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Foreign Financial Institutions in Japan

Since the late 1970s, Japan's financial system has undergone continual liberalization. Prominent features of the process have included interest rate deregulation and the relaxation of capital controls on international transactions. These reforms have transformed Japan's domestic financial system in recent years from one dependent on bank lending, funded largely by deposits with officially controlled interest rates, to one with a growing variety of assets carrying market rates available to foreign and domestic investors.

Another important element in the liberalization has been the granting to foreign financial institutions of greater access to Japan's financial markets. Access to the potentially profitable Japanese financial services sector presents an attractive opportunity to banks and securities firms from the United States and other countries. Indeed, the number of foreign banks in Japan increased from 63 in 1979 to 79 as of September 1986, including 19 banks from the United States. As of November 1986, there were 36 foreign securities firms, 18 from the U.S. with fully licensed branches in Japan — up from only 8 in 1983. In 1986, Tokyo's stock exchange accepted its first six foreign members, three of which were American.

This *Letter* discusses the treatment of foreign banks and securities firms in Japan. While progress has been made in improving the treatment of foreign institutions, as the increase in their number implies, foreign banks and security firms still face problems penetrating Japanese markets.

Improved position of foreign banks

Recent reforms have undeniably alleviated overt discrimination against foreign banks in Japan, and, from a legal standpoint, Japanese and foreign banks are now generally accorded "equal treatment." Some specific measures that have enhanced the competitive position of foreign banks are reviewed below.

First, the end of limits in June 1984 on the conversion of foreign currency into yen by banks with foreign currency dealings and the gradual reduction in ceilings on the issuance of certificates of deposits in 1985 and 1986 provided foreign banks with major new sources of yen funding. Without the strong yen deposit base from regional branches that Japanese banks possess, foreign banks generally rely on such alternative sources to finance their Japanese operations. Permission in the spring of 1985 to issue a new funding instrument — money market certificates — has also been beneficial.

Second, in June 1985, Japan authorized the entry of foreign banks into the highly profitable business of managing Japanese trust and pension funds, until then limited to resident banks and life insurance companies. Nine foreign banks, including 6 American banks, were approved for licenses to establish trust banking subsidiaries at the time. In addition to being the first instance of authorization for foreign trust banks, it was also the first time foreign banks were permitted to establish banking subsidiaries of *any* form in Japan.

Third, beginning in April 1984, foreign banks were permitted to deal in Japanese public securities and to obtain membership in the government bond underwriting syndicates. This put foreign banks on the same footing as domestic Japanese banks that had been given the same authority in 1983. In June 1986, it was announced that the approval process would be speeded up for foreign banks that had sufficient experience in overseas markets. As of September 1986, 11 foreign banks, including 8 from the U.S., had been approved for dealing in all Japanese government bond issues.

Problems of foreign banks

As their increasing number implies, foreign banks have indeed taken advantage of greater access to Japan's financial markets. However, despite the steps taken to widen the scope of opportunities available to them, foreign banks still remain fringe participants in Japanese banking markets. In March 1986, they accounted for 4 percent of all banking assets in Japan, down

from 5 percent three years earlier. (U.S. banks account for about 30 percent of total foreign bank assets.)

The inability of foreign banks to make significant inroads is attributable to a number of factors. For one, foreign banks generally bear higher funding costs than their Japanese competitors, which possess strong yen deposit bases gathered from their branch networks. Despite recent reductions in the use of interest rate ceilings, it is estimated that 70-80 percent of these deposits still remain subject to interest rate controls, putting foreign banks, who have limited access to such regulated accounts, at a disadvantage. Reductions of swap limits and the enhanced ability to issue certificates of deposit and money market certificates have provided alternative sources of funds, but these funds are priced at higher market rates.

Ironically, another factor that has put foreign banks at a disadvantage has been a reform measure that allowed foreign currency lending by Japanese banks to local residents in 1980. This area had previously been a profitable monopoly of foreign banks. As a result, the liberalization has diluted foreign banks' share of the foreign currency lending business in Japan.

A more fundamental problem faced by foreign banks is that Japan's banking system, despite recent reforms, still remains very segmented. The system is composed of several major types of banking institutions: 13 large city banks, which operate nationwide; numerous smaller local or regional banks; three long-term credit banks; numerous small savings banks; and 7 domestic trust banks, which are the main managers of trust and pension funds. This structure limits the ability of foreign banks to expand into areas that are the preserve of special classes of banking institutions. For example, while some foreign banks have been authorized to engage in the profitable business of managing corporate trust and pension accounts, most have not. General restrictions on the opening of new branches intended to protect the smaller banks in Japan put foreign banks at a particular disadvantage by limiting their deposit base.

In face of the limited opportunities encountered in their lending business, foreign banks have sought greater access to business in securities markets. While many have been allowed to deal in government securities, their ability to engage in general securities business is limited by Article 65 of the Securities and Exchange Law — Japan's equivalent of the U.S. Glass-Steagall Act. This regulation prohibits commercial banks from engaging in the securities business, except for activities related to public bond issues, which dominate the bond market. Because Japan's Ministry of Finance does not wish to extend privileges to foreign banks without granting the same powers to Japanese banks, it has been cautious in allowing foreign banks to deal in securities.

