Toshihiko Fukui: Toward strengthening competitiveness of Japan's financial system

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Introduction

I am deeply honored to be given the opportunity to speak before many distinguished guests in the financial sector on the theme of strengthening the competitiveness of Japan's financial system.

The financial system and financial markets not only allocate funds from the overfunded sector to the underfunded sector but also they sort out firms with high profitability and growth potential. The efficient and competitive financial system and financial markets are therefore vital to a country's economic growth. First I will explain the changes surrounding Japan's financial institutions, and then assess their competitiveness and profitability. I will then address the steps toward strengthening their competitiveness. Finally I will touch upon the lessons learned from the subprime mortgage problems.

1. Changes in the environment surrounding financial institutions

Changes in firm activity

Since the 1990s, the world economy and financial markets have undergone substantial changes. Behind that are various factors, among which globalization and information technology (IT) innovation are particularly important.

The economic globalization has enabled diverse goods and services to move across the border, thereby enhanced the division of labor between the countries and the convergence of prices and wages. Advances in IT raised the efficiency of information processing and communication at a remarkable pace, which in turn eased time and geographical constraints, and led to a large cutback on the cost of remote business transactions. Against such a background, notable changes emerged in firms' international activities. Firms have been relocating their production sites overseas at a faster pace and global M&A activity has been actively taking place. Accordingly, the division of labor between the firms has also progressed. For example, in the area of software development and data processing, outsourcing has been taking place across the border. More recently, an open source approach - i.e. releasing an idea for new products and inviting other firms which are in the possession of competitive technology for possible joint production - has gained popularity. Arguably, the global IT network has underpinned the information flows behind the above-mentioned processes.

Changes in financial activity

With the remarkable changes in firm activities, financial transactions have also gone through significant changes.

First, in terms of financial instruments, the derivatives market has grown considerably with the help of finance theory and IT development. Transactions have expanded at a rapid pace: not only those dealing with assets such as government bonds and foreign exchange whose market prices are readily available, but also those dealing with credit risk whose price is derived from theoretical models. With regard to M&A finance and real estate finance, a new financial approach that attaches greater importance to cash flow has been widely accepted.

In addition, progress in the securitization method has created a variety of securitized products.

Second, in terms of market participants, now many types of investors are playing the market. Most notably, hedge funds and private equity funds have begun to play an important role in the global financial system. Such funds' strong demand for investment opportunities appears to have been the driving force in creating a variety of investment products including real estate financing and M&A activity.

Due to such development of financial transactions and an increasing prominence of various investment funds, risk money with a diverse risk appetite is racing around the global financial markets. The current subprime mortgage problems clearly indicate that this is an era where the risks in a certain sector of a country will be distributed and be held widely by financial institutions and investors worldwide.

Changes in financial institutions' business model

Under such circumstances, the business model for developed countries' financial institutions, which form the centerpiece of the global financial system, has gone through substantial changes. In particular, innovative financial institutions in Europe and in the United States have increasingly relied on the so-called "originate and distribute" business model, where credit risk inherent in lending is transferred to investors *via* securitization. Such an increase in securitization business stems from the fact that it has become difficult to generate profits from the traditional wholesale transactions such as lending to large firms in light of the development of capital markets. In addition, it reflects a diversified risk appetite of various investment funds. Against such a background, financial institutions overseas are striving to gain higher returns on capital, taking account of stockholders' demand while securing enough capital to maintain high credit ratings.

Financial institutions in Japan

Japan has been making efforts to overcome the nonperforming loan problem for more than ten years since the 1990s. Financial institutions disposed of nonperforming loans, streamlined the workforce, closed down domestic and overseas branches, postponed IT investment, and refrained from strategically allocating new management resources. Such efforts paid off. Around 2005, the nonperforming loan problem was largely cleared up. Since then, they have been stepping up their efforts into more forward-looking resource allocation such as recruiting new employees, investing in new businesses and re-expanding their overseas sections.

Meanwhile, the last ten years also witnessed the structure of Japan's economy and its financial system facing major changes, due to globalization and IT innovation. For example, Japanese firms including medium sized firms have been actively expanding their business overseas, and the number of M&As involving Japanese firms has been on the rise. While the corporate sector, on the whole, has become the overfunded sector, the savings rate of the household sector has been on a downward trend, due to the declining birthrate and the aging population. Therefore, it is uncertain whether the traditional financial intermediation - collecting funds from the household sector and lending them to the corporate sector - will provide plenty of profit opportunity. Moreover, the easing of regulations has allowed non-financial industries to enter financial businesses.

