Tentative Translation

# Recommendations for Vitalizing Financial and Capital Markets



December 13, 2013

Panel for Vitalizing Financial and Capital Markets

# Panel for Vitalizing Financial and Capital Markets
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## Overview

1. Since the burst of the economic bubble, the Japanese economy has found itself in a prolonged "deflationary trap." The firm expectation among companies and households that deflation will continue has led to a very large portion of the financial assets of households and public pension funds being allocated as cash and deposits, and hence the risk money provisions and funding for growing businesses are limited.[1] Companies curbed their long-term capital investments, resulting in stagnant corporate earnings and share prices, as well as a sluggish rise in workers' wages. As a consequence, the Japanese economy fell into a vicious cycle in which a drop in aggregate demand self-fulfills a deflationary expectation. (Under such situation, Japan's financial and capital markets have remained stagnant for a long time, and have resulted in claims that its international presence has diminished.)

Since the start of the Abe administration in December last year, the Japanese economy is currently in the process of leaping back to a *positive equilibrium* rendering sustainable economic growth out of a *negative deflationary equilibrium* by fostering growth expectations among households and companies with the "three arrows" of Abenomics: the first arrow being bold monetary policy; the second being flexible fiscal policy; and the third being a growth strategy to stimulate private investment.

In order to bring the momentum for revitalizing the Japanese economy to the next stage, where a sustainable and vibrant society is to be established based on the *positive equilibrium*, and to deepen the growth strategy, it is essential to focus on the structural problem of depopulation and the aging of society. Firstly, with the decline in the working population, an environment to enhance the per capita productivity and competitiveness of companies is required. Secondly, with a decline in household savings and a continuation of trade deficit expected, all sorts of assets built up over years need to be utilized more effectively for the future

[1] These assets are sometimes referred to as being "inactive." In a deflationary environment, this was a rational economic decision to some extent, and had been partially directed to finance government bonds.

and then to revitalize the Japanese economy. Thirdly, it is necessary for Japan to grow and evolve along with economies with growth potential, by promoting the expansion of human resources, goods, funds, and information across borders, as well as by attracting them to the Japanese markets.

Following the burst of the bubble economy, the Japanese financial system has restored its soundness after overcoming the financial crisis and the non-performing loan problem, and has since remained sound even through the global financial crisis. The Japanese financial system must now play an active role in ensuring that the economy leaps back to the *positive equilibrium* and in sustaining a vibrant society under such equilibrium. In other words, as part of "the third arrow," a strategic structural reform policy aimed at enhancing growth potential must be pursued in financial and capital markets as well. This effort is exactly what is required to turn the above vicious cycle into a positive cycle and fully accelerate the development.

In particular, financial assets held by households, which amount to nearly 1,600 trillion yen, and public pension funds, are expected to be mobilized as risk money and funding for growing businesses, while having the decline in the real value of the those assets minimized in an inflationary environment. Measures should be taken to enhance this shift of financial assets.

Furthermore, with Asian economies growing rapidly, Japanese companies and financial institutions are proactively expanding overseas, to Asia in particular, as Japan's birthrate declines and its population ages. Considering such global expansion, it is important to contribute to the enhancement of the market functions in the Asian region as a whole and to the development of Asian economies by providing maximum support in the financial area to help Asia exert its full potential. In order to pave the way for the Japanese economy and financial and capital markets to grow along with the Asian economies, it is also important to support Asian countries in developing their financial infrastructure, as well as to develop a business environment that is essential for Japanese companies and financial institutions to operate in Asian countries. It is also necessary to take measures to assist foreign investment in Japan so as to achieve a more sophisticated and competitive Japanese economy.

At the same time, with the companies in Asia rapidly increasing their competitiveness, Japanese companies, which have just started to engage in forward-looking investments in the midst of the move away from deflation, need to further enhance their competitiveness by reforming their management structure and industrial structure. From the viewpoint of providing risk money and funding for growing businesses, companies are expected to increase their attractiveness for investment, while financial intermediaries and asset managers are expected to provide diverse and attractive financial products and services. In light of this, measures need to be taken strategically aiming at dramatically enhancing comprehensive financial expertise, such as financial institutions' abilities to identify companies with growth potential and help their growth by providing consulting services, their abilities to provide high-quality products and services, and the abilities of institutional investors and asset managers in fund management. Moreover, in order for Japan to grow alongside with Asia, it is important for Japanese companies to actively expand to Asia on the premise of active and healthy turnover in Japanese industries and companies, while at the same time, to win the confidence from foreign peers in the competitiveness and management skills of Japanese industries and companies.

Furthermore, in order to change the flow of funds and to increase the attractiveness of Japan's financial and capital markets globally, in addition to reviewing financial regulations, it is necessary to secure and develop highly-skilled human resources with high levels of global business expertise in respective industries including institutional investors and financial institutions. It is also necessary to enhance the attractiveness of various business and living environments surrounding Japan's financial and capital markets. These reforms concerning the underlying business and living environment are also important in the context of maintaining and enhancing the international competitiveness of Japan's financial and capital markets.

