

Source: Compiled by Nomura Research Institute from data published on January 20, 1999 by the Financial Reconstruction Commission.

Table 2 Schedule for Reforms of the Financial and Capital Markets

1999	February	Enforcement of Servicer Law
	March	Start of injection of capital in line with the normalization law Completion of solution of the bad debt problem of major banks Start in progressive stages of disclosure of consolidated accounting (Term to March)
	April	Abolition of securities transaction tax and stock exchange tax Commencement of FB public offerings Establishment of Resolution Trust Company Introduction of early correction measures for insurance firms Relaxation in the limits on investments by the Employees' Pension Fund
	October	Abolition of the restrictions on operations of subsidiaries of banks, securities firms and trust banks (scheduled) Total deregulation of stock brokerage commissions (scheduled) Lifting of ban on issue of straight bonds by banks
2000	January	Total separation of fiscal and financial functions of MOF, integration of financial administration
	March	Lifting of ban on establishing banks subsidiaries of insurance firms Full-scale start of disclosure of consolidated accounting and introduction of accounting for income tax (Term to March)
	?	Movements relating to the financial service law Start of Japanese version of 401(k) Conversion of life insurance firms into joint-stock companies Start of RTGS Start of issuing fiscal investment and loan program bonds and fiscal investment and loan program institution bonds
2001	March	Lifting of ban on making life insurance subsidiaries of banks (Establishment of life insurance subsidiary of securities firms into will be brought forward) Termination of postponent of payoff Start of market value accounting of financial products (Term to March) Full-scale start of disclosure of retirement benefit accounting (Term to March)
	?	Lifting of ban on sales of fire insurance and credit life insurance by banks Abolishment on restrictions on operations of subsidiaries of life and non-life insurance firms operating in each other's territory

Source: Nomura Research Institute

2. Problems of superficial emergency measure debate

Drastic changes have started based on a solid understanding of the problem. However, at the same time, due to the impatience felt over the prolonged recession and the credit crunch problem, caution is needed in view of the consideration of superficial measures by some people. Broadly speaking, there are two ideas being discussed relating to the securities market. One is the prevention of a fall in stock prices and the other is an expansion of the flow of funds through the securities market in view of the tight credit conditions of banks.

1) Problems relating to the stock price view

(1) Are politicians and corporate executives traders?

The anxiety regarding the reliability of banks has become marked from the second half of 1997 due to the fall in the price of bank stocks. As the stock market in general has been sluggish and the stock held by banks are falling in value, this has resulted in a drop in the capital adequacy ratio of banks. In view of this, the idea of preventing stock prices from falling has repeatedly emerged.

However, the stock market is a mirror of the real economy. Thus, it is loosing touch with the nature of the problem by trying to move the real economy by intervening in stock prices. The most common proposal is to take measures to prevent the drop in stock prices due to selling to correct the cross share holding situation. If this were only for a short period of time, it might be possible. However, stock prices are decided by the value of companies and the real economy, and it is not a problem of the supply and demand of number of shares.

If stocks are too cheap, the investors are likely to step in and buy them. The advantages of getting rid of the system of cross holding of stocks have been pointed out. They state that if this is done in an ordinary market, stock prices will fall, so they think that measures are needed to prevent this fall. However, up to a few years ago, the advantages of cross holding of stocks were eulogized by various sectors including academics in Japan and overseas. Thus, even they try to create a special framework and even provide special tax considerations to scrap cross holding of stocks, the general public will not support the proposition. If this mutual cross holding system is not of benefit to the corporate sector, scrapping the system should lead to an enhancement of the value of the firms involved.

The proper task of management is to make decisions by comparing the benefits of stock cross holding against the return that would ensue if the cross holding stocks were sold and the cash generated were invested in new management measures. Traders are the ones who should be thinking about how to minimize the market impact due to the temporary imbalance of the market created by the sale of stock. This is not the job of management and certainly not the job of politicians.

