Toshihiko Fukui: Significance of efficient financial services for the future of Japan's economy

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Introduction

I am pleased to be here today to address such a distinguished audience drawn from Japan's economic and financial circles, who naturally have a strong interest in the future of Japan's economy. Against the background of new business strategies including mergers and acquisitions underway in the financial sector toward the planned full removal of blanket deposit insurance in April 2005, today I will discuss the roles that efficient financial services should play in the future in Japan's economy.

I. Need for efficient financial services

A. Current state of the Japanese economy and financial system

The Japanese economy has been recovering since the latter half of last year, driven by a virtuous cycle in which an increase in exports leads to a pickup in production and corporate profits, which in turn raises capital spending. Recently, the household sector has also been recovering in line with the improvement in employment. To support the ongoing recovery, the Bank of Japan is continuing with its current quantitative easing policy until the year-on-year rate of change in the core consumer price index (CPI) registers zero percent or higher in a stable manner. In this regard, let me emphasize our firm commitment to maintain the accommodative monetary policy.

To achieve sustainable economic growth and strengthen the dynamism of the Japanese economy over the long run, a smoothly functioning financial system is an obvious necessity.

Let me begin with the current state of Japan's financial system. A reduction in nonperforming loans (NPLs), one of the most significant problems requiring resolution, has been proceeding steadily. The ratio of NPLs to total outstanding loans at major banks decreased to almost 5 percent at the end of March 2004. Even regional banks that seemed to be slowing in their reduction of NPLs were able to lower their ratio to below 7 percent. In addition, approximately 90 percent of both major banks and regional banks posted positive net income for the fiscal year ended March 2004. For the current fiscal year starting from April 2004, I am confident that we will come closer to resolving the NPL problem, as corporate profits are expected to increase further and banks are accelerating their efforts to revitalize firms with large debts. So, as we move toward the full removal of blanket deposit insurance planned for next April, I think it is fair to say that Japan's financial system is on track to restore its soundness and stability.

In addition to tackling of the NPL problem, reforms have been implemented in various areas such as accounting, taxation, and bankruptcy laws, and a framework has been established for improving corporate governance. The rules and practices that have been supporting economic growth in Japan up to recent years have emphasized long-term relationships among firms as well as between firms and banks, based on the assumption that high growth would continue. These rules and practices enabled firms to expand their business over the long term while absorbing moderate economic shocks. Nonetheless, they are no longer adequate to address the problems resulting from the ever-changing nature of today's global economy. We have made substantial progress in reforming the rules and practices that used to support the economy but had grown obsolete. Without such progress, we might never have been able to reach the point where we now stand: on the verge of achieving a solid footing for the revitalization of our economy. The more than ten years following the bursting of the bubble have often been termed the "lost decade". They were longer than expected, but may have been necessary to achieve the step-by-step reforms.

B. Roles of financial services in the future

We must keep forging ahead because, from now on, both firms and financial institutions will need to continuously improve their competitiveness to create new business value.

Firms' operating environments are changing significantly. For example, competition from emerging economies has intensified, and rapid progress in IT has reduced the life span of existing competitive strengths by lowering the barriers of time and geography. Japanese businesses have been making great efforts to survive this tidal wave of structural change. Their performance depends on not only business activities, such as the development of new goods and services as well as company-wide increases in productivity, but also financial activities, such as reduction of funding costs and control of market- and payment-related risks.

We can also observe changes in the financial needs of households. The diversification of employment and rapid aging of the population have been significantly affecting how people, both young and old, plan their lives. This is evidenced by the fact that pension reform became a major issue in the recent election for the House of Councillors. Such a change in the attitude of households has inevitably come to influence their financial activities such as choices of asset investment, life insurance, and consumer loans. Demand for financial services has grown quite diversified among differing generations and at different stages of individuals' lives.

Let me describe the roles of financial services that are expected by both businesses and households based on their ever-changing needs.