2. Meanwhile, manufacturing is Japan's strength when aiming to maintain and develop the country's international competitiveness. When considering the growth strategy for financial and capital markets, it is important for financial institutions and industries to establish a relationship in which the two grow in tandem, just like two wheels of a cart. This relationship, built through a process where financial institutions not only provide financing to industries, but also provide industries with highly value-added consulting and utilize discerning abilities for growth potentials, which in turn, leads to value creation in real economic activities, is important. It should be noted that vitalization of financial businesses not in tandem with the development of real economic activities will not lead to sustainable growth.

Furthermore, the long-term outlook of the macro-environment surrounding Japan's financial and capital markets suggests that Japan's fiscal situation is in an unfavorable condition where government debt has reached twice the size of the country's economy. Ensuring fiscal sustainability is becoming increasingly important in promoting the supply of money for growth and achieving sustained growth with stable price levels, while at the same time maintaining the stability of the government-bond market. From this perspective, it is important to strive resolutely to ensure the country's fiscal soundness.

3. Despite several initiatives to reform financial and capital markets aiming at vitalizing the economy by providing risk money and funding for growing businesses, it is difficult to say that these efforts have been highly successful in a situation where deflationary expectations were pervasive and deep rooted. Now, however, with the fostering of inflationary expectations, risk-taking in asset management has become increasingly rational, while funding demand for infrastructure development is strongly recognized. Now is a precious opportunity to truly vitalize financial and capital markets. It is desirable to proceed with the vitalization of financial and capital markets while affluent stock of household savings still exists.

The expectations for, and attention to, the Japanese economy from home and abroad have risen to levels not seen in recent years due to the ongoing implementation of Abenomics and the selection of Tokyo as host city for the 2020 Olympic/Paralympic Games.

It is important to take advantage of this opportunity to vitalize the financial and capital markets by, for example, setting the goal of establishing a leading position as an international financial center by 2020 (aim at becoming Asia's number one international financial center in 2020), drawing a picture of each issue in 2020, and strategically and boldly taking measures to realize such goal while keeping in mind the image of 2020 for each area of challenge.

4. In this recommendation, with a picture of 2020 in mind, specific policies to be realized in the next seven years are stated with regard to the following four areas:

(1) Establishing a positive cycle in which abundant financial assets held by households and public pensions are allocated more to funding for growing businesses (Utilizing “inactive” funds)

(2) Realizing Asia’s growth potential, improving the market function of the Asian region, paving the way for integral growth of Japan and Asia (Supporting the development of financial infrastructures in Asian countries and fostering a necessary environment for Japanese financial institutions and companies to conduct business in Asia through cooperation between the FSA and relevant authorities)

(3) Strengthening corporate competitiveness and promoting entrepreneurship

(4) Developing human resources and establishing a better business environment

Additionally, the seven-year period is divided broadly into the following two stages:

-- In the first stage, with the current monetary easing aimed at achieving the price stability of 2% in terms of the year-on-year rate of change in the consumer price index (CPI) at the earliest possible time, with a time horizon of about two years, measures to be launched immediately and to be addressed within one year or so from 2014 are entailed. A course for the transition to an economic structure suitable for an *positive equilibrium* should be set by presenting a vision of the future to encourage expectations, and structural reforms should be commenced.

-- In the second stage, measures to ensure the positive cycle of funds in the course of exiting from deflation, and agenda for accelerating and boldly tackling structural reforms are entailed. While such agenda should also be addressed immediately, some of them will take time to become fully effective, and others are related to the reform of the underlying businesses and living environments, such as the development of human resources and governance reforms.

## 1. Establishing a positive cycle in which abundant financial assets held by households and public pensions are allocated more to funding for growing businesses (Utilizing "inactive" funds)

### 1-1. Establishing an environment to enable asset building by households in line with lifecycles

To exit from deflation and to make a definitive transition to a *positive equilibrium*, contribution should be made to build up Japanese public assets. To this end, measures should be taken so that funds such as household assets nearing 1,600 trillion yen[2] and public pensions are adequately managed, and risk money and funding for growing businesses are supplied through such measures.

By 2020, such environment should be created where households' proper investment activities, which are in accordance with their life-cycle, are adequately supported. With that in mind, firstly, high quality financial education should be provided to enhance the financial literacy of each household. Secondly, financial advisory services, which provide appropriate financial information with primary attention to client interest, should be prompted.

From this perspective, the following issues should be addressed immediately.

