EMERGING FINANCIAL CONGLOMERATES IN THE JAPANESE FINANCIAL MARKET: TRENDS AND ISSUES

Akiko Nomura

INTRODUCTION

More than a decade has passed since the real estate and financial asset bubble burst and the Japanese economy entered its longest setback ever. Throughout the 1990s, the Japanese government set forth a number of measures to fight the banks' bad loan problem and at the same time to overhaul the country's financial system. It carried out financial deregulation, which in part enabled Japanese banks to engage in a broad range of securities and other financial activities. As a result, Japan now has four large financial groups, Mitsubishi Tokyo Financial Group, Sumitomo Mitsui Financial Group, Mizuho Financial Group, and UFJ Group, which offer banking, trust, and securities services.

A similar trend of financial deregulation occurred elsewhere around the same period. In the United States, the Glass-Steagall Act that separated banking and securities businesses was amended by the Gramm-Leach-Bliley Act of 1999 (GLB Act). The GLB Act enabled U.S. financial institutions to form conglomerates, such as Citigroup, which encompasses Citibank, Salomon Smith Barney, and Travelers Group.[1] Each of these entities is a leader in the U.S. and global financial markets.

The attitude toward financial deregulation changed sharply in 2002 as the Enron accounting fraud, and the role that financial conglomerates played in it, came to light. Now, the negative aspects of financial conglomerates, particularly their potential for conflicts of interest, are attracting more attention than ever in the United States.

This paper questions whether the financial conglomerates that emerged in Japan at the end of the 1990s face similar conflicts of interest.[2] It starts with a brief discussion of the

1. In fact, Citigroup was formed before the GLB Act was enacted, but the Act spared the newly formed Citigroup from giving up some of its insurance operations in the post-merger transition period.
2. Financial conglomerates can offer a wide range of products and services to both retail and wholesale

financial deregulation during the 1990s, which resulted in a number of mergers and alliances among major financial institutions in Japan. It then describes the presence that bank affiliates rapidly achieved in the corporate bond underwriting market. The third section discusses the need to balance the potential for conflict of interest against and the benefits of financial conglomerates and how regulators in Japan and the United States addressed this problem. Next, the paper examines the dealings between Citigroup and Enron Corporation and suggests how they appear under the U.S. and Japanese regulatory approaches. The final section draws some lessons from the Enron case for improving regulation of Japan's new financial conglomerates.

DEREGULATION AND THE EMERGENCE OF FOUR LARGE FINANCIAL GROUPS

Deregulation of Banking Activities in Japan

Under Article 65 of the Securities Exchange Law, Japan once prohibited banks and bank affiliates from conducting securities business in general. This separation of banking and securities business was established after the Second World War and was modeled after the American system. Japan was about to start its postwar rehabilitation, and bank dominance was deemed undesirable for the financial market. In order to foster growth in the securities industry and the financial market, it seemed necessary to protect securities companies by limiting competition. At the same time, separation also would shelter banks from the securities business, which by nature involves relatively high risks.

Changes in the financial environment, such as the massive issuance of Japanese Government Bonds, necessitated regulatory changes in the early 1980s. In 1983, banks started selling Japanese Government Bonds to the general public. Review and discussion of the separation of banking and securities businesses continued throughout the late 1980s. In

customers. Japanese financial conglomerates offer retail and corporate banking; retail brokerage and investment banking; investment trust and other asset management; and certain insurance products. This paper focuses on banking and securities services offered by financial conglomerates to wholesale customers.

the end, a law passed in 1992 amended Article 65 of the Securities Exchange Law and enabled banks to enter the securities business. At the same time, it allowed securities companies to enter into the trust bank business.

A major characteristic of the reform of 1992 was that it only allowed banks to enter the new business via a subsidiary. The same was true for securities companies entering into the trust bank business. Requiring banks to conduct their securities business through a separate legal entity insulated them from whatever risks the new business incurred. This "subsidiary method" was considered to pose less risk to the banking system than the "universal bank method" in which banks themselves conduct securities business.

A third method, the "financial holding company method," in which a bank and a securities company become affiliates under the same holding company, also involves separate entities for banking and securities businesses and is often cited as the safest way for banks to enter other businesses. This option was not available in Japan in 1992, however. The Antimonopoly Law prohibited formation of holding companies in general. This restriction was removed with an amendment to the Antimonopoly Law in December 1997, and an amendment to the Banking Law in March 1998 made possible the establishment of financial holding companies.

