Transforming Japan’s fund flow

Keynote speech by
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Thank you, Mr. Matheson, for your kind introduction. Good afternoon, everyone. It is my pleasure to be back here in New York. From 2003 to 2006, I served as the chief representative of the Japanese Finance Ministry in New York, having an office just across the street from here.

I still cherish the memory of the dialogue I had with people here in Wall Street. I was impressed with how vivid and diverse the New York market was, as the city itself was. Such a wide range of sophisticated players were here, from commercial banks and investment banks to hedge funds and private equity firms. Through their interaction, numerous innovative products and services were produced day and night.

True, it is sometimes not clear how beneficial financial innovation such as opaque structured products or algorithm trading are to market efficiency or transparency. But the capability in asset management, which I believe is the biggest advantage of New York’s capital market compared to the Japanese one, has clear benefits for the household and the society. In New York, asset managers, intermediaries, professionals and information from around the world gather and are accumulated to make it literally the financial center for the world.

Let me briefly explain the situation in Japan. Japan has a tremendous amount of wealth. Japan’s household sector’s financial assets amount to 14 trillion dollars, and the country has been posting current-account surplus for 35 years consecutively. But more than half of the accumulated wealth has been invested in assets such as cash, bank deposits and Japanese Government Bonds (JGBs), which are safe but post only low return.

Traditionally, the banking sector has dominated financial intermediation in Japan and market based finance is still underdeveloped. There are many banks who want to extend senior loans but not enough providers of mezzanine or equity finance, though the latter are indispensable for companies to grow.

Investment strategies of institutional investors, such as Government Pension Investment Fund (GPIF), whose assets amount to more than 1 trillion dollar, had not been sophisticated enough either, allocating more than half of their assets in JGBs.

Reflecting such attitudes of the household and institutional investors, global asset managers and financial intermediaries were not strongly interested in getting business from Japanese investors. Thus, not enough information was accumulated in Japan’s market. Foreign investors, not Japanese ones, with their ability and information, dominated Japan’s equity market. In such a vicious cycle, the return for investment by Japanese investors has been kept low.

Prolonged deflation which has lasted for nearly 15 years partly incentivized the vicious cycle. The Abe administration, which was inaugurated three years ago, rightly gave top priority to overcoming deflation and revitalizing the Japanese economy by executing bold policy measures. Since then, we at the Financial Services Agency of Japan (JFSA) have been making reforms in capital market and corporate governance, which I mention today, to break away from the vicious deflationary cycle.

We intend to change the fund flows from bank-centered ones to market-based ones. The transformation will increase Japan’s household assets in the long run and help the Japanese society meeting the challenges of fast proceeding aging. It will also provide risk money indispensable for sustainable growth. The change, we hope, will also contribute to making Tokyo a place where sophisticated players and information gather.

This is, so to speak, the financial sector side strategy of the Abenomics. The Japanese household, broker-dealers, banks, institutional investors, and corporate sector are all going through significant changes.

As I have mentioned, more than half of Japan’s 14 trillion dollar household assets are invested in cash and bank deposits. Thus, their return has been kept low. In the US, where households hold cash and bank deposits for just about 13% and invest half of their assets in equities and mutual funds, the return has been significantly higher. From 1995 to 2015, household assets in the US more than tripled, even going through downturn in global financial crisis. In the same period, that in Japan increased by only about 40%.

However, many new developments are ongoing, facilitating Japanese household to embark on more diversified longer-term investments. We introduced the NISA, Nippon (Japan) Individual Savings Account, a tax-exempt investment account program two years ago. At the end of 2015, the total balance of NISA accounts reached around 55 billion dollars, and the number of accounts advanced to nearly 10 million. Also, this year, we are raising the annual investment limit on the NISA and launching a new program, Junior NISA, for individuals younger than 20 years old. As a result, the total tax-exemption amount for a family with two children is doubled.

Broker dealers are also changing their strategies. Their flagship products shift from those betting on narrow specific risks to those with well diversified portfolios suited to longer-term investment. Their service and advice focus more on long term growth of their customers’ assets, for example, by utilizing fast increasing wrap accounts, rather than on gaining commissions by continuously recommending new products to them.

Japan’s banking sector, which holds nearly 850 billion dollars in JGB and 1.3 trillion dollars in current accounts of the Bank of Japan, is streamlining its balance sheet to adapt to changes such as expected entry into force of the Basel leverage ratio requirement. Japanese banks are shifting their focus from attracting deposits to selling products such as mutual funds.

Let me now turn from household sector to institutional investors. Tremendous amount of assets are under their management: GPIF holds more than 1.1 trillion dollars, other public pension funds hold 275 billion dollars, Japan Post Bank 1.7 trillion dollars, and Japan Post Insurance 703 billion dollars. Although their assets are huge, their methods of asset management had not been refined enough. Most of their portfolio had been comprised of JGBs, and thus, its return has been very low compared, for example, to pension funds in the US. The level of service required to the Japanese asset managers and custodians had naturally been commensurate with the investment strategies of their customers.

Last year, however, GPIF decided to change its benchmark portfolio fundamentally from concentrating on JGBs to being diversified to domestic equity and overseas assets. Other public pension funds have followed suit. A bill to reform the governance system of GPIF to improve their capacity of asset and risk management is planned to be submitted to the current session of the Diet.

