JAPAN

BANKING

SUMMARY

Japan generally provides *de jure* national treatment for foreign banks, and in a few isolated instances, has provided better than national treatment. Nonetheless, until recently foreign banks have remained only marginal players in the Japanese banking market. This was partly a reflection of Japan's regulatory environment and partly the consequence of exclusionary business practices. Strong relationships between members of related business groups, often involving cross-shareholding arrangements, have made it extremely difficult for nonmembers (i.e., foreign banks) to compete effectively in the Japanese banking market. The beginning of the unwinding process of cross-shareholding, the flight to quality from some of the weaker Japanese banks, strategic business tie-ups between foreign and Japanese institutions, and the ability of foreign banks to capitalize on expanded opportunities for new products and services as a result of deregulation have combined to begin to expand the presence of foreign banks in Japan.

The recognized overcapacity in the Japanese banking industry has discouraged new entrants and the murky accounting of loan quality has discouraged equity purchases of existing Japanese banks. However, the Big Bang initiative to reform the Japanese financial system, and extremely low yen interest rates, have improved business opportunities for existing foreign financial institutions, including banks. Relaxed restrictions on cross-entry between sectors in the financial industry, and permission for banks to market investment trusts (similar to U.S. mutual funds) are features of the "Big Bang" that have been beneficial to developing new opportunities for foreign and domestic banks in Japan. The attention of foreign financial institutions has been focused on asset management, targeting Japanese individual financial assets, estimated at 1,200 trillion yen, that have traditionally been placed in bank deposits and postal savings.

Foreign Banking Operations in Japan

As of:	12/31/93	6/30/98
All Foreign Banks		
Total number of branches	145	144
Bank subsidiaries	9	9
Majority owned acquired banks	0	0
Representative offices	112	113
Joint venture banks	0	0

As of:	12/31/93	6/30/98
U.S. Banks		
Number of branches	41	41
Trust bank subsidiaries	6	6
Majority owned acquired banks	0	0
Representative offices	10	10
Joint venture banks	0	0

As of year end 1997, 19 U.S. banks had operations in Japan, 13 banks had 41 branches with assets of US$33.1 billion and ten banks had subsidiaries with assets of US$1.4 billion. Among these subsidiaries are six trust companies and four leasing companies. Ten U.S. banks also maintain representative offices in Japan. In contrast, as of year-end 1993, 19 U.S. banks in Japan operated 41 branches with assets of US$18.3 billion and 15 subsidiaries with assets of US$2.3 billion.

In contrast, the presence of Japanese banks in the United States is many times larger. At the end of 1997, 29 Japanese banks in the United States operated 31 agencies with assets of US$24.9 billion, 61 branches with assets of US$205.3 billion, and 17 subsidiaries with assets of US$62.5 billion. In contrast, as of year-end 1993, 54 Japanese banks in the United States operated 48 agencies with assets of US$49.0 billion, 84 branches with assets of US$272.1 billion, and 26 subsidiaries with assets of US$63.0 billion. Japanese banks or individuals controlled four Edge or Agreement Corporations with assets of US$136 million. Japanese banks maintain 39 representative offices in the United States.

DESCRIPTION OF THE MARKET

Structure of the Market

The structure of the Japanese banking market is beginning to change as a result of the "Big Bang" financial deregulation initiative announced by Prime Minister Ryutaro Hashimoto in November 1996, particularly in terms of sweeping away the demarcations between types of banks, as well as allowing cross-entry with securities and insurance companies by 2001. However, at present, the banking sector remains divided into city banks, long-term credit banks, trust banks, regional banks, and various specialized institutions.

The largest Japanese banks are the nine "city banks," which are similar to American money center banks. This is a decrease from 11 city banks in 1994, reflecting the failure of Hokkaido Takushoku

in November 1997 and the merger of Bank of Tokyo and Mitsubishi Bank in April 1996. The nine city banks had total assets in 1997 of US$2.92 trillion and a total market share of 26 percent, down from 35 percent in 1993. City banks have nationwide branch networks, generally make short-term loans and fund their activities primarily through consumer and business deposits and short-term money market instruments. They tend to have a stable commercial customer base, frequently involving share ownership with their most significant commercial clients.

