The Regulatory Reform Law and Reform of Government-Affiliated Financial Institutions in Japan

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I. Introduction

The Regulatory Reform Bill ("Bill to Promote Regulatory Reform to Make Government Simpler and More Efficient") was passed by the House of Councilors in plenary session on 26 May 2006 and promulgated on 2 June 2006.

The Law, which aims to make government simpler and more efficient, focuses on five main areas of reform: government-affiliated financial institutions, independent administrative institutions, governmental special accounts, the total employment costs of public-sector workers, and state assets and liabilities.

The debate about reform of government-affiliated financial institutions began in the early 2000s. In December 2001 the Cabinet passed a resolution to abolish the Government Housing Loan Corporation within five years as part of its Reorganization and Rationalization Plan for Special Public Corporations.[1] However, it decided that solving the country's bad debt problem should take precedence over reform of the eight other government-affiliated financial institutions until the economic and financial situation improved.

In February 2005 the issue of the reform of government-affiliated financial institutions came up for serious discussion again when the Council on Economic and Fiscal Policy presented a report recommending that these institutions be either abolished or amalgamated. The outcome of this was the Regulatory Reform Bill.

While the passing of the Postal Privatization Law, the cornerstone of the Koizumi government's reform program, in October 2005 marked the first stage in the process of reforming Japan's Fiscal and Investment Loan Program, the passing of the Regulatory Reform Law in June 2006 marked the final stage of this process—namely, the reform of government-affiliated financial institutions.

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1 The Government Housing Loan Corporation is due to be abolished on 1 April 2007 and replaced by the Japan Housing Finance Agency, an independent administrative entity that will assume the Corporation's rights and obligations, and also provide securitization support services. (The Agency will be established in accordance with the "Japan Housing Finance Agency Law," promulgated on 6 July 2005.)

The publication soon afterwards (on 27 June 2006) of a blueprint for reform of government-affiliated financial institutions ("the Blueprint") presented an even clearer picture of the government's plans.

In this report we shall focus on just one of the five main areas of reform covered by the Regulatory Reform Law: the amalgamation and restructuring of government-affiliated financial institutions.

II. The Government's Views on Government-Affiliated Financial Institutions

The government's views on government-affiliated financial institutions are contained in a policy document ("Basic Policies for Reform of Government-Affiliated Financial Institutions") agreed by the government and the ruling coalition and published by the Council on Economic and Fiscal Policy on 29 November 2005.

The main thrust of the document is that government-affiliated financial institutions should confine their role to three activities—(1) helping small businesses and individuals to obtain finance, (2) providing the finance needed to ensure that Japan has access to essential overseas natural resources and is able to compete with other countries, and (3) providing official aid (a combination of public-sector lending and official development assistance)—and discontinue all other activities.

It divides the activities of existing government-affiliated financial institutions into three categories: (1) those they should discontinue, (2) those that are essential to government policy and should be continued, and (3) those that should be continued for the time being but discontinued at some point in the future. The Regulatory Reform Law adopts a similar approach.

In the rest of this report we shall look at the reform of Japan's government-affiliated financial institutions in more detail.

III. Overview of the Reform of Government-Affiliated Financial Institutions

Japan has eight government-affiliated financial institutions: Shoko Chukin Bank, the National Life Finance Corporation, the Agriculture, Forestry and Fisheries Finance Corporation, the Japan Finance Corporation for Small and Medium Enterprise, the Japan Finance Corporation for Municipal Enterprises, the Okinawa Development Finance Corporation, the Japan Bank for International Cooperation, and the Development Bank of Japan.[2] Under the Regulatory Reform Law, two of these (Shoko Chukin Bank and the Development Bank of Japan) are due to be fully privatized, and the Japan Finance Corporation for Municipal Enterprises is due to be abolished, while the remaining five are due to be amalgamated in fiscal 2008 (Figure 1). However, the role of the Japan Bank for International Cooperation (JBIC) as a provider of official development assistance is due to be transferred to the Japan International Cooperation Agency (JICA), an independent administrative institution (Article 4(1)), while the Okinawa Development Finance Corporation will continue in its present form until fiscal 2011 (the final year of the current Okinawa Promotion and Development Plan) and be amalgamated with the other institutions after fiscal 2012 (Article 11(1)).

The Law restricts government-affiliated financial institutions to two roles: (1) helping the general public, small businesses and those engaged in farming, forestry and fishery to obtain finance, and (2) promoting the development overseas of natural resources to which Japan needs access and helping Japanese companies to maintain or increase their competitive edge (Article 4(1)).