The Emergence of Financial Conglomerates

With these drastic changes in the regulatory framework, virtually all of Japan's major banks entered the securities business. By the end of 1994, every city bank had established a securities subsidiary.[3]

Then came a period of turmoil in the banking system which led to a wave of mergers among the largest Japanese banks. In November 1997, Hokkaido Takushoku Bank, a city bank, went into bankruptcy. By that time the myth that banks would not be allowed to fail had already been destroyed, but the fall of a city bank was still a shocking event. In 1998 the Long Term Credit Bank of Japan and Nippon Credit Bank filed for special public

3. City banks are ordinary banks with headquarters in large cities and nationwide branch networks.

administration. As the soundness of even the largest banks came under question, Industrial Bank of Japan (IBJ), Dai-Ichi Kangyo Bank (DKB), and Fuji Bank announced a merger in August 1999, followed by Sumitomo Bank and Sakura Bank which announced their merger in October of that year. IBJ, DKB, and Fuji became subsidiary banks of newly formed Mizuho Holdings in September 2000, and they later merged to form Mizuho Bank for retail banking and Mizuho Corporate Bank for corporate business. Sumitomo Bank and Sakura Bank started as Sumitomo Mitsui Banking Corporation (SMBC) in April 2001. In December 2002 SMBC became a wholly owned subsidiary of Sumitomo Mitsui Financial Group, a newly established holding company.

The remaining city banks, joined by some larger regional banks and trust banks, were also trying to find partners. In June 2000, Sanwa Bank, Tokai Bank, and Toyo Trust and Banking Company announced the formation of UFJ Holdings, which also came into being in April 2001, and later, the three banks merged to become UFJ Bank. Asahi Bank and Daiwa Bank were the last to announce their move; in March 2002 they joined under a new holding company with the name of Resona Group.[4]

Although it did not tie up with any other banks in this round, Bank of Tokyo-Mitsubishi did adopt a financial holding company structure to align its businesses, forming Mitsubishi Tokyo Financial Group (MTFG) in April 2001. Thus, all of this reorganization left Japan with four large financial groups–Mizuho Holdings, Sumitomo Mitsui Financial Group, UFJ Holdings, and Mitsubishi Tokyo Financial Group (Figure 1).

The reorganization of the banking sector also meant that the resulting financial groups each encompassed several securities companies with overlapping features. For example, Mizuho Financial Group included Dai-Ichi Kangyo Securities, Fuji Securities, and IBJ Securities, which were merged into Mizuho Securities in October 2000. The Mizuho group also maintains Mizuho Investors Securities and Shinko Securities as affiliates.

The more numerous regional banks form the next tier.

4. Resona Group is not discussed this paper as it does not have a securities business division like others.

UFJ Group underwent a similar restructuring of securities companies within the group. First, Sanwa Securities and Tokai International Securities merged to form UFJ Capital Markets Securities in July 2001. This subsequently merged with Tsubasa Securities to become UFJ Tsubasa Securities in June 2002.

SMBC took a somewhat different path. As Sumitomo Bank had long been on friendly terms with Daiwa Securities, in April 1999 the two set up a joint venture for wholesale securities business, Daiwa Securities SB Capital Markets. Sumitomo Capital Securities, Sumitomo Bank's subsidiary, was merged into this new operation. When Sumitomo Bank and Sakura Bank merged in April 2001, Sakura Bank's subsidiary, Sakura Securities, was also merged into Daiwa Securities SB Capital Markets and the resulting entity was re-named Daiwa Securities SMBC.[5] The group's Sakura Friend Securities conducts retail securities business.

In December 1999 Bank of Tokyo-Mitsubishi had formed an alliance with Kokusai Securities, then the fourth largest securities company next to the "Big Three" of Nomura Securities, Daiwa Securities, and Nikko Securities.[6] By the end of March 2001, Bank of Tokyo-Mitsubishi owned 32.6 percent of Kokusai Securities' outstanding shares. Prior to this acquisition, Bank of Tokyo-Mitsubishi and its trust bank affiliate, Mitsubishi Trust Bank, already had established Tokyo Mitsubishi Securities, Mitsubishi Trust Securities, and Tokyo Mitsubishi Personal Securities as subsidiaries. In September 2002, these three, along with Kokusai Securities, were all merged into Mitsubishi Securities.

Today, these four financial groups not only encompass the largest banking institutions in Japan but also are capable of competing with traditional securities companies in some investment banking areas. In other words, the financial groups that emerged from this decade of deregulation and restructuring in Japan had become true financial conglomerates.

5. Daiwa SMBC is owned 60 percent by Daiwa Securities Group and 40 percent by SMBC. For the purposes of this paper, it is treated as belonging to Daiwa Securities Group rather than as an affiliate of SMBC.

6. It used to be the "Big Four" which included Nomura Securities, Daiwa Securities, Nikko Securities, and Yamaichi Securities. Yamaichi Securities closed down in November 1997.

IMPACT OF THE FINANCIAL CONGLOMERATES ON JAPAN'S FINANCIAL MARKET

The main securities-related activities undertaken by the four new financial conglomerates have been in investment trust sales and corporate bond underwriting.[7] Their activities in corporate bond underwriting illustrate the achievements of the restructured financial institutions.