With regard to the Japanese version of the Individual Savings Account (NISA) scheme, which will be launched in January 2014, efforts in the public and private sectors to encourage its use should be continued. At the same time, the government should make the scheme more convenient, for instance, by making it possible to switch a NISA account to a different financial institution on an annual basis. Furthermore, from the perspective of broadening the range of investors and expanding the provision of funding to growing businesses,

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[2] A breakdown of household assets in Japan reveals a high percentage of cash and deposits, while that of stocks and investment trusts is about 10%, a level lower than most Western countries and below the level in the 1980s prior to the bubble (average of 20% at that time). Net household assets excluding household debts amount to 1,233 trillion yen (as of end of June 2013).

consideration should be made, taking into account the actual usage and its effect.

As to investment trusts, approaches should be taken to develop and promote products suited to the lifecycle of customers ranging from the young to the elderly. Sales and marketing style with an emphasis on sales commission from short-term switch of products should be reexamined, and the transparency of fund management should be improved. Strong initiatives should be taken to foster the development and the promotion of products that place priority on the individual investors' interests and truly suit the customers' investment objectives and needs, in line with each investor's life-stage. Further, in relation to sales of products, it is necessary to pick and offer the products that match the needs of individual investors and lead to long-term asset building.

With regard to public and quasi-public funds, such as the Government Pension Investment Fund (GPIF), necessary measures should be taken in line with the Final Report of the Panel for Sophisticating the Management of Public/quasi-public Funds (released on November 20, 2013), which recommends a review of the fund management and governance structures in view of the exit from deflation. Especially, given the extreme importance of securing human resources to carry out sophisticated investment and risk management, expert personnel should be recruited.

In order to diversify the investment of the GPIF, for example, it would be effective to jointly invest with overseas pension funds by utilizing the know-how of the Development Bank of Japan (DBJ). In addition, the financial functions of the Japan Bank for International Cooperation (JBIC) will be enhanced, and with investments from GPIF and other funds in mind, consideration will be given to the liquidation of claims pertaining to infrastructure projects. Taking the outcome of consideration into account, GPIF will carry out a study on the diversification of its investment portfolio.

At major financial centers around the world, demanding eyes of pension funds and government funds have led institutional investors and asset managers to compete with each other by enhancing their skills . With this in mind, for instance, one effective means to enhance the quality of the operation and management of asset management companies, which manage investment trusts and pension funds' assets, would be, for example, to foster and enhance asset management companies by having GPIF appropriately select its asset managers. In such case, it would also be effective for asset owners, such as pension funds, to encourage asset management companies to have an adequate fund management base and an information hub function in Japan's financial and capital markets.

The JPX-Nikkei Index 400, comprising companies deemed attractive for investments with due considerations to factors such as high ROEs and independent directors, will start to be calculated in January 2014. For the promotion and development of products tracking the index, the proactive use of the index by a broad range of investors including public and quasi funds would be preferable.

In addition, there is a view that executives and employees of listed companies, while having the financial ability and literacy to engage in investments, are overly cautious in holding stocks due to the insider trading regulations. To address this, revisions to the in-house rules and amendment of the regulations on insider trading may be required. The diffusion of financial products outside the scope of the insider trading regulations, such as investment trusts, would also be effective.

More fundamentally, as part of fostering an environment for adequate risk-taking in line with individuals' life-cycles, enhancement of financial and economic education is essential. It is extremely important to raise the level of financial literacy among elementary and secondary school students, working adults as well as the elderly.

As the next step, the following issues should be addressed.

Further measures to improve individuals' financial literacy and to encourage investment should be discussed in view of the experiences from the promotion of NISA while Abenomics realized its effects. Furthermore, private pensions should be reviewed following the considerations of all pension funds, with a view to promoting investment by working generations in line with their lifecycles.

As for investment trusts, the situation of development and sales of products after the introduction of NISA should be reviewed, and with the cooperation between public and private sectors, further measures should be taken to develop and promote products that truly meet the investment objectives and needs of customers.

With regard to GPIF and other similar funds, efforts should be made to realize the desirable fund management, risk management, and governance structure in line with the recommendations made by the Panel for Sophisticating the Fund Management of Public/Quasi-public Funds.

Efforts should also be made to further utilize and promote indexes focusing on investment returns, such as JPX-Nikkei Index 400.

Financial and economic education should be further developed by accelerating cross-industry efforts among sectors such as banking, securities, insurance, and asset management.

### 1-2. Improving the market environment and increasing the attractiveness of the market

With funds such as financial assets held by households and public pensions being steered toward investment, it is critical to set in motion a virtuous cycle by expanding Japan’s markets in both volume and scope, as well as by improving the attractiveness of the markets.

In 2020, the Tokyo market should be able to meet various funding needs on par with other major financial centers and become a solid market offering foreign and domestic investors a variety of investments in a timely fashion.

