(Provisional Translation)

Report of the Financial System Council

Overview of the Medium-term Vision for the Future of the Japanese Financial System

Introduction

The Japanese economy is suffering from stagnant growth and continues to be marred by deflation, amid the radical changes caused by the burst of the bubble economy and other factor. Moreover, existing industries are hollowing out, following the rapid progress of globalization and IT utilization and the intensification of international competition.

Under these circumstances, the Government has been implementing institutional reforms, including the reform of the financial system, with a view to establishing an active and stable financial system. In order to examine further efforts, the Government needs to have a clear vision for the future of the financial system in line with the changes of the times.

The Japanese financial system is currently facing challenges such as the non-performing loan (NPL) problem, with the sluggish stock market in the backdrop. It would be desirable to deal with such imminent challenges by having and dealing consistently with a solid vision for the future.

Based on the recognition of problems mentioned above, *the Roundtable Committee on the Vision of the Japanese Financial System and Policies in the Future* was established in October 2001, as an informal gathering for Minister for Financial Services Hakuo Yanagisawa. The Committee deliberated on the vision for the future of the Japanese financial system, and released a report titled *The Vision for the Future of the Financial System and Policy* in July 2002. On the other hand, the Cabinet adopted *the Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2002* in

June 2002, which required Financial Services Agency (FSA) to promptly formulate a medium-term vision.

Following such developments, Mr. Yanagisawa requested the formulation of a Report on the medium-term vision for the Japanese financial system, at the 11th general meeting of the Financial System Council held on July 31, 2002.

In response to this request, the Council established a study group on the medium-term vision (chaired by Shoichi Royama) and held joint meetings by the general meeting and the Sectional Committee on Financial System. Their discussions on the medium-term vision for the Japanese financial system have been crystallized in the form of this Report.

It is hoped that the Japanese financial system will become highly convenient and attractive, properly demonstrate its various functions, and largely contribute to help stimulate the Japanese economy, based on the vision presented in this Report.

It is important not only for financial authorities but also for financial intermediaries, companies and individuals supporting the Japanese financial system to reconfirm their role respectively and examine their future actions accordingly. It is hoped that the Report will be instructive for them in that respect.

Part 1: The Vision for the Future of the Japanese Financial System

1. Need to Construct a Financial System harnessing Both Industrial Financing and Market Financing

(1) Changes in the Economic Environment surrounding the Financial System

When the Japanese economy was in the stage of catching up with other countries, financial intermediation functioned effectively based primarily on bank deposits and loans with a prerequisite of a long-term relationship with borrowing companies (hereinafter referred to as the "industrial-financing model"). However, by the 1980s, the Japanese economy grew out of the catching-up stage and became a frontrunner in the world economy. Now, uncertainties are growing in the industrial sector: for example, industries are expected to explore frontiers by themselves with no proceeding examples. Furthermore, existing industries that have played a significant role in the catching-up stage are hollowing out, amid the rapid progress in globalization and IT utilization and the intensification of international competition in recent years. Under these circumstances, the risks that need to be addressed by the financial system are on the increase.

The financial system has two basic functions: the financial intermediation function and the payment and settlement function. It is through the financial intermediation function that risks taking must be properly shared. However, risks are concentrated in deposit-taking financial institutions in the Japanese financial system, which is primarily dependent on the industrial-financing model, and it is becoming difficult to absorb the growing risks. Furthermore, the financial system as a whole is expected to properly serve as an intermediary of funds according to, say, the growth stage of companies, and further demonstrate its functions to provide information to companies in this process. The financial system could help stimulate the Japanese economy by sufficiently demonstrating such functions.

Asset management by individuals remains heavily skewed towards safe assets such as deposits. It is necessary to ensure confidence for the market, offer a wide range of financial products that generate returns commensurate with the risks taken, and risks need to be taken widely in the whole financial system.

(2) Need to Construct a Financial System harnessing Both Industrial Financing and Market Financing

The Japanese financial system was principally dependent on the industrial-financing model for a long period of time. While the economy was in the catching-up stage, it was relatively easy to reach a consensus and make decisions on what kind of projects and companies deserved funding. At the moment, importance was placed on how to monitor the execution process efficiently and properly subsequent to funding, which made the industrial-financing model – assuming a long-term relationship with borrowing companies– suitable for these times. As explained below, the effectiveness of the industrial-financing model will be sustained in the future, as far as financing for small- and medium-sized enterprises (SMEs) and individuals are concerned.

In contrast, financial intermediation through the market in which the price mechanism is at work (hereinafter referred to as the "market-financing model") involves market participants who take part in the market based on their own preferences for risks and returns. Here, demand and supply of funds are matched through the price mechanism. In the market-financing model, many market participants perform checking tasks based on their own information. The market-financing model needs to be further utilized as the economy grows out of the catching-up stage. This is because when the type of projects or companies that deserve funding has become unclear and the judgment have come to differ from person to person, the importance of this judgment increases.

The utilization of the market-financing model also helps formulate a proper risk-and-return regime based on the industrial-financing model, through the securitization of loan.

Moreover, the role of the market-financing model, in which risks are widely allocated by the choice of many market participants, will become all the more important, as risks are concentrated in deposit-taking financial institutions and it is becoming difficult to absorb the growing risks in the Japanese financial system, which is primarily dependent on the industrial-financing model.

In order for the financial system to fulfill the requirements associated with changes in the economic environment as mentioned in previous (1), the Japanese financial system will have to be reconstructed to harness both industrial financing and market financing, with market functions set as its core, in the sense that the industrial-financing model will remain viable but the role of the market-financing model will become more important. In both models, it will be important to properly assess risks and ensure returns commensurate with the risks taken, so as to make the financial system function effectively.