Prior to the banking deregulation of the mid 1990s, the "Big Four" securities companies dominated investment banking in Japan.[8] The corporate bond market had a number of restrictions, and bond issuance was controlled by a group of underwriters and "corporate bond trust banks".[9] Reform of the corporate bond market also took place in the early 1990s. When Japanese banks were first allowed to enter the securities business via subsidiaries they were not allowed to conduct equity-related business, but they were able to participate in the corporate bond underwriting market.[10]

Financial Conglomerates in the Commercial Bond Underwriting Market

Entry of the securities subsidiaries of banks dramatically changed the landscape for bond underwriting. By 1998, just before the wave of bank mergers, more than ten banks had securities subsidiaries active in corporate bond underwriting. Even though the mergers decreased this number, the securities divisions of the new financial conglomerates have established a noteworthy presence in the market. For example issues underwritten by financial conglomerates were similar to those underwritten by independent securities

7. Not only financial conglomerates but also various other types of financial institutions including regional banks sell investment trusts. Also, banks do not have to conduct these sales through a subsidiary or affiliate; banks themselves can sell investment trusts. In less than four years, banks have established themselves as a major sales channel for investment trusts, with banks accounting for more than 20 percent of all investment trust sales by net assets at the end of September 2002.

8. For example, in FY1990 their share of securities underwriting deals was 80 percent while the share of the top seven securities companies was 89 percent.

9. Prior to the 1993 amendment to the Corporate Law, a corporate bond issuer was required to designate a corporate bond trust corporation as an agent for the bond issuance and the management of outstanding issues. Only banks were eligible for the role so they were called corporate bond trust banks. The 1993 amendment repealed the requirement for the designation of corporate bond issuance and the entity in charge of managing outstanding issues was called a corporate bond management corporation.

10. Such restrictions on activities of bank subsidiaries were lifted as of October 1999.

companies, although their average amount per issue was somewhat smaller.

Aggregate underwriting fees published by the Bond Underwriting Association showed no declining trend between April 1994 and August 1998, when bank subsidiaries began underwriting corporate bonds. However, Matsuo (1998) points out that underwriting fees on individual issues started to decline from early 1998, especially for issues with higher credit ratings. He cited increased competition due to the entry of bank-affiliated securities companies, together with the abolition of the restriction on the repatriation of proceeds from Euro yen bond issuance by domestic corporations, as the reason for the reduction in underwriting fees.[11]

Main Bank-affiliated Underwriters

Another factor in Japan's corporate bond market is the existence of financial institutions that serve as so-called main banks for corporations. There is no legal definition of a main bank, but a corporation's main bank is often referred to as a banking institution with the following features:

- It is the largest lender to that corporation;
- It is the largest stockholder in that corporation among financial institutions;
- Its managers are on the board of the corporation;
- It has a long-term, stable relationship with the corporation; and
- It would arrange a financial rescue package when the corporation is in crisis.

The banking institutions in each of the four financial conglomerates serve as the main bank for a number of large corporations in Japan. They are not only the largest creditors but also among the largest shareholders (often the largest) of major Japanese corporations.

The corporate bond underwriting activities of the securities companies affiliated with these main banks are summarized in the right-hand column of Table 2. From January 1999 to September 2002, main bank securities affiliates underwrote 26 percent of all corporate

11. Differentiation of fees by credit rating is discernible in the data on corporate bond issues used in Table 1. Underwriting fees ranged between 25 and 70 basis points for AA and AAA issues; between 35 and 100 basis points for A issues; and between 35 and 120 basis points for BBB issues. Fee reduction was not evident during the four year period. Average fees charged by independent securities companies and bank affiliated companies were not significantly different for AA and AAA

bond deals and 24 percent by value. In other words, three-fifths of the underwriting deals won by financial conglomerates involved securities firms whose related banking institution had a special relationship with the corporate issuer. In addition, the average amount per issue by main bank-related underwriters was larger than the overall average for issues by all bank-affiliated underwriters.

The fact that main bank-related underwriters have established a substantial share of the corporate bond underwriting market suggests that the main banks may have had some influence in these deals, although market share per se is not conclusive evidence of such influence.[12] This, in turn, hints at the type of conflict of interest that can arise for banking institutions and affiliated securities entities.

CONFLICTS OF INTEREST AND REGULATION OF FINANCIAL CONGLOMERATES

The possibility of conflicts between the interests of financial institutions and the interests of investors or depositors is inherent to financial conglomerates. For example, when the prospects of a bank's client corporation deteriorate without the public realizing it, a commercial bank division could persuade its underwriting affiliate to bring out a securities issue on behalf of the client corporation and use the proceeds to repay the corporation's outstanding bank loans, without fully disclosing its adverse information about the corporation's prospects. In this case, depositors may be protected but the investors in the securities may be subjected to undue risks. In another case, in order to avoid a bond default, a banking division of a financial conglomerate may extend credit inappropriately to an issuer of a bond underwritten by its securities affiliate. In this case, the action may improve the status of the bond investors but increase the risk to the bank's depositors. Such unsound banking practices would weaken the banking institution and pose a risk to the banking system

issues and A issues.