Infrastructure financing is a method for financing the development of infrastructures through investment by funds and lending by financial institutions. With infrastructure financing, large funding demand is expected in developing countries, such as countries in Asia. In Japan, it is an effective tool for developing various infrastructures, as well as for enhancing both the quality and quantity of healthcare facilities in response to the aging society. Considering these factors, a vibrant infrastructure-financing market should be fostered, and efforts should be made so that the private sector plays an active part in such market.

In line with these efforts, the Japan Exchange Group, as a Comprehensive Exchange, will list a variety of financial products, such as foreign and domestic companies' equities, as well as derivatives (including financial futures) of those products and commodity derivatives. It will firmly establish its place as the top-level market in Asia attracting various foreign and domestic investors.

Supplying funds for growing businesses through capital markets and fostering an infrastructure financing market will meet the adequate investment needs of funds, such as financial assets held by households and public pension funds, amidst the falling birth rate and aging population. It will also lead to providing companies with risk money and funding for growing businesses, at the same time enabling infrastructure improvements with lower fiscal burdens.

From this perspective, the following issues should be addressed immediately.

While financial and commodity markets are being strategically integrated overseas, the idea of working to develop a <u>Comprehensive Exchange</u> has been put forth in Japan as well, in strategies such as the "Implementation Plan for Regulatory Reform" (Cabinet decision made on June 14, 2013). Efforts should be made to realize a Comprehensive Exchange.

It is also recommended that measures be taken to expand the supply of funds into markets. One effective means is for the Tokyo Stock Exchange to create a listed infrastructure fund market and for the government to support such effort. Other possible means include promoting the development and diffusion of products tracking the JPX-Nikkei Index 400, encouraging the utilization of PPP and PFI, fostering an environment for the development of infrastructure funds and health care REITs, and liquidating claims of JBIC.

In addition, bearing in mind the particularity of Japan in that it is located especially in the far-east corner of Asia, efforts should be made to expand the trading hours of the Tokyo Stock Exchange, which are short compared to major overseas exchanges.

Moreover, in line with the “The Present Policy on the Application of International Financial Reporting Standards (IFRS)” (June 19, 2013) published by the Business Accounting Council, necessary measures should be taken to build up the examples of voluntary application of the International Financial Reporting Standards (IFRS) in Japan and strengthen Japan’s capability to have its opinions heard in the development of IFRS.

Furthermore, with regard to foreign exchange reserve management, it is recommended to utilize external fund managers and their knowledge with due consideration of the impact that it may have on the foreign exchange market.

As the next step, the following issues should be addressed.

First of all, a wide variety of financial products, including commodity futures and infrastructure funds, should be traded in the market and the range of investors should be broadened.

By realizing a Comprehensive Exchange, the product line-up including commodity derivatives at the exchange should be broadened, and the attractiveness of markets including the commodity markets should be increased.

To make Japan's financial businesses more efficient, more advanced IT systems should be employed to realize paperless transactions. The Social Security and Tax Number System (the "My Number" system) should be actively utilized in financial operations to enable the streamlining of name-based aggregation, and considerations should be made to provide customers with prompt and accurate financial services. In addition, to reduce the risks pertaining to securities settlements, steady progress should be made to shorten the settlement period of securities. It is also important to speed-up the reform of the corporate bond market by enhancing access by companies with comparably low creditworthiness.

In addition, stronger foundations in terms of legislation and human resources are required for strengthening the competitiveness of markets. The quality of audit also needs to be enhanced to maintain and ensure international confidence in the auditing system in Japan. To this end, it is crucial to make the certified public accountant qualification more appealing.

## 2. Realizing Asia's growth potential, improving the market function of the Asian region, paving the way for integral growth in Japan and Asia

### 2-1. Promoting support for developing financial infrastructure in Asian countries

In 2012, Asian emerging and developing countries accounted for 25% of the world's GDP and achieved a real growth rate of 6.4% (*World Economic Outlook*, IMF). With a view to contributing to Asia's economic development and improving the market functions of the whole region, thus achieving growth alongside Asia, it is important that Japan, by strengthening cooperation between FSA and other countries' respective authorities, provides various support to enhance market functions in Asian countries as a whole. This includes <u>support for the development of financial infrastructure</u> and improvement of the business environment for Japanese companies and financial institutions.

Some countries in Asia, e.g., Cambodia, Lao PDR, Myanmar, Vietnam, and Mongolia, have financial infrastructures (e.g., financial systems) in the process of development. Japan needs to contribute to the growth of Asia and improve the market functions of the whole region, by providing support tailored to different levels of development in financial infrastructure in each country. Such support includes: (1) developing "soft infrastructure" such as regulations; (2) developing "hard infrastructure" such as introducing an IT system in the settlement system and establishing/operating stock exchanges; and (3) sharing knowledge and experiences in areas such as financial administration and disaster management. Developing financial infrastructures in Asian countries will also help Japanese companies and financial institutions to expand businesses in these countries.

