Toshihiko Fukui: New trends in financial services - creation of innovative retail services

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at the Forum on Retail Financial Services, Tokyo, 21 July 2005.

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Introduction

It is a great pleasure for me to speak at this forum about a topic, retail financial services, which is indeed of great interest to central bankers around the world.

Retail financial services have just entered a new stage of development in Japan. This is evident, for example, in the fact that an increasing number of banks are allocating substantial management resources to various areas of retail financial services. Behind this movement is a business strategy among banks to strengthen their profitability, now that the nonperforming-loan (NPL) problem has been nearly overcome. Enhancement of retail financial services, however, is not a trend seen only in Japan, but it has been a common feature in financial industries worldwide since the 1990s.

In the sessions to follow at this forum, experts and practitioners in retail financial services will discuss the details of their business in Japan. In my speech today, I would first like to talk about significant changes in the structure of the world economy and financial markets that are behind the increased emphasis on retail financial services. I will then proceed to a discussion of the key factors necessary for the sound and robust development of retail financial services in Japan, focusing on financial services for individual customers.

I. Background of the Increased Global Emphasis on Retail Financial Services

A. Changes in Corporate Behavior

Since the early 1990s, industrial countries have faced a period of fierce competition. This has been fueled particularly by economic globalization and the rapid progress in IT, which together have lowered barriers both in time and distance. Now we frequently see companies with a successful business in one country being challenged by foreign competitors and rapidly losing their competitiveness. The difficulty in projecting future economic developments, together with the geographic expansion of the market and the shorter life cycle of products, have provided firms with new business opportunities, but also resulted in increased uncertainty for corporate management.

Given the changes in the business environment that I have just noted, firms are increasingly aware of the need to improve their financial strength in regard to executing management or investment decisions, to overcome such uncertainties. In other words, it is evident that a growing number of firms, both at home and abroad, are increasingly mindful of the size of their debt obligations and undertaking investment decisions in a very cautious manner. Reflecting such behavior, the ratio of corporate free cash flow to GDP is at historically high levels in both Japan and the United States. This does not necessarily mean that firms are adopting a conservative management stance, but that they are seeking a greater degree of flexibility in carrying out capital investment or participating in mergers or acquisitions when they find a profitable line of business.

B. Changes in Household Behavior

The environment for household financial behavior is also changing.

Interest rates in industrial countries are at historically low levels against a background of modest inflationary expectations. Interest income from low-risk assets, such as government securities and bank deposits, is also at low levels. In order to achieve robust and sustainable national economic growth amid the fierce global competition that I mentioned earlier, it has become critically important for a provider of funds to select promising firms with cutting-edge business opportunities and extend financial support to their business activities. A nation's wealth will grow if investors, including households, can succeed in choosing promising firms with healthy prospects, and provide financial support and bear part of their risks through investment in various financial products. In other words, the financial behavior of individuals determines the future of a nation's economic growth, which in turn decides their own future welfare.

C. Response of Financial Institutions

Structural changes in the global economy and financial markets have had a significant impact on the business model of financial institutions.

With the management stance in the corporate sector that I have described gaining ground among firms, it has become difficult for financial institutions to earn high profits from large corporate customers through transactions such as lending and underwriting of corporate bonds. Furthermore, a change has occurred in the balance between the intermediary function played by financial institutions and that by markets, as a result of the development of capital markets and increased disclosure of corporate information. In other words, large firms and institutional investors are now in a much better position to directly satisfy their financial needs through markets.

In light of these developments, the growing trend among financial institutions around the world is to strengthen lines of business pertaining to individual customers. This move makes economic sense in that this category of customers is usually able to obtain less financial information than other categories and is thus more dependent on standard financial services, such as loans, deposits, and investment trusts, provided by financial institutions. Thus, there is greater scope for financial institutions to play a large intermediary role.

Another factor underlining this trend is banks' need to control their risks. Both Japanese and foreign banks, which have experienced the NPL problem, are increasing their share of small-sized loans extended to households in order to diversify the risks of their loan portfolios. In addition, personal loans such as residential mortgage loans can be easily off-balanced or securitized thanks to advances in financial technology.