The three long-term credit banks were created decades ago to provide long-term loans to private industry. The liabilities of long-term credit banks are primarily medium-term bank debentures with maturities of up to five years. Long-term loans make up the majority of their assets, although long-term credit banks also are active in bond markets as investors, underwriters, and as "commissioned banks" in the issuance of corporate debt instruments. Assets outstanding of the three long-term credit banks totaled US$606 billion in 1997. Their market share in 1997 was five percent, down from eight percent in 1993. Falling profitability and the difficulty in continuously issuing debentures led to severe financial problems for Nippon Credit Bank in spring 1997, resulting in a bailout by life insurance companies. The Long-Term Credit Bank (LTCB) also suffered financial difficulty in summer 1998 and in October 1998 it was nationalized by the Japanese government.

Due to the segmented nature of scopes of business, trust activities can only be handled by trust banks. Thus, securities firms and commercial banks find it advantageous to have a trust bank subsidiary – not to pursue trust bank business per se or to do banking transactions, but to handle any trust-type activities in their normal lines of business. There are 53 trust banks in Japan, with total assets in 1997 of US$2.2 trillion. Financial system reform under the 1993 Financial System Reform Act, which permitted mutual entry in other financial business fields by establishing a separate subsidiary, led to an increase in the number of trust banks since 1993. At present, nine are foreign trust bank subsidiaries established in the mid-1980s. Seventeen are Japanese banks established pursuant to the April 1993 Financial System Reform Act. In addition, 19 regional banks have been licensed to do certain trust banking business directly, without establishing separate subsidiaries (two regional banks in Okinawa had been engaged in trust business prior to 1993). Eight of the Japanese trust banks and the nine foreign trust bank subsidiaries established in the mid-1980s are permitted to engage in a full range of trust banking business. The rest of the trust banks are restricted to a narrower range of non-core trust business only, and are prohibited from managing pension funds. From the early 1990s, the trust banks' business began to suffer as a result of the steep fall in Japanese asset prices and the subsequent economic recession that put many of their loans in jeopardy. In addition, as a result of the 1995 Framework Financial Services Agreement between the United States and Japan, other financial sector firms, particularly investment advisors, have been able to enter the pension fund management business, further eroding the profitability of the trust banks. U.S. trust banks have been performing better than their Japanese counterparts in recent years.

There are 127 regional banks in Japan - 64 "first-tier" regional banks, of which some are quite large, and 63 "second-tier" banks. The number of regional banks increased significantly in 1989 with the

conversion of 66 *sogo*, or mutual savings and loan institutions, into second-tier regional banks, more than doubling the total number of regional banks. Altogether, regional banks had US$2.1 trillion in total assets at the end of 1997 and a combined market share of 19 percent, down from 28 percent in 1993. Regional banks traditionally have relied on savings deposits from individuals to fund their activities. Their assets are concentrated in loans, particularly to small businesses, but their asset base also includes some domestic securities and some foreign assets.

In addition, there are other specialized institutions involved in banking activities. Credit cooperatives (*shinyo kumiai*) and credit associations (*shinkin*) take deposits and lend to individuals and small businesses. Agricultural cooperatives perform the same function for farmers. The Norinchukin bank is owned by agricultural cooperatives and acts as a clearinghouse for transactions among regional agricultural financial institutions, and between those institutions and other non-agricultural financial institutions. It is also a concentrated correspondent bank for the agricultural cooperatives.

An extremely important element in the overall deposit-taking system in Japan is the postal savings system, which competes with conventional banking institutions for personal deposits. By law, these funds must be transferred to the Finance Ministry's Trust Fund Bureau, which then manages the funds either by directly investing in money market instruments and public securities, or by reallocating the funds to the Fiscal Investment and Loan Program (FILP) where they are used for public investment projects or on-lent through public sector financial institutions. Postal savings system deposits averaged ¥198 trillion in 1994, and in September 1998 were ¥247 trillion. It is the largest financial institution in the world. Lending by FILP-related public sector financial institutions accounted for virtually all new lending growth in 1997 and 19.8 percent of all loans outstanding, up from 16.6 percent in 1993. The 30 percent growth in postal savings deposits since 1993 partially reflects a flight to quality from weak private sector banks to the government run postal savings system, since the postal savings system enjoys a full faith and credit guarantee. As part of a reform of the Fiscal Investment and Loan Program, postal savings funds will no longer be required to be deposited with the Trust Fund Bureau as of FY2001, and the funds will instead be managed by the successor organization to the Ministry of Posts and Telecommunications, a new postal agency to be established in 2001 as an annex to the new General Affairs Ministry.