2. Efforts to Construct a Financial System harnessing Both Industrial Financing and Market Financing

(1) Government's Efforts in the Past

The Government has implemented institutional reforms aimed at establishing an active financial system, including the reform of the financial system, in light of developing a competitive environment that would enable market functions to work effettively. It has clarified the rules for different types of businesses to enter each other's markets through subsidiaries and for newly entering the banking business, completely liberalized stock trading commissions and took other measures to promote competition. It has also worked on improving the market environment, as exemplified by the abolition of the exchange-concentration duty, the introduction of exchange demutualization and the electronic conversion of the corporate disclosure system. Furthermore, it has taken measures to ensure fair-trading (including tougher penalties against insider trading), organized schemes to increase the liquidity of assets and reformed the securities settlement system. Despite such wide-ranging efforts by the Government to develop the legal framework, the intended outcomes are yet to be fully attained.

While it is impossible to pinpoint the causes, it may be due to the fact that individuals became more safety-oriented and steered away from risky financial products, and that financial intermediaries (Note) failed to fully take advantage of the improvements in the system developed in the past, partly because the Japanese financial system had primarily been based on the industrial-financing model for a long time, with the stagnant economy and the sluggish stock market in the backdrop. The problem that the securities market has not achieved sufficient public confidence also may have caused this situation. In addition, there are factors that make it difficult for the price mechanism to work in the market, such as the large share of public financing.

It is important that the parties involved in the financial sector —not only the Government but also financial intermediaries— humbly accept this reality and reconfirm the need to construct a financial system assisting both industrial financing and market financing, and actively cope with their respective challenges.

(Note) Financial intermediaries in this context refer collectively to banks, securities companies, insurance companies, investment trusts, etc. that engage in financial intermediation between the supplier and demander of funds.

(2) Basic Directions of Financial Intermediaries

While the environment surrounding financial intermediaries such as continuing stagnant economy is likely to remain tough, financial intermediaries should head towards the following three directions in order to construct a financial system harnessing both industrial financing and market financing.

(i)Ensure Returns based on Proper Risk Assessment

From now on, financial intermediaries will have to clarify the relationship between the risks and returns associated with financial intermediation, and ensure appropriate returns commensurate with the cost of funds and the risks taken. In the case of financial intermediation through the market, prices are automatically formed commensurate with the risks taken as a part of the market function. In contrast, in cases where loans are negotiated bilaterally without considering the market mechanism, it is important to be more aware of ensuring the returns based on proper risk assessment. In such cases, it would be desirable to alter the practice of requiring collateral for loans in the first place. Collateral, etc. should be used as a supplementary means to make adjustments when the profitability of a business is insufficient relative to the returns that need to be ensured. Additionally, public financing will have to be reformed in harmony with the financial system with market functions set as its core, as it is undeniably hindering the private sector from ensuring returns based on proper risk assessment.

(ii)Disaggregation of and Specialization in Functions of Financial Intermediaries

In a financial system harnessing both industrial financing and market financing, financial intermediaries need to offer advanced and specialized financial services to companies depending on their growth stage, etc. For this purpose, it is important to encourage financial intermediaries to disaggregate and specialize in various functions, and offer financial services by adequately combining these functions.

As already explained above, one of the problems of the conventional financial system is the excessive concentration of risks in deposit-taking financial institutions. It is important to strengthen the risk-sharing capacity of the economy as a whole by utilizing the market, by means of using syndicate loans and securitizing loan. It is extremely significant for financial intermediaries to disaggregate and specialize in functions in order to proceed with the securitization of loan. Specifically, it is important to disaggregate the functions into the loan construction function, the loan securitization function, and the office operational function required for securitized products, and perform operations specializing in each area.

(iii)Diversification of Financial Products and Improvement in Access

The financial system as a whole needs to offer a wide range of different and attractive financial products according to the risk preference or the life cycle of individuals who supply funds.

It is also important to improve the access to financial products, in view of improving user convenience. Conceivably, in the future, a financial intermediary could offer a wide range of financial products, not necessarily directly but at least indirectly as an agent, while considering management soundness. Provided that banks, securities companies and insurance companies' relationship with customers has been somewhat static, it is important to diversify the sales channels of financial products, with a view to realizing a financial system with market functions as its core and achieving a desirable allocation of assets and risks. Financial intermediaries need to give due consideration when expanding their product range, so that their management soundness would not be undermined as a result.

Simultaneously, financial intermediaries need properly to fulfill their accountability in light of user protection so that buyers can accurately acknowledge the risks involved in the financial products and other product characteristics.

It should be noted that these are directions for financial intermediaries to disaggregate and specialize in functions with respect to the management and supply of procured funds, while giving consideration to customer convenience. They are for building a stratified division-of-labor structure, and do not recommend universal banks or general financial service providers as the vision for the future of financial intermediaries.

(3) Involvement of Companies and Individuals

It is necessary to offer various means of financing according to the growth stages of companies, etc. and provide various financial services associated with financing.

Mature companies are likely to have greater needs for investment banking services, i.e. financial services that support reorganization for revitalization and propose schemes for financing from capital markets.

Young companies in the startup stage have a high demand for external funds. It is necessary that various means of financing are made available to them, including not only bank loans but also venture capital and others. Heavier utilization of the market will increase the birthrate of new companies and projects. In the financial intermediation process, it is important that the functions to provide information to companies as well as governance functions will be properly demonstrated.

Although the likelihood of using the market may increase for many SMEs, it is expected to take some time for them to actually do so. This means that banks will need to continue supplying funds to them. Even if the basic structure of banks financially supporting SMEs does not change in this case, it will be necessary to ensure returns commensurate with the risks taken.

With respect to individuals, it is important to offer a wide range of financial products that generate returns commensurate with the risks taken, and deepen their understanding of various financial products through education etc., so that they can make choices, according to their life cycle. As individuals, they will be required to act in compliance with the new financial system. If sufficient information on financial products is not provided, individuals might not be able to identify the risks involved in financial products and incur unexpected damages as a result. Therefore, it is important to develop an environment in view of user protection, in which individuals can engage in transactions with trust. Notwithstanding the high expectations for individual investors to supply risk money as such, many individual investors cannot directly investing in high-risk products in the market without limitation. The role of investment trusts, which can reduce the risks of investors by taking advantage of the large numbers through diversified investment on a collective basis, is expected to become more important in such cases.