In order to promote the above-mentioned technical assistance, it is essential that Japan closely cooperates with financial authorities in Asia. Japan will promote the constructing of a framework that leads to achievement of this goal as soon as possible, and proactively promote the exchange of human resources through such framework as the "Asian Financial Partnership Center" (tentative name), which is planned to be established within FSA in the next fiscal year. Considerations should also be given to how to address various challenges with regard to Asian financial and capital markets, including Japan's, as well as how to provide technical assistance in a systematic manner. Outcomes of such considerations should be utilized to promote the support for developing financial infrastructures in Asia and to strengthen the roles that the Japanese financial and capital market and financial institutions play in Asian countries.

Enhancing the cooperation between FSA and financial authorities in Asian countries through these efforts will contribute to facilitating business development by Japanese companies and financial institutions in those Asian countries. In addition to developing financial infrastructures, efforts should be made to encourage finance-related business professionals, including lawyers and accountants, to expand into Asia, so that Japanese financial experts can play active roles in the

Asian countries where Japan is providing assistance.

### 2-2. Facilitating corporate funding and lending in Asian countries

Regulations on foreign currency exchange and capital controls still remain in many Asian countries. At the same time, transactions in their local currencies have expanded in line with their economic developments.

In 2020, the relationships between Asia and Japan will be tightened, with regard to human resources, goods, capital, and services. Hence, in order for Japanese companies venturing into and expanding in Asian countries to steadily obtain funds and operate their businesses, Japan's institutional systems and infrastructure should be highly developed, thereby to realize an environment where said Japanese companies can easily obtain local currencies as well as efficiently conduct cash management on a global basis, including at overseas business locations. Efforts should also be made to strengthen the financial and market stabilization functions of Asian markets and to establish markets and infrastructures for cross-border cash and securities transactions and settlements.

From this perspective, the following issues should be addressed immediately.

In response to Japanese companies' needs for ways to facilitate their obtaining of local currencies, it is important to steadily take necessary measures that enable Japanese financial institutions to serve as agents or intermediaries for transactions between foreign banks and Japanese companies.

Support from public sector financial institutions should be enhanced. Such support includes local currency-denominated private sector investments and finance by the Japan International Cooperation Agency (JICA) and guarantees for inter-bank currency swaps by the JBIC.

To bring greater efficiency to cash management of Japanese companies, relevant regulations should be revised so that the companies can build optimal cash management systems as a group that includes their foreign subsidiaries.

In addition, consideration will be given to the feasibility of direct trading between Asian currencies and Japanese yen, in lieu of the current cross-trading through USD. As part of such efforts, it is important to support private entities participating in the Asian-wide ATM inter-linkage network.

In the next step, the following issues should be addressed.

Further improvements must be made to Japan’s financial market infrastructures, such as extension of the operating hours of the Bank of Japan Financial Network System (BOJ-net), to foster an environment to make it easier for Japanese companies and financial institutions to smoothly access local currencies and manage cash efficiently on a global basis, including their overseas business locations.

In addition, it is necessary to strengthen financial and market stabilizing functions of Asian markets. To this end, it is important to foster cross-border collateral arrangements, a scheme that enables central banks of Asian countries to supply local currency by using Japanese government bonds as collateral, to ensure the stable funding of local currencies.

In order to strengthen the regional financial safety net, it is also important to enhance bilateral swap arrangements with Asian countries.

Furthermore, through regional financial cooperation, market functions of the whole Asian region should be enhanced. To foster a stable financial intermediary mechanism, corporate bond markets should be enhanced. In addition, the facilitation of cross-border securities investment and cross-currency transactions should be enhanced by developing infrastructures for intra-region cross-border securities settlements. It is also important to develop a settlement environment for retail remittances.

### 2-3. Strengthening the functions of the Tokyo markets as a global financial center supporting global development

For Japan’s economic growth, it is necessary to contribute to the economic development of Asian countries, and to enhance the market functions of the region, as well as to pave the way to growth along with other countries, including Asian countries.

For this purpose, it is important to efficiently intermediate global funds that invest in growing sector and seek investment destinations in the growing Asia and to contribute to Asia’s development, as well as to bridge such development to the growth of the Japanese economy by transforming Tokyo into a global financial center in Asia. Economic growth of Japan will set in motion a virtuous circle that will accelerate the development of Tokyo as a global financial center. To this end, diligent efforts need to be undertaken promptly, in view of the accelerating financial system reforms in the region. At the same time, it is necessary to take measures to encourage foreign companies to invest in Japan, and to utilize such investment for achieving a more sophisticated and competitive Japanese economy. When working on such measures, the strengths and the weaknesses of Japan’s financial sector should be taken into consideration.