Similarly, Japan Post Bank has formed a skilled investment team under its new Chief Investment Officer, a prominent asset manager recruited from outside the Bank. The Bank has changed their remuneration system from that with fixed salary to that with performance based payment to strengthen incentive for asset managers. Their portfolio is in the process of global diversification. This year, Japan Post Insurance will also embark on enhancing its investment strategies and diversifying its portfolio.

The Japanese household sector and institutional investors are making fundamental changes in the way they allocate their huge assets, accelerating investment flow to Japanese equity and overseas asset.

For nearly 20 years, stock rallies in Japan have been led by foreign investors. I was repeatedly asked by foreign investors, “How long should we wait till Japanese investors start to buy Japanese stock?” Finally, the time has come. Japanese investors are starting to increase their investment in Japanese equity.

The household sector and institutional investors are mostly long-term investors. To make their investment successful, it is imperative that invested companies attain sustainable growth in their corporate value. Thus, the efforts to reform the fund flow structure will not be complete without reforms in corporate governance.

The reform of corporate governance has been highlighted as a top agenda of Abenomics. Two years ago, we introduced the Stewardship Code, which encourages institutional inverstors to have constructive engagement with invested companies, and last year the Tokyo Stock Exchange (TSE) and the JFSA jointly introduced the Corporate Governance Code, which sets principles for effective corporate governance to enable companies to take transparent, timely and entrepreneurial decision with due regard to shareholders and other stakeholders.

Significant initial outcomes have been attained. First, approximately 80% of all listed companies maintain that they comply with over 90% of the 73 principles in the Corporate Governance Code at the end of last year. Second, around 50% of the TSE First Section listed companies now have more than two independent directors, a significant increase from around 20% in 2014. Third, unwinding of cross shareholding is proceeding. For example, Japan’s three major banking groups announced last November that they would reduce their stockholdings held for the purpose of keeping business relations by around 30% within three to five years. In some cases, unwinding of cross shareholding is combined with share buybacks.

Almost all major institutional investors in Japan and many overseas investors, totaling 201 in number, have accepted the Stewardship Code. The Code has contributed to the enhanced dialogue between listed companies and institutional investors. In the past, many regarded Japanese institutional investors as “silent shareholders.”

They are not any more.

But there is no room for us to be complacent with these initial outcomes. To jump start a virtuous cycle of economic growth, these two Codes must function like two wheels of a cart and result in real enhancements in the effectiveness of corporate governance practices, not just in statements or in form. To make this happen, we established the follow-up council for the two Codes last August. After holding six meetings, the follow-up council published an opinion statement this February. It emphasizes the following two points.

First, it focuses on the selection of the CEOs. For a listed company seeking sustainable growth of corporate value, the selection of the CEO is the single most important strategic decision. It is thus indispensable that the selection process ensures objectivity, timeliness and transparency. Also, the governance framework should be effective enough to properly assess CEOs performance and dismiss them when necessary.

Second, the follow-up council also focuses on the extent the board of directors exercise its oversight function and determine strategic directions in collaboration with the management. It emphasizes the importance that the board is composed of members with qualification and diversity adapted to the company's strategic need and that the composition secures the board's independence from the management. It also proposes that the board meetings should be conducted in a manner to allow their discussion focus on companies' strategic directions and that the effectiveness of the board be reviewed continuously.

Most listed companies in Japan are currently in the process of selecting candidates for the board of directors to be approved in annual shareholder's meetings, which are mostly held in June. I hope that the selection would be in line with the proposals presented in the opinion statement.

The effectiveness of the dialogue between institutional investors and invested companies should also be enhanced. GPIF has started to have meetings with its asset managers and to send questionnaires to invested companies to see how the asset managers engage with invested companies. We expect that the dialogue between institutional investors and asset managers will work to enhance the effectiveness of asset managers' engagement with invested companies.

The JFSA also intends to have more intensive dialogue with asset managers and other intermediaries on their fiduciary duties and behaviors expected to them in maximizing the benefit to the investors. Engagements to enhance the corporate value of the invested companies should be an important element in serving for the best interest of the customers.

As I mentioned, the investment strategy of buy-side players are changing. The change will stimulate asset managers and custodians. Some of the globally active asset managers who had stayed away from Japan recently set up offices in Tokyo. The faster the reforms proceed, the bigger the opportunities in the Japanese market for skilled asset managers will be.

The global economy has been plagued with deflationary tendencies and the market has been with increased volatility. We need to meet many challenges. However, if we are cautious and proactive enough, such environment may also provide great opportunities.

For instance, a decline in equity price in global risk-off sentiment may provide Japanese companies with their accumulated retained earnings good opportunities for inorganic growth. Also, in a challenging environment, courageous leaders of companies may dare to restructure their business to concentrate in core competence, which may lead to their future success. Effective corporate governance will help them go through the challenges and capitalize the opportunities. I believe Japanese companies have significant upside in their corporate value.

At the end of January, the Bank of Japan introduced the negative interest rate policy. The efforts I have described should be able to leverage this policy, which is intended to foster portfolio rebalancing of market players, for the creation of a virtuous cycle in the Japanese economy.

During the last decade, the JFSA has strived to build a relationship with financial institutions and other market participants so that candid dialogue can be made, and I believe the exchanges of views between the JFSA and market participants are among the most open in the world. In cooperation with the private sector, we would like to further accelerate the reform I mentioned today.

Thank you for your attention.