The Financial "Big Bang" of 2001: 
Law and the Role of Government

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1 What is the "Financial Big Bang" of 2001?

As a result of the general elections in 1996, the Liberal Democratic Party became the largest party in the House of Representatives and formed the first government with Prime Minister Hashimoto, the president of the party. This government declared, both inside and outside Japan, that it will carry out a "financial reform" by the year 2001. Following the descriptive name "Big Bang" used for the reform of the stock market carried out in Britain in 1986, they called the reform "The Japanese Version of the Financial Big Bang". The government of Hashimoto announced that this will make the market of Tokyo free, fair and global. The government made financial reform one of its 6 most important political issues (reforms in the fields of fiscal affairs, economic structure, administrative structure, social security, education and finance), and in order to realize these reforms promised the nation to carry out a major revision of all existing systems, including the legal one. And all this to be achieved by 2001, which means in only 4 years.

2 Background: a legal system, aiming at protection and fostering

After the end of World War II, there was no doubt that "protection" and "fostering" by the administration played an important role in the economic recovery of Japan. Then, the objects of protection and fostering were, on the one hand, the enterprises and the market, and, on the other, the consumers, investors, depositors, and insurance policyholders. For a period of 50 years following the war, there was not even one bankruptcy of banks, something common

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in prewar days. The bankruptcy crisis of a big securities company caused by management failure was once politically avoided by means of "special financing" from the Bank of Japan.

In the practice of enterprises, the so-called "circulars" (administrative letters) were given great importance. Although those "circulars" had no legal binding power, enterprises started to employ people whose sole responsibility was to gather quickly information about the policy decisions of the government offices. (For example, people in charge of collecting information in the Ministry of Finance were called "MOF-tan" from the English abbreviation MOF and the first part of the Japanese word "tantō", "person in charge", and through novels and television dramas this word became well known to all Japanese). The general public also, counting on final state protection, lost completely the chance to become conscious of taking "personal responsibility" for investment risks, to mention but one example.

And in the legal system too, we can see the same tendency towards irresponsibility. If we take, for instance, the Securities and Exchange Act, we will see that until now there was no case of application of penalties under the Act and no lawsuit of pursuing liability. Thus we can say that for people in responsible positions it was a period of incredible happiness. This is not to say, of course, that there was no one action of violation of the Securities and Exchange Act during this period in Japan. It was a time, however, when it was believed that "preliminary adjustment" by the administration was working well. But it was just "believed" to be so, actually there were cases of violation, but they were hidden or got rid of by the administration. Afterwards, upon the burst of the bubble economy, when a variety of cases came out, we understood that those ways of resolving conflicts or of adjusting conflicts of interests had not, in fact, been working well.

Let us take some examples under the Securities and Exchange Act, showing the failure of such preliminary adjustment. Now in Japan, the problems in securities companies are scandals related to "sokaiya" (corporate extortionists), but before, the problems were related to scandals involving the "covering of losses". In those cases,
some of the top managers of big securities companies were obliged to resign from their positions. A few years later most of the same people came back into top management positions, and the present scandals forced them to resign again.

What is "covering of losses"? This is the act of a customer who makes a securities company cover his losses, when, for example, in anticipation of an increase in prices, the securities company sells securities to the customer, but contrary to what was anticipated, the prices fall and (instead of gains) the customer suffers losses. In the common sense, this is the risk of fluctuation in prices, that should reasonably be taken by the investor, but it was not the case. A lawsuit for covering of losses drew public attention, because in this case the parties were a famous Japanese securities company (Nomura) and one of its main customers, a broadcasting station (TBS). Unfortunately, in the former Securities and Exchange Act there was no clear provision prohibiting this kind of action. Some scholars interpreted it as a violation of the law, relating it to the interpretation of the provision prohibiting unfair transactions. But in business and academic circles, it was much more commonly thought that such action was acceptable because it was not directly addressed in the text of the law. Needless to say, when the facts came out, the small but numerous investors (dispersed investors) were more than dissatisfied with this state of affairs.