12. Preceding empirical studies have not reached consensus on this issue. Konishi (2000) asserts the existence of the "net main bank effect" when corporate bond issues between January 1995 and November 1996 were examined. On the other hand, Osano and Hori (2002) states such effect was not evident from bond issuance data between April 1998 and March 1999.

as a whole. They would also undermine public trust in the financial market. Because of these possible consequences, the propensity for creating conflicts of interest is viewed as a fundamental weakness of financial conglomerates.

Another negative aspect of financial conglomerates is that they could lead to an undue concentration of resources. One of the main rationales for the separation of banking and securities businesses was that a financial conglomerate could have too strong control over an industrial company's financial activities. Moreover, a financial conglomerate could use its concentration of resources to engage in unfair trading practices. For example, a bank could exploit its power as a lender to win a deal for its securities affiliate that the affiliate could not win under usual business terms, and thus create inefficiency in the market.

Against these negatives, the affiliation of banking institutions with securities dealers offers advantages to financial institutions, to consumers, and to the entire financial market. First, financial conglomerates can take advantage of economies of scope from the coordinated provision of commercial and investment banking services. For example, the banking division's expertise in corporate lending could be applied to the underwriting business of the securities division. If the formation of a financial conglomerate leads to a broader customer base and more deals, it may generate economies of scale as well. These could result in a financial institution with a more efficient business model. Also, a financial conglomerate may be able to diversify business risk as it engages in various types of financial activities.

Second, consumers could benefit from the convenience of "one-stop shopping" when a single organization offers a variety of financial services. For example, a bank customer would be able to purchase securities services from the bank's affiliate. If economies of scope are realized, the increased convenience may be accompanied by higher quality of services for customers.

Third, the entry of a bank affiliate into the securities business could increase competition and efficiency in the financial market. If the banking division's expertise in corporate lending makes the bond underwriting services of its affiliate more efficient, then other players in the market would be required to provide equally efficient services in order to stay competitive, and the market as a whole could become more efficient.

Regulation of Conflict of Interest

To allow society to reap the benefits of financial conglomerates regulation must try to control their potential harm. In particular, regulation should prevent financial conglomerates from engaging in activities and unfair trading practices that go against the interests of consumers, the soundness of the banking system, and the security of the financial market. If regulation is too stringent, however, the benefit of financial conglomerates—economies of scope, customer convenience, and more efficient financial markets—may be lost.

For this reason, at the same time that Japan deregulated the financial industry by permitting banks to enter the securities business, it also adopted detailed rules, or so-called firewall measures, to regulate trades that involve both a parent and its subsidiary. In particular, the Banking Law and related rules prohibit a bank from (1) conducting a trade with its affiliated entities (parent, subsidiary or affiliate) on terms less favorable to itself compared to a trade conducted with a third party and (2) conducting a trade with customers of its affiliated entities on terms less favorable to itself compared to a trade of similar type and quantity.[13] For example, a bank cannot provide credits on terms favorable to a customer of its affiliate in order to obtain business for that affiliate.

In addition, the Securities and Exchange Law prohibits a securities company from (1) conducting a securities transaction with its parent or subsidiary on terms that could harm the fairness of the trade and (2) entering into a securities business contract with a customer knowing that its parent or subsidiary has provided credits to that customer under the condition that such contract be agreed upon.[14] Securities Companies Rules of Conduct prohibit securities companies from:[15]

- Selling securities it underwrites to a customer without making proper disclosure when the issuer of such securities borrows funds from its parent or subsidiary and the proceeds from the securities issuance will be used to repay that borrowing;

13. Banking Law Article 13-2 and Banking Law Rule 14-10 and 14-11.
14. Securities and Exchange Law Article 45.
15. Securities Companies Rules of Conduct Article 12. Exceptions are granted in some of these clauses.

- Becoming a principal underwriter of its parent or subsidiary;
- Entering into a contract with a customer knowing that its parent or subsidiary is offering services to that customer with provisions better than available in the market under the condition that the fore mentioned contract with the securities company be agreed upon;
- Selling to a customer the securities it has underwritten within the past six months, knowing that its parent or subsidiary has provided credit to that customer for the purpose of purchasing that security;
- Conducting trade with its parent or subsidiary with provisions substantially different from those available at arm's length;
- Selling security it has underwritten within the past six months to its parent or subsidiary;
- Receiving from or providing to its parent or subsidiary non-public information on an issuer or a customer except when the issuer or the customer has agreed in writing on such sharing of the information;
- Sharing electronic information processing system with its parent or subsidiary bank; and
- Misleading its customers by failing to disclose that it is a separate legal entity from its parent or subsidiary bank when visiting the customer together with its parent or subsidiary bank.

Evolution of Regulation in the United States

These firewall measures adopted in Japan were modeled after those that the U.S. Federal Reserve Board (FRB) instituted in the late 1980s when it began moving away from the strict separation of commercial and investment banking imposed by the Glass-Steagall Act. In allowing the so-called section 20 bank holding companies to conduct certain securities business that banks themselves were not eligible to participate in, the FRB erected twenty-eight firewalls to protect the banking system. These firewalls included restrictions on credit extensions to customers of the underwriting subsidiary, limitations to maintain separation of an underwriting affiliate's activity, and requirements for disclosures by an underwriting subsidiary to its customers.