Until April 1, 1998, only "authorized foreign exchange banks" could do a full range of foreign exchange business. This system was changed with the revision of the Foreign Exchange Law effective April 1, 1998, which allowed a much broader range of participants (in addition to banks) to conduct foreign exchange business. The principal requirement that Japanese residents buy or sell foreign means of payments from or to an authorized bank or licensed exchange broker in Japan, has been lifted. In conjunction with these changes, MOF issued an administrative notice effective March 31 to expand the scope of foreign exchange activities allowed for securities firms, which appears to respond to industry requests. As a result, all of the first-tier regional banks have announced that they will withdraw from foreign exchange yen settlement business and arrange for the city banks to

handle these transactions for them. Instead, the regional banks will specialize in foreign exchange and cross-border money remittance transactions.

The following table summarizes assets held by the various kinds of banks in Japan:

Assets of Banks in Japan by Type of Bank
In billions of yen

Japanese Banks:	Loans	Deposits	Number	Total Assets
City Banks	221,656	218,414	9	378,242
Long-Term Credit Banks	45,802	9,726	3	78,437
Trust Banks	54,543	21,160	7	286,640
First -Tier Regional Banks	139,786	171,260	64	199,130
Second-Tier Regional Banks	53,660	61,094	63	70,055
Credit Associations	71,387	100,611	401	113,613
Credit Cooperatives	17,076	21,801	351	26,377
Labor Credit Associations	6,481	10,559	47	11,700
Agricultural Cooperatives	21,102	69,619	2,083	72,046
Central Cooperative Bank for Agriculture and Forestry	17,460	28,887	1	48,239
Postal Savings System*	1,001	240,540	40	247,249
Foreign Banks:	**Loans**	**Deposits**	**Number**	**Total Assets**
Commercial Banks	8,622	8,989	93	51,848
- of which U.S.	n/a	n/a	19	n/a
Trust Banks	n/a	n/a	9	n/a
- of which U.S.	n/a	n/a	6	n/a

Notes: The number of banks is as of April 1, 1998. Total assets are as of year-end 1997, except for the postal savings system (3/31/98). In addition to the institutions in the table above, there are 17 trust bank subsidiaries of Japanese financial institutions established under the April 1993 Financial System Reform Act. Asset data of these subsidiaries are not available.

* The vast majority of postal savings assets are required to be deposited with the Ministry of Finance's Trust Fund Bureau, which onlends the funds through the Fiscal Investment and Loan Program. Technically, these loans are not

assets of the postal savings system, but rather the postal savings system's assets would be the deposits with the Trust Fund Bureau.

While most Japanese banks are privately owned, there are a number of public sector banking and finance institutions. State-owned banks in Japan implement government policies through lending to specific sectors to fulfill government policy objectives. Examples include loans to less developed areas of the country, for environmental protection, and to small businesses which generally pay lower returns and carry higher risks. State-owned banks usually do not take deposits, although the postal savings system, which indirectly lends funds to the state-owned banks through the Fiscal Investment and Loan Program, does. Advantages include the ability to borrow under the government Fiscal Investment and Loan Program at generally lower than market rates, and government guarantees of their borrowing in the market. Generally, however, government-owned financial institutions in Japan do not compete directly with private sector or foreign banks.

Available data on the assets of government-owned banks is limited, with only loan data available. As of December 31, 1997, loans made by government-owned financial institutions (see below) excluding the Japan Export-Import Bank, which functions more as an export credit agency with most of its assets placed outside Japan, totaled 134 trillion yen.

Lending by Public-Sector Finance Institutions
(as of December 31, 1997)

	Loans (¥ trillion)
Japan Development Bank	15.8
People's Finance Corporation	9.1
Housing Loan Corporation	72.7
Agriculture, Forestry & Fisheries Finance Corp.	4.4
Japan Finance Corp. for Small Business	7.1
Hokkaido & Tohoku Development Corp.	1.5
Japan Finance Corp. for Municipal Enterprise	19.9
Small Business Credit Insurance Corp.	0.6
Environmental Sanitation Business Finance Corp.	1.1
Okinawa Development Finance Corp.	1.7
TOTAL	133.9

The most serious challenge to the health of the Japanese financial system in the 1990s has been the growing problem of non-performing loans. Most lending in Japan is secured, usually by real estate or with third-party guarantees. As long as the pledged collateral held its value and the economy remained robust, the danger of defaults and of losses accruing from defaults was minimized. But as asset prices plummeted from their peak values in 1989/90, and the growth of the Japanese economy slowed markedly, Japanese banks across the board have faced a serious problem in managing their increasing exposure to nonperforming loans. Inadequate disclosure requirements have made it difficult to fully evaluate the severity of the bad-loan problem plaguing Japan's banking industry, although disclosure requirements have been expanded recently.