The first role is to support dynamism in corporate activities. Firms require sophisticated financial services such as financing of newly developed businesses, arranging of capital to satisfy shareholders, reorganizing of global businesses, and hedging of wide-ranging business risks.

The second role is to contribute to increasing households' wealth. The financial system as a whole should efficiently provide a broad range of financial products and services enabling households to invest and raise funds according to their various financial needs. By performing these roles appropriately, financial institutions will both contribute to increasing households' wealth and promote revitalization of the economy through the efficient allocation of resources.

C. Challenges of creating a new financial system

Thus, financial institutions are expected to enable firms and households to expand their potential activity and participate vitally in the future of Japan's economy. In this regard, a wide range of institutions involved in financial services should take on three challenges.

1. Efficient division of labor and provision of services through diversified channels

The first challenge is to establish an efficient division of labor in the financial services industry and the provision of services through diversified channels. The financial services industry is immense, developing a variety of financial products, taking on various risks through the sale of such products, and reallocating these risks to economic agents. As such, it can be described as not only a provider of financial services but also a manufacturer and distributor of these services.

In nonfinancial industries, particularly manufacturers who are in the front rank of global competition, we observe various types of division of labor in the efficient provision of goods and services. Similarly, I think that in the financial services industry there should be a more diversified division of labor, not only within each financial group, but also among a wide range of economic agents with substantial expertise in the development and sale of financial services as well as in risk-taking methods. Under such a system, institutions with superior monitoring capability should focus on extending loans. Those with a customer base of affluent households should focus on providing investment and savings services. And those with highly-advanced financial engineering techniques should focus on performing advisory functions in cutting-edge financing activities such as securitization. In this way, various combinations of division of labor could produce multiple business models.

As for the extension of credit, I have been advocating the need for diversified channels by constructing a "seamless credit provision system", in which customers can choose any type of credit in the spectrum from borrowing from banks to raising funds in capital markets. Such a seamless system for credit provision can be developed within the context of a diversified division of labor.

If and when a diversified division of labor is achieved, the discussion on the ideal number of financial institutions is likely to lose its meaning. Currently, we hear comments about the rather complex situation of Japan's financial system. For example, some have voiced criticism that the provision of financial services is not sufficient, while others say that Japan's financial system is over-banked. As the division of labor becomes diversified, however, the complex situation should gradually be resolved.

2. Improvement of integrated risk management and prompt and appropriate actions to changes in the environment

The second challenge is how to make the integrated risk management framework more sophisticated as well as take prompt and appropriate actions to respond to changes in the environment. Many financial institutions need to take on various risks over the short term and long term to smoothly satisfy their customers' needs. The more capital a financial institution holds, the more risks it can manage. What is required of financial institutions is to take on risks using a finite amount of capital, thereby satisfying customer needs and maximizing their profits.

Thus, financial institutions need an entity-wide framework in which they can handle various types of risks stemming from routine businesses and carefully judge the balance between risks and financial strength as well as sector-by-sector profitability. This framework is called the "integrated risk management system".

Under this system, we measure the magnitude of various risks such as market risks and credit risks, and integrate the results using Value-at-Risk and other benchmarking methods. Then, we calculate the magnitude of entity-wide risks and appropriately allocate risk capital to various business areas. It is inevitable that the risk profiles taken on by financial institutions will change as the financial needs of firms and households become more diversified and complex. Consequently, we should continuously upgrade the framework of risk management by adopting the most recent theories of finance and utilizing new financial engineering techniques.

Having said this, let me emphasize that the most significant factor for the effective functioning of the risk management framework lies in human judgment, particularly that of the top management.

In fact, operating environments sometimes move in a direction different from that initially expected due to factors such as a change in the economic situation, the volatile movement of market prices, and the emergence of geopolitical risks. On such occasions, financial institutions' management should be able to make decisions calmly and promptly. Such ability depends on continual updating and preparation on a daily basis.