In 1997, after reviewing a decade of experience with the section 20 bank holding companies, the FRB decided to eliminate many of the firewall restrictions and consolidate others, because they were found to be overly burdensome or to duplicate other laws or regulations. The twenty-eight firewalls were trimmed down basically to simply require banks to comply with Sections 23A and 23B of the Federal Reserve Act and Section 106(b) of the Bank Holding Company Act. Section 23A of Federal Reserve Act places restrictions on the amount of a bank's transactions with its affiliates; it limits transactions with any one affiliate to ten percent of its capital and with all affiliates in aggregate to twenty percent. Section 23B requires financial conglomerates to conduct business at arm's length. It states that the terms of transactions between a bank and its affiliates must be substantially the same as those for comparable transactions with nonaffiliated companies or, in the absence of comparable transactions, as those that would in good faith would be offered to nonaffiliated companies. This provision in fact applies not only to transactions between a bank and its affiliates but also to transactions between a bank and a customer of its affiliate. For example, if a bank extends credit only if its affiliate provides investment banking services, it could be violating Section 23B. Finally, Section 106(b) of the Bank Holding Company Act prohibits what is called tying arrangements whereby a bank extends credit or furnishes a service on condition that the client engages in some other business with the bank. [16]

In 1999 when the U.S. Congress adopted the GLB Act that formally ended the separation of banking and securities businesses, it basically relied on these three existing provisions of the Federal Reserve Act and the Bank Holding Company Act to curb financial institutions from acting with conflict of interest and engaging in fair trading practices. Thus, the United States replaced the relatively specific requirements of the firewalls laid down initially with more general provisions such as the arm's length provisions.

LESSONS FROM ENRON

It is difficult to determine whether the firewall measures or arm's length provisions are

16. Specifically, Section 106(b) of the Bank Holding Company Act states that a bank shall not extend credit or furnish any service on the condition (1) that the customer shall obtain some additional credit or service other than a loan, discount, deposit or trust service; (2) that the customer shall obtain some additional credit or service from a bank holding company of the bank or from any other subsidiary of such bank holding company; (3) that the customer pro vide some additional credit or service to the bank, other than those related to in connection with a loan, discount, deposit or trust service; (4) that the customer provide some additional credit or service to a bank holding company of the bank or any other subsidiary of such bank holding company; or (5) that the customer shall not obtain some other credit or service from a competitor of the bank, a bank holding company of the bank or any subsidiary of such bank holding company, other than a condition that the bank shall reasonably impose in a credit transaction to assure the soundness of the credit.

adequate or effective in preventing unsound practices by financial conglomerates. So far, none of Japan's financial conglomerates has been involved in a major case alleging conflict of interest.[17] In the United States, however, one of the issues raised by the collapse of Enron Corporation in late 2001 was the role played by financial conglomerates and the conflicts of interest they may have faced. Here, we examine the transactions between Enron and Citigroup in order to draw some lessons for Japan's firewall measures.

Enron's Prepays

In July 2002, seven months after Enron's bankruptcy filing, the U.S. Congress held a series of hearings to shed a light on what role the largest financial institutions in the United States might have played in Enron's accounting fraud.[18] One of the issues debated was whether conflicts of interest were involved in the relationships between the financial conglomerates and Enron.

A team of Congressional investigators took seven months to review one million pages of documents and conduct numerous interviews. Robert Roach, Chief Investigator, presented their report (hereafter, the Roach Document) at the hearings. Central to its allegation was that some U.S. financial conglomerates "actively aided Enron in return for fees and favorable consideration in other business dealings."[19] In other words, the financial institutions allegedly engaged in a tying arrangement.

The focus of the investigation was on the financial vehicle known as a "prepay" or a prepaid forward contract. This is an arrangement in which one party pays in advance for a product or a service to be rendered in the future. In the case of Enron, a series of commodity trades was constructed so that payments Enron received from the trades would be treated as prepays and be reported as liabilities from price risk management on its financial statement.

17. There was one case of a breach in the firewall on customer information by a bank employee in 1997. At that time the sharing of information on bank customers was prohibited regardless of the customer's consent. During a regular inspection by the Securities and Exchange Surveillance Commission, an employee of Fuji Securities was found in possession of information on the financing activities of a Fuji Bank customer.

18. "The Role of the Financial Institutions in Enron's Collapse," Permanent Subcommittee on Investigations, Committee on Governmental Affairs, the United States Senate, 23 and 30 July 2002.

Two financial conglomerates, Citigroup and J.P. Morgan Chase, were named among others having assisted Enron in the prepays. Enron reported the prepay proceeds as cash flow from energy trades rather than cash flow from loans, and by so doing it could reduce its balance sheet debt and increase cash flow from operations. According to the testimony of Mr. Roach, however, the transaction was in substance a bank loan.