(2) The worst kind of IR activities

The idea of manipulating stock prices is based on a fallacious way of thinking and it is doubtful if it could be effected in reality. In the first half of the 1960s, during the stock market depression, Japan Mutual Securities and Japan Securities Holding Union were established to buy up stocks and support stock prices. However, the market continued to fall unabated, and it was not possible to avoid the Yamaichi Securities crisis. In July 1965, stock prices reversed and started to rise when a thoroughgoing economic stimulation measure package was announced including the issue of long-term government bonds, the first such issue since the enactment of the Public Finance Law.

Moreover, it should not be forgotten that the situation today is very different and the Japanese market is open to the world. Foreign investors hold 10% of Japanese stock and sometimes they account for 50% of the value of trading. When we consider the value of the assets held by investors worldwide, a shift in their assets could not be controlled by manipulation of stock prices. Illogical price formation tends to increase undesirable speculation opportunities and may lead to major turmoil on the market. It is not possible for the government, the issuing firms and some investors to grasp the true value of financial products traded on the market and they cannot force a particular price level into existence. Only when we wish to return to the age of currency control and controlled interest rates, this might be possible. This is true even for the currency and bonds issued by the government. Intervention in the market of securities issued by private sector by the public sector is a denial of the existence of the securities market.

It is laudable that Japan's management sector has been paying more attention to stock prices. However, this only has meaning in terms of undertaking management operations designed to enhance the value of stocks. If a situation arises where, when stock prices rise sharply corporate management does not call for the stabilization of stock prices, but when there is a major fall in stock prices they want to depend on the help of the government, and if we see an nature of such Japanese management personnel running companies, this gives the impression that they are firms which do not have the moral right to issue stock and are not worth including in investor portfolios and that is how the top level institutional investors worldwide will evaluate such firms. This is the worst kind of IR activity and it will only result in forcing down the real value of the stock.

2) The problems associated with measures to solve the credit crunch

The concept of strengthening finance through the securities market as a measure to counter tight lending at banks and the recalling of loans is fine as far as it is a general proposition. However, if rough and forcible measures are used to this end this could have an undesired effect on the development of the stock market. The concept of expanding intermediary financial through the securities market as an alternative to indirect financing through banks is a core element of the Big Bang. In the final report of the Securities and Exchange Council, this was a basic element. The series of reforms carried out in the securities market were introduced to expand intermediary funding through the stock market through improved efficiency, fairness and a more international approach.

Some of the debates proposing direct financial strengthening show a tendency to demand an increase in the scale of direct financing even if this means distorting market forces all with the object of creating alternatives to bank lending.[*2] For example, the idea of regarding the issue of CPs or corporate bonds with a public sector guarantee backing is a form of intervention in market forces and so it requires very careful consideration. For example, the idea of launching the securities of a smaller sized firm on the market with government backing if the firm itself is unable to procure funds on the capital market, would result in investors considering this product to be the same as a bank deposit covered by deposit insurance, and the creation of this kind of situation presents problems. It must not be overlooked that the Bank of Japan is actively holding CPs, and it would be extremely dangerous to extend this way of thinking to corporate bonds.

Superficially it appears that there is a drop in the dependence on bank loans by the corporate sector and the issuing of CPs and securities is covering this shortfall and changes appear to have occurred in the structure of money flow. However, if we look at this another way, it means that the economy has fallen into a situation similar to the former socialist countries when for example Gosbank financed state-run companies. Some people express the view that the issuance of private placement securities should be actively encouraged. However, in the case of the issuance of private placement securities in the US (Particularly, those based on Rule 144A), it required a degree of disclosure close to that of a public offering and they also obtain credit rating. However, the private placement market in Japan has a strong characteristic of a quasi loan market and disclosure is insufficient. Unless these properties are changed, the act of increasing these issues will merely distort the market.

*2 Direct financing is a misleading word. Investment trusts and pension funds are not the final investors, and fund flows through them is classified as indirect financing. When we consider the importance of securities investment through the market by these investors, these days a technical term known as "market oriented indirect financing" is used. Here we will use the term "market oriented financing" which includes the original direct financing.

