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The New Forward-Looking Phase of Japan's Financial System Japan's Challenge: Moving toward a Financial Services Nation

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Good afternoon, Ladies and Gentlemen.

It is my great pleasure to have this opportunity to speak about the new forward-looking phase of the Japanese financial system in front of such distinguished members at the Japan Society in New York, which has been playing an important role in deepening political and economic cultural exchanges between the United States and Japan.

First of all, I would like to mention the rehabilitation of the Japanese financial system which has been in a state of stagnation since the collapse of the bubble economy. Then, I would like to explain the “Program for Further Financial Reform”, which was made public around the end of last year, from the viewpoints of,

- 1) Enhancing market functions and improving confidence in markets; and
- 2) Financial administration and a financial system with international views.

This new program reflects our views that the Japanese financial system is now entering into a new forward-looking phase aiming at establishing a desirable financial system for the future, having now moved beyond the emergency reaction.

Past policy measures and the current state of the financial system

I was appointed as Minister of State for Financial Services last September and began to take charge of the Japanese financial administration. For two years before taking office as the Minister, I had been in charge of financial administration as Senior Vice Minister along with my predecessor, Mr. Heizo Takenaka. During this period, in October 2002,

immediately upon assuming office as Senior Vice Minister, we established the “Program for Financial Revival,” in order to normalize the non-performing loans problem. As you know, this non-performing loans problem was regarded as the main cause of the dysfunction of the post-bubble Japanese financial system. Since then, I have been making every effort to steadily implement this program.

As a result, the Japanese banking sector has almost recovered from its difficult situation. Under the “Program for Financial Revival,” we targeted normalizing the non-performing loans problem by reducing the non-performing loans ratio of major banks, 8.4% as of end-March 2002, to about half by end-March 2005. Currently, the non-performing loans ratio of major banks has been reduced to 4.7% as end-September 2004. Although the ratio as of end-March 2005 will be revealed around the end of this month, we are sure that we are steadily on track toward achieving our goal.

On April 1st of this year, the remaining blanket deposit insurance was removed as scheduled. This removal had been postponed for two years until the end of March 2005. Since taking office, smooth implementation of the scheduled removal of the remaining blanket deposit insurance has been my biggest challenge. This removal will indicate that financial institutions must compete with each other to be chosen by depositors and win their trust. This successful removal indeed demonstrates that the Japanese financial system is now entering a new forward-looking phase.

Program for Further Financial Reform; Japan’s challenge: moving toward a financial services nation

The Japanese financial system is entering a new forward-looking phase aiming at establishing a desirable financial system for the future, having now moved beyond the emergency reaction against the non-performing loans problem, as I mentioned before.

Namely, this new phase could be described as one in which the attitude of the Japanese financial administration toward the financial system changes from an emphasis on “financial system stability” to an emphasis on “financial system vitality.” Taking the change in phase from “stability” to “vitality” into consideration, we must aim to establish an attractive financial system with high international evaluation, and we must realize this through the effort of the “private sector.” The shift “from savings to investment” will be accelerated through this reform and it is expected to contribute to

the establishment of an economic structure with flexibility in dealing with risks.

We named this set of financial goals “Japan’s challenge: Moving toward a financial services nation,” and formulated this program as the successor to the “Program for Financial Revival” at the end of last year.

Five viewpoints of the Program for Further Financial Reform

Taking this background into consideration, we organized the contents of the reform to be developed in the future from five viewpoints. That is, firstly, emphasis on users’ needs and thorough implementation of user protection rules; secondly, strategic use of IT for strengthening the competitiveness of financial institutions and further developing financial infrastructure; thirdly, further development of a financial system which is internationally open and a financial administration with an international perspective; fourthly, contribution to regional economies; and lastly, establishment of a reliable financial administration that complements market discipline.

Concrete measures in the Program for Further Financial Reform

Today, from these viewpoints, I would like to introduce concrete measures focusing on two key terms, “Enhancing market functions” and “Internationalization,” because I am in New York, the largest international financial market in the world.

Enhancing market functions and improving confidence in markets

Firstly, the point of “Enhancing market functions and improving confidence in markets” is important from the second viewpoint of “Strategic use of IT for strengthening the competitiveness of financial institutions and further developing financial infrastructure.”

In recent years, several cases of illegal corporate accounting have occurred in the world, such as Enron and WorldCom in the United States and Palmalat in the EU. Since last autumn, we also have seen some problematic cases in Japan surrounding disclosure and governance of listed companies. In particular, since this February, appropriate approaches to business transfer of listed companies has been vigorously discussed. Now, rapidly and in a very short period, we are learning various M&A methods, including hostile takeover, which the United States has experienced since the 1980s.

Under these circumstances, currently, the FSA is broadly reviewing our capital market system. In looking back at the past, Japan's "Big Bang" liberalization of the financial sector in late 1990s tried to establish free competitive conditions at the same level as in the United States. Now once again, referring to the structure of wide investor protection in the United States, and for the purpose of establishing infrastructure toward our policy "From Savings to Investment", we are studying the "Investment Services Law" as a functional and cross-sectional framework of investors' protection covering overall investment services instead of sectional regulations, while financial products which cannot be defined as traditional securities are beginning to appear. We will settle the basic way of thinking about these matters by June, 2005.