In 2020, it will be necessary for the Tokyo market to meet diverse needs from domestic and foreign investors. For example, it is pursued that the listing of foreign companies, and the issuance and trading of yen-denominated and foreign currency-denominated bonds in the Tokyo market be as active as those in Hong Kong and Singapore. At the same time, efforts will be made to facilitate the trading of Asian currencies on the Tokyo market so that the market will function as a global market hub for cross-currency transactions of Japanese Yen, US Dollar, Renminbi, and others. In addition, as a medium- to long-term strategy, foreign and domestic infrastructure funds should be established and listed on the Tokyo market to strengthen infrastructure-related project finance, an area in which Japanese financial institutions are already among the top in the league table, along with measures to improve the ability to syndicate loans, so that the demand for infrastructure improvement at home and abroad is fulfilled.

From this perspective, the following issues should be addressed immediately.

The beginning and the ending dates of the fiscal year of business reports required to Financial Instruments Business Operators under the Financial Instruments and Exchange Act sometimes differ from those of the accounting year of overseas institutional investors and securities companies. The regulation should be revised to lighten the compliance cost.

Efforts should also be made to vitalize the Tokyo Pro-Bond Market, a market offering great convenience for overseas issuers (the listing procedure is to be simplified and made flexible, e.g., both English-only disclosure and program listing will be allowed in the Tokyo Pro-Bond Market). Specifically, considerations are needed to amend regulations as necessary, and to utilize DBJ (establishing a framework for investment in the Tokyo Pro-Bond Market).

Furthermore, the issuance of samurai bonds should be encouraged by expanding the scope of JBIC's guarantees and the acquisition framework for samurai bonds.

Japanese financial institutions need to make efforts to attract direct investment in Japan from Asian companies by, for instance, enhancing "reverse search" services (i.e., matching services provided to Asian companies that wish to collaborate or merge with Japanese companies).

As the next step, the following issues should be addressed.

It is important to facilitate cross-border bond issuances and transactions, as well as cross-currency transactions in the Tokyo market, in order to make efforts to further improve the environment for the financing of Asian currencies in the Tokyo market and strengthen the market function on an Asian-wide basis. To this end, it is necessary to make progress on the standardization of bond issuance procedures and development of a settlement environment for foreign currency-denominated bonds.

Improvements of legal stability with regard to cross-border securities issuances and derivatives contracts, including legal status in a bankruptcy, will be important in securing stability and transparency in financial markets.

With the size of the Islamic financing market growing, providing support for developing Islamic financing through JBIC is also an effective measure.

Additionally, it is important to build Tokyo as a hub for finance-related information and thus a global financial center in Asia. This can be done by holding international conferences where financial experts and policymakers gather, as well as by creating venues that would bring together representatives from the industry, government, and academia (e.g., a Japanese-version of the Davos Conference or Chatham House).

## 3. Strengthening corporate competitiveness and promoting entrepreneurship

### 3-1. Promoting entrepreneurship and new ventures

To vitalize the Japanese economy, reforms in the financial and capital markets must be pursued in tandem with the reforms in the real economy, just like two wheels of a cart. This will require making available appropriate financing in accordance with the stage of a company’s growth: startup, listing, business expansion, and overseas development. Although Japan possesses technologies that could serve as business seeds, they have often not resulted in business startups.

In 2020, the startup rate of Japan should be raised to 10% (current rate: 5 %). While the number of initial public offerings (IPOs) in Japan has rebounded since the Global Financial Crisis, the number is not necessarily high and should also surpass those of Hong Kong and Korea.[3]

To this end, funds must be appropriately supplied to stimulate innovation and to promote entrepreneurship and new ventures. Creating a cluster where venture businesses, research institutions, venture capitals and other relevant institutions gather would also be important from the viewpoint of supporting entrepreneurship efficiently.

From this perspective, the following issues should be addressed immediately.

The Financial System Council's "Working Group on the Provision of Risk Money to Emerging and Growing Companies" is currently studying the possible improvements to encourage business startups and new ventures. <u>Crowdfunding</u> should be promptly established as a means of pursuing the supply of risk money needed to commercialize technologies and ideas, and <u>burdensome requirements for new listings</u> should be eased to encourage companies to list.

As the next step, the following issues should be addressed.

First, it is important to establish an environment which enables companies at the stage of R&D and startup to procure funds easily by utilizing crowdfunding, which connects new or growing companies and investors through the Internet.

At the same time, considering the importance of providing equity funding and support for commercializing businesses, in addition to providing funds, supportive measures such as hands-on support in commercializing ideas and technologies, provision of managerial staff and networking of personnel with expertise, should be strengthened by

[3] The numbers of IPOs throughout the year in Japan (TSE), Hong Kong, and Korea (average listings from 2010–2012) are 48, 92 and 70 respectively (WFE).

promoting enhanced actions by the financial group as a whole.