Why did the securities company cover the losses? The background is as follows. A big customer, following the advice of a securities company, deposited its capital with a trust bank and entrusted the bank with its practical use, but concerning detailed investments, the customer, following again the advice of the securities company, gave instructions directly to the bank, and the role of the trust bank consisted in merely carrying out these instructions. The Ministry of Finance indicated "confidentially" that it is necessary to stop this kind of transactions, because they provide the evil practice of exorbitant speculation. But, at that time, on the eve of the burst of the bubble economy, most of the sales inflicted losses. In this kind of “investment scheme”, the seller, the securities company, covered the losses suffered by the buyer, the big customer. The reason was, that
the big customer appointed the securities company as an underwriter of its large securities issue, that the securities company obtained a considerable amount of commission from the underwriting, and thus that the big customer became its largest and best client. The court in this case decided that there was no violation of the Securities and Exchange Act. The administration tried to prevent the conflict (before it happened), but by dealing “confidentially” with it, made the problem complicated and finally gave rise to the case.

Let us take another example, related to the bankruptcies of banks and life insurance companies. Up to now, in this field as well, preliminary control exercised by the administration was believed to be effective. But recently, as a result of failures in the management of financial institutions, including some banks, everybody (even the general public) knows that administrative control is not always a sufficient method for monitoring financial institutions. Moreover, under the pretext of protecting depositors, large amounts of taxpayers’ money have been used to deal with failures. The reason consists in the fact that the so called deposit insurance system was malfunctioning. Although it was a bank, the use of taxpayers’ money for management failures of private enterprises caused the resistance of the general public and led to the collapse of the then Murayama Prime Minister government (at the end of 1995-beginning of 1996). In the background of the financial Big Bang, there is another important element for rising the conscience of taking risk. This is the appearance of (new) markets on the stage as rivals to the Tokyo market. However, more attention should be paid to the already explained fact of revelation of the failure of the preliminary administrative regulation system.

3 The substance of the conception: What does the “financial reform” consist of?

The basic conception of the actual “Financial Reform” is shown in the report of the Economic Council dated December 3rd, 1996.

First, aiming at a wide-spread competition, to remove control in the fields of banking, brokerage, insurance and other financial operations, to accelerate cross penetration, to establish a legal system appropriate to “asset management and operation businesses”.

Second, to raise the functionality of the capital market, to accelerate the liberalization of financial instruments and the liberalization of foreign exchange transactions.

Third, to change the structure of regulation and control from the former "convoy system" to a new "administration on the basis of rules".

The present political administration and supporting it economic world aim to establish a new system by revitalizing a free, fair and global Japanese market, especially the Tokyo market, taking a course of diminishing or eliminating the extent of, and changing the substance of, administrative intervention, such as that by the Ministry of Finance and the Ministry of International Trade and Industry, in the Japanese economy. Certainly, diminishing or eliminating in comparison with the past. It is said that "deregulation" will be the basic stance of the financial reform.

Certainly, it is a fact that it is insisted on the necessity for stronger control on financial transactions, after the scandals with Sumitomo Corporation in London and with Daiwa Bank in New York, some successive bankruptcies of banks and life insurance companies, and finally the suspicions of violations of the Securities and Exchange Act by the four biggest securities companies, with Nomura Securities Company in the center. For the legislation, judicial system and administration of Japan, the establishment of a system, which would prevent the recurrence of such scandals, and tighten control is a new task of the highest importance. But the conception of the financial Big Bang, as intended to be accomplished at present, basically consists in efforts to relax the system of excessive administrative intervention. One of the misunderstandings in relation to the word "deregulation" lies in the apprehension that "all regulations will be given up". This is not so. Deregulation means, on the one hand, to relax the excessive former type of regulation, and, on the other hand, to tighten control to a certain extent.

I think that the former method of control of the Japanese market was much more dependent on the wisdom of the Japanese bureaucratic elite than on market mechanisms. There were even some ironic comments, such as "Japan is a socialist country". Because
it was not a method in which players played a free and fair game, but one in which bureaucrats first ascertained the results of the game, and after that pushed the market and the players in this direction. For example, they made efforts to realize the liberalization of securities companies commissions, while at the same time trying to prevent the excessive competition between them, and consequent bankruptcies, continuously called for a fixed commission. If costs and risk are in inverse relation, it is a matter of the investor's personal responsibility to deposit his money with a securities company giving discount on commission, and to suffer a loss.