Furthermore, it should be noted that financial institutions can reduce their own risks by providing a wide range of financial products and services to households with appropriate support, such as close investigation of risk profiles of corporate businesses and comprehensive explanation of financial products to households. This is because such an active intermediary function of financial institutions can lead to steady channeling of part of household funds toward firms with high growth prospects.

D. Deregulation

Besides the structural changes in the economy, there are at least two additional factors accelerating financial institutions' efforts to strengthen retail financial services.

The first is financial deregulation. Since the 1990s, authorities around the world have steadily eased or abolished regulations that separately governed the businesses of banking, securities, and insurance. The relaxation of the segregation rules that used to restrict financial services providers to offering only their specialized lines of business has opened the way for "one-stop-shopping," in which a single institution can provide integrated financial services. This change is clearly for the better. Besides offering greater convenience to customers, it generates an incentive for financial institutions to benefit from the effects of synergy. Many financial institutions are aiming to realize the benefits of synergy through mass sales of standardized products in the area of retail financial services.

It is interesting to note that in order to profit from synergy, financial institutions around the world are adopting two seemingly opposing policies--"consolidation of business" and "division of labor"--simultaneously, with each complementing the other. In Europe, there exists a tendency favoring financial conglomerates, comprising the banking, securities, and insurance affiliates, in an attempt to take great synergy profits. Large establishments, however, tend to be slow to react to changes in the environment. Across national boundaries, therefore, there is a movement toward "division of labor" among financial institutions, which should enable them to rapidly meet the diversified needs of customers. The policies being adopted here appear to be strengthening the lines of business where one enjoys a comparative advantage, while opting for outsourcing or a business alliance where there is no such advantage.

E. Innovations in Financial and IT Technologies

The second factor accelerating financial institutions' efforts to strengthen retail financial services is the remarkable progress in recent years in financial and IT technologies, which together have had a tremendous impact on the conventional thinking in the financial industry.

Previously, small financial institutions with strong local ties excelled in loans to individual customers and other retail financial services, while large financial institutions considered such business less profitable relative to its costs. Retail transactions, compared with corporate transactions, involve far greater numbers of customers and correspondingly large amounts of data, and require a large number of competent employees at branch offices to provide various financial products and services. The progress in IT, however, has made it much easier to process massive amounts of data efficiently. Furthermore, financial institutions have now introduced an efficient method of credit screening using statistical models based on probability theory and drawing on accumulated customer data. This is quite unlike the previous practice, in which each and every loan application had to be individually examined. Another change appears in the area of sales. Banks used to "respond" to the needs of customers when the latter visited bank premises. Now, however, banks are "proactive," drawing on customer data compiled on the basis of age, sex, and other criteria. Such data allow them to better grasp customer needs and develop potential business. Customer contact through direct mail may result from such analysis.

II. Special Features of Retail Financial Services in Japan

As I have described, moves to strengthen retail financial services can be observed throughout the industrial countries, but the United States and Europe have taken the lead, far outpacing Japan, which has been burdened by the NPL problem for an extended time. Within the Japanese financial industry hereafter, it will be necessary to establish high-quality financial services for individuals and households, taking the special features of retail financial services in Japan into account. I will now point out these special features.

A. Customers' Preference for Access to Financial Services through Bank Premises

First, individual customers in Japan show a strong preference for access to financial services through bank branch premises, given that the level of administrative work at Japanese banks is relatively high among banks worldwide. This implies that the network of bank branches in Japan is of extremely high value as a distribution channel for various financial products and services.

Under these circumstances, in meeting the financial needs of individuals, it would be extremely effective if the providers of various financial services utilized the network of bank branches as their sales channels for the financial products and services in which they specialize. For example, following the lifting of the ban on over-the-counter sales of investment trusts at banks in 1998, banks--not only major banks but also regional ones--have continued to expand sales of investment trusts, such that these over-the-counter sales account for approximately 40 percent of total investment trust sales at present.