3. Market forces should be at play especially during crises

1) The incorrectness of arguments regarding the securities market which ignore market forces

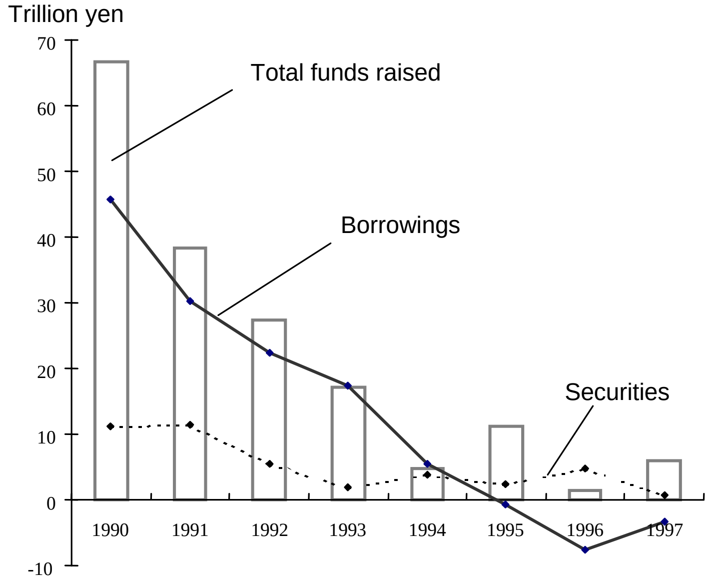
Discussion on measures regarding stock prices and discussion on utilizing the securities market as a means of overcoming the credit crunch are both measures involving the use of the securities market to escape from the present situation. However, as we have seen so far, they are both measures that require us to go against market forces and they present many problems. If we consider the situation calmly, it is illogical to think that if the lending market is not functioning, the stock market should be used.

First and foremost, we must be aware of the fact that Japan is now facing a structural contraction of credit. As can be seen in Figure 1, in the area of corporate fund raising, there is a major decrease in borrowings. However, fund raising on the securities market is also sluggish. During 1998, the issuing of straight corporate bonds continued at the highest level ever of one trillion yen per month. However, the problem lies in the whereabouts of the outstanding amount of 480 trillion yen shown to be lent out by the domestic banks on their books. Looking only at procurement on the securities market, just by manipulating prices and the flow of funds the overall problem will not go away.

Relation based transactions such as those on the lending market allow a large amount of internal information on the participants to be used in making a decision. However, the participants in the securities market require a decision to be made with only public information available. At this time of anxiety regarding trustworthiness, market oriented financing reacts more sensitively and contracts. Under these economic conditions, it is quite natural that the lackluster state of the stock market continues to prevail. It is unavoidable that some issues are heavily sold due to the intensification in anxiety.

Trying to prevent this phenomenon in isolation is an impossible task unless the basic economic environment shows an upturn. In fact, if stopgap measures are implemented, this may lead to undesirable side effects. The idea of reforming the securities market should be considered taking into account the basic principles of strengthening the market functions and not being distracted by trends in stock prices or credit crunch trends. Even if immediate results are not obtained on the economy, if they lead to the creation of an efficient, fair and internationally oriented market in the medium- to long-term market, this is a good thing. Reforms in systems based on these concepts have been realized to a considerable extent in the Financial System Reform Law. Firstly, the most basic requirement is for the private sector to show initiative under this law.

Figure 1　Fund Raising by the Corporate Sector



Note:　In addition to borrowings and securities, the total of funds raised also includes CPs, borrowing from overseas, etc.
Source: "Flow of funds", by the Bank of Japan

2) The real measure needed to deal with crises is to invoke market forces

(1) Emergency and unprecedented measures have already been taken

At times of crisis like these some people disagree with the theory of going back to basic principles.　However, in order to respond to crises, it is dangerous to invoke the concept of the desirability of engaging in strategic intervention ignoring basic market forces.　We must not forget that, in view of the awareness that Japan is facing some kind of a crisis, a massive amount of public funds (60 trillion yen) was made available in October 1998 to create a framework to solve the problem of the bad debts of Japan's banks, the core element of Japan's economic problems.　Indeed, unprecedented emergency measures have been taken due to the awareness that this is an emergency situation.　Japan is burdened with massive fiscal deficits, and seen in that context the weight of 60 trillion yen means that it is impossible to maintain the same arguments before and after October 1998.