It is said that the method of the State in the future must consist in both setting up the rules of the playing field, e.g. guarantees for the fairness of the market, and in watching over their observation. If it does this, possibly "Japan will also become a democrative State" at last.

In this way, the control is tightened in the field of market rules. At the same time, I would like to pay attention to the introduction of Prompt Corrective Action (PCA) from April 1998 as a method of preliminary regulation. PCA took as a model the system of "prior prevention of loss spreading", introduced after the savings and loans crisis at the end of the 80's in the USA, and the "Risk Based Capital Act" of the "National Association of Insurance Commissioners". Concerning banks and securities companies classification is made according to the specific ratio of their own capital (to those with a branch abroad, the standard of the Bank for International Settlements is applied, to the rest a national standard, eased in a great measure, is applied). As regards insurance companies, classification is made according to the solvency margin. When they fall below the standard, administrative intervention is undertaken, such as giving different orders for improvement of operations. The problems of accounting are related to the above. In the academic world, for example, there are discussions about international accounting standards, and the necessity to introduce market evaluation is recognized.

There is also a project to create a deposit insurance "safety net". Although this is not related to the relaxation of the regulations, but rather to their tightening, for the protection of the "national econo-
my” from management failure in financial institutions, this kind of administrative “preliminary” intervention is necessary as well. Such intervention differs greatly from the former administrative measures, which were based on not open to the public “confidential” standards, because it consists in administrative measures based on specific standards clarified in advance and on the preparation of a system which will make complete disclosure of the financial situation of any enterprise.

Another keyword is the enlargement and the perfection of disclosure. Not only disclosure by enterprises, but also disclosure of the regulatory standards, as a link in the chain of the administrative “open information to the public”.

4 Realization of the conception

The big reform of the financial system has already started. For example, the Bank of Japan Act was revised in 1997. The Bank of Japan Act (before this revision) was passed in 1942, during World War II, and its art. 1 says: “The Bank of Japan has, for its object, ..., pursuant to the national policy, in order that the general economic activities of the nation might adequately be enhanced”. That means that state control was very strong; nevertheless, the economic recovery of postwar Japan was achieved on the basis of this law. In the present reform of the financial system, the purpose is, as with the Federal Reserve Bank (FRB) in the USA, that the state administration should decide the official discount rate, and the Bank of Japan, the central bank, independent of the Ministry of Finance, should specify it. Thus, if we exclude some unimportant revisions of the act, we can say that now a large scale revision has been achieved for the first time in 60 years.

The revision of the legal system concerning foreign exchange control is thought to be the front runner of the Big Bang. As far as I remember, it was the same with the Big Bang in England. In the official title of the new law of foreign exchange the word “control” was eliminated. Because the repeal of the restrictions on the outflow of capital from the country rises the possibility of Japanese money, especially some part of the ¥1200 trillion individual assets, to go to
foreign markets, it is intended to exert pressure to increase the international competitiveness of the domestic market. Also, different ideas are actively discussed, e.g. the idea to establish a “Financial Supervision Agency” as an independent administrative body overlooking unfairness in securities and financing (the act for the establishment of this body is already drawn up), the idea to draft a cross-section law, like the Financial Services Act in England, regarding financial transactions and others. Some of them are already partially realized. It is necessary to add the revision of the specific Japanese Anti-monopoly Act, that changed from a principal ban on holding companies to their free establishment in principal. Being an object of capital investments and an investment organization at the same time, the reorganization of the enterprise is recently discussed a lot, especially discussions about “corporate governance” are very active. As a scholar in the field of business law, I have a lot of things to say about the last issue, but its relation to today’s general theme is not so close, so I will skip a detailed explanation. But I would like to mention that the big financial reform and the government’s policy intentions share many common elements. The real purpose of the present reform is, as politicians say, the “vitalization” and “the reconstruction of the Japanese economy”, and we can give to the policy the place of a part of this ultimate purpose.

5 Financial Services Act

Suppose that you deposit your money with somebody else, and this person puts the capital in the entrance of a “black box”. The invested capital could come out from the box either increased or diminished. By the way, there would also be cases when nothing comes out from the box. The capital investments themselves could be different in this “black box”. To be more precise, they could be a purchase of “commodities”, such as treasury bonds, stocks, bonds; a purchase of “derivatives”, such as futures and options; or bank deposits; or purchases of floating insurance. Recently, a black box of “a certain combination of those goods” (hybrid goods) has been prepared. Even if there is a difference in the extent of the risk with each purchasing goods, there are some common features in the legal
regulation of such investment and speculation.