For financial institutions to be able to react promptly and appropriately to changes in the environment depends on the efforts of both staff and management. For example, staff should, regularly and concretely, provide management with information and analysis about not only the current situation but also future scenarios such as demand forecasts. At the same time, management should always strive to retain a broad perspective, solid insight, strategic ability, and strong determination.

3. Reform of public finance including the postal savings system

The third challenge is the need to reform the postal savings system and other public financial institutions. It has been pointed out that a fairly large portion of funds is intermediated outside of the market mechanism, reflecting the substantial share of postal savings among financial assets in Japan. Some claim that this may result in distorting the efficient allocation of resources.

Furthermore, due to the full protection of demand deposits, the share of deposits with public protection is extremely high among financial assets. In such an environment, individuals are less inclined to closely review risk-return profiles of various financial assets and hold diversified types of savings. This appears to be one of the obstacles hindering innovation in Japan's financial system. The Japanese government has therefore already taken action. For private banks, the removal of blanket deposit insurance is scheduled in April 2005, a little more than eight months from now. The privatization of Japan Post is also under serious discussion.

In discussing the privatization of the postal savings and insurance system, we consider three points especially important from the viewpoint of the central bank. First, equal footing with private banks must be maintained. Second, a sufficient risk management system must be established and profits must be earned. Third, financial businesses must be clearly insulated from the risks associated with nonfinancial businesses.

I strongly hope that the discussion of postal savings privatization will produce a concrete blueprint, which contributes to fair competition and further innovation in the financial system.

II. Effects of sophisticated financial services on the economy

The financial services industry offers a variety of services, including payment and settlement services, means for customers to raise funds and invest, hedging of risks, managing of assets for customers, and provision of information. I will now take up some of these categories and use them as examples to show the kind of sophisticated services required by firms and households.

A. Supporting firms' activities

1. Provision of credit

When providing credit to firms, financial institutions need to continually find ways to satisfy the complex and diverse requirements of their customers in developing new business. In fact, Japanese financial institutions have started to review their heavy dependence on real estate collateral, and expand the scope of loans that are without collateral and based on the evaluation of future cash flow. To promote this trend, financial institutions should improve their methods for evaluating cash flow in line with new business projects created by firms. They also need to make use of various forms of tangible and intangible assets such as accounts receivable and intellectual property in order to complement credit in place of real estate collateral.

For large corporations with easy access to capital markets, the role of intermediation through securities business is vital. For example, some domestic and foreign securities firms recently underwrote convertible bonds (CBs) publicly issued by internationally active Japanese firms, separated the bonds into equity options and straight bonds, and sold them to a wide range of investors including foreign investment funds. Going forward, financial institutions need to perform higher levels of credit intermediation to satisfy both firms and investors.

Moreover, it is also important for financial institutions to establish deeper relationships with firms. The relationships between lenders and borrowers are so complex that much research has been conducted in areas such as the "principal-agent problem" and "information asymmetry".

I think the traditional relationship between banks and firms in Japan may have been behind the strong tendency toward mutual restraint and interdependence as exemplified in cross-shareholdings. Moreover, the traditional business practices of pursuing profitability not of individual transactions but rather of business as a whole may have weakened business discipline between lenders and borrowers.

For financial institutions, maintaining close relationships with firms is critical to fully utilizing their information production capability. If such a relationship creates too much mutual restraint and weakens mutual discipline, however, it may result in inefficiency and work unfavorably in a competitive environment as both financial institutions and firms face continual and frequent change. This relationship cannot be regarded as desirable.

The long-term close relationship between firms and banks in Japan has attracted attention globally as a model for corporate finance. But it is now necessary to modify this relationship into one that is more suitable to a world in which lenders and borrowers make proactive proposals and check each other.