As these emergency and unprecedented measures have been taken, it is impossible to understand the need for the introduction of measures contrary to the spirit of Big Bang which aims at financial system in which the market functions properly.　If people hold the belief that "In a crisis anything goes", the market will engage in retaliation in the form of a rise in long-term interest rates due to fears of an increase in the fiscal deficit.

(2) Emergencies would create and develop securities markets

Recovery from the state into which Japan has now descended is being delayed by the lack of serious consideration of market forces, and attention should be focused on the fact that one approach to solving the crisis is to let market forces work to the full.　Looking back at the history of the formation and development of the government bond market in the US and that of the Euro market, the formation of the securities market in Japan after the Meiji Restoration, the movement to open up the securities market to the general public after the dissolution of the Zaibatsu (conglomerates) after the Second World War, the massive issuing of government bonds and the creation of a secondary market in government bonds, we can see that it is in times of crisis that securities markets are created and develop.

Direct financing know-how is difficult to acquire. However, it is also not possible to create such know-how deliberately over a period of time. As seen in the example above, when the need arises, and market forces are allowed to operate, at that time the market is created and expands naturally. In order to avoid unnecessary confusion, it is necessary to make efforts to change systems. However, if the market forces of the securities markets are not allowed to function, know-how will never be acquired. Improvements in systems should advance by coming into contact with actual problems and repeating a process of trial and error. The curbing of falls in stock prices, and the curbing of credit premiums on interest rates levied in accordance with actual state of the companies lead to the prevention of natural market forces working and nip the development of market oriented financing in the bud.

(3) Providing public sector support to banks which have little regard for the market principles is a problem

Reviewing the measures now being taken in Japan's market seen from this viewpoint, we can see that not only do the measures hinder the shift from an indirect financing system to a market oriented financing system, but in fact they are sacrificing market oriented financing and seeking to support an indirect financing system. Supporting the stock market by buying up stock to protect the position of the banks is one example of this. Financing through CPs in Japan is at a level of one tenth that of the US, it is difficult to issue BBB rated bonds for investment and a high-yield bond market with an even lower rating has not yet been formed in Japan.

The background to these is the reality that banks continue to provide finance without letting them issue corporate bonds or CPs with a rate high enough to make institutional investors want to buy them. In Japan, banks still purchase and continue to hold the CPs or corporate bonds of firms at a rate which is lower than the actual market rate to ensure that the banks can maintain a long-standing relationship with them. The banks do this not only for sound firms which can issue CPs or corporate bonds, but also for companies that are not necessarily sound but with which the banks has had a long-standing relationship.

Thus, the lending of banks does not reflect the actual market situation. In the corporate bond market, from the second half of 1997, major differences emerged in the credit worthiness of the corporate bonds issued. However, the lending rate of banks does not reflect this. Consequently, there is a major gap between the rate of lending by banks and the secondary market for securitized loan. This means that the banks are sapping their own strength.

The banks continue to go against market forces while receiving injections of public funds and cash flow support from the Bank of Japan. Here, too, we see that a mechanism is at play in which superficially justifiable measures to cope with the emergency situation are put in place but in reality they are delaying changes in the money flow structure of Japan and they are putting off the solution of the problem. For example, even if it is necessary to take unprecedented emergency measures to support the banking system, it is essential that they also strongly insist on a simultaneous correction of the behavior of the banks which is not in line with market forces seen from the viewpoint of developing market oriented financing. The Financial Reconstruction Commission should ensure this observance is included in the operational reconstruction and rationalization of management now being demanded of the banks.