It is interesting to note that the policy document "Basic Policies for Reform of Government-Affiliated Financial Institutions" assigns the role of (1) helping small businesses and individuals to obtain finance to the domestic arm of the new institution to be formed by amalgamating existing government-affiliated financial institutions, and the role of (2) providing the finance needed to ensure that Japan has access to essential overseas natural resources and is able to compete with other countries to the overseas arm of this institution. Similarly, it preserves the Japan Bank for International Cooperation's role of (3) providing official aid but transfers it to the Japan International Cooperation Agency.[3]

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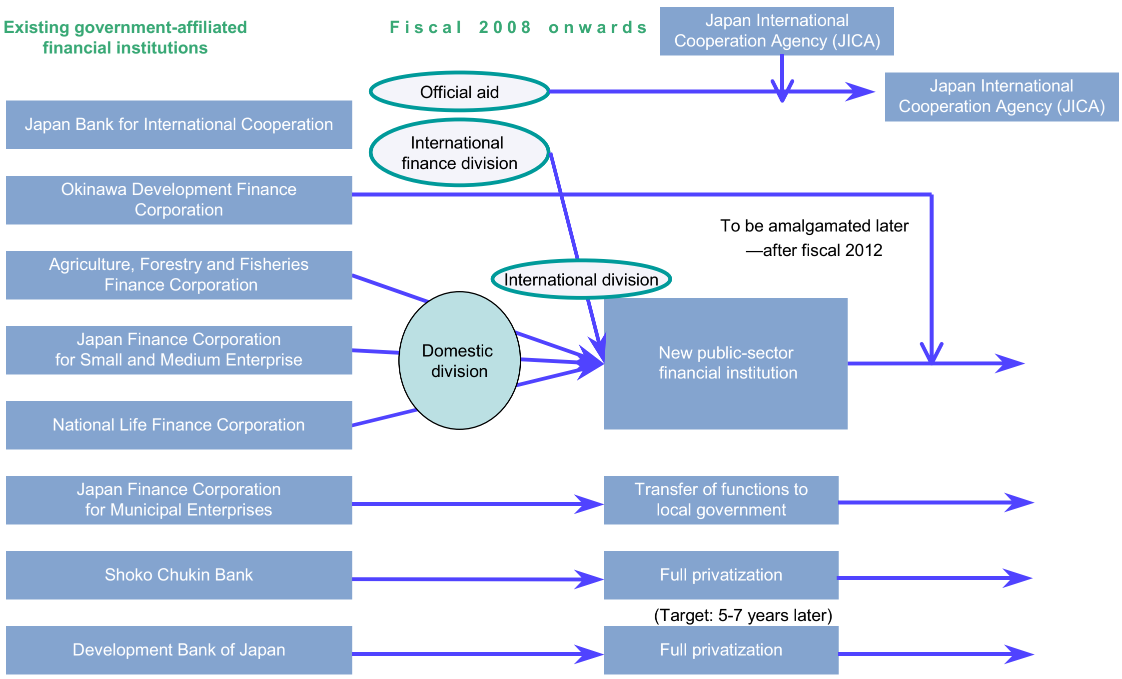
[2] The Development Bank of Japan was established in October 1999 as the successor to all the rights and obligations of the Japan Development Bank and the Hokkaido-Tohoku Development Finance Public Corporation. The finance functions of the Japan Regional Development Corporation and the Japan Environment Corporation were also transferred to the Bank.

[3] However, the Ministry of Foreign Affairs will continue to provide grant aid where flexibility is a priority.

Figure 1 Restructuring of Japan's Government-Affiliated Financial Institutions



Source: NICMR, from various sources.

IV. Government-Affiliated Financial Institutions post October 2008

1. New institution to be formed from existing government-affiliated financial institutions

The Blueprint makes it clear that the new institution to be formed from existing government-affiliated financial institutions will be incorporated as a special company under the Japanese Corporate Law.[4]

As was mentioned above, five of the existing eight government-affiliated financial institutions are due to be amalgamated in October 2008. However, the new institution will not retain all of their functions. It will therefore be subject to certain numerical restrictions on its lending. More specifically, the Law requires that the combined amount of loans outstanding at the new institution and the Okinawa Development Finance Corporation as a percentage of nominal GDP at the end of fiscal 2008 be no more than half that of existing government-affiliated financial institutions at the end of fiscal 2004 (Article 5(2)).

[4] According to the Regulatory Reform Law (Article 5(1)), the new institution will be established in fiscal 2008 in accordance with a specific law and by a specific legal act as a corporation, independent administrative entity or similar body.