Enron Credit-Linked Notes[20]

The transactions between Citigroup and Enron are of interest as they involved both lending and the issuance of credit derivatives. Citigroup became involved in the prepay scheme with Enron in 1994. Table 2 lists the all of the prepay transactions between Enron and Citigroup. In the original scheme of prepays, Citigroup's commercial banking arm, Citibank, provided funds to Enron via a special purpose entity. As the amount of funds extended to Enron in the prepays increased to a substantial amount, Citigroup added a new feature to the scheme in 1999. A trust called Yosemite was established to issue Enron Credit-Linked Notes (Enron CLNs) and offer them to qualified institutional investors. Salomon Smith Barney, the investment banking arm of Citigroup, arranged the Enron CLN. Investors provided funds through the purchase of the notes and these funds were then passed on to Enron via the special purpose entity.

Yosemite issued a total of $825 million on Enron's behalf, $750 million in debt notes and $75 million in equity certificates. It invested in "Enron Investments," specifically defined in the Offering Memorandum as "payment obligations supported, in whole or in part, directly or indirectly, by Enron." $800 million was invested in the prepay through the special purpose entity and the remaining $25 million was invested in Enron bonds.

Disclosure about the Prepays at the Enron CLN Offering

According to the Roach Document the information about Enron's prepay transactions with Citibank was never disclosed, even in the documentation associated with the Yosemite

19. U.S. Senate, Committee on Governmental Affairs, 2002a.
20. Description of Enron CLN in this sub-section is based on U.S. Senate, Committee on Governmental

offerings. An Enron presentation excerpted in the Roach Document stated that the Yosemite structure "provides for a unique 'black box' feature which provides considerable flexibility" and that the "black box allows Enron the ability to provide a permanent take-out feature for highly structured transactions in the capital markets while limiting disclosure of prepay to Citibank."[21]

Standard & Poor's rated the Enron CLN, but according to testimony by its Managing Director of Utilities, Energy and Project Finance Group, "Enron did not, despite our repeated requests for complete, timely and reliable information, disclose any information revealing a link between the prepaid forward transactions and the swap transactions. Similarly, Enron provided no indication that these transactions were in any way related to any of the Yosemite or Credit-Linked Notes transactions despite an explicit inquiry by Standard & Poor's regarding the effect, if any, of these structured finance transactions on Enron's financial situation."[22]

Citigroup, on the other hand, does seem to have had knowledge about the relationship between the Enron CLN and the prepays. First, an internal Citigroup memorandum included in the Roach Document stated, "these prepays [Roosevelt and Truman] will be repaid with the proceeds from the Yosemite."[23] Yosemite was issued in November 1999, and the amount invested in the prepay was $800 million, which was, as the Roach Document pointed out, "the exact amount of prepay obligations due in the fourth quarter of 1999 to two Citibank-structured prepays known as 'Roosevelt' and 'Truman'" (see Table 2).[24] Moreover, in testimony before the Senate Permanent Subcommittee on Investigations, the Managing Director and Co-Head of the Credit Derivatives Group at Salomon Smith Barney North American Credit/Citigroup stated: "in the case of the Yosemite transactions, the proceeds of

Affairs, 2002a.
21. U.S. Senate, Committee on Governmental Affairs, 2002a.
22. U.S. Senate, Committee on Governmental Affairs, 2002b.
23. U.S. Senate, Committee on Governmental Affairs, 2002a.
24. Ibid. Roosevelt and Truman, the names of the prepays with the original scheme in which Citibank provided funds for the deals, were both extended with new maturity dates of November and December 1999. The total amount of extension was $800 million.

these CLN offerings happened to be used–on day one–to fund prepaid transactions."[25]

Had investors known about the prepays, their decision to invest in the Enron CLN notes may have been significantly altered. As the Roach Document pointed out, if Enron had reported the prepays as loans instead of "liabilities from price risk management," it's debt would have increased by $4 billion and its credit profile would have changed dramatically" (Table 3).[26] Enron's credit rating could have changed, too. The managing director of the Utilities, Energy and Project Finance Group at Standard & Poor's stated in the Senate Subcommittee hearing that $4 billion in additional debt-like obligations would in all likelihood have significantly altered Standard & Poor's analysis of Enron's creditworthiness.[27]

Firewall Measures in the Context of the Enron CLN Offering

We could summarize the Roach Document's findings on the Enron and Citigroup deals as follows. Citigroup was extending credits to Enron through its commercial bank (Citibank) while its investment bank (Salomon Smith Barney) was helping to arrange the Enron CLN. The proceeds of the offering were passed on to Enron via the special purpose entity, which invested them in "Enron Investments". Enron used the proceeds to repay the funds extended by Citigroup in previous prepays, and Salomon Smith Barney had knowledge of that.