Under such new relationships, both firms and banks are expected to take advantage of opportunities. For example, banks should closely monitor the condition of a firm's business, and promptly revise the conditions attached to credit when the firm's situation changes substantially. The firm can then accelerate its actions to improve performance in response to the changes, and both firms and financial institutions can move forward in a dynamic environment. To this end, it may be useful to clarify the covenants of loans from their origination, or to differentiate debt and equity functions by utilizing financial techniques such as giving a lender an option to purchase new stocks issued by a borrower in the future. If we are able to rebuild the sophisticated relationship between firms and banks, eventually it may even be possible to present this as a "new" model for corporate finance.

2. Hedging of risks

Firms are exposed to a wide range of risks in the form of foreign exchange risks, market risks, and credit risks of business counterparties. Financial institutions play an important role in providing firms with financial services including hedging of risks. It is expected that the request for risk hedging tailored to the business profile will increase as business activities diversify further in the future. The development of financial theories and cutting-edge technologies has enabled financial institutions to hedge even extremely complex risks. And yet, it is not easy to satisfy such demands with specialized hedging. The more specific the request, the more difficult it will be to find risk takers.

Financial institutions that routinely bear broader risks may nonetheless be able to unbundle the customized risks into standardized risks and take on the risks by themselves or transfer them in the relevant derivatives markets. In the process of unbundling and transferring risks, the division of labor may be effective among a wide range of financial institutions with specialized skills. The provision of risk-hedging tools to firms will be of primary importance on a par with the provision of loans.

B. Supporting households' activities

1. Investment

Turning to households, I will begin by looking at investment needs. The risk preferences of households occasionally shift in response to changes in the environment. For example, the year-on-year growth in banknote issuance outstanding reached 16 percent in April 2002 when blanket deposit insurance was partially lifted. Currently, the growth rate has declined as low as the 1-2 percent level as stability returns gradually to the financial system. Furthermore, households began to take a positive attitude toward equity investment as corporate profits recovered. As a result, the share of equities traded by individuals increased to over 20 percent in fiscal 2003, second only to nonresident investors.

Financial institutions have already started taking advantage of this opportunity. For example, the sales of mutual funds and insurance products through bank branches have increased dramatically over the past two years. The increase may be partly due to deregulation. It may also partially reflect the successful division of labor between banks and providers of these products such as asset management companies and insurance companies, which work effectively to satisfy a wide range of customer demand. Furthermore, the government is taking up the challenge to satisfy the diversified investment needs of households by increasing the issuance amount of government bonds that specifically target individual investors. In the retail financial area, from now on various business strategies implemented by financial institutions will emerge following the efforts of the most advanced retailers.

In this regard, I emphasize the importance of solidifying mutual trust between financial institutions and households rather than focusing on marketing techniques. If financial institutions can establish solid relationships with households as well as explain to them the risk profile of each product and the effects of diversification and if households can make wise decisions about portfolio management with full understanding of the information provided by financial institutions, this system will lead to a more efficient allocation of resources. From the perspective of consumer protection, financial products are already governed by various regulations. However, solid and well-maintained relationships between households and financial institutions could potentially protect consumers even more effectively than such regulations, and therefore help to promote the efficient allocation of resources.

2. Financing

Next, I will turn to the issue of how to support households to raise funds. In the past, when households in Japan needed temporary and short-term funds, they appeared to prefer to withdraw money from time deposits or sell financial assets such as stocks rather than borrow money. This may be partly because the consumer loan market in Japan is dysfunctional: for example, there is a substantial divergence between interest rates on consumer loans by banks and those offered by consumer finance companies. Such a large gap may indicate the existence of unsatisfied financing demand of households. Although there may still be difficulties in risk management of consumer loans as distinct from corporate loans, the law of large numbers is as effective a way as any other to manage credit risks of consumer loans. I do not think there is any problem with the method of risk management.

Financial institutions are utilizing their extensive branch network to improve their marketing strategies for consumer loans, or strengthening business alliances across different types of institutions in light of the current situation in which banks, credit card companies, and consumer finance companies are all segmented. These efforts will contribute to the improvement of financial services.