### 3-2. Strengthening corporate governance to improve the medium- to long-term competitiveness and management capabilities of companies

In order for the financial and capital markets and industries to develop in tandem like two wheels of a cart, reforms of financial and capital markets and enhancement of corporate competitiveness will need to be conducted in parallel over the medium to long term, and companies' management capabilities needs to be improved. Winning the confidence of overseas investors in the competitiveness and management capabilities of Japanese companies is also a key issue.

In 2020, dynamic and sound turnovers and restructurings will take place among companies and businesses within companies, second chances will be broadly allowed, and new businesses will evolve and grow actively. In addition, society will be one in which many truly global companies flourish as attractive investment destinations over the mid to long term.

From this perspective, the following issues should be addressed immediately.

While examining their managerial strengths and weaknesses, such as teamwork in the field and technological competence, companies themselves should make efforts to reform their business by selecting sectors with growth potential and concentrating their resources in such sectors. By achieving high-quality corporate governance and securing shareholder returns on equity (ROE) on par internationally, the competitiveness of companies should be enhanced. From the perspective of promoting such efforts and thus realizing higher ROE of Japanese companies, development and promotion of <u>products tracking the JPX Nikkei Index 400</u> should provide Japanese companies with effective incentives. Accordingly, these products should be used widely in the asset management of GPIF and other funds.

To bring about high-quality corporate governance, companies should introduce outside (independent) directors in line with the partial revisions to the Companies Act submitted to the Diet in November this year and the revisions to the listing rules of the Tokyo Stock Exchange, which are expected to be implemented in February 2014. In line with such movements, it is necessary to encourage listed banks and banking holding companies to introduce independent outside directors through the supervision of financial institutions.

In addition, a wide range of institutional investors, including asset managers (asset management companies) and asset owners (pension funds, etc.), should engage in constructive dialogues with companies to encourage their efforts to enhance the management capabilities. To this end, it is necessary to promptly draft the Japanese Version of the Stewardship Code, which is now under discussion. In addition, the FSA needs to publish the list of institutional investors that accepted the Code, as well as their disclosure statuses in accordance with the Code, and to fully disseminate the Code both at home and abroad.

As the next step, the following issues should be addressed.

First, further development and establishment of market indexes which focus on the growth potential of companies will effectively promote turnover in companies and give them incentives to select and focus on growth sectors. Consideration should also be given to the modalities of business restructuring and insolvency, in reference to the trends in Germany and elsewhere, to ensure that companies have sound turnover.

Attention should also be paid to the state of corporate governance, taking into account the degree to which outside directors have been appointed in line with the supplementary rules to the partially amended Companies Act, and to further approaches to strengthening corporate governance.

Further improvements should be made to the Japanese Version of the Stewardship Code through periodic reviews in light of the degree of implementation of the Code, including its acceptance and disclosure among institutional investors. Periodic reviews should be undertaken to raise the awareness among institutional investors and thereby to further firmly establish the Code as standard practice.

### 3-3. Considering growth potential in financing by financial institutions

In order to promote reforms in financial and capital markets in industries in tandem like two wheels of a cart, enhanced consulting functions and abilities to assess business performance accurately of financial institutions should necessarily be improved.

Financial institutions should not rely excessively on the value of mortgage collateral and guarantees, but instead should consider the growth potential of borrower enterprises by utilizing techniques such as Asset Based Lending (ABL) and equity-like debt. Accordingly, financial institutions should establish their ability to discern the business potential of borrower enterprises, as well as their consulting and hands-on support functions, should be enhanced, and financial institutions should give full support to small and medium-sized enterprises in improving their business profiles and reinforcing their business structure.

Public finance including public credit guarantees, and private finance, need to play its part properly to support the respective stages of development.

From this perspective, the following issues should be addressed immediately.

When supervising financial institutions, pursuant to the supervisory policies, <u>the efforts for new loans and the support for business improvement and recovery</u> are intensively verified. Additionally, in line with the Financial Monitoring Policy, <u>financing decisions that takes well</u>

into consideration the growth potential of the debtor's business in addition to the debtor's financial soundness is encouraged, and financial institutions' asset classification of small and low risk exposures is respected by on-site inspections. Financial institutions should be encouraged through these efforts to actively perform their financial intermediary functions under appropriate risk management.

Furthermore, with the aim to promote business startups and quick business revitalization, the "Guidelines regarding Personal Guarantees" was issued on December 5, which establishes that company managers are not required to provide guarantees themselves when certain conditions are satisfied. It is important to promote the active utilization and the establishment of the Guidelines.

With regard to public credit guarantees, it is pointed out that moral hazard is created for small and medium companies when they excessively rely on such guarantees, and that the judgments of financial institutions are spoiled. To break out of 100% guarantees, the special measures listed in Safety Net Guarantee Program No. 5 should be promptly reviewed.

In order to foster an environment aimed at private financial institutions creating new ventures and businesses, as well as to promote the efforts for improving business management and turnarounds, it is important that public financial institutions supplement private financial institutions in these areas.

As the next step, the following issues should be addressed.