The FRB, which was the umbrella supervisor for the U.S. institutions, apparently did not detect any problem in Enron's transactions with Citigroup or other financial institutions. During the Congressional hearings, a lawmaker asked a representative from the FRB what the Board's views were on the bank losses through transactions with Enron. The FRB representative replied "[we] have not identified illegal tying by banks and thus do not have evidence that such tying activity was a cause of recent losses. In particular, the syndicated loan facilities extended to Enron were priced within a range of market spreads for similarly rated companies at the time the credit was extended."[28]

On the other hand, the transactions between Enron and Citigroup would have been seen

25. U.S. Senate, Committee on Governmental Affairs, 2002c.
26. U.S. Senate, Committee on Governmental Affairs, 2002a.
27. U.S. Senate, Committee on Governmental Affairs, 2002b.

differently under Japan's firewall measures. The first Rule of Conduct for Securities Companies specifically prohibits securities companies from selling securities they underwrite to a customer without making a disclosure when the issuer of such securities borrows funds from its affiliate and the proceeds from the securities issuance will be used to repay that borrowing. This kind of requirement alone may have forced Salomon Smith Barney to disclose the fact that the proceeds from the Enron CLN were to be used for the repayment of the prepays. The type of structured finance involved and the extent of disclosure required for that particular type of structured finance would have been irrelevant. Furthermore, whether Enron had reported the receipt of the funds in its own financial statement would also have been irrelevant.

The FRB's reaction to the Enron incident suggests that the regulation of financial conglomerates in the United States continues to be based on arm's length principles. U.S. regulators showed no inclination to reinstate abolished firewall measures in the wake of the Enron experience. Nevertheless, it seems evident that the United States could strengthen the current regime by introducing a requirement for banking divisions to disclose their dealings with customers of their securities divisions.

CONCLUSION

A report on the mid-term perspective for Japan's financial system issued by the Financial System Council in September 2002 set forth, among other things, the need for "minimizing the current firewall measures to those pertaining to the arm's length rule."[29] This statement was included among proposals to improve access to the financial market. Although the proposal to minimize firewall measures seems mainly targeted at the retail market, any changes to the firewall measures will apply to wholesale financial transactions as well.

Similar changes were made in the United States in 1997, when the firewall measures were trimmed down to those stipulating the arm's length rule for transactions between a

28. Federal Reserve Board and Office of the Comptroller of the Currency, 2002.
29. Financial System Council, 2002.

bank and its affiliates. The modifications were deemed to "allow section 20 subsidiaries to operate more readily in conjunction with an affiliated bank, thereby maximizing synergies, enhancing services, and possibly reducing costs."[30]

The challenge facing regulators in Japan now is how to strike a balance between the advantages of allowing financial conglomerates and the dangers of weakening preclusion of conflict of interest. In this regard, a lesson from Enron would be that when a banking division of a financial conglomerate extends credit and a securities division offers investment banking services, the benefit of requiring the disclosure of those facts to investors may outweigh the burden of such requirement.

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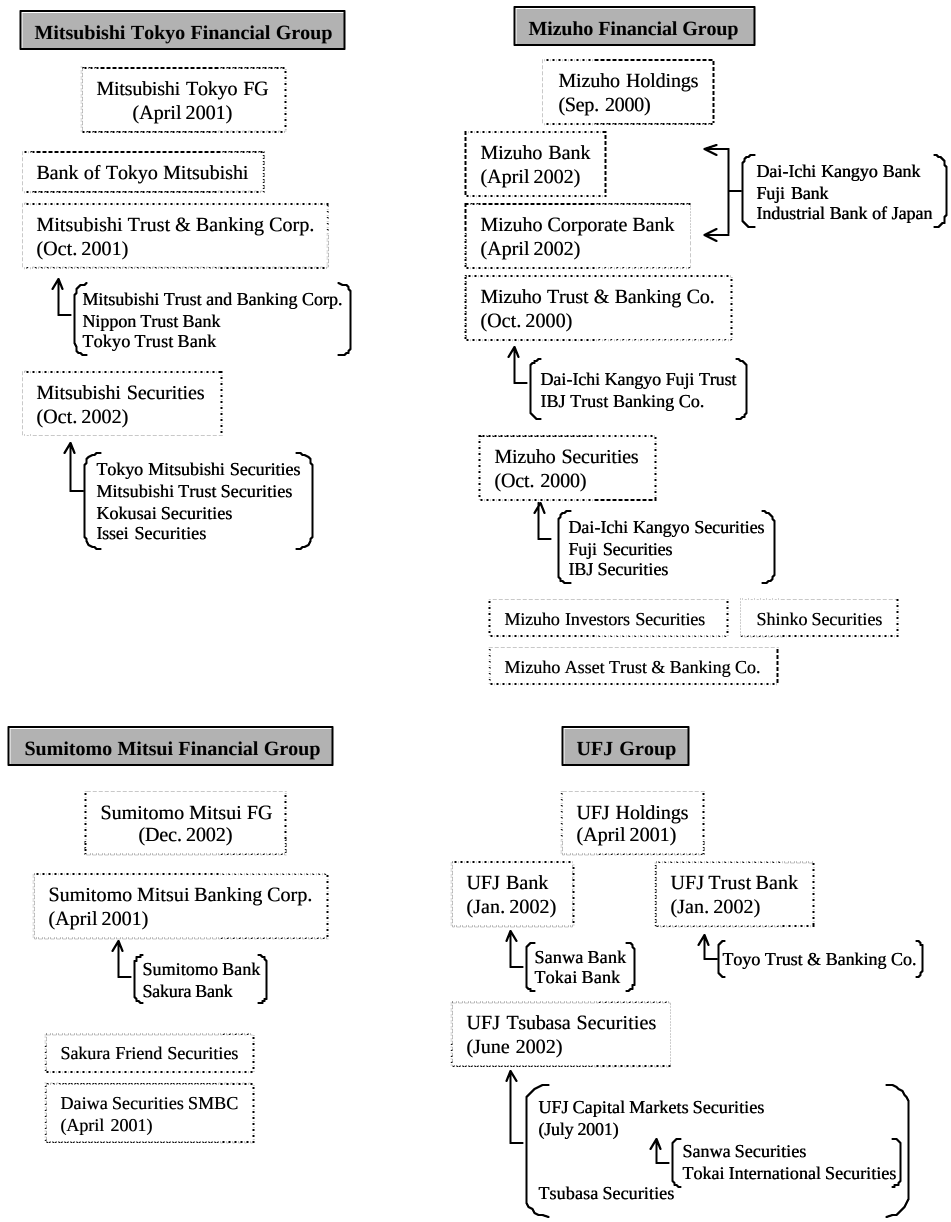
FIGURE 1
Formation of Four Financial Conglomerates