Also, individuals' needs for loans are expected to diversify according to their life cycle, etc. It will be important for financial intermediaries to meet such individuals' needs with precision.

(4) Government's Efforts

For the Government, it is important to promote competition among financial intermediaries while giving consideration to user protection and ensuring management soundness, so that they can offer a wide range of attractive financial products and services, improve access, and disaggregate and specialize in functions of financial intermediaries. To achieve these purposes, the Government needs to improve the environment to promote competition, and continue to properly engage in financial administration focusing on the functions, according to the progress in the disaggregation of and specialization in functions of financial intermediaries.

As for the securities market, which will play a heavier role in a financial system harnessing both industrial financing and market financing, the Government should make comprehensive efforts to create a truly thick market that fully demonstrates market functions and enjoys the participation of a wide range of investors. The government organization in charge of making such efforts varies by country:

countries such as the U.S. have a government organization divided by sector, due to their historical background, whereas the U.K., Germany, South Korea and other countries that have recently executed organizational reform have cross-sector financial authorities. In any case, necessary reform of the securities market should be promoted based on a cross-sector organization divided by function and subject to constant review, considering the consolidation of financial players as exemplified by the advent of financial conglomerates, and the tendency to develop and offer financial products integrated with various financial services.

Tackling systemic risks and promoting consumer education and user protection will continue to be important roles of the Government.

The share of financial intermediation based on public financing through Postal Savings, Postal Life Insurance and government-affiliated financial institutions is extraordinarily large in the Japanese financial system compared to those of other countries.

While Postal Savings and Postal Life Insurance are scheduled to be transferred to Postal Services Corporation in 2003, the huge amount of funds might suppress the profitability of private financial institutions and undermine the price mechanism of the market if they behave inconsistent with the market mechanism. Additionally, Postal Services Corporation will have to engage in risk management completely by itself, as investment of funds at its own discretion is expanded.

Financing by government policy can be said to perform a certain role when it is not appropriate to leave everything to market functions, such as cases where there are substantial exogenous economic factors. However, it exclusively needs to serve as a compliment to the private sector, under the principle that the private sector should be in charge of what it is capable of.

Further studies will be conducted with respect to public financing, including the form of management. The Government needs to carry out reforms regarding Postal

Savings, Postal Life Insurance and government-affiliated financial institutions in harmony with the financial system with market functions as its core.

3. The Financial System harnessing Both Industrial Financing and Market Financing

(1) Supply of Funds in the Financial System harnessing Both Industrial Financing and Market Financing

Efforts in the basic directions mentioned above would convert the Japanese financial system, which has primarily been based on the industrial-financing model, into the financial system harnessing both industrial financing and market financing. The financial system harnessing both industrial financing and market financing needs to perform financial intermediation according to the growth stage of companies, and, in the process, properly demonstrate functions of providing information to the companies. It is also important for the system to offer various financial products to meet individuals' needs according to the life cycle, amid the progress in the accumulation of assets by individuals. With regard to the supply side of funds, the roles played by the market-financing model and the industrial-financing model are reviewed in the following sections based on the characteristics of risks and returns and assuming the division between wholesale financing and retail financing.

(Wholesale Financing)

In Japan, the industrial-financing model was predominant in wholesale financing, which targets large companies and medium-sized companies, rather than the market-financing model. However, the shift towards the market-financing model will make progress firstly in this wholesale sector, considering the aforementioned changes in the economic environment. Companies will basically change their means of financing from loans to securities. Other than corporate financing from the market, progress is expected in the securitization of existing loan assets. Conceivably, new loans could be subject to loan construction with resale and securitization in mind. Such efforts will enable financial intermediaries to fulfill risk-transfer functions without bearing all the credit risks by themselves, and ensure a proper risk-and-return relationship through the price mechanism in the market. In conjunction with this, it is important for financial intermediaries to disaggregate and specialize in their functions.

(Retail Financing)

In retail financing, which targets SMEs and individuals, the industrial-financing model is sustaining its effectiveness, considering that not all companies will be able to use the market, and that risks can be managed based on long-term relationships.

Even if the industrial-financing model remains effective in retail financing, it will be necessary to enhance risk management techniques and abilities to ensure returns based on proper risk assessment. In retail financing, portfolio diversification is possible based on small accounts, as the amount of lending per borrower is small. Distinctively, the law of average comes into play even though the risks associated with each borrower are large. This means that it is possible to enhance the risk management abilities by accurately identifying the data on default rates. Also, it is worth considering new business models of retail financing as seen in the U.S., which provide loans to SMEs and individuals at low cost without much labor, utilizing a scoring system.

It is necessary to heed that such improvements in risk management ability will help expand the scope of lending.

Moreover, there are cases in which it is effective to utilize the market-financing model in retail financing. For example, it is conceivable to pool a large volume of small assets and sell them in the market in the form of asset-backed securities (ABS).

At the regional financial institutions, loans to local SMEs take up a large proportion of their portfolio. Therefore, their management tends to be substantially affected by trends in the regional economy. To counter this, possible risk management techniques include, for example, the development of a structure that diversifies risks jointly with financial institutions in other regions.

(Venture Companies, etc.)

Companies in the startup stage require funding for capital investment, as well as a wide range of financial services such as the provision of information. It can be said that such companies often face difficulties in utilizing the market immediately. The supplier of funds need not be limited to banks in this case; it may also be venture capital investors. Whereas relationships in the industrial-financing model are based on long-term ones, venture capital investors get involved in the startup stage with the aim to make capital gains when their stocks are listed. Even if the nature of the relationship is different, it is important that functions to provide information, as well as the governance function, are properly demonstrated in conjunction with funding. This is regarded to be effective also for fostering companies in the startup stage.