III. Role of the Bank of Japan

Finally, I will touch upon the role of the Bank in improving the efficiency of financial services.

A. Sophisticated financial services and financial system stability

First, I should mention the relationship between enhancing the activities of financial institutions and maintaining financial system stability. The Bank has been striving to ensure financial system stability by providing ample liquidity to the market and by fulfilling the function of the lender of last resort. However, if too much emphasis is put on the goal of minimizing the risks taken on by banks to avoid failures, the financial intermediary function may lose its vigor and financial innovation may become difficult to promote. After the removal of blanket deposit insurance, we should think dynamically by aiming to maintain financial system stability with the assumption that new entries into and exits from the financial system naturally occur.

In this regard, the new Basel Capital Accord that was published on June 26, 2004 is based on the assumption that banks may fail. The new regulation requires banks to hold minimum capital to cover the maximum annual loss which may occur once in 100 years.

In case of even larger losses, a bank may go bankrupt. Conversely, if there are 100 banks with the bare minimum of capital, one bank could fail per year. After the removal of blanket deposit insurance, we must strike a balance between maintaining managerial flexibility of financial institutions and avoiding systemic risks.

Furthermore, it will become increasingly important in the future to design bank supervision and regulation to avoid hampering financial innovation by the private sector. Such thinking has already been adopted in the new Basel Capital Accord. In the new regulation, the manner in which the amount of required capital is calculated has become more sophisticated. A framework has been adopted that carefully reflects the risk profiles of various assets and allows banks with greater risk management skills to use their internal risk management models. Thus, the new regulation has been designed to give banks an incentive to further improve their own risk management systems.

In general, regulation or supervision of financial institutions should not be conducted by giving institutions detailed instructions in advance on how to act, which proved workable during the crisis mode. Rather, we should respect the unique management of each bank and back managerial innovations by financial institutions. On-site examinations by the Bank are being conducted with a recognition of the importance of supporting such innovation.

B. Financial market functioning and monetary policy

Let me turn to the relationship between financial market functioning and monetary policy. A look at economic developments at home and abroad during the last decade indicates that central banks should make an appropriate evaluation of economic and financial conditions in conducting monetary policy, with a view to not only developments in real economic activity but also the interaction between real economic activity and financial activity. This issue appears to be a common one for the world's central banks given the rapid and continuous expansion of financial and capital markets, and the dramatic rise in the role of these markets against the background of deregulation, globalization, and developments in IT.

For example, such interaction was a factor behind the increased and prolonged interdependence between economic and financial developments after the bursting of the bubble economy as well as the economic turbulence in affected countries at the time of the Asian financial crisis. Currently, the need for close communication between the central banks and markets has become more important than ever in the discussion of the conduct of monetary policy after the long period of low interest rates around the globe. This should also be understood in the context of the interaction that I just mentioned. The Bank will do its utmost to pursue an appropriate monetary policy while closely monitoring the changes in financial markets and their influence on the activities of financial institutions and firms as well as on the economy as a whole.

We must continue improving the functioning of financial markets and financial institutions. This is very important, particularly in Japan, from the viewpoint of strengthening the transmission mechanism of monetary policy and nurturing the dynamism of the Japanese economy over the long run.

To improve the functioning of financial markets, the Bank has been expanding the scope of assets that are eligible to be purchased or to be pledged as collateral for open market operations. We will continue to work together with market participants to enhance the functioning of financial markets including credit markets.

To improve the functioning of financial institutions, the Bank will use its on-site examinations and off-site monitoring to provide an environment in which banks can build new business models and function efficiently with a highly sophisticated and integrated risk management system.

Conclusion

Today I have focused my talk on the future of financial services. I strongly hope that financial services in Japan will open up new possibilities for firms and households and contribute to strengthening the economy. Let me conclude by expressing my wish that Japan's financial institutions will export new, enhanced financial technologies and services from Japan and play a greater role in the development of the world economy.