Naturally, this does not mean that all investment products are accepted by individual customers only because they are sold over bank counters. In the years just after the ban on investment trust sales was lifted in 1998, banks mostly sold low-risk-type investment trusts, such as money market funds, but sales growth during those few years was modest. Growth in stock investment trusts for the last couple of years, particularly the surge in monthly-distribution-type investment trusts that mainly purchase foreign bonds, has greatly expanded the sales volume at banks' counters. Investment trusts sold by affiliates within the banking groups has increased, but this does not seem to be the primary reason for the rapid growth. Rather, it has been due to a change in the sales strategy of independent medium-sized investment companies and foreign investment companies, which have no strong sales network of their own but have started to take advantage of the sales power of bank branches. Such investment companies developed products that would be suitable for bank customers, such as monthly-distribution-type products, and also provided bank staff with training on how to sell the investment trusts.

I think the key to developing innovative retail financial services hereafter in Japan will be how to meet the needs of individual customers by establishing an efficient division of labor within the financial services sector overall, making full use of the effectiveness of sales channels, namely, the network of bank branches.

B. *Competitors Other than Private Financial Institutions*

The second special feature in Japan, in the field of financial services for individual customers, is the relatively large presence of nonbanks and public financial institutions in comparison with private banks.

For example, nonbanks specializing in consumer finance have a significant share of business dealing with the borrowing needs of individual customers. In addition, even in the area of credit cards, affiliates of retailers such as supermarket chains and independent commercial companies have shown their own strengths in revolving credit. Banks have tried to challenge nonbanks by providing loans with lower interest rates than nonbanks, taking advantage of their low fund-raising costs and solid branch networks. Nonbanks, however, have established a competitive advantage in loan collection expertise and consumer credit data, and have even fully worked out their distribution channels by introducing automated contracting machines. Such competition is behind the recent marked movement toward capital and business alliances between major banks and nonbanks. There have also been efforts to boost administrative efficiency by sharing back-office functions among several credit card companies, including those of bank affiliates.

Next, in the field of residential mortgage loans, the Housing Loan Corporation (HLC) has been playing an important role. This public corporation once held the largest market share for residential loans in Japan, but following the government's decision to implement a gradual contraction of its operations in 2001, the private sector has taken aggressive action in this market, and a substantial amount of residential loans has shifted to the private sector. Furthermore, the competition among private financial institutions has increased the variety of loan products, and loan interest rates have actually declined. The HLC now undertakes operations that are difficult for the private sector to initiate immediately, for example, selling 35-year loans at a fixed interest rate through the branches of private financial institutions and securitizing those loans by itself. Thus, I think the change in the HLC's role has provided the private sector with a new business opportunity and led to an enhancement of the level of financial services for individual customers with public institutions complementing private-sector services.

Considering the steady expansion in sales of government securities for individuals through the post office networks, I think Japan Post (JP) can serve as a distribution channel for financial products to individuals. At present, the postal privatization bills are under discussion in the Diet. In regard to the privatization of JP, we consider it especially important to secure a level playing field for competition with the private sector and to insulate risks between the business lines of JP, as we have pointed out up to now.

C. *Efficiency of Retail Payment Services*

The third special feature of retail financial services in Japan is that highly efficient retail payment services are being provided here. In the United States and Europe, personal checks are widely used for retail payments, such as utility bills and credit card payments. In Japan, on the other hand, direct debiting/crediting using bank accounts is widely used. Furthermore, transfer instructions sent via the Internet are also increasing.

Given that such efficient retail payment services have long been available in Japan, people tend to consider that these services are public goods like water and air, and do not seem to fully recognize the risks and costs associated with these services. In fact, direct debiting/crediting using accounts across financial institutions, for example, bears some settlement risks until final settlement, and incurs administrative costs. Checking accounts are frequently used in the United States, but not everyone can write a check, nor can they do so every time they want to. In contrast, in Japan ordinary deposits allow payment transactions on an unlimited basis while bearing interest. Taking this feature into account, ordinary deposits in Japan are indeed a value-added financial service. As implied by this case, it is important for Japanese financial institutions to earn rational profits from the day-to-day retail payment business.