In which box to invest its capital depends entirely on the discretion of the capital holder. According to the differences in their preference to take or not to take risk, there would be people asking for a high return for taking high risk, and also people investing capital where there is practically no risk. In this case, if losses are suffered, this is a matter of personal responsibility. The efforts of the State are directed to the preparation of a system where everybody is able to bear the burden of personal responsibility, and if such a fair market exists, it is not necessary to give protection to investors, who have suffered losses. However, former Japanese administrations insisted on giving protection to such investors. The reason was that the final investors of such capital, including deposits, were enterprises and financial organizations in close relations with the Japanese economy, and if the general public were to stop investing capital with them, it was thought that this would cause a serious problem for the economy. The logic that the task of the administration was to create an environment where the public could invest “without anxiety” (with a sense of security) was biased by the policy of giving protection to an ignorant public, allowing them to enjoy some economic relief. The law as well, in the substance of its provisions and in their application until now, admitted in essence this kind of position. Now, the present conception gave birth to the key word “personal responsibility”. That is why, another key word “disclosure” appeared on the stage again. In relation to this, great importance is attached to the “obligation of explaining” on the part of enterprises selling “investment instruments”, and the academic world is now discussing the nature of this obligation.

In the construction of the financial system of one country, how and to whom to distribute the risk from transactions is an important matter in policy decision making. This does not mean to regulate post factum, using the name “protection” and “recovery” from losses once occurred, but to ensure in advance a fair market, to place the offer of such a market to all persons making transactions in the center of the administration or regulations, and finally to ensure that the responsibility for bad results from transactions in such a market
will be taken by the investors themselves. Efforts are being made
to incorporate all this in the fundamental stance of the reform.

In the former protection and forecasting style of administration,
there were a great number of regulations and measures aiming at
the protection of investors or depositors. The industrial world set
out different requirements for relaxing the regulations, and one of
the aspects of the Big Bang consists in their realization. However,
we should not forget that in order to guarantee market fairness, there
is another aspect of tightening, including the method of self-imposed
control.

Transaction costs are an important factor in market choice. The
liberalization of securities transactions’ commission and the revision
of the tax system related to transactions are under discussion. Con-
cerning the problem of settlement, the diminution of transactions’
costs is also being discussed. In other countries, including Australia
and Singapore in the same longitude, in order to win in the competi-
tion between markets, the construction of a free market is required.

The substance of the above mentioned reforms of the system is
completely different from the former way of regulation and for that
reason the expression “global standard” is used as a standard for
the construction of such a system. But it is not completely clear what
this global standard is. For example, standards in America and
Europe are not always exactly the same. There is also the expression
“world tendency”. This world tendency is to apply the principle of
market evaluation in the accounting of financial assets, and it is said
to be a global standard, but it is not scientific to insist that because
in other countries it is done like that, for this reason alone we should
introduce it in our country. I think that researchers like us have to
catch up with the rationality of this new standard, and from a scien-
tific point of view to study whether its introduction is justifiable and
reasonable or not.

6 Conclusion

I have doubts as to whether this Prompt Corrective Action, which
I have discussed, truly differs from the former method of regula-
tion, regarding the behavior of the enterprises and the State. But on
the condition of different kinds of disclosure, which I have also men-
tioned, there is a qualitative difference in the supervision (control)
of the enterprises exercised by the administration, ensuring trans-
parency, in comparison with the former regulations, which real power
consisted in the "confidential" method. When the establishment and
the maintenance of market rules become important, I suppose that
the role of the State will change, transferring the priority from the
administration to the judicial system. The administration will also
give importance to pre-judicial settlements, e.g. the methods of
decrees and recommendations by the Fair Trade Commission. Don’t
you think that transparency regarding the administration should prob-
ably develop in this way?

For the realization of the Big Bang, the reform of the tax system
is also indispensable. In this report, because of lack of time and con-
sequent inability to explain the whole picture, subject to the present
discussion, I will omit this point, but I cannot ignore that it is a very
important element in the problem of the relations between the finan-
cial system and the State. I would like to develop this point further,
if there is another occasion.