Total loans outstanding at the government-affiliated financial institutions at the end of fiscal 2004 amounted to ¥90,653.9bn, the equivalent of 18.3% of nominal GDP, which was roughly ¥496trn. Since total loans outstanding at the two government-affiliated financial institutions due to be privatized (the Development Bank of Japan and Shoko Chukin Bank) and the Japan Finance Corporation for Municipal Enterprises, which is to be abolished and its functions transferred to local government, amount to just over ¥48trn, the goal of halving lending by government-affiliated financial institutions as a percentage of nominal GDP by the end of fiscal 2008 should be achieved, provided nominal GDP is the same as at the end of fiscal 2004. This has led a number of observers to comment that the Law's lending provisions will therefore not achieve the declared aim of reducing lending by government-affiliated financial institutions.[5]

The new institution to be formed by amalgamating five of the existing government-affiliated financial institutions will have two main divisions: a domestic division and an international division. The Law grants both divisions considerable powers to enable them to employ and train specialists (Article 5(4)). It has even been reported that the government plans to make the two divisions semi-independent.[6]

The plan is supposedly that the roles of four of the existing government-affiliated financial institutions (the Japan Finance Corporation for Small and Medium Enterprise, the National Life Finance Corporation, the Agriculture, Forestry and Fisheries Finance Corporation, and the Okinawa Development Finance Corporation) will be assumed by the domestic division, while that of the Japan Bank for International Cooperation will be assumed by the international division. In particular, it would seem that the government would like the international division to retain as much as possible of the status that the Japan Bank for International Cooperation has acquired overseas (Article 5(4)) and is planning to allow the Bank's international division to retain its independence in the hope of making the most of that status. In fact, the Blueprint states that the Bank's name may be used in the English version of the name of the international division in combination with that of the new institution as a whole in order to retain this status.

5 See "Seisaku Kin'yu Kaikaku e no Rodomappu" [A Roadmap for Reform of Japan's Public-Sector Financial Institutions], Kin'yu Zaisei Jijo [Financial and Fiscal Affairs], 20 February 2006, p. 13.

6 "Shinseifukei Kin'yu, Kanpanisei ni—Kokusai Bumon Dokuritsu, Togo Koka Sogu Osore" [Government Plans to Make International Division of New Public-Sector Financial Institution Semi-Independent: Synergy Effect May Be Lost], Nihon Keizai Shimbun (morning edition), 20 March 2006.

Figure 2 Types of Government-Affiliated Financial Institutions

Existing government-affiliated financial institutions	Function	Reason	Types(*)	Loans outstanding as of March 2005 (¥100mn)	Loans outstanding as of March 2005 (¥100mn)
Development Bank of Japan (Full privatization)	Lending to large and medium-sized companies	Unlike during the period of rapid economic growth in the 1950s and 1960s, companies can now obtain funds from a variety of sources (e.g., by issuing bonds or shares) as well as private-sector lenders.	(a)	139,656	139,656
Shoko Chukin Bank (Full privatization)	Full-service banking	Withdrawing from full-service banking (e.g., deposit taking and bill discounting) as offered by private-sector financial institutions.	(a)	95,888	95,888
	Lending to cooperatives	Since lending to cooperatives should be a membership system whereby members offer each other assistance, there is no need for public-sector finance.	(a)		
Japan Finance Corporation for MunicipalEnterprises in fiscal 2008 (Abolition)	Joint issuance of local government bonds	Withdrawing from joint bond issuance by local authorities.	(a)	250,241	250,241
Japan Finance Corporation for Small and Medium Enterprise	General lending	Withdrawing because, unlike during the period of rapid economic growth in the 1950s and 1960s, when there was a general shortage of capital, there is now a surplus of capital and therefore no need for additional sources—even of capital for small businesses.	(a)	NA	79,723
	Special lending	To be limited to implementing government policy for small businesses.	(b)	NA	
	Special lending	To be subject to regular review and to be discontinued where need has declined.	(c)		
National Life Finance Corporation	Lending to small businesses	To continue to lend to small businesses (e.g., business improvement and environmental health loans) as part of government policy where this is unprofitable for smaller private-sector institutions.	(b)	84,202	95,775
	Lending money to pay tuition fees	To continue with lower earnings ceilings, but on a reduced scale, because of the need of low-income families for such loans.	(b)	11,131	
	Lending money to pay tuition fees	To discontinue offering such loans where alternatives (e.g., loans from private-sector institutions or scholarships from the Japan Student Services Organization, an independent administrative entity) are available.	(a)		
Agriculture, Forestry and Fisheries Finance Corporation	Lending to those engaged in farming, forestry and fishing	To continue to offer super-long-term low-interest loans where capital markets offer no alternatives.	(b)	26,702	32,699
	Lending to food-processing companies	To discontinue offering such loans to large and medium-sized companies.	(a)	5,998	
	Lending to smaller food-processing companies	To offer only loans with a maturity of 10 years or more.	(b)		
Japan Bank for International Cooperation	Overseas economic cooperation	To transfer the role of provider of overseas economic cooperation (official aid) to the Japan International Cooperation Agency and to focus on official development assistance, an area where the private sector is not involved.	(b)	113,405	198,403
	International finance	To retain only those international finance functions (e.g., trade finance, investment and untied loans) necessary to provide access to overseas natural resources and to enable Japanese companies to obtain a competitive edge.	(b)	84,998	
	International finance	To discontinue other international finance functions.	(a)		
Okinawa Development Finance Corporation	Same functions as mainland finance corporations	To put the Corporation on the same footing as mainland corporations with regard to continuing or discontinuing functions.	(a)(b)	NA	14,154
	Special development projects and preferential rates for Okinawa	To retain functions that can be justified for historical or geographical reasons.	(b)	NA	