It is good news that Japan's financial institutions are sound again and are able to once again implement a forward looking strategy, and I commend the efforts of those concerned. Nevertheless, it should be noted that the circumstances and conditions facing competition have changed drastically during those periods, and the business strategies need to be refined accordingly.

2. Profitability of financial institutions in Japan

Competitiveness of financial institutions

One may ask what is the best way to gauge the ability of financial institutions to add values, when the financial sector's competitiveness is assessed with the amount of added value stemming from financial transactions. Added value means creating value that exceeds the investment cost and it cannot be assessed simply by comparing the quantity of funds and the size of assets. It needs to be assessed in light of profitability. In this regard, highly profitable banks can be seen as those that have gained support of many customers, who are satisfied with the products and services as well as the banks' pricing strategy. I now go on to review the profitability of financial institutions in Japan and discuss how to enhance their profitability.

The current assessment of profitability

In fiscal 2005, both major banks and regional banks posted an all time high net profit, and maintained almost the same profit level in fiscal 2006 as well. The capital adequacy rate at the end of fiscal 2006 registered 12% for major banks and 10% for regional banks. Meanwhile, out of 12 trillion yen, the amount of the public funds injected since 1998, 9 trillion yen, which accounts for three quarters of the total money injected, has already been paid back. In sum, profit and capital levels of financial institutions have been recovering significantly in recent years.

Such recovery of profits has been brought about, because credit costs have been kept at extremely low levels since provisions for loan losses, which increased drastically in the process of disposing of nonperforming loans, have become no longer necessary in light of improved business conditions and progress in corporate revitalization. Indeed, net interest income and income from fees and commissions have been either decreasing or showing a sluggish growth and thus the core profitability in the banking sector has not necessarily improved.

The Bank of Japan releases the *Financial System Report* biannually, presenting a comprehensive analysis of Japan's financial system. The latest edition released in September this year analyzed the long-term profitability of the overall banking sector (i.e. the major, the regional and the *shinkin* banks) since the early 1980s, and the following results came up. First, returns on assets (ROAs) were at around 0.5% even if the periods were excluded when ROAs continued to register below zero, due to large losses incurred by the disposal of nonperforming loans. Looking at the composition of ROAs, the net interest income rate and the general and administrative expense rate have been stable at around 1.3% and 1.0% respectively. That means that net asset profitability was only around 0.3%, and it could only remain positive if the credit cost was kept exceptionally low, for example, due to the reversals of allowances for loan losses. There is a risk that asset profitability will become negative, should the allowances for loan losses return to normal and credit costs rise.

The low profitability of Japan's banking sector is highlighted, compared with other countries. For example, the rate of banking assets to nominal GDP in Japan is 150%, while it is only 50% in the United States. By contrast, the ROA of the U.S. banking sector has been at about 1.5% on average since the early 1980s, reaching nearly 2.0% in recent years, whereas it has been at around 0.5% in Japan, even if the years with negative ROAs are excluded from the sample. In terms of general and administrative expenses, Japan's banking sector has a considerable advantage, but the narrow interest margins from assets as well as the low non interest income ratio have been pushing down the ROAs of Japan's banking sector. In sum, while financial institutions in Japan hold more assets than its U.S. counterparts, their assets have lower added values. Moreover, contributions from profitable products and services that do not rely on the volume of assets remain meager.

Factors behind the low profitability

Let us now discuss why the profitability of Japan's financial sector remains low.

First, as a business model, many financial institutions still rely heavily on traditional deposit taking and lending, which can be provided by any financial institution, as a source of profits. In general, it is difficult to sharpen the competitive edge of those products unless their pricing is constantly being reviewed. Moreover, while Japanese firms, having learned the lessons from the bursting of the bubble economy, have become less inclined to borrow even in the midst of favorable business conditions, bank loans still account for more than 50% of the total assets of Japan's financial institutions. With sluggish demand for loans, any attempt to increase its volume will inevitably lead to narrower profit margins.