In June 1998, the 19 major Japanese banks reported that their problem loans at the end of March 1998 totaled 21.98 trillion yen (about US$160 billion). The percentage of the problem loans for the 19 major banks in terms of total loans was 6 percent, higher than the 5.4 percent reported for the entire banking system. The amount of problem loans and the percentage of the problem loans to total loans by type of banks follow.

Reported Japanese Bank Problem Lending
(as of March 31, 1998)

	Billions of yen	Percentage of Total Lending
City banks	12,819	4.8
Long-term credit banks	4,680	10.0
Trust Banks	4,479	8.4
Total 'Top-19'	21,978	
First-tier regional banks	5,198	3.7
Second-tier regional banks	2,582	5.3
TOTAL	51,736	

Note: The 19 major banks are comprised of the city banks, the long-term credit banks and the trust banks. Regional banks are not among the 19 majors, but are included in the above table for comparison purposes.

New disclosure standards for non-performing loans, applied for the first time in FY97, led to a larger-than-expected increase of 39 percent in disclosed non-performing loans relative to the previous standards. The new disclosure standards include more comprehensive definitions of problem loans than those previously applied, and U.S. categorization was used as a basis for new standards measuring risk elements. The old disclosure rules require Japanese banks to report the

aggregate amount of loans in each of three categories: (1) loans to bankrupt borrowers; (2) loans with interest payments past due 6 months or more; and (3) restructured loans, for which the interest rate has been reduced below the Official Discount Rate. A key problem with the old rules is that banks would informally restructure loans so that they could avoid categorization. The new disclosure rules broaden the second category to include loans with interest payments past due 3 months or more, and broaden the definition of "restructured loans" to include loans to borrowers receiving renegotiated and more favorable terms due to problems with repayment, including loan forgiveness. Despite the intention of enhanced transparency, the new disclosure rules standards have not eliminated market concern about the reliability of disclosed bad loan figures. Bank analysts argue that improved uniformity in the reporting of restructured loans and consolidated disclosure is necessary.

Internally, and for reporting to the Financial Supervisory Agency, banks calculate "self-assessments" of the quality of their loan portfolios, according to rules which are more broad-based and include: loans where collection is deemed to be not feasible or loans that are deemed to have no value (Category IV); seriously doubtful loans with high loss potential but for which reasonable estimate of such losses is difficult (Category III); loans where known information about possible credit problems of borrowers, etc. causes management to have doubts as to the collectibility beyond the normal risk tolerance criteria (Category II); and loans not included in other three categories , i.e. loans which raise no specific doubt as to the complete collection (Category I). Many market experts are now urging the banks to disclose these more comprehensive asset quality assessments, to improve transparency and market confidence in the banks.

The credit cooperatives and agricultural financial institutions also have significant bad loan exposure, the latter particularly to the group of failed specialized housing lenders (*Jusen*). Norinchukin bank was the single largest lender to the *Jusen*, whereas agricultural financial institutions as a whole were the lenders of about 40 percent of all *Jusen* borrowing. Agricultural financial institutions increased their real estate lending aggressively during the very last stage of the asset bubble in the early 1990s, following constraints imposed by the Finance Ministry that limit commercial banks' growth in real estate lending to no more than the growth in total lending. In 1993, the agricultural financial institutions agreed, albeit reluctantly, to share in the burden of bailing out the *Jusen* through interest forgiveness. The debate over who should pay for the clean-up of the *Jusen* dominated Japanese politics throughout the spring of 1996, and resulted ultimately in the June 1996 injection of public funds, the July 1996 establishment of the Housing Loan Administration Corporation, and record-high bad loan write-offs in the year ending March 1996.

A number of organizations have been set up to deal with the bad loan problem, including the Housing Loan Administration Corporation, the Cooperative Credit Purchasing Corporation, and the Resolution and Collection Bank. These entities have made only slow progress in selling off bad assets of the housing lenders, credit cooperatives, and banks. (Legislation passed by the Diet in the fall of 1998 will restructure these organizations.)

Following the failure of Hokkaido Takushoku bank in November 1997, the Japanese government increased the public funds available to support the financial sector, allocating ¥30 trillion (US$214 billion) in December 1997. Of that total, ¥17 trillion (US$121 billion) was used to replenish the resources of the Deposit Insurance Corporation and ¥13 trillion (US$93 billion) was made available for capital injections into the banks. In April 1998, the government injected ¥1.8 trillion (US$13 billion) fairly evenly into 21 banks. In October 1998, the Diet passed legislation to abolish the 13 trillion fund, but replace it with a ¥25 trillion fund for recapitalization of weak, but viable banks, and an ¥18 trillion yen fund to be used to nationalize large insolvent banks, as well as leaving the ¥17 trillion fund for the Deposit Insurance Corporation in place. The legislation also authorized the creation of "bridge banks" to maintain credit to "sound borrowers" in the event of a medium-sized bank failure.