(2) Role of Indirect Market Financing in a Financial System harnessing Both Industrial Financing and Market Financing

The innovation of information technology is making market transactions more sophisticated and complicated. As expertise is required to actually make a profit through market transactions, it would be effective to have a framework in which a specialized risk management service comes in between the market and individuals to allocate risks among individuals under proper management by experts, and at the same time, generate reasonable returns for individuals. A service specializing in connecting individuals with the market will be required to pursue economies of scale by, for example, reducing costs much more than by collecting information on an individual basis, and to reduce the risks by spreading the investments widely on a collective basis, not to mention the need of technical expertise required for market transactions. It would also be effective to have a service specializing in connecting companies with the market, offering information on the sale and securitization of loan and other financial services targeting companies to facilitate the flow of funds.

Financial intermediation between individuals and the market, and between companies and the market accompanying such specialized services is called "indirect market financing", and is differentiated from indirect financing, which involves intermediation by traditional banks. Expectations for various financial intermediaries, including institutional investors conducting this function, are likely to grow in the financial system harnessing both industrial financing and market financing.

Moreover, underwriters of stocks, bonds and investments in corporate recovery funds, as well as loan assets constructed and securitized by banks, will have a greater presence in the financial system harnessing both industrial financing and market financing. Institutional investors serving as underwriters are expected to fulfill their responsibilities as agents of the final beneficiaries, and in the process, demonstrate the governance functions with respect to the object of investment.

(3) Ensuring International Competitiveness of the Japanese Financial System: Cooperation with Other Asian Countries

Competition between markets is becoming increasingly fierce on an international scale, amid the globalization of the financial sector. It is important to restructure the Japanese financial system to set highly-efficient market functions as its core, in light of ensuring its international competitiveness. For the Japanese financial market to be attractive internationally, the financial system needs to be transparent and trustworthy, and the tax system concerning financial transactions needs to be simple and easy to understand for investors, while maintaining its consistency with the rest of the world.

The Japanese economy is located in the Asian region and has a mutually-dependent relationship with the Asian economy. It is necessary to heed the fact that it is important for Japan to play a pivotal role in the integration of the Asian region in both financial and real economic aspects, as a member of Asia. To achieve this, Japan needs to make efforts in a wide range of fields, not only in the financial sector, but also in promoting Yen as an international currency. In the financial sector, it would be desirable, for the enhancement of Japan's market functions, to domestically securitize Asian banks' loan assets and develop project financing in the Japanese market based on the participation of Japanese banks, etc. Also, it would desirable to promote the development of an environment in which individual investors can easily invest in Asian stocks and bonds based on individual choice and risk management, in view of asset management by Japanese individual investors in the aging society.

Part 2: Challenges to be Addressed as a Bridge to the Envisioned Future

1. Basic Approach

As mentioned in Part 1, the Japanese financial system needs to be restructured to harness both industrial financing and market financing, with market functions set as its core, in order for the financial system to meet the requirements associated with changes in the economic environment, in the context that the industrial-financing model will remain viable but the role of the market-financing model will become more important. So far, institutional reforms have been carried out, including the reform of the financial system, and activities to securitize loan have started to take place. However, the composition of financial assets in households and the status of financing methods employed by companies show that the Japanese financial system does not yet harness both industrial financing and market financing, with market functions as its core. Not only the Government but also a wide range of parties in the financial sector, including financial intermediaries, need to make continual efforts to construct a financial system harnessing both industrial financing and market financing.

Towards the construction of a financial system harnessing both industrial financing and market financing, financial intermediaries themselves —the players in the financial system— need first to change their business models so that they can properly demonstrate their functions in the new financial system. Institutional investors, including investment trusts, are expected to play a more important role in encouraging Japanese people to widely participate in the market, considering that many individual investors will not be able to directly invest in high-risk financial products in the market without limitation.

In addition, reform must continuously be promoted with respect to the securities market, which will play a more important part in the financial system harnessing both industrial financing and market financing utilized with the market functions, by boosting confidence in the players (issuing companies, market intermediaries, market operators, etc.) and improving the accuracy and timeliness of disclosure information, so that the market mechanism itself gains sufficient public confidence.

The conversion towards a financial system harnessing both industrial financing and market financing would make progress, provided that financial intermediaries change their business models and confidence in market transactions is ensured by promoting the reform of the securities market. Nevertheless, the Government should not merely wait for changes in the business models to take place; it needs actively to take measures to promptly construct a financial system harnessing both industrial financing and market financing. For example, regarding the loan assets market, the Government need to take measures to help expand the loan assets market in conjunction with the reform of government-affiliated financial institutions, and work on the tax system to give preferential treatment to risky financial products, rather than simply waiting for the growth of the market based on the private sector's initiative.

2. Conversion of Financial Intermediaries' Business Models

(1) Conversion of Financial Intermediaries' Business Models

(i)Deposit-taking Financial Institutions

For deposit-taking financial institutions to be able to properly perform not only financial intermediation but also payment and settlement functions in the medium and long term, their management bases need to be further strengthened based on increased profitability. The following aspects are important when converting the business model to achieve this.

(a) Promotion of Disaggregation of and Specialization in Financial Functions and the Securitization of Loan

In a financial system harnessing both industrial financing and market financing utilized with the market function, deposit-taking financial institutions are required to have a higher level of expertise and efficiency in regard to functions such as financing, lending, loan management and office operations. Therefore, they need to unbundle and specialize in each function.

The unbundling of and specialization in each function is also necessary for proceeding with the securitization of loan. The legal framework for the securitization of loan has improved, due to legislations such as the Special Purpose Companies (SPC) Law, and securitization utilizing SPC has actually started. However, it is necessary to expand the scale and accelerate the speed of this trend from now on. To achieve this, it is highly expected that, in particular, sale of the assets held by government-affiliated financial institutions will vitalize and expand the market.