It is interesting to note that there is a clear difference between Japan and the United States when the number of financial institutions from which small and medium sized enterprises (SMEs) borrow funds are compared. In the United States, 80% of SMEs borrow funds from only one financial institution, whereas in Japan a majority of SMEs borrow from more than three financial institutions. That illustrates how severe competition is in Japan's loan market and it implies that Japan's financial institutions are yet to build mutual trust between them and their customers by offering unique customer-oriented financial services.

Second, in terms of governance, it appears that most stakeholders, shareholders in particular, have been tolerant of the low profitability that has continued for a long time in Japan's banking sector. Indeed, cross-shareholdings between financial institutions and firms used to be prominent. Under such relationship, firms acted both as a shareholder and a valued customer for banks. Hence, corporate governance, in its pursuit of higher profitability, did not function well: on the one hand firms called for improvement in shareholders' value; on the other hand they pursued favorable terms and conditions on loans. Recently, cross-shareholdings have dissipated and shareholdings by foreigners and investment funds, to whom maximizing shareholders' value is a priority, have been on an increasing trend. And legislative efforts to strengthen internal control are being taken. Nevertheless, looking at Japan's financial sector as a whole, initiatives that are intended to improve banks' profitability through stronger governance by shareholders and market participants as well as corporate governance within the bank still appear to be limited.

Problems regarding prolonged low profitability

I know other views, too. One might say that a narrow interest margin is a result of the reimbursement of profits to customers and many stakeholders are still tolerant of the low profitability. That view suggests that even if the profitability of financial institutions remains low, it may not pose a problem for the time being, and moreover that the low profitability of financial institutions may support Japan's economy through low borrowing costs. However, should the low profitability of Japan's overall financial institutions continue, it could raise concern in the following two respects.

First, the future vitality of Japan's economy remains concern. The low profitability holds true not only for the financial institutions but also for many other firms in Japan. Currently, however, it is becoming increasingly difficult for businesses that only provide low value-added products and services to survive in the global economy. For a country's economic development, the sectors with high productivity and potential for growth need to play an active role. And it is essential that risk money is channeled to such sectors without hindrance, and for that purpose, the limited resources on the part of financial intermediaries should be allocated efficiently and concentrated in the areas with highly added value. Therefore, if financial institutions do not reinforce the provision of higher value-added financial services and support firms exploring new business opportunities, the economy's future may look grim. Of course, while active overseas financial institutions could play a complementary role in reinforcing the intermediary function, they might not be able to participate aggressively in areas such as SME financing where the extent of disclosure is relatively limited.

Second, securing Japan's financial stability over a longer period also is an issue. Periodical earnings are the fundamental source of strengthening a bank's capital base. Raising additional funds from the capital market is, of course, an option, but such funding can be done only if the profitability and the potential of the business are attractive to investors. Therefore, should the low profitability continue, there may not be sufficient capital in the medium to the long term to counter an increase in credit costs in case of an economic downturn, and accordingly the stability of the financial system may be put in jeopardy.

3. Measures to enhance the profitability of financial institutions

Enhancing the profitability of financial institutions is particularly important in ensuring financial system stability and economic growth. Next, I discuss the measures towards enhancing profitability.

Objective assessment of risk and return balances

First, financial institutions should further improve the methods of assessing risk-return balances. In order to improve profitability, they must first assess the nature and the size of the risks inherent in financial products and services as well as the risks with the related asset holdings and financial transactions. Without the accurate assessment of its risk-return balances, specific action plans that contribute to enhancing profitability cannot be taken.

It has been pointed out that investment banking and overseas business activities need to be reinforced at major banks, which currently have a hard time improving profitability *via* their domestic commercial banking business. Looking at the risk taking behavior of major banks from the perspective of integrated risk management, both credit risk and the risks associated with long-term stockholdings have increased. As such, overall risks including interest rate risk and operational risk are already reaching an amount equivalent to their core capital. That is, most of the core capital has already been used to cover the risks associated with the current financial products and services. Therefore, be it investment banking or overseas business activities, banks need to scrape together capital by assessing the current operations' risk-return balances and scale down those with low risk-return balances in order to explore new risk taking opportunities through new business operations with a higher additional value. Efforts are being made among major banks where the so-called "credit portfolio management" is used to reduce concentrated credit exposure, enhancing the efficiency of loan portfolios. Further efforts on this front to improve returns are called for.