Recently, however, the provisions of Article 65 have been interpreted to permit general securities licenses for some banks from European countries that allow universal banking activity, and to allow several other foreign banks, including those from the U.S., to acquire brokerage houses that hold securities licenses. Foreign banks are restricted, however, to 50 percent ownership in Japanese securities branches.

Treatment of foreign securities firms

Foreign securities companies have also been permitted greater access to Japan's domestic financial markets in recent years. Initially, their business focused on the intermediation of international securities transactions — selling foreign securities to Japanese investors or Japanese securities to foreign investors. Increasingly, foreign firms have also sought to expand their Tokyo operations to participate in the Japanese debt and equity markets in competition with Japanese firms for Japanese customers.

A major reason for the willingness of the Japanese government to encourage the entry of foreign securities firms has been the sharp expansion of the Japanese government debt market and the need to interest a broader set of investors in the issues. The total amount of government debt outstanding increased from less than 10 percent of GNP in the mid-1970s to more than 30 percent in the early 1980s, and represents more than half of all bond issues in Japan (excluding bank debentures). The Japanese sell long-term government debt through underwriting syndicates rather than auctions

because the government feels the volume is too large for the market to absorb smoothly. In 1984, 6 foreign securities firms, as well as 9 foreign banks, were allowed into these syndicates for the first time.

Medium-term (2-5 year) government bonds, introduced in Japan in 1978, have been sold in volume through auction only since 1982. In February 1986, auctions of bonds of less than one year's maturity were initiated. While foreign securities firms were excluded from bidding in the medium-term government bond auctions (2-4 years) until August 1986, they have since been able to corner a significant share of the business in this and the short-term market.

In 1986, a number of foreign firms were also allowed to arrange private yen bond issues in Japan.

More problems

Foreign securities firms, as well as banks, have experienced problems in attaining a reasonable share of business in the long-term government bond market. Since allocations of each bond issue are based only on a syndicate member's size of operations and experience in Japan, the percentage of bonds allocated to foreign firms does not generally correspond to their position in the marketplace, either in Japan or internationally. In fact, even large foreign securities firms receive an extremely small fraction of each issue, usually less than 0.1 percent each, even though it is estimated that 20 percent of these issues are ultimately purchased by nonresidents (this figure includes the branches of Japanese banks and securities firms located outside Japan).

The current Japanese government position is that the issue of bond allocation should be resolved by the larger Japanese security firms and bank members of the syndicate. The U.S. government has strongly urged Japanese authorities to allow long-term Japanese government bonds to be sold through auction, as is done for medium- and short-term issues, to enable foreign firms to compete for a larger market share. However, foreign institutions also complain about auctions for the shorter maturity issues. They contend that these auctions are too infrequent and too small, and that minimum denomination requirements that are too high discourage individual and foreign investors.

Perhaps most problematic from the point of view of foreign firms is their inability to use the full experience they have acquired in other markets to their competitive advantage in Japan's financial markets. The guarded pace of Japanese deregulation still limits their ability to capitalize on techniques and services, such as innovative financial services, developed successfully abroad. For example, foreign firms have sought to sell foreign financial futures in Japan, offer money market accounts and indexed securities, and to sell government securities short. Japan's Ministry of Finance contends its slowness in authorizing some of these measures stems not from any intention to protect Japanese firms but from the need to satisfy itself that the measures will not create problems for investor safety.

Conclusions

The liberalizing direction of Japan's recent financial policies is unmistakable, and the resulting treatment of foreign banks and securities firms has improved. However, while official discriminatory policies have diminished, foreign financial institutions continue to find Japanese markets difficult to penetrate. Many of their problems stem from the cautious pace of the liberalization and the fact that Japanese financial markets still remain somewhat more regulated than those of other developed countries where foreign financial institutions now compete.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/1/87	Change from 3/25/87	Change from 4/2/86 Dollar	Percent[7]
Loans, Leases and Investments[1 2]	205,835	2,176	1,674	0.8
Loans and Leases[1 6]	184,419	1,838	− 1,034	− 0.5
Commercial and Industrial	54,300	519	400	0.7
Real estate	68,054	232	1,682	2.5
Loans to Individuals	37,038	− 90	− 3,599	− 8.8
Leases	5,440	− 10	− 211	− 3.7
U.S. Treasury and Agency Securities[2]	14,301	342	3,494	32.3
Other Securities[2]	7,115	− 4	− 786	− 9.9
Total Deposits	213,691	8,271	7,061	3.4
Demand Deposits	57,778	7,038	6,004	11.5
Demand Deposits Adjusted[3]	38,253	2,314	3,532	10.1
Other Transaction Balances[4]	20,072	713	3,858	23.7
Total Non-Transaction Balances[6]	135,842	521	− 2,801	− 2.0
Money Market Deposit Accounts—Total	46,615	316	197	0.4
Time Deposits in Amounts of $100,000 or more	32,180	− 88	− 5,732	− 15.1
Other Liabilities for Borrowed Money[5]	23,247	404	− 5,458	− 19.0

Two Week Averages of Daily Figures	Period ended 3/23/87	Period ended 3/9/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	87	91
Borrowings	11	18
Net free reserves (+)/Net borrowed(−)	77	72

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change