For the time being, it will be necessary to enhance services to assist the securitization of housing loans by the Government Housing Loan Corporation, while the Government facilitates the use of asset liquidization scheme, i.e. SPC law, by reviewing current institutional and legal framework promptly. Moreover, it will be essential to consider developing an environment that promotes the securitization of banks' loan assets, such as constructing a database of credit risk information in alliance with private financial institutions.

Also, the Government needs to consider the securitization of loan not only held by the Government Housing Loan Corporation but also by other government-affiliated financial institutions. Furthermore, it needs to promote the securitization of NPLs and real estate collateral by the Resolution and Collection Corporation (RCC), and work on the tax system to support the process of securitization.

(b) Review of Structure of Deposit-taking Financial Institutions, etc.

Organization structure and personnel treatment are basically matters of business judgment. Each deposit-taking financial institution should be properly reviewed by themselves, in the course of changing their business models to adapt to the new financial system. In organizations in the West, a relatively small number of experts in operations serve as executive officers, taking responsibilities for profits in operations and for all personnel affairs. The organizational structure is flat to enable quick decision-making, and the difference of remuneration is stipulated according to each employee's workload in their personnel system. Conceivably, it will be important for Japanese deposit-taking financial institutions to draw upon their experiences and review their respective organization structures and personnel treatment schemes while disaggregating of and specializing in functions, to raise their efficiency and profitability.

(c) Setting Interest Rates commensurate with Risks and Raising Cost Consciousness

Lending by deposit-handling financial institutions needs to be based on the proper assessment of the relationship between risks and returns. This arrangement helps improve deposit-taking financial institutions' profits, expand the scope of companies eligible for borrowing, and securitize loan.

Accordingly, the Government must develop an environment in which the price mechanism functions effectively, including the structural reform of public financing, and continue carefully monitoring the financial conditions, etc. of deposit-taking financial institutions to ensure their management soundness, apart from each individual lending.

(d) Enhancement of Retail Financing

In retail financing, the relationship-oriented industrial-financing model is likely to continue playing a key role. Nonetheless, it will be important to make further improvements in profitability and soundness, rather than carrying on business in the conventional way. It is believed that the basic direction for building a new business model will be to strategically select financial products and services to be made available, according to the customers' risk preferences, etc.

For example, in terms of offering financial products and services, one may consider a model that promptly offers low-risk products at low cost. On the other hand, it will be necessary to pursue a model like private banking, which offers a wide range of products according to investors' needs, in parallel with a high level of services including asset management. In terms of lending, one way is to collect detailed information keeping close relationship with the local community and issue loans on a case-by-case basis; an alternative way is to utilize the scoring system and thereby process large volumes of loans at low cost targeting SMEs and individuals.

Moreover, credit accommodation will have to be enhanced with respect to individuals, and income generated from account management fees and other commissions will have to be raised. Currently, Japanese banks generally have insufficient know-how to enhance credit accommodation for individuals. Thus, it is necessary to develop a risk management structure based on the analysis of data such as default rates, and review commission income in light of cost effectiveness.

(e) The Vision for the Future of Regional Financial Institutions

Conceivably, regional financial institutions would continue strengthening their management bases primarily by focusing on the local community, identifying companies' management status in detail, and meeting the needs of local residents and companies in a meticulous manner. As loans to local SMEs account for a large proportion of regional financial institutions' lending portfolio, trends in the local economy substantially affect the management of these financial institutions. In light of this, it will be important to enhance their risk management ability. For example, their risk management ability can be improved by forming alliances with regional financial institutions in other regions. It will also be important for regional financial institutions to strengthen their management bases by effectively investing management resources into their specialized fields, and by taking advantage of their economics of scale through organization restructuring, such as merger and other forms of consolidation.

It will be important for cooperative financial institutions to take the approach mentioned above, as regional financial institutions. There are other aspects to cooperative financial institutions in addition to the above. A cooperative financial institution can neither sustain stable management nor sufficiently fulfill the credit accommodation functions for members unless the depositors approve of its management soundness as a deposit-taking financial institution. On the other hand, it is distinctive in that in the spirit of mutual aid it returns the surplus funds to members according to their share of business usage and financial contributions, rather than keeping them as retained earnings. Bearing these aspects in mind, the important challenge for cooperative financial institutions is to build an optimum business model so as to fully perform functions as regional financial institutions, as regional providers of financial services, in line with the actual status of the regional economy and changes in the financial environment.

(ii) Securities Companies

The role of securities companies as a player in the market-financing model will become more important in a financial system with market functions as its core, in terms of encouraging investors to participate in the market and contributing towards corporate financing.

Although the system has been considerably improved in recent years, further reform of the system is necessary. It is becoming increasingly important for each securities company to formulate and implement a new business model in consideration of its comparative advantage and target customer group. Securities companies may build various models: a model that meets customers' needs by reducing brokerage commissions by making maximum use of the Internet; a model that meets customers' needs by focusing on offering high-quality advice and services to select customers; a model based on asset-management-type operations; and a model that focuses on investment banking services.

While securities companies that implement new models have actually started to emerge, most securities companies seem to have no clear vision for the future. It is required for each securities company to continue making positive efforts in building their own business model.

Also, as various comments have been made about the confidence in securities companies, they needs to make further efforts to gain customers' confidence, regardless of what kind of business model they pursue. In order to make securities companies execute operations more faithfully to customers, the Government needs to endeavor to widely identify the actual status of securities companies' operations and verify what they ought to be, and take necessary actions for making further improvements in terms of rules, inspections and supervision.

(iii) Insurance Companies

In the financial sector, insurance products differ from other financial products in that it fulfills a security function based on the spirit of mutual aid. Moreover, its actuarial framework is complicated and difficult to understand for customers. While various regulations have been imposed in light of user protection for these reasons, they have undeniably slowed down reforms in the insurance companies themselves.

In a progressively aging society, with increasingly complicated socioeconomic aspects, insurance companies need to enhance their security functions against various risks, in line with changes in companies and individuals' needs. Insurance companies also play a part as institutional investors, managing the funds collected from policyholders.