Note: Only banking corporations and securities companies are shown. Institutions in charge of other businesses such as credit cards or leasing are omitted.
Source: Nomura Research Institute

TABLE 1
Characteristics of Corporate Bond Underwriting Market by Type of Underwriter
(Jan. 1999 to Dec. 2002)

	Independent Securities Companies	All Bank Subsidiaries or Affiliates	Main Bank-related Underwriters
Share of issues	56%	44%	26%
Share of total amount underwritten	64%	36%	24%
Average amount per issue (¥100 million)	171	126	139
Credit rating distribution			
AAA & AA	32%	27%	25%
A	55%	55%	60%
BBB	13%	18%	15%
	100	100	100

Note: The data comprise domestic corporate bonds excluding those of NTT, JR, and the electric power companies. Bank and securities company issues are also excluded .
Source: Nomura Research Institute.

TABLE 2
Prepays between Enron and Citigroup

Transaction Name	Issuance Date	Commodity	Citigroup Commitment US$ millions	Amount US$ millions	Final Maturity Date	Amount Outstanding at Bankruptcy US$ millions
Citibank Delta Energy 1994	Sept. 1994	Crude	125.0	125.0	April 1996	0.0
Roosevelt (Natural Gas)	Dec. 1998	Gas	310.0	310.0	May 1999	0.0
Roosevelt (Crude Oil)	Dec. 1998	Crude	190.0	190.0	May 1999	0.0
Roosevelt Extension	May 1999	Crude	125.0	125.0	Dec. 1999	0.0
Truman	June 1999	Crude	250.0	500.0	June 1999	0.0
Truman Extension	Sept. 2000	Crude	337.5	675.0	Nov. 1999	0.0
Yosemite I	Nov. 1999	Crude	37.5	800.0	Nov. 2004	800.0
Nixon	Dec. 1999	Crude	104.0	331.4	April 2000	0.0
Yosemite II	Feb. 2000	Crude	16.0	305.0	Feb. 2007	305.0
CLN I (Yosemite III)	Aug. 2000	Crude	0.0	500.0	Aug. 2005	475.0
Yosemite IV						
CLN II	May 2001	Crude	0.0	500.0	May 2006	475.0
Euro CLN	May 2001	Crude	0.0	155.0	May 2006	155.0
Sterling CLN	May 2001	Crude	0.0	161.0	May 2006	161.0
Citibank Natural Gas	June 2001	Gas	250.0	250.0	Dec. 2001	250.0
Total			1,745.0	4,927.4		2,621.0

Note: Issuance date of Truman Extension contradicts with its maturity date. Since the maturity date is confirmed in the text of the testimony, the issuance date must be mistaken.
Source: Appendix E to the Testimony of Robert Roach, Chief Investigator, Permanent Subcommittee on Investigations, U.S. Senate, 23 July 2002.

TABLE 3
Effect of the Prepays on Enron's Financial Statement

	2000 Reported Financials	Adjustment reflecting Prepays	2000 Adjusted Financials
Total debt	$10.2 billion	$4.0 billion	$14.2 billion
Total equity	$14.8 billion		$14.8 billion
Total capital	$25.0 billion		$29.0 billion
Debt/equity	69.2%		96.2%
Debt/total capital	40.9%		49.0%
Funds from operations	$3.2 billion	$1.5 billion	$1.7 billion
Interest and other	$1.1 billion	$0.2 billion	$1.3 billion
Funds flow interest coverage	4.07		2.37

Source: Appendix A, Testimony of Robert Roach, Chief Investigator, Permanent Subcommittee on Investigations, Senate Committee on Governmental Affairs, 23 July 2002.