	906,539
Nominal GDP (¥100mn)	4,962,351
As % of nominal GDP	18.3
	9.1

Note: (a) to be discontinued; (b) to be continued as a necessary part of public finance; (c) to be continued for the time being but discontinued at some point in the future.

Source: NICMR, from Council on Economic and Fiscal Policy's "Basic Policies for Reform of Government-Affiliated Financial Institutions."

2. Shoko Chukin Bank and the Development Bank of Japan

The Law states that in fiscal 2008 action will be taken to reduce government involvement in both Shoko Chukin Bank and the Development Bank of Japan to ensure their independence and that all government funding will be withdrawn (i.e., that both institutions will be privatized) 5-7 years later (Article 6(1) and 6(2)).

Shoko Chukin Bank is the only government-affiliated financial institution in Japan with a private-sector involvement. 78.4% (or ¥405.3bn) of the Bank's capital is owned by the state.[7] In contrast, all of the Development Bank of Japan's capital of ¥1,272.2bn is owned by the state. The Law states that this must be reduced, eventually to zero.

In order to ensure that Shoko Chukin Bank and the Development Bank of Japan both continue to be able to operate properly after they are privatized, the House of Councilors' Special Committee on Regulatory Reform appended a resolution to the Law supplementing its provisions and calling on the government to take the necessary action.[8] In addition, the Blueprint describes the future shape of both Shoko Chukin Bank and the Development Bank of Japan in more detail.

In the rest of this section we shall take a closer look at what is envisaged for both institutions.

1) Shoko Chukin Bank

First of all, the Law makes specific provision for action to be taken to ensure that Shoko Chukin Bank retains its ability to provide finance for trade associations such as the Cooperative Association of Small and Medium Enterprises and their members (Article 6(3)). In this regard, the supplementary resolution also calls for regulatory action to be taken after Shoko Chukin Bank is privatized to ensure that it continues to be able to provide the finance needed by small businesses.

This reflects the view that a cooperative institution such as Shoko Chukin Bank set up to enable small businesses to offer each other financial assistance should be able to continue to perform this role even when it no longer receives any government funding.

The supplementary resolution also contains two provisions to enable the Bank to continue to perform this role: first, that it should be allowed for the time being to continue to issue one-year discount and five-year interest-bearing debentures to enable it to raise any capital it needs; and, second, that it should build up reserves to match most of the government's share of its capital to enable it to operate on a sound financial basis.[9]

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7 The remaining 21.6% (or ¥111.8bn) is owned by small business cooperatives (as of end-March 2005).

8 "Supplementary resolution appended to the 'Bill to Promote Regulatory Reform to Make Government Simpler and More Efficient' by the House of Councilors' Special Committee on Regulatory Reform" (25 May 2006). A "supplementary resolution" is a legally nonbinding expression of opinion appended to a bill that has been voted on about how it should be implemented.

9 The two provisions were also included in the Blueprint as transitional measures.

Furthermore, the Blueprint calls for regulatory measures such as restrictions on who can become a shareholder in order to ensure that the Bank can continue to service the needs of small business associations and their members even when it is fully privatized.

2) Development Bank of Japan

The Law also makes specific provision for action to be taken to ensure that the Development Bank of Japan retains its ability to provide long-term business finance (Article 6(3)). In addition, the supplementary resolution calls for action to be taken to ensure (1) that, even after it is fully privatized, the Bank continues to be able to provide medium- and long-term finance (e.g., for regional development) and (2) that it makes the most of its standing (e.g., by maintaining its creditworthiness and ensuring a stable shareholder structure) and uses a wide range of financing tools to maximize shareholder value.

V. Outlook

As well as amalgamating Japan's existing government-affiliated financial institutions and providing guidelines for both the new institution that they will form and the two institutions that will be privatized (Shoko Chukin Bank and the Development Bank of Japan), the Regulatory Reform Law provides a more detailed blueprint for the reform of Japan's government-affiliated financial institutions.

However, even this blueprint is not always specific. For a more detailed picture of the new institution and the future of both Shoko Chukin Bank and the Development Bank of Japan we shall have to wait for the publication of a related bill, the "Government-Affiliated Financial Institution Reform Bill" (tentative name), that is due to come before the Diet next year.