A look at the business environment surrounding insurance companies reveals that while traditional products are maturing and policy contracts volume is on a decreasing trend, intrasectoral competition, competition between life insurance and non-life insurance sectors, and competition with other financial sectors are intensifying in conjunction with the progress of deregulation, and this tendency is likely to gain more momentum. Insurance companies need to build new business models as key players in the financial system, without being prepossessed with old ideas.

Although there are still few signs of insurance companies building new business models, some new developments have been already emerged.

In regard to product development, life insurance companies and non-life insurance companies have started to enter each other's market through subsidiaries, and their entry into the so-called "third sector" is progressing and initiating competition. As life insurance companies and non-life insurance companies are forming business alliances with each other, the possibilities for product development and sales are expanding beyond the scope of old ideas, as exemplified by products that are difficult to categorize in terms of life insurance or non-life insurance. By nature, insurance needs to be underwritten and the risks need to be properly intercepted by each insurance business unit, in order to implement proper risk management. Assuming this, it is conceivable to develop products that immediately meet customers' needs, such as developing new products based on a combination of life insurance and non-life insurance with different risk characteristics.

Moreover, non-life insurance products are competing with derivative products such as weather derivatives to a higher degree, and life insurance products have started competing with annuity products. There is a possibility that new services will be provided based on a combination of insurance products with financial products in other sectors, rather than solely in the insurance sector. In relation to this, in the U.S., where aircraft lease securitization is widely practiced, residual value insurance (Note) is combined with the securities to enhance their merchantability. Insurance companies may also explore sectors that support the flow of securitization as shown by this example. In addition, insurance products with strong saving characteristics are due to be sold by banks over the counter.

(Note) An insurance targeting lease agreements on aircraft, etc., which compensates for the loss incurred when the market value of aircraft at the time of termination of the agreement is less than the residual value set at the time of concluding the agreement.

As for the functions of insurance companies, insurance companies have sold and underwritten insurances, and managed the funds en bloc. On one hand, they are required to demonstrate advanced management abilities based on a high level of expertise as institutional investors (i.e. professional investors). On the other hand, they are required to improve their ability to offer various insurance products according to customers' needs with precision. Under these circumstances, the insurance sector should consider the disaggregation of functions into sales, underwriting and asset management to raise efficiency.

With respect to the form of insurance companies, mutual corporations account for a large proportion, especially among life insurance companies. It is important to select the adequate company form, including the conversion of a mutual corporation into a joint stock company, so as to ensure strict corporate governance and enable the insurance company to operate business in a diversified manner.

Under the current conditions, in which interest rates are being sustained at extremely low levels, the problem is how to improve the risk management abilities of insurance companies and ensure confidence in their management bases. Suggestions have been made about this problem in terms of the so-called "negative spread" issue marring life insurance companies, and the safety net for life insurances provided as an exception to the rule for a limited time until the end of FY2002. These issues should be discussed from a broad perspective, in consideration of stabilizing the management of insurance companies and ensuring confidence in the insurance system, while assuming efforts made by insurance companies themselves.

(iv) Institutional Investors such as Investment Trusts

In a financial system harnessing both industrial financing and market financing utilized with the market function, institutional investors such as investment trusts are expected to play a greater role in connecting individuals and companies with the market, as a player in indirect market financing.

For example, the development of various financial products utilizing investment trusts will make it easier for a wide range of investors, including individual investors with limited investment experience, to participate in the market. Institutional reforms have been implemented in recent years for the introduction of investment trusts offered through private placement, corporation-type investment trusts, real-estate investment trusts, Exchange-Traded-Funds (ETFs), etc., and products based on the new system have started to appear. It is expected that attractive products will be offered effectively utilizing the new framework, in the financial system harnessing both industrial financing and market financing.

As a matter of course, institutional investors need to improve their know-how on asset management, and fulfill their responsibilities as agents of their respective final beneficiaries.

(2) Measures to Promote Mergers and other forms of consolidation

In order to further reinforce the financial system and help stimulate the economy, deposit-taking financial institutions need to strengthen their management bases by improving profitability. Considering the vision for the future, especially in regard to regional financial institutions, the effective injection of management resources into their own competitive fields, and reorganization through merger and other forms of consolidation, etc. may be strong options. Naturally, nothing is more important than the parties' efforts in strengthening their management bases through merger and other forms of consolidation, etc., under market discipline. However, there are various obstacles to mergers, etc., in terms of procedures and costs. It is important that the Government develops an environment to facilitate mergers and consolidations in terms of procedures, and takes necessary measures to support mergers, such as those aimed at alleviating the costs involved in mergers, etc., and boosting capital through the injection of public funds to counter the fall in the capital adequacy ratio caused by mergers, etc.

(3) Removal of the Blanket Deposits Insurance (Restarting the "Pay-off" Scheme) and Ensuring the Stability of the Payment and Settlement Functions

Deposit-taking financial institutions are required to continue making exceptional efforts to strengthen their financial and managerial bases and improve their profitability. Depositors should screen out deposit-taking financial institutions to make the institutions strengthen their financial and managerial bases and improve their profitability even more seriously, with a sense of tension, so that the efficiency of the financial system would improve as a whole. From this viewpoint, it is appropriate for the deposit insurance system to return to a partial coverage system to protect small depositors (i.e. restart of the "pay-off" scheme).

On the other hand, it is dispensable in the interest of the public to ensure the stability of the payment and settlement functions performed by financial institutions, as most of the payment and settlement in our economy are conducted through this channel. In other words, it is extremely important that economic entities definitely complete payments and settlements in economic transactions. As a safety net for payment and settlements, it is necessary to provide for a safe and secure means of payment and settlement other than cash, and make it accessible to everyone. Specifically, it is necessary to provide a type of deposit as a safe and secure means of payment and settlement, which is a deposit to be protected fully in the event of a failure of a financial institution ("payment and settlement deposit"), and prepare measures to ensure the completion of payment and settlement transactions in process.