4. Toward a diversification in the finance and financial service sectors - waiting hopefully for the Financial Services Law

1) Advances in securitization and a strengthening of market oriented indirect financing

Big Bang stressed strengthening of direct financing functions. As previously discussed, it is extremely important to utilize to the fully market oriented financing in the case of the failure of indirect financing to function. The interim report of the Economic Strategy Council announced on December 23, 1998 stressed the importance of direct financing and market oriented financing. "The failure to function of financial intermediary system currently occurring demonstrates the limitations of the financial structure centering on indirect financing. In order to correct the corporate financial structure which depends too much on the traditional indirect financial routes, it is essential to diversify fund procurement methods and routes and get them firmly in place as soon as possible through methods such as securitization and market oriented indirect financing."

The author also stressed and urged these measures in the book Securities Big Bang, thus the author is in agreement with the above. However, since this point of view has become very widespread, and in this report the author would like to stress that it is not enough. As can be seen from the points stressed in the Economic Strategy Council's report, they stress securitization and market oriented indirect financing as alternatives to indirect financing. Regarding market oriented indirect financing, the focus is directed on to CPs, corporate bonds and investment trusts.

Regarding securitization, the SPC Law was enforced in September 1998, and advances were made in building up schemes using SPC. Regarding CPs, corporate bonds and investment trusts, due to the various reforms initiated by Big Bang, these instruments are showing improvement. Consequently, in these areas, sustained efforts to bring about further reforms will continue as public opinion is focused on this area in spite of the fact that further efforts are needed regarding the improvement of the SPC Law, the issuance of non-bank corporate bonds, the securitization of the credit of the Housing Loan Corp. and a shift to paperless handling of CPs.

2) Alternative financing flow

However, the discussions up to now have not focused very much on a very important area which is the alternative investment sector. Alternative investment means investment outside the conventional asset class such as stocks or bonds and this includes venture capital, buy-out funds, distressed funds and hedge funds, etc. In the US, the mechanism used for investment in these alternative investments include operation in the form of limited partnership. The investors hold a limited partnership share. In the case of venture capital, buy-out funds, and distressed funds, normally it is difficult to cash them prior to maturity, thus they have almost no secondary market. Generally speaking, in the case of hedge funds, after the one year closed period, upon prior notice at one to three months in advance, the investor is allowed to cash in once every three months or once a year. This is a far cry from the liquidity of normal investment trusts. It is almost impossible to transfer the holding itself.

When we exclude hedge funds which investing in products with liquid market, the people who manage these operations do not just invest in certain stocks such as venture company stocks, buy-out company stocks and distressed funds and wait for their prices to rises. They are deeply committed to the management of these companies, and they play a major role in formulation and implementation of strategies involving products, sales, personnel and finances. Through this, they are able to greatly enhance the value of the firms they invest in and actively generate an increase in the value of the stock and non performing assets held.

In terms of the holdings lacking in liquid secondary market and increasing the value of the investment through direct commitment to the management of the firm they invest in, this clearly has a very different character to securitization or the normal type of market oriented indirect financing.

