The 4th International Conference
Regional Finance in the Recent Period and the Way Forward

(Summary of the