(4) Disposal of Non-Performing Loans (NPLs)

(i)Various Aspects of NPL Problem

In April 2002, the FSA requested major banks, as a general rule, to dispose of 50% of all loans classified as "in danger of bankruptcy" or below within a year and most of such loans (targeting: approximately 80%) within 2 years. Major banks need to promptly dispose of NPLs- utilizing the market mechanism, and make sure they achieve these targets.

With this in mind, considering the various aspects of the NPL problem, NPLs are partly attributable to overborrowing by companies. Based on this view, the revision of the Extraordinary Law for Revival of Industrial Vitality is slated to take place. However, as new NPLs will continue to arise in large amounts as long as deflation continues, it will be important to overcome deflation.

The NPL problem may also be described as a problem arising from the Japanese financial system's over-reliance on financial intermediation through banks deposit and the concentration of risks on banks. It is important that banks engage in converting their business models to improve their profitability and promote the securitization of loan as explained above, in light of overcoming the NPL problem as well.

(ii)Government Supervision of Banks for the Foreseeable Future

Various debates are taking place in regard to how the Government should get involved in the management of banks, so as to solve the NPL problem. As a matter of course, the Government needs to continue to strictly inspect and supervise to ensure the soundness of bank management. Although the NPL problem should essentially be discussed between the banks and the debtors, a certain degree of government intervention is unavoidable under the current circumstances, as the problem is not likely to be solved swiftly and is having a significant impact on the real economy. However, one should always bear in mind that government intervention in individual transactions between banks and borrowers distorts economic rationality and should be strictly avoided.

The Government may set specific numerical targets in regard to management indexes such as rate of return on equity (ROE) and rate of return on total assets (ROA) and require banks to meet them. However, the basic rule for the Government supervision of banks is to ensure the soundness of bank management by assessing as a whole the soundness of management in a comprehensive manner based on the proper management of credit risks, market-related risks, liquidity risks, etc., rather than by determining it solely on the basis of such indexes as ROE and ROA. It should also be noted that setting specific targets for management indexes and requiring their fulfillment might undermine banks' flexibility in allocating funds.

As a matter of course, it is important that banks disclose their new business models, both internally and externally, and make efforts to achieve them. It is important that the Government also endeavors to improve an environment to promote such efforts by banks.

The Government has been engaged in the offsite monitoring of banks' financial conditions, etc. From now on, it will be necessary to take a closer look at and systematically identify their financial conditions, etc. through continual monitoring, taking into account the restart of the "pay-off" scheme.

3. Efforts to Promote the Reform of the Securities Market, etc.

In the securities market, there are certain signs that the reform of the financial system, etc. has been promoting competition in the market, as exemplified by the dramatic reduction in brokerage commissions. However, the securities market remains stagnant, notwithstanding the sluggish real economy, and is insufficient to serve as the driving force behind the new financial system, in which the market-financing model will play an important role.

With this in mind, the FSA released *the Program for Promoting Securities Markets Reform* in August 2002, with the aim to create a truly solid securities market in which a wide range of investors participate. The concrete measures in the Program need to be speedily and steadily implemented. Further studies will have to be conducted in the future with respect to the system concerning issuing companies, market intermediaries, market operators, investors, etc., accurately adapting to changes in the financial and economic environments and the emergence of new needs of market participants.

(1) Ensuring Fairness and Transparency in the Market: Ensuring Confidence in the Market

For the Japanese securities market to fully demonstrate market functions, including the proper management and allocation of risks under an effective price mechanism, and to become a truly solid market in which a wide range of investors participate, it is indispensable to make the market fairer and more transparent, and ensure that Japanese people have confidence in the players, namely, issuing companies, market intermediaries, market operators, and the securities market itself.

For issuing companies to gain public confidence, it is necessary to reinforce corporate governance from investors' standpoint, drawing upon the recent accounting scandals in the U.S., and enhance and reinforce accounting and auditing. This requires a review of the status of certified public accountants (CPAs), such as increasing the number and improving the quality of CPAs. As the infrastructure of the financial system harnessing both industrial financing and market financing, it is expected that not only CPAs but also other experts such as lawyers will be enhanced.

For ensuring market confidence, it is also important that company-related information is disclosed to investors, etc. in an accurate and timely manner. In conjunction with making enhancements and reinforcements in accounting and auditing, it is necessary to actively enhance disclosure, including the enhancement of information to be disclosed on a continuous basis, and the enhancement of quarterly disclosures by listed companies.

In addition to strengthening the efforts directed at issuing companies as such, the vital challenge is to ensure confidence in market intermediaries who connect investors with the market. Efforts need to be made to further improve the compliance of not only intermediaries such as securities companies, investment companies and investment advisors, but also institutional investors, as to whether they are executing operations faithfully to customers and trustors.

Furthermore, in order to ensure fairness in the market, it is essential to functionally enhance and structurally reinforce the Securities and Exchange Surveillance Commission, including strengthening of surveillance against disclosure violations that undermine confidence in the securities market.

(2) Improving the Stability and Efficiency of the Market

In regard to improvements in the market infrastructure, it will be necessary from now on to construct a highly convenient, stable and efficient market for investors, while acknowledging the international competition between markets and innovations in financial technologies.

Accordingly, studies will have to be conducted on the status of the market from a broad perspective, such as the roles to be played by exchanges including preparations for cross-border transactions, in consideration of the progress in globalization and IT utilization. It will also be necessary to further improve the environment by establishing a unified securities settlement system including stocks, and realizing a paperless securities system.

The tax system relating to financial transactions needs also to be corrected in light of the international competition between markets.

For the bonds and debentures market, measures need to be considered to improve not only the liquidity but also the fairness and transparency of pricing. Consideration needs also to be given to transactions involving Japanese government bonds (JGBs) so that the price mechanism would function more efficiently: on the issuing side, studies should be conducted to enable so-called WI (When Issued) transactions, which serve as an issue market before bidding, and on the distribution side, purchase by the Government and interest rate swaps should be utilized. Furthermore, greater improvements need to be made in the environment so that JGBs will be held by a wider range of entities, including individuals, body corporates and nonresidents, considering that the risks involved in JGB holdings are skewed towards financial institutions.