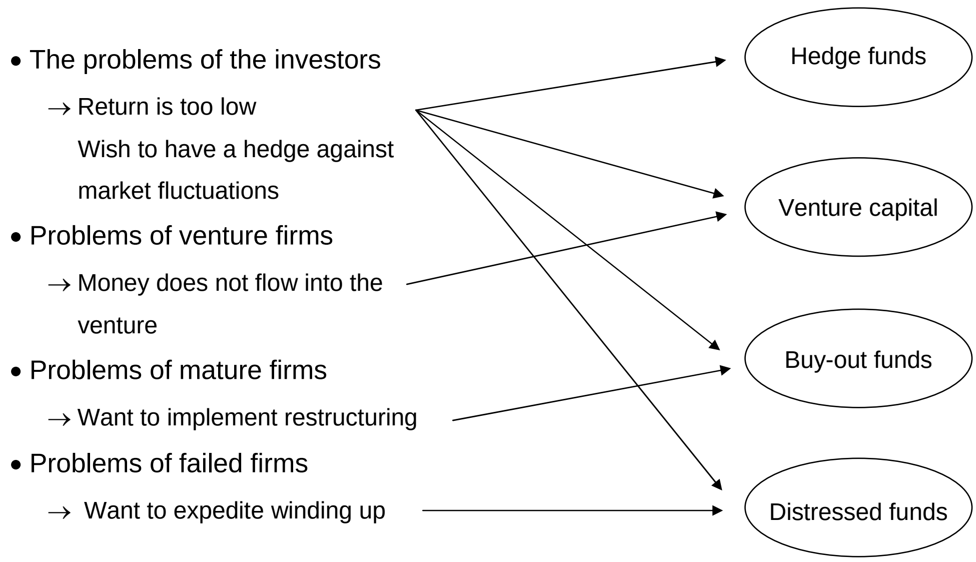
3) Alternative investments could help saving Japan

It is thought that these alternative financial flows can perform a definite role in solving many of the problems Japan's economy now faces. (Figure 2) That is to say, in order to create venture firms to support Japan in the 21st century, venture capital will be essential. In order to promote the restructuring of existing companies, buy-out funds are essential. Again, in order to expedite the dissolution of failed companies the existence of distressed funds is necessary. For the Japanese investors who suffer due to the low profitability of their conventional assets, these funds will provide opportunities to earn attractive returns and to diversify their portfolios.

Venture capital has existed up to now, but unlike the case of the US, in Japan there is no major flow into venture capital of funds of institutional investor such as pension funds or funds of affluent individuals. One reason for this is that Japan's venture capital has been managed as an investment operation partnership, a voluntary partnership under the civil law, which lacks in the clarity and solid limited liability status as opposed to the limited partnership status in the US. Regarding this, from November 1, 1998, a law concerning the partnership contracts of medium and small companies, etc. with limited liability regarding investment operations was enacted. This defines the extent of responsibility of the partnership participants and it achieves a major improvement in information disclosure.

However, this is a special rule in partnership contracts under the civil law with the objective of promoting the development of venture business. Thus, it is not applicable to other forms such as buy-out funds, distressed funds and hedge funds which presents a problem. There are cases of these funds being established overseas and brought into Japan in the form of performance-linked notes issued by SPC, beneficiary securities of foreign investment trusts and partnerships. However, regarding partnerships, the Securities & Exchange Act is not applicable.

Figure 2　Problems in Japan's Economy and the Alternatives



4) A comprehensive framework is needed for diversified finance and a diversified financial service sector

Since last year, foreign funds have been actively buying up Japan's bad debts, and incorporating them in products, and the Japanese investors are buying them.　That is to say, there are sources of funds available in Japan willing to invest in high-risk, high-return products.　However, these funds do not flow freely in Japan and they travel via foreign funds back into investment in Japanese assets. Naturally, the domestic investors have to bear the currency exchange risk.

If there is an expansion of distressed fund business in Japan, it will facilitate the investing of funds by domestic investors who seek high-risk, high-return products.　In addition, the banks would be able to dispose of their old bad debts more easily and this would make it possible for banks to start implementing new lending to borrowers with appropriate risk return factors.

However, here the author wish to emphasize that it is not just a matter of facilitating the establishment and sale of these funds in Japan.　The reason for this is that if this format alone is emphasized, it will give rise to a movement to create new laws to regulate it.　If this happens, the problem will be that innovation will be in play and new types of financing and financial services, previously inconceivable, will emerge, and again Japan will get off to a late start because new laws and regulations will be created to control them.

Thus, the important thing is to create a comprehensive framework to cover all the diversified finance and the financial service sectors facilitating the creation of a broad spectrum of new products in Japan, and not just shining the spotlight on each new creation as it comes along such as securitization, market oriented indirect financing and alternative investments.

This will avoid a situation of theories emerging in advance of realities with people saying indirect financing is outmoded, it is now the age of direct financing and alternatives.　If this is done, various financing systems matched to the needs of the age will emerge with flexibility.