Regulatory Structure

The Japanese banking market is highly segmented, although the restrictions are gradually eroding under the "Big Bang." Banks, including foreign institutions, must obtain a different type of license depending on the type of banking business they would like to enter (for example, commercial banking license, trust banking license, or long-term credit bank license, although no long-term credit bank licenses have been issued since the 1950s). Foreign banks so far primarily have selected commercial banking licenses, although there are a few foreign trust banks. Establishment by foreign banks is regulated by the Banking Law. Full branch licenses are permitted and there is no discrimination in terms of types of activities against foreign branches, although foreigners are required to obtain a license for each branch while domestic banks are not. Minimum capital requirements for commercial (city) banks and trust banks is 2 billion yen, while the minimum for long-term credit banks is 20 billion yen. We are not aware of any licensing or other restrictions that discourage new foreign banks from establishing a banking presence in Japan.

Under the Banking Law banking business was reserved for banks. The April 1993 Financial System Reform Act permits Japanese securities firms to engage in banking business, including a limited range of trust banking business through separate subsidiaries and a broader range of foreign exchange business. The April 1998 revision of the Foreign Exchange and Trade Control Law abolished the "authorized foreign exchange bank" system, and subsequent regulatory changes expanded the scope of foreign exchange business allowed to securities companies, although foreign exchange settlement business remains reserved for banks.

Until June 1998, supervision and regulation of the banking industry was carried out by multiple administrators, including the Ministry of Finance, the Bank of Japan, and the industry's self-regulatory organizations. The Finance Ministry had authority for licensing banks, and for regulating and supervising commercial banks, trust banks, smaller banking institutions, life and nonlife insurance companies, and consumer finance companies, both Japanese and foreign, as well as the Tokyo International Financial Futures Exchange (TIFFE). With Finance Ministry oversight,

self-regulatory functions were carried out by the TIFFE, the Federation of Bankers Associations, and by other bank-related self-regulatory groups. The Bank of Japan supervised banks based on contractual agreements with individual banks. Under the new scheme effective June 22, 1998, the new Financial Supervisory Agency is responsible for all supervision activities, while the Finance Ministry retains its policy planning role for the banking, securities, and insurance industries. Administrative reform plans call for MOF's remaining financial policy powers to shift to the FSA in April 2001. Meanwhile, emergency banking legislation passed in October 1998 has created a temporary, three-year Financial Revitalization Commission, comprised of a Cabinet Minister and three other members, which has authority to direct the FSA and MOF on matters related to bank recapitalization, nationalization, and closure, as well as general bank supervisory policy.

Various laws regulate foreign bank mergers and acquisitions. Essentially, treatment of foreign bank M&A is not different from treatment applied to local banks. For example, the Banking Law requires approval of all bank M&As by the Finance Minister. The Foreign Exchange and Foreign Trade Law also apply to foreign M&A, but do not provide any restrictions on foreign investment in Japanese banks. Establishing a joint venture bank is essentially no different from establishing a foreign presence. There is no legal quantitative limit on the degree of foreign ownership in joint venture banks. There is also no minimum capital requirement for foreign bank investment in joint venture banks.

Several steps have been taken since the 1994 National Treatment Study to further relax regulations in the banking sector. Most of these steps represent extensions of liberalization measures taken in earlier years.

Money Markets

As a proxy for repurchase agreements, the bond loan market has grown to be a major component of Japan's money market since it was created in April 1996. The incentive to use bond lending as a proxy for repurchase agreements arises from the securities transaction tax, which makes true repurchase agreements economically unattractive. The outstanding size of the bond loan market reached about 38 trillion yen (roughly US$290 billion) at the end of May 1998, roughly the same size as the call money market. The size of the market is likely to continue growing as the Bank of Japan began conducting market operations in the "repo" markets late in 1997 in order to strengthen its ability to influence interest rates.

Other typical short-term money market instruments are as follows with the average outstanding (unless otherwise indicated) at end-March 1998: call money (39 trillion yen) ; discount bills (22 trillion yen); certificates of deposit (40 trillion yen); commercial paper as of the end of August 1998 (13 trillion yen); government short-term securities as of the end of 1998 (13 trillion yen); and the Tokyo offshore market (9 trillion yen). A rough estimate of the total size of the money market, including the bond loan market, is 174 trillion yen ($1.25 trillion).