Regional banks allegedly have a mission to provide long-term support to regional customers' economic activity. For example, one might say that in dealing with a regional customer, a long term business relationship is more important than short term profits and the bank has to give support to the firm which might face a temporary downturn of its business. If regional banks are to take the risks associated with long term commitment to their respective regions, it is essential that they have the capability to assess such risks. For example, if the duration of loans to a local firm has become long, then it is necessary to quantify the risk by taking account of the period of loans extended. Moreover, if part of the loan is constantly rolled over, its associated risk should be treated in line with the risk of equity investments. Once the risks associated with regional commitment are assessed, there is a possibility that the amount of risks increases. Under such circumstances, it is necessary to secure corresponding capital. Many regional banks have already built up capital well exceeding the amount of risks they have calculated. That may suggest that those banks have implicitly prepared for the risks associated with regional commitment. However, if the risks remain vague, the improvement in returns cannot be hoped for. Clear recognition of the risks associated with regional commitment would in turn allow regional banks to take measures with respect to returns. For example, to the firms with poor business performance, early support for business revitalization can be made, which could improve their cash flow and lead to higher net interest income for regional banks. For loans that have become "pseudo-capital", regional banks can act as an intermediary to invite external risk money and thus earn fee income.

Selection and concentration of business operations

Second, financial institutions should check whether the services they provide have a comparative advantage and need to limit the extent and to adjust the method of resource allocation accordingly. As I explained earlier, in the case of financial products and services that are commonly provided by many entities, it is difficult for the entities to pull out from unprofitable price competition. The comparative advantage of each financial product and service should be assessed, based on the non-price factors such as the ability for banks to reinforce brand potential, to offer solutions to customers, to collect non-public information, and to judge the growth potential of each product line. It is also necessary to check whether the combination of prices and the quality of financial services could be refined and moreover to address the most appropriate channel for providing such services. Having done that, financial institutions need to draw the line between the operations where more resources should be allocated and those that should be scaled down or should be done with higher efficiency. They then need to come up with a specific action plan to carry out such management decisions.

It is not easy to specify the business areas that have a big comparative advantage since different financial institutions face different business environments and have different characteristics. In general, however, it is effective to explore the possibility of the added value by focusing on the nature of management resources.

For major banks, for example, comparative advantages may arguably lie in a wide branch network, a large network of payment and settlement systems, a solid customer base centering on large firms, the diversity of affiliate companies and personnel, the strength to build large portfolios with diversified risks, and its business strength in the Asian region. In response to various needs such as overseas business activities of firms including M&A, demand for new risk hedge measures, the utilization of intellectual property, and product development according to various life stages of the household sector, each bank should seek the areas of great advantage. Providing adequate products and solutions to satisfy such needs, banks will secure profits for themselves as well. Also banks are expected to bridge the gap between the investment needs of domestic investors and the growth challenges faced by Asian firms. There is, however, a limit to banks' capital, and in conducting overseas operations, market participants will scrutinize credit ratings and ROEs. Banks therefore need to further streamline the areas that do not have a comparative advantage while strengthening those with greater advantages. Part of the risks should be taken by banks themselves but it is also important to accommodate various types of domestic and overseas risk money.

As for regional banks, most of the customers are small and medium sized firms. Lending to SMEs which provide little information and have limited capability to pledge collateral would be a difficult business task for banks. It is hard to assess the creditworthiness and potential of SMEs through financial disclosures alone, and thus the ability to obtain unpublicized information -- such as firms' actual business conditions and the qualities of the managements -- is all the more important. In that respect, regional financial institutions have an advantage in that they could make daily and close contact with regional customers. For example, information on the blueprint of new businesses top executives draw up, concern over financial and accounting matters, successor related issues, can be obtained through a close liaison while having acute awareness of a business opportunity. Such information might lead to increased profitability of the regional financial institutions if they could make a proposal to improve such firms' cash flow with whatever special skills they have.

It is also important to share, and not to store away, such "live" information within the organization and to construct a database that enables concerned parties to use the information from various perspectives. It requires certain costs to maintain a framework that collects non-disclosed information based on close contact with customers and therefore, measures to further enhance the efficiency need to be taken, such as the use of outsourcing, with respect to the number and the distribution method of products and services with a small competitive advantage.

