



## **Competing to be the financial centre of Asia:**

### **Why an integrated financial services industry is crucial to Tokyo's success**

The European Business Council in Japan (EBC) welcomes the Government's renewed focus on promoting Tokyo as a global financial centre. Two study groups have been established to develop policy recommendations, one under the Council on Economic and Fiscal Policy and the other under the Financial Systems Council in the Financial Services Agency. Each must wrestle with the question of how Tokyo can attract enough financial services talent and business to out-compete its regional rivals and match the success of London and New York. While due consideration should be given to factors such as transport infrastructure, taxation, language skills, education, human resources and type of stock exchange, the EBC believes the primary focus must be on regulation and, in particular, addressing the drawbacks of Japan's current approach.

The EBC has long argued that Japan's unique regulations requiring the artificial separation of financial services (banking, securities, asset management, insurance, etc.) undermine the attractiveness of the Japanese market as a centre for global financial groups. Despite regulatory reforms that have partially reduced firewalls, financial companies are still not permitted to operate in Japan on a group basis, even though they can do so in every other advanced market. Integrating operations remains inherently risky, since the grey area between what is allowed and what is not remains considerable.

#### **Japan's current regulations reduce efficiency and increase risks for everybody**

Japan's firewall restrictions pose problems for global financial services groups operating banking, securities and other financial services businesses in Japan:

- They are not permitted to be represented by a single country manager in Japan, but instead must appoint separate managers accountable for each business line. This makes the integration of the Japanese business into the global business extremely complicated: reporting lines and responsibilities have to be specially adjusted to fit the Japan-specific situation.
- The lack of integrated leadership in Japan also constrains efficient business management and risk analysis at the group level – leaving everybody more exposed to

risk.

- Each of the business lines needs to maintain certain separate functions and organisational structures, which could otherwise have been shared on a group basis. Such duplication creates inefficiencies and extra costs.
- Stifling the flow of information between different units in the group inhibits growth, especially since business opportunities appear and disappear in the course of just a few minutes in the financial services industry.
- Stifling financial innovation as only products cleanly fitting within Japanese business definitions (banking, securities, insurance product, asset management etc..) can be introduced into Japan without regulatory risk. Investors are eventually paying the price for this by reduced access to investment opportunities and higher price for the service as costs to fit the unique Japanese business model have to be covered.

The effect on global financial groups is that:

- They continue to conduct business outside Japan that could have been conducted here, if the rules were different.
- Their Japanese operations remain isolated, since the unique structure required to meet Japan's rigid firewall restrictions make them difficult to integrate into the global business.
- The possibility of establishing Tokyo as their regional business centre in Asia can scarcely be contemplated.

### **Integrating financial services markets is a global trend**

Integrated financial services markets are becoming the norm in countries across the world, having proved to be the most efficient way for financial companies to fulfil their role in society of allocating resources in the economy while dealing with risks for investors. Although Japan has taken small steps in this direction, discussion on reducing firewalls is held back by the prevailing assumption that allowing banks to offer securities services and mutual funds would inevitably lead to conflicts of interest and other risks harmful to customers' interests. This assumption contrasts with the growing consensus in Europe, the U.S. and other parts of Asia (Hongkong and Singapore) that market mechanisms can be relied upon to punish actors who abuse their positions to promote the interests of individual people, departments or clients: "reputation risk" acts as a very substantial deterrent.

In line with these developments, the focus of financial regulators across the world has shifted from simply forbidding companies to engage concurrently in certain types of businesses, to enforcing internal control and corporate governance mechanisms, which ensure that potentially conflicting interests (such as underwriting and brokerage) are kept separate. The trend is for regulators to work together with industry participants to develop clear codes of conduct and rules of enforcement. Rules forbidding insider trading have proved an adequate alternative to economically devastating firewall regulations, with

disclosure requirements for investment analysts, credit rating analysts and auditors proving effective in revealing any interests they have in firms they analyse or audit.

### **Reforms in Japan have been limited in scope and have increased risk**

The Hashimoto Government's 1996 financial "Big Bang" brought liberalisation to many fields such as international capital transactions, brokerage, securities, investment trusts and derivatives. However, even though cross-sector integration of the financial services industry was initially amongst the goals of the programme, little was achieved in this direction. Though the ban on financial holding companies was lifted, the requirement to separate management control between different business entities remained. This effectively undermined any use of the holding company structure by global financial companies since it provided neither for integrated management control nor sharing of risk information.

In 2001, revisions of the ordinances relating to Articles 65 and 45 of the *Securities and Exchange Law* were introduced to permit a larger degree of sharing of internal control functions, such as compliance and risk management, between regulated entities within a financial conglomerate. These revisions were followed by the Financial Conglomerate Guidelines issued in 2005, which attempted to clarify the circumstances and type of information that could be shared between different entities in "related" financial services companies. The decision to leave the regulations themselves unchanged, and only provide guidelines on the circumstances in which they can be circumvented, has unfortunately resulted in more ambiguity and complexity, which means increased risk and costs on the part of the regulated entities. The same holds for the rules allowing the sharing of certain customer information provided prior written consent is received: the general rules are difficult to apply to specific situations and the prior consent procedure too arduous.

### **What should be done?**

Japan should profit from the experience of other major markets, where regulators have demonstrated that adequate levels of risk control and supervision can be achieved without resorting to strict separation of each financial services business undertaken within a financial conglomerate. Their approach has been shown to foster efficiency, development of new products and better risk analysis. Both the financial services industry and the economy at large have benefited extensively from integration of businesses at global level. If Japan wants to establish Tokyo as a global financial centre, it is essential to follow the same path. The EBC recommends that:

- (1) The ban on concurrent management of banking and securities businesses should be lifted by revising Article 33 of the new Financial Instrument Exchange Law.
- (2) Article 1 of the same Law concerning the concurrent management of trust businesses by financial institutions should be revised to include branches of foreign banks.
- (3) The sale of insurance products through financial institutions should be fully liberalised.

- (4) Asset management companies should be allowed to place orders on behalf of overseas affiliates as well as promote off-shore funds for related companies without additional licensing being required.

**About the EBC:**

The European Business Council (EBC) is the trade policy arm of the 17 European national chambers of commerce and business associations in Japan. Established in 1972, the EBC works to improve the trade and investment environment for European companies in Japan. The EBC currently represents more than 3,000 local European companies and individuals who are members of their national chambers of commerce. 350 of these companies participate directly in the EBC's 28 sector-based committees.