Commercial Paper

Restrictions on the issuance of commercial paper have gradually been liberalized over the past several years. The 1995 U.S.-Japan bilateral financial services agreement permitted foreign securities firms not meeting the qualification criteria to issue yen commercial paper with a parent guarantee. In 1996, issuance of commercial paper with a parent guarantee was more broadly allowed. In addition, the requirements that issuers be listed on a Japanese exchange or have three years of continuous financial disclosure were eliminated, while minimum rating requirements were lowered. In April 1998, the first domestic direct placement of commercial paper was launched as rules that effectively forced issuance of domestic commercial paper through approved dealers were removed. The short- and long-end maturity restrictions were completely eliminated by June 1998. Also in June, MOF eliminated its system of administrative notices (*tsutatsu*), which effectively abolished the prohibition on Japanese financial institutions and the offshore affiliates issuing commercial paper in Japan, and eliminated the minimum sales unit per investor for domestic and foreign commercial paper previously set at 100 million yen (US$714,300). In May 1998, a bill was submitted to the Diet to eliminate the restriction that nonbanks not be allowed to use the proceeds from commercial paper for lending purposes, which has been a longstanding concern for U.S. firms. As of November 1998, the Diet had not yet enacted the bill but it is expected to consider the bill in a future session.

Asset/Capital Positions of Banks

Combined core-business operating profits reported by Japan's 19 major banks for FY97 declined sharply to ¥3.57 trillion (about US$26 billion), down 20.9 percent from ¥4.51 trillion in FY96. On a pretax net basis, calculated after including bad loan write-offs, the banks posted a combined loss of ¥ 4.55 trillion (U$33 billion) in FY97, much larger than the combined net loss of ¥163 billion yen in FY96. Fourteen of the 19 banks posted net pretax losses in FY97. Core-business operating profits are defined as operating revenues minus operating expenses, and do not include bad loan writeoffs, and gains and losses from sales of land and equities. The combined core-business operating profits and net losses and the percentage in terms of combined assets follow:

Profitability for Top-19 Japanese Banks
(FY 1997)

	Trillions of yen			Percentage	
	Assets	Core-business Operating Profits	Net losses		
	(A)	(B)	(C)	(B)/(A)	(C)/(A)
FY 96	775.2	4.56	-0.16	0.59	0.02
FY 97	747.4	3.57	-4.55	0.48	0.60

For FY98, which ends in March 1999, the Federation of Bankers' Associations compiled and released the following information based on banks' "official" projections: Major banks project that their combined operating profits will fall by another 15 percent, to ¥3.03 trillion yen (US$22 billion), but their net pretax profit position is expected to improve dramatically, with the banks posting combined profits of ¥1.1 trillion (US$8.2 billion). All 19 banks assert that they will post net profits in FY98, reflecting their plan to sharply curtail bad loan disposal in FY98. Next year's planned ¥1.8 trillion in combined bad loan disposal is less than one-fifth of the total for FY97. The Federation notes that market and economic conditions will likely influence whether banks can meet these expectations.

Despite the losses incurred by the major commercial banks in FY97, all of them posted capital adequacy ratios above the eight percent minimum required for international operations by the Bank for International Settlements. However, the Japanese government provided considerable help to the banks in calculating their March 1998 ratios, in the form of the infusion of 1.82 trillion yen of public money, the option of book-value accounting for equity holdings, and a special two-year measure to allow banks to count a part of the unrealized gains on their land holdings as Tier 2 capital, without subjecting the gains to corporate income tax until those gains are realized. As reported by the banks at the end of May 1998, their fiscal year-end capital adequacy ratios ranged from a high of 10.32 percent for LTCB to a low of 8.53 percent for the Bank of Tokyo-Mitsubishi. As one indication of the difficulty of relying on published capital adequacy figures, in June LTCB was rumored to be in trouble, and in October it applied to be nationalized (thereby indicating it was in fact insolvent).

U.S. PRESENCE IN THE MARKET

As of fiscal year-end 1997 (March 31, 1998), there were 93 foreign commercial banks in Japan, all operating as branches, of which 19 were American-owned. Most of the growth in the foreign bank presence in Japan occurred in the 1970s and 1980s. At the end of 1970, there were only 18 foreign banks in Japan, with a total of 38 branches. These numbers grew to 64 and 86, respectively, by 1980, and to 82 and 122, respectively, by 1990. As of fiscal year-end 1997, there were a total of 144 foreign bank branches (some banks have more than one branch in Japan). Of this latter total, U.S. banks operated 41 branches.