Merits and pitfalls of mergers and consolidations

So far, I have described that general financial services offered by a number of financial institutions are difficult to differentiate and that it does not necessarily lead to enhanced profitability. One might argue that the profitability of such businesses could be enhanced by mergers and consolidations of financial institutions. Economic theory shows that the scale economy can take place and indeed some empirical analysis confirms that the efficiency of general and administrative expenses could be improved, while another analysis suggests that a mere increase in asset size would push down lending rates, offsetting the improvement in general and administrative expenses.

Since many analyses on mergers and integrations cover the period when financial institutions struggled with the non performing loan problem, the picture may turn out to be different when financial institutions engage in M&A activity as part of a forward-looking business strategy. As I mentioned in the beginning, various types of M&As are currently taking place in the non-financial industries. Japan's financial industry will naturally engage in M&A activities in their pursuit of raising their corporate value. For example, acquiring business operations that bring a greater synergy with the current operations, or selling business operations with a small competitive advantage are a few means of enhancing their corporate value. With respect to cross-border M&As, the recent revision of Japanese corporate law enabled overseas firms to conduct a forward triangular merger through the exchange of shares. In fact, the first case took place in the financial industry, where a large U.S. banking group acquired a major securities firm in Japan. In summary, while mergers and integrations that simply increase the asset size do not necessarily lead to enhanced profitability, M&As could be an effective tool for improving profitability if they are used to strengthen and streamline business operations that have a comparative advantage.

Measures for legal and accounting infrastructure

So far I have outlined the measures taken and challenges faced by financial institutions themselves. Improvement in its infrastructure is also imperative in enhancing the profitability and competitiveness of Japan's financial system. Now I mention a few issues that require improvement with respect to legal and accounting infrastructure.

First, the transparency and reliability of financial accounting information should be enhanced. In order for financial institutions and investors alike to adequately assess the risks when extending credit or making an investment decision, further disclosure of firms' financial information is necessary. In that respect, the Financial Instruments and Exchange Law enacted in September 2007 introduced mandatory quarterly releases of financial information to listed companies. And to secure the reliability of the released information, the law obliges companies to submit certification of an annual report and an internal control report. Still for SMEs the scope of financial statements subject to external auditing is relatively limited in Japan, compared with other countries and further improvement in raising the reliability of disclosed information is called for.

Second, the reform of Japan's financial system should enable financial institutions to provide flexible financial services in response to diversified needs of the corporate and household sectors. More specifically, consideration should be given to easing the firewall regulations between banking and securities business, which are somewhat stricter than other developed countries. From the financial institutions' perspective, that has an effect of facilitating more synergy within a financial group. The major premise behind such regulation easing is to ensure that prevention rules of unfair transactions such as prohibition of insider trading and rules to protect retail investors be firmly put in place.

Third, the reform of the public financial sector should be carried out without delay. Japan Post has already begun its business and preparations for integrating public sector financial institutions are currently underway. Financial institutions due to be privatized are to build robust risk management and operational systems and are expected to take part in a sound and fair competition with other private financial institutions. As for government sponsored financial institutions fulfilling government policy objectives, if the areas of overlap with private entities are large, it may prevent private financial institutions from adjusting risk-return balances. The operations of public institutions should be based on the principle that they are complementary to the private sector.

Consideration from overall economy

So far, I have talked about the measures taken by financial institutions and the reform strategy of the financial system towards enhancing the profitability of financial institutions. However, low profitability relative to asset size and capital is also applicable to many Japanese firms with the exception of large firms facing severe competition in the global market. In terms of risk taking towards new businesses, the amount of cash and deposit against the total asset outstanding in Japan's manufacturing industry is two times as high as that of the U.S. counterpart. That may suggest that Japanese companies are more cautious about taking new business risks. Put it another way, if companies hold excess liquidity at hand against future investment opportunities, that may suggest that financial services intending to provide funding in a flexible manner are not functioning well.