(3) Widely Promoting Japanese People's Participation in the Market

(i)Improvement in the Market Access

In order to realize a truly solid market in which Japanese people widely participate, it is important to further promote diversification of sales channels and improve the environment so that individuals can easily access a wide range of attractive financial products and services. Such improvements in the environment are expected to promote competition between sales channels and improve products and services, adapting to customers' needs even further.

Firstly, in view of enhancing the functions of securities companies —which are major market intermediaries— as sales channels, it is necessary to consider introducing an agency system with the possible utilization of financial planners, and reducing the amount of the minimum capital requirement. Simultaneously, it is essential to work on measures to enable the operation of new businesses, such as allowing securities companies to shift to asset-management-type operations.

Secondly, in view of further utilizing banks, etc. as sales channels, it is necessary to realize branches run jointly by banks and securities companies, and facilitate banks to pass on documents required for securities trading. The existing firewall regulations should also be reviewed and streamlined to the bare minimum, such as the arms-length rule.

Also, in view of encouraging the entry of unique businesses in the field of investment trusts and investment advisory services, which are expected to play a more important role in a financial system harnessing both industrial financing and market financing, it is necessary to consider reducing the amount of the minimum capital requirement.

Moreover, in view of diversifying the players of trusts, it is essential to consider the status of the trust companies and the status of debentures issued by banks.

(ii)User Protection and Changing Individual Investors' Mentality

When envisioning the future of the financial system, it is important to improve user convenience of the financial system and properly offer user protection. When new financial products and services are provided or sales channels are diversified, these policy responses can avoid increasing troubles and disputes between customers and financial intermediaries.

In view of user protection, the important challenge for the time being is to make sure that financial intermediaries provide an explanation thoroughly and enhance disclosure. It is also essential to consider enhancing the alternative dispute resolution procedures in the financial sector, by referring to the argument in the Financial service dispute resolution liaison group. Furthermore, in view of developing an environment in which users can engage in transactions with peace of mind, sales and solicitation rules have been laid down for financial products, and collective investment schemes have been improved. It is necessary to sustain efforts to improve and enhance the legal framework by function from a cross-sectional perspective.

With regard to the protection of personal information, the handling of personal information in the relationship between individuals and financial intermediaries is likely to become an important issue for discussion in the future, regardless of the type of business. In consideration of the deliberation status of the Bill on the Protection of Personal Information, it is necessary to consider how such information ought to be handled in the financial sector.

Furthermore, it is important to implement consumer education and change individual investors' mentality, in order to switch to a new financial system. The Government needs actively to promote efforts in these areas, including the further promotion of financial and securities education at school, affirmative activities by the Central Council for Financial Services Information, and the proper distribution of information by the authorities.

4. Aggressive Efforts in Alternative Measures that help the Prompt Construction of a Financial System harnessing Both Industrial Financing and Market Financing

(1) Reform of Public Financing

It is important to promote the reform of public financing in view of shifting to a financial system harnessing both industrial financing and market financing, with market functions set as its core.

In Postal Savings and Postal Life Insurance, the movement of funds in huge amounts against the market mechanism might distort the market functions of the financial system as a whole. While studies have been conducted on the forms of management with the aim to improve the conditions so that they can compete fairly with private financial institutions based on the market mechanism, it is necessary to at least secure an equal footing with private financial institutions.

Government-affiliated financial institutions need to avoid competition with private financial institutions in terms of lending, based on the principle that the private sector should be in charge of what it is capable of. If they are to complement lending by private financial institutions, the interest rate needs to be set in harmony with the market based on proper risk assessment, according to economic rationality.

In the U.S., the growth of the loan market is said to have been triggered partly by the government's active promotion of the securitization of housing loans, etc. Similarly, it is expected that the Government Housing Loan Corporation and other government-affiliated financial institutions will enter the market as sellers to help expand the loan market in Japan. Based on this view, it is important that government-affiliated financial institutions adjust lending and borrowing rates equivalent to those in the market. By doing so, the loan should become more attractive for investment, making it easier to sell and securitize them.

Government-affiliated financial institutions can compress the interest rate risks incurred amid low interest rates, by reducing the difference in maturity between procurement and investment (the time taken to procure and invest funds) through the diversification of means of financing.

In the U.S., it has been suggested that the expansion of the loan market was substantially attributable to the standardization of loan contract forms, which made it easier to trade and securitize them, and development of the infrastructure for providing information on prices and attributes of loan. It is believed that standardizing forms and making improvements in the information infrastructure will be effective in Japan as well.

(2) Tax System for Financial Products

Following the innovation of financial technologies and the expansion of competition among financial intermediaries, various financial products and services which can not be clearly classified under the conventional framework of financial services are now emerging, and the forms of transactions are becoming increasingly diverse and complex. As this trend is likely to be accelerated further, taxation method and the tax rates on financial products need to be simplified and made easier for investors to understand in consideration of keeping consistency with the actual status of financial transactions.

Up until now, the Japanese financial system has been based primarily on the industrial-financing model. From now on, it will be necessary to construct as soon as possible a financial system harnessing both industrial financing and market financing, with market functions set as its core. With this in mind, it will be important for public policy to put more emphasis on investments including stock and investment trusts rather than deposits and savings, and to promote such trend intentionally. For the foreseeable future, preferential tax treatment needs to be laid on stocks, investment trusts and other investment financial products compared to saving financial products. Specifically, preferential tax treatment needs to be given to stock investment trusts, which are easy for individual investors to purchase, the existing preferential tax treatments for stock capital gains should be farther enhanced. Taxation on dividend income needs to be reviewed as well, in order to raise the merits of holding shares.

International consistency is also required, when examining the taxation on financial products. Capital flight needs to be carefully avoided for the sake of excessive taxation on financial products.