In 1985, the trust banking market was opened to a fixed number of foreign financial institutions. As of June 30, 1998, nine have been permitted to enter the market (one more than the number of Japanese banks doing a full range of trust business). Of the nine, six are U.S. trust banks. All are subsidiaries. After an initially uncertain start in which some foreign trust banks did quite well but others did not, the combined earnings of the nine foreign trust banks have improved recently. In the Japanese fiscal year ending 1997, the nine foreign trust banks posted combined net profits of 3.9 billion yen ($32 million), up 85 percent from the prior fiscal year.

Since 1985, a number of foreign banking entities have been allowed to enter the domestic securities market through branches of offshore securities subsidiaries, provided their equity stake in their subsidiaries is no more than 50 percent. At present, there are 12 such securities branches, four of which have U.S. parents. In addition, there are three other U.S. banks that have entered the domestic securities market through branches of offshore securities subsidiaries where their equity stake exceeds 50 percent, following a 1994 MOF ruling permitting entry with no capital participation limit if firewall rules are implemented. Beginning in 1991, several securities firms were granted banking licenses, primarily to conduct foreign exchange operations. As of July 1997, five such banking licenses had been authorized. All five belong to offshore banking subsidiaries of U.S. securities firms.

In addition, as of June 30, 1998, there are 113 representative offices of foreign banking institutions in Japan (of which 10 have U.S. parents). This compares to 112 in 1993, 131 in 1989, and 71 in 1974. These offices are limited primarily to observing the market and to reporting on developments to their home office. They are not allowed to take deposits or to make loans. Most banking institutions establish a representative office prior to applying for a bank branch license.

No acquisition of a Japanese bank by a foreign bank (including by a U.S. bank) has occurred as of the time of this report, but neither have any U.S. financial institutions expressed an interest in acquiring a Japanese bank. However, the Finance Ministry continues informally to assure the U.S. Treasury Department that acquisition is possible and that the ministry would approve such a purchase, if and when an interest is expressed.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Management of Pension Funds

After close to 15 years in the market, U.S. trust banks are beginning to have limited success in the US$1 trillion public and private pension fund market in Japan, despite the added competition from investment advisors in the past few years as liberalization of pension management has taken place (See Investment Management section in the Securities chapter). Since 1993, foreign trust banks in Japan have increased their aggregate management of public pension funds from 1.7 percent to 7.2 percent of total assets, and management of private pension funds from 0.3 percent to 0.9 percent.

In the past, the principal obstacle facing U.S. and foreign trust banks in Japan in gaining a greater share of the pension fund management market was the practice of awarding management mandates to fund managers on the basis of corporate relationships rather than on the basis of investment performance. Often these relationships involved some degree of cross shareholding. While this practice still exists, there has been a shift toward performance based allocation as recognition of the significant potential underfunding of pension accounts grows with the low returns available in the

Japanese financial markets. A key factor in making U.S. and foreign trust bank management more attractive has been the phasing out of asset allocation guidelines over the past several years. These guidelines had forced all fund managers to invest in a "balanced portfolio" rather than in assets or currencies where they have greatest expertise.

Remaining areas to be pursued include strengthening the fiduciary responsibilities of pension plan sponsors in order to encourage sponsors to pay greater attention to performance, adopting standardized performance evaluation criteria along the lines of those of the U.S. Association for Investment Management and Research (AIMR), and valuing all pension fund assets at current market value rather than at book value. The shift to market value accounting has started for pensions with employee pension funds (EPFs) which are required to mark financial assets to market beginning FY97. However, no schedule has been set for introducing such a standard for other pension programs. U.S. trust banks believe that if the changes described were adopted, pension fund plan sponsors would be in a better position to accurately assess the relative performance of fund managers, including the performance of foreign trust banks.

Many of the provisions of the 1995 bilateral Financial Services agreement (see below) were aimed at expanding market access for investment advisory companies, although U.S. trust banks also benefitted from the elimination of asset allocation guidelines and other measures. Prospective deregulation measures are expected to include broader application of market value accounting, although all of the details are not yet clear. In 1998, MOF's advisory council on corporate accounting released a report recommending enhanced pension disclosure in corporate financial statements, including marking to market corporate pension assets and reflecting the "real"picture of beneficiary obligations starting in FY 2000. During the summer of 1998, the Securities Analysts Association of Japan developed a draft proposal for standardization of a corporate pension fund performance reporting system. The draft proposal is expected to be finalized by early 1999 for implementation as early as April 2000. These measures are anticipated to benefit U.S. financial institutions by providing more transparency and comparability in disclosed performance data.