In order to provide adequate and sufficient support to companies in need, support by financial institutions for improvement of SME's business profiles and reinforcement of business structure should be expanded and established, and the experience should be accumulated by financial institutions.

## 4. Developing human resources and establishing a better business

**environment**

There is no doubt that human resources are the foundation supporting Japan’s development of industries and the financial sector, and that it is what makes it possible to compete in the global markets. In the eighteenth century, the first futures market in the world, *Dojima Rice Exchange,* was created in Japan. We inherit such power of imagination and creativity, which are great characteristics for conducting globally sophisticated financial businesses. The following recommendations with regard to developing high-developed human resources are made from the viewpoint of utilizing such characteristics.

It is assumed that full efforts are to be made to address the problem of the low birth rate by promoting the participation of elderly people and women who are highly motivated and competent, as well as by taking measures to increase the birth rates.

In 2020, the development of human resources and the recruitment of highly-skilled human resources from overseas must be pursued simultaneously to adequately secure international human resources in terms of both quality and quantity.

To that end, the utmost effort should promptly be devoted to developing global human resources, with English-language skills a given, via elementary, secondary, undergraduate, and graduate education, as well as through in-house education in companies.

As a major premise for human resources strategies, the business environment must be improved to attract domestic and foreign high-leveled financial human resources. In the course of developing the Tokyo market into a global financial center which surpasses other competitive markets, such as Singapore, Hong Kong and Shanghai, the whole business conditions, including operation cost, living environment, and regulations and tax system, should be improved to make Tokyo competitive. The information-hub function of Tokyo markets should be enhanced and, at the same time, steps should be taken to enable Japanese and foreign specialists in international finance, legal affairs and accounting, as well as other highly-skilled personnel, to readily come to Tokyo. The ability to address matters of financial administration in English also needs to be bolstered, as does the ability to handle matters of financial services and corporate management in foreign languages.

An emphasis on English in elementary and secondary education, and the internationalization of universities are essential approaches that need to be initiated right away. Accordingly, efforts must be made to drastically increase the numbers of Japanese students studying abroad and foreign students studying in Japan, and substantially expand the numbers of foreigners and business professionals among university instructors as well. It is also important to utilize private-sector experts, particularly senior, more experienced professionals with a wealth of business and overseas experience, in elementary and secondary education.

In addition to accelerating the enhancement of English-language and IT skills in public and private institutions related to financial services, financial-related laws, ordinances, and guidelines should all be translated into English. For example, there are still subordinate regulations of financial-related statutes such as the Financial Instruments and Exchange Act that have not been translated into English. Moreover, even when the laws and regulations themselves have been translated into English, there is often a shortage of English-language materials available for interpreting these laws and regulations, a problem that must be addressed promptly.

The following issues should be addressed over the medium term.

It is crucial to improve the foreign-language skills of human resources in financial businesses. In the future, in addition to developing human resources capable of providing international financial services, it will be essential to develop global managers capable of bringing out the potential of their highly-professional subordinates. To this end, financial institutions should actively dispatch personnel to foreign branches. At the same time, development of domestic human resources by utilizing highly-skilled foreign professionals through attracting foreign financial institutions and fund management offices, and active hiring of competent foreign personnel at Japanese financial institutions would also be effective measures. In this regard, hiring systems should be made more flexible to facilitate the recruitment of highly-professional human resources. Career systems also need to be revised to develop IT personnel for the financial sector.

With regard to the establishment of a business environment necessary for human resources strategies, Tokyo should foster an environment better than that in other international financial centers. For this purpose, a comprehensive policy, including the Special Zone system, should be considered to encourage foreign financial institutions to establish offices in Japan and to secure domestic and foreign highly-professional financial human resources in Tokyo. In addition, better access to airports is among the improvements that should be made, and the living environment should be upgraded by expanding international schools and increasing the number of hospitals capable of treating patients in English. At the same time, visa conditions should be eased to accept finance-related professionals, such as financial specialists, attorneys, and accountants, as well as physicians, nannies and other personnel serving the day-to-day needs of these professionals in Japan. The FSA should also provide a one-stop service in English for finance-related administrative procedures.

## 5. Conclusion

The panel held discussions with a view of the direction in which Japan should proceed, and bearing in mind the picture in 2020, compiled the necessary measures into this recommendation.

The picture in 2020 represents a huge leap forward from the status quo, and aggressive and bold efforts at an unprecedented level will be required to realize such picture. At the same time, developing professional financial human resources and securing human resources to support ventures and business management, as well as fostering a global business and living environment, are challenging measures. To achieve these goals, continuing efforts are required. The recommendation should be implemented steadily, follow-ups should be conducted to review the progress, and additional measures should be considered and aggressively implemented. As such, the panel will convene even after compiling this recommendation, and will continue to discuss the particular measures necessary to realize the picture in 2020.