5) The faults in an institutional approach such as the Servicer Law

Let's look at another example of the adverse effects of a lack of a comprehensive framework. In October 1998, the Servicer Law came into existence and the servicer institutions will soon emerge.[*3] However, a major feature of this is that a new type of institution has come into existence in Japan in the form of debt collection firms which undertake debt management and recovery operations, and Servicer Operations are to be carried out by Servicer firms. Moreover, the servicer firms are required to be dedicated only to these operations and there are many barriers to hinder the entry of newcomers.

In the US there are people who carry out servicer operations but legally there are no servicer firms and no such systems. Consequently, there are no firms that have been authorized or designated as servicer firms. The background to this positioning is that in Japan the Servicer Law allows the management and recovery of debt by the private sector, operations formerly restricted to lawyers, and the framework is based on the laws relating to lawyer. Consequently, it is not necessarily a problem of financial laws and regulations of financial administration.

However, within the wave of reforms seeking to remove the barriers separating sectors, and achieve global standards, a new exclusive sector has again been created in Japan's financial sector, and this is a sector which does not even exist in the US. The feeling that this kind of result is natural is because Japan is a country where the financial service sector is closely limited in terms of the creation of subsections such as banking, securities and insurance, and these are all subjected to various laws created specially for each sector, and they are controlled and regulated in this way based on outdated concepts.

This is the Japanese way. Thus, when a business emerges which does not fit into any of the categories existing such as banking or securities, it is designated as a new sector and new laws and regulations are created to govern it. Moreover, the result is that when a certain firm needs to decide if it can undertake a different operation, discussions are not held based on business reasons, but sterile discussion are repeated due to the vested interest involved. This prevents various financial sector firms from being able to provide numerous different types of financial services closely matched to the needs of the economy and society with flexibility and speed.

As we move into the 21st century, in the financial markets of the world, the conventional frameworks of financial services such as banking, securities and insurance are being reviewed. This means that it is necessary to correct and reform the frameworks created based on the idea of outdated sector laws and it is necessary to create a framework which encompasses diverse financing and financial operations.

6) Toward the creation of a financial system for the 21st century

This kind of framework is just what is needed for the new Financial Service Law which is expected to be drafted. Movements related to the Financial Service Law include the holding of meetings "Meetings on new flows in financing" from July 1997 to June 1998, as joint study sessions with the participation of the ministries related to financial matters. Here discussions were held on the nature of the new financial laws and regulations based on the concept of the introduction of the Financial Service Law. Subsequently, from December 1998, a meeting was

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*3 For details, See “Enactment of the Servicer Law”, Shinichi Iimura, *Capital Research Journal,* Spring 1999 held of the first section of the Financial Council and discussions were undertaken.

Thus, as the author have stressed in this report, the need is for comprehensiveness, and not just a review of the conventional vertically segregated world of finance. It is necessary to encompass everything, even the sectors which previous were not covered by conventional financial frameworks, if it is at all relevant to finance. However, at the same time, it is necessary to understand why these special laws, different to those of other industries, are needed in financial sector. In the new framework, it is essential to eliminate the possibility of damaging things such as competition and innovation and to avoid preventing or discouraging diversity in the financing and financial sectors.

The Financial Service Law is essential as a vehicle allowing flexibility in the creation of new financial products and services. Regarding this, considerable discussion was made at the "Meetings on new flows in financing". However various problem areas remain such as how to create a framework different to that of ordinary firms which has to encompass measures to deal with systemic risk, measures to ensure protection of investors and measures to ensure the integrity of the market.

It is certain that merely by cleaning up the bad debt problem and implementing Japan's Big Bang, it will not be possible for Japan's present financial industry, a sector that has caused major turmoil in the economy and the society, to have a fresh start in the next century. Only when a Financial Service Law type framework is put in place will the preparations be available to reconstruct Japan's financial industry for the coming century. Close attention is fixed on the deliberations of the Financial Council.