On the other hand, with regard to the corporate governance of listed companies, the U.S. Securities and Exchange Commission and stock exchanges are playing an important role, significantly differing from Japan. Recently, in Japan, various corporate defense methods against "hostile takeover" were reported by the media, and most Japanese are unfamiliar with them. In this regard, it is important to understand that these corporate defense methods are available only based on the condition that outside board members independent of management and tense relations between boards and management exist. It is important to ensure the system in which boards can make objective judgments regarding which management is preferable for stock holders. For Japan, which is facing the recent activation of M&A, I think the experiences of the United States will give us many lessons regarding what the market regulator and stock exchanges should do to protect investors.

The New York Stock Exchange has recently announced changes to its management structure. While demutualization and listing are in the international current, pursuing both the public interest and the efficiency of management is getting more and more difficult. In this regard, the New York Stock Exchange is seeking for efficiency of management as a listed company, while on the other hand, they are going to separate their self-regulatory functions. This will give us good input in considering the self-regulatory system in Japan.

In the "Program for Further Financial Reform", some measures to ensure the credibility of disclosure are included. Specifically, for instance, with regard to the effectiveness of internal control over financial reporting, it is important that management assesses its

effectiveness and a CPA verifies the management's assessment. For each, we will clarify the standards by August 2005. In this regard, it is important to establish standards that are well balanced between cost and benefit, by referring to Section 404 of the Sarbanes-Oxley Act.

I sincerely expect that the capital market reform in Japan will enhance the transparency of the Japanese market for investment by investors of the United States, and give corporations of the United States a good chance to consider the Japanese market as a funding market.

Financial administration and a financial system with international views

Secondly, I would like to talk about measures regarding "further development of a financial system which is internationally open and financial administration with an international perspective" aiming at further internationalization of our financial markets.

First of all, when we look at international situations of financial services, there is a trend toward a convergence of regulations and standards especially in the world's major financial markets, such as Japan, the United States, and the EU. This is along with the further progress in globalization of financial transactions and financial markets. For instance, there are common issues such as international convergence of accounting standards and enhancing oversight of accounting firms in the global markets.

On the other hand, there is also a trend which can be called the "paradox of globalization." This means there is a possibility that when domestic regulations for investors' protection are introduced to respond to globalization, these regulations could become constraints upon market access, which would have backward impacts on globalization in the end. Recently, regulations under the United States Sarbanes-Oxley Act and equivalence requirements to foreign regulations and standards through EU directives which intend to promote integration of its financial markets contain such a possibility.

The world's major financial markets such as Japan, the United States, and the EU, need to continue to maintain their open and global nature without taking an inward-looking approach in the name of "equivalence." At the same time, financial regulators of the "three poles" of Japan, the United States, and the EU need to cooperate and tackle

common issues in the global markets. With such recognition in mind, we will promote the strengthening of dialogues with the United States and the EU, and continue to develop and improve our domestic regulations and standards in order that they become internationally consistent.

In this regard, supervisory frameworks to address the recent emergence of financial conglomerates is particularly drawing public attention. As for risks of financial conglomerates, we are particularly focusing on inefficient management caused by complex organization, conflict of interests, risk contagion within a group, appropriateness of intra-group operations, and risk concentration. These days, the supervisory authority of each country is facing the same issues; how a group should manage those risks and how the authority should supervise the properness and the sufficiency of such management.

Taking this situation into consideration, in Japan, we will formulate and announce the “Guideline for Supervision on Financial Conglomerates” this summer. The draft guideline is currently in the process of collecting public comments on our website. The guideline clearly defines financial conglomerates, and focuses on risks which could seriously affect financial strength and appropriate operations of group companies, and the risk management system of the group. Furthermore, in order to ensure effective and efficient supervision of financial conglomerates which operate internationally, the guideline is aiming for cooperation with foreign authorities.

Closing

This is a brief description of the new phase of the Japanese financial system.

While the phase of the financial environment is greatly changing, we, as a financial supervisor, should change our stance as well. I would like to think about the financial supervisor’s future stance based on the following three viewpoints. Firstly, the essence of our core role is to be a complement of market discipline. Secondly, we need to establish a “Code of Conduct” for the financial administration along with a full review of current regulations and repeal of unnecessary regulations. Thirdly, we need to develop and thoroughly implement user protection rules so that users do not suffer unexpected losses. As for the “Code of Conduct” as a first step we will formulate “Basic Guidelines for Inspection” to specify implementation procedures of inspection and

enhance transparency and predictability of the process, and we are now soliciting public comments on the draft.

As I mentioned at the beginning, the financial administration must aim to establish an attractive financial system with high international evaluation. And this should be led by the efforts of the “private sector.”

We formulated and announced the “Work Schedule” as a concrete implementation schedule at the end of March, in order to steadily implement each measure shown in the “Program for Further Financial Reform.” From here on, I, as Minister of State for Financial Services, will make my best efforts to realize a financial system in which the level of users’ satisfaction is high, based on the program and the work schedule, thus contributing to a part of the structural reforms by the Koizumi Cabinet.

Thank you for your kind attention.