Concurrent with the progress in IT, there has been an increase in financial crimes not seen previously. At the same time, households are demanding greater information security from financial institutions in addition to efficiency in transactions. For the financial system to function stably, it is necessary for each financial institution to take appropriate measures to ensure information security. At the same time, I think such efforts to ensure information security can be an important key to differentiating the quality of "invisible" payment services and thus allowing the setting of rational charges.

III. Toward Further Development of Sound Retail Financial Business

A. Policy Issues

Let us next consider the significance of further developing financial services for individuals in view of overall economic activity and social welfare.

First, meeting the financial needs of households more efficiently by providing a wide range of retail financial services not only supports the economic activity of households, but also, by channeling part of household funds stably to various firms, contributes to future growth in the Japanese economy as a whole.

Second, it contributes to enhancing the robustness of the Japanese financial system. It cannot be denied that, in Japan, financial assets held by households have been concentrated heavily in deposits, and this has caused the concentration of various risks at banks. If households were to hold assets of varying types of risks, the risks borne by banks would be reduced, thus enhancing the robustness of the financial system.

To achieve this result, some call for policies to induce a shift of household assets "from savings to investment." However, the asset portfolios of households cannot be changed significantly merely by imposing a one-sided risk transfer from financial institutions. It is important to encourage households to voluntarily take on risks suitable for their own risk preferences. To this end, financial institutions should provide products and services that meet the financial needs of households through appropriate channels concurrent with full explanations of the risks.

Finally, I would like to discuss policy issues related to inducing the creation of innovative financial services for individual customers.

B. Ensuring Sound Competition

First, in order to encourage the creation of retail financial services that accurately meet the various needs of households, it is necessary to ensure sound competition among financial institutions. However, in the past, the government and the Bank showed extreme care in handling even a small sign of instability within the financial system, bearing in mind that it could generate systemic risk and damage the stability of the entire system.

However, in the course of the last ten years, we have seen the firm establishment of a safety-net system necessary for handling such situations as the bankruptcy of a financial institution, and the government and the Bank have accumulated practical experience in dealing with such emergencies. Furthermore, financial institutions have now nearly overcome the NPL problem, and from April 2005 the blanket guarantee of deposits was fully lifted without any disruption. Considering this situation, in order to promote the sound development of the Japanese economy, I think it is appropriate to shift the main focus of policies regarding the financial system from crisis management to strengthening the financial function.

Enhancement of financial functioning is strongly needed also in retail financial services. For example, complicated financial products that require a high level of knowledge are increasing. In this situation, financial institutions are expected to fulfill their function by providing individuals with easy-to-understand product information, and adequately transforming complicated products into easily understood ones. To this end, a key policy issue will be to secure an environment that allows free competition among a wide range of financial institutions, including public ones, to promote innovations in improved financial products and services.

C. Solidifying Mutual Trust between Financial Institutions and Households

Another key policy issue is to establish a relationship based on enhanced mutual trust between financial institutions and households. Between financial institutions and households, there exists an extremely large disparity in financial knowledge and amount of access to relevant information. In addition, financial institutions store a massive amount of personal information. From a policy perspective, therefore, it is extremely important to minimize harmful influences stemming from this information disparity and information concentration, and to encourage voluntary measures by financial institutions to contribute to a relationship with customers based on enhanced mutual trust. Considering the high possibility that various types of financial institutions, including companies other than banks, will become involved in a wide range of financial services, a relationship based on enhanced mutual trust with individuals becomes all the more important. Mutual trust should be reinforced in various stages of intermediary functions, such as during the development of financial products, sales, and asset management. I would like to emphasize two points indispensable to that end.