For the future of Japan's economy, it is essential that both the ability of firms to take new risks in creating higher value-added products and the capacity of financial institutions to provide risk money and business solutions should develop hand in hand together. Fortunately, Japan has the manufacturing industry with strong international competitiveness and moreover it has the world's largest accumulation of financial assets. The IT infrastructure such as high-speed telecommunications wire networks is as much developed as in Europe and the United States. It is strongly hoped that both the industrial sector and the financial sector, taking advantage of their comparative superiority both in stock and flow measures, create further added values through technology and knowledge in order to vitalize Japan's economy.

4. Closing remarks

In closing, let me give a few remarks on the recent turbulence in global financial markets triggered by the subprime mortgage problems.

As the subprime mortgage problems have worsened and spread more widely in financial markets abroad, the impact on Japan's financial institutions has been felt at a pace faster than expected. For instance, some financial institutions registered losses as a result of a decline in the market value of investment products, and others posted losses from revaluation on the unsold products arranged as part of their securitization businesses overseas. However, since Japan's financial institutions' exposure to the U.S. credit markets is relatively low, it appears that so far each financial institution/group has been able to absorb the losses within its annual earnings or its capital base. While further developments in the U.S. and European financial markets need to be monitored closely, it seems unlikely that this particular problem will pose a significant threat to the stability of Japan's financial system.

Based on the experience pertaining to the subprime mortgage problems, several lessons could be drawn for the management of financial institutions and the functioning of financial markets. And two lessons seem particularly noteworthy.

The first lesson stems from the difficulty of both transferring and disconnecting the risks from financial institutions. Subprime mortgage loans are, indeed, riskier than normal housing loans, and most of the risk was believed to be transferred from financial institutions to investors via securitization. The outbreak of the subprime mortgage problem made it clear that risks in fact manifested themselves among financial institutions in a variety of forms.

As it became increasingly difficult for financial institutions to resell securitized products to investors, they were forced to carry an unexpected inventory of such products. When the market liquidity dried up, they had to post a vast amount of losses as well as valuation losses. Since investment funds with a large amount of securitized product investments found it difficult to raise short term funds from the market, some financial institutions --whether they set commitment lines or not-- provided a substantial amount of liquidity.

Those incidents indicate that in an era of highly distributed risks and well diversified financial intermediation, financial institutions are involved in risk intermediation in various forms and they sometimes have to face unexpected risks once a large shock hits the market.

Based on that experience, financial institutions and those engaged in securitization businesses need to improve risk management practices, such as revising the valuation model of securitized products and developing an evaluation model of market liquidity risk. In addition, it seems that the "originate and distribute" type of business model still requires further improvement.

Second, it is important to enhance transparency when developing new financial technologies and products. In particular, when a great financial shock occurs, concern spreads over the entire market, and it is likely to provoke an excessive response. Ten years ago, during the Asian currency crisis, criticism was leveled at the opaqueness of hedge funds in terms of their investment strategy and scale. As for the current subprime mortgage problem, concern over the difficulty in identifying the location of risks has risen since they have been dispersed worldwide through securitization. All in all, it should be noted that risk transfer transactions such as securitization and credit derivatives have indeed the function to stabilize the financial system through diversifying risks.

Various innovative activities including the development of highly sophisticated financial technology should never be hindered, and the fruits of such activities should be used for the purpose of stabilizing and developing the global economy. Toward that end, it is of utmost importance that financial institutions and relevant parties that endeavor to build a new market using the state-of-the-art technology revise the transaction rules and practices and disclose information on a voluntary basis. With respect to regulation and supervision, the framework needs to be designed in view of encouraging private financial institutions to create a new added value and accordingly to promote sophisticated risk management.

In any case, the issue faced by Japan's financial system remains to be the over-concentration of risks in the banking sector and it is still being addressed. The low profitability of the banking sector may be a reflection of such a problem, and it is important for Japan's financial institutions to further hone risk management skills and enhance the value-added financial services and profitability. And while it is an ironclad rule "not to invest in the products with obscure riskiness", it is necessary to improve the ability to assess the complex nature of risks and to make efforts to provide higher value-added financial services. Such prudence and continued efforts towards innovation will contribute to maintaining the stability of Japan's financial system and to enhancing its competitiveness.

The Bank of Japan will continue to support such efforts to enhance risk management and to create additional values of financial services through on-site examination, off-site monitoring and seminar activities. Thank you for your attention.