Accounting and Disclosure

U.S. banks have complained that weaknesses in Japan's approach to accounting and disclosure of information by financial intermediaries (and nonfinancial corporations) give a distorted picture of counterparty risk, the financial well-being of Japanese banks, and credit evaluation of prospective borrowers. Insufficient disclosure, as noted above with respect to nonperforming loan portfolios, also clouds the picture.

Lack of Transparency

A chronic complaint of U.S. financial institutions operating in Japan is the lack of transparency in the Japan's regulatory environment. This has been a longstanding problem that unnecessarily

complicates the ability of foreign (and U.S.) banks to do business in Japan. These complaints persist even though the Finance Ministry has taken steps in recent years to improve communications and increase its frequency of contact with U.S. banks.

Issuance and Use of Commercial Paper

Restrictions on the issuance of commercial paper have been relaxed as part of the "Big Bang" deregulation initiative, addressing the complaints of past potential issuers that the rating, listing, and disclosure requirements are too severe. The restriction prohibiting nonbanks from using the proceeds from the issuance of commercial paper for lending purposes may be eliminated as early as 1999, once legislation that has already been submitted to the Diet is passed.

TREASURY-MOF FINANCIAL MARKET NEGOTIATIONS

In the mid-1980s, following the Yen-Dollar Agreement between the U.S. Treasury Department and the Japanese Finance Ministry, many of the issues on the bilateral agenda focused on bank-related areas of interest (i.e., development of a deeper and more liquid money market, deposit rate deregulation, access to the public bond underwriting market, securities licenses for banks, and the introduction of certain derivatives products, including forward rate agreements). While most of the banking issues have been resolved, at least with respect to the ability of foreign banks to obtain market access "in principle," most U.S. banks still feel that the business climate in Japan could be greatly improved if the regulatory environment were made more transparent. Also, despite considerable progress of late in improving accounting and disclosure practices, foreign bankers still see much room for improvement in accounting and disclosure in both the financial markets and the real economy.

In February 1995, Treasury and the Ministry of Finance (MOF) signed a bilateral Financial Services Agreement under the U.S.-Japan Framework for a New Economic Partnership, as the latest step in a 15-year series of discussions with the Japanese government on liberalization of financial services. Periodic reviews of the agreement have generally found the government of Japan fully implementing the Agreement, in some cases ahead of schedule. The agreement covered several areas with practical benefit for foreign banks, including improvements in the pension fund market for trust banks, the removal of many existing restrictions on cross-border capital transactions and greater transparency.

Additional deregulation has been ongoing under the auspices of Prime Minister Hashimoto's "Big Bang" financial liberalization initiative, announced in November 1996. The goal of the initiative is to make Japan's financial market comparable with those of London and New York by utilizing the three guiding principles of "free, fair, and global" to achieve widespread deregulation. One of five government advisory councils formed to make recommendations on the specific measures to be implemented under the "Big Bang" focused on banking sector issues. The recommendations of

the council focused primarily on eliminating segmentation between types of banks in Japan, and allowing cross-entry between the banking, securities, and insurance sectors. Treasury will continue to monitor the progress of this initiative within the context of regular financial services consultations with MOF and other agencies.

One of the first liberalizations under the "Big Bang" initiative was a comprehensive revision of the Foreign Exchange Law implemented on April 1, 1998. The Foreign Exchange Law completed the cross-border capital liberalizations pursued under the 1995 bilateral agreement. Practical benefits for foreign (and domestic) banks include removal of restrictions on Japanese overseas deposits and permission for Japanese to freely buy foreign currencies from and sell them to foreign financial institutions, among other things. Most importantly, the new Foreign Exchange Law made it clear that there should be no limitation on cross-border and domestic capital transactions involving foreign exchange unless otherwise specifically legally restricted.

In June 1997, also under the auspices of the Framework, the governments of the United States and Japan engaged in a new dialogue called the U.S.-Japan Enhanced Initiative on Deregulation and Competition Policy. Under the Enhanced Initiative, meetings of high-level officials and five expert-level groups covering telecommunications, housing, medical devices/pharmaceuticals, financial services, and deregulation/competition policy have been conducted over the past year. Discussions for the financial services group have been held in tandem with the review meetings for the bilateral agreement mentioned above and have provided a forum for reviewing the deregulation efforts being made by the Japanese government under the "Big Bang" initiative.

As part of the successful conclusion of the WTO's financial services negotiations in December 1997, Japan committed itself to remove certain restrictions on overseas deposits and trust contracts and services related to capital transactions, such as trading in foreign exchange, and to generalize to the other members of the WTO the benefits of its bilateral financial services agreement with the United States.