My first point concerns the way to protect investors. The current framework for investor protection in Japan is not based on the nature of the product or service, but stipulated according to segmentation of the business, for example, banking, securities, trust banking, and life insurance. To improve this structure, introduction of a unified framework based on an investment services law is currently under discussion. For providers of various financial services, the setting of unified obligations to protect investors will be the minimum requirement. However, here I would like to emphasize that the aim should not be a regulation which enumerates detailed obligations issue by issue. What is needed in the new legal framework for investor protection is to clarify the basic principles to be observed by financial institutions, for example, to fulfill fiduciary duties such as faithful execution of investment instructions given, and segregated management of customers' assets. In addition, it is more important to provide a framework that encourages voluntary actions by the financial institutions themselves, to build a higher level of trust with customers.

The driving force spurring financial institutions to take such actions is, simply speaking, market discipline. With the full removal of blanket guarantee of deposits, it is expected that depositors themselves will make a rigorous selection of financial institutions, but amid the increasingly diverse and complex range of financial products, market discipline will not work fully based merely on the selections made by depositors alone. It is necessary for all parties concerned to make market discipline function effectively. These parties include the shareholders of the financial institutions, the creditors, the stock exchanges that list the shares of the financial institutions, the auditors, the credit rating agencies, and the external directors of the financial institutions. In addition, market participants, not the supervisory authorities, should take the lead in the formation of market rules necessary for the practical functioning of market discipline.

My second point is that it is necessary to secure a high level of information security. As mentioned earlier, extremely efficient retail payment services are provided in Japan, but as can be inferred from the recent cases of fraud involving various types of cards, the level of information security in financial transactions in Japan has not reached the top level globally. If technological capabilities in Japan are fully applied to enhance security, however, I believe that the Japanese financial industry is capable of providing security at the world-class level, while maintaining its efficiency.

In other words, I would like to emphasize that we should not underestimate the importance of security issues in providing retail services, and leave problems pertaining to security unresolved, because this could eventually result in excessive nationwide regulation. This is also true for the financial industry. Therefore, regarding the security of financial information, I think it is extremely important for financial institutions to continually study cutting-edge technologies and provide tools and infrastructure to ensure security in a preemptive manner, before the public demands it of them. In this case, it may be sensible for the costs associated with provision of a high level of infrastructure to be allocated and borne appropriately between the financial institutions and end-users.

At the same time, individuals need to have a clear idea of how to safeguard their personal information through their own efforts. We take various measures to prevent thieves from breaking into our home, but our awareness of how to protect ourselves against financial crime is relatively weak in comparison. Needless to say, in all transactions, we should ensure the safety of transactions by ourselves. Of course, on the part of financial institutions, it is necessary to encourage individual customers to adequately understand the measures that are indispensable for self-protection.

Conclusion

I have mentioned important points indispensable to the sound development of retail financial services in Japan.

To reiterate, if financial institutions can provide various financial services that meet the needs of households, and through such actions, effectively utilize the funds of households to support corporate activity, it can contribute not only to increasing households' wealth, but also to promoting the economic growth of Japan. At the same time, through the reallocation of risks, this will contribute to enhancing the robustness of the financial system in Japan to counter external shocks.

Considering that the Japanese financial system is regaining its stability, we at the Bank of Japan has taken a number of steps with the intention of contributing to developing and spreading advanced financial technologies through our functions of on-site examinations and off-site monitoring to encourage financial institutions' efforts to provide more advanced financial services. To this end, the Bank established the Center for Advanced Financial Technology in July 2005 within the Financial Systems and Bank Examination Department. The department was created by integrating the former Financial Systems Department and the former Bank Examination and Surveillance Department. In addition, from the perspectives of enhancing the functions of financial markets and settlement infrastructure, we are determined to make greater efforts together with market participants to enable market discipline to fully perform its function. In this respect, along with the organizational changes in July that I have mentioned, we established the Payment and Settlement Systems Department by making independent a part of the function performed by the Financial Markets Department. And with the aim of bolstering research on information security, at the start of April 2005 we established the Center for Information Technology Studies at the Institute for Monetary and Economic Studies. Through such measures, we aim to do our utmost to promote the steady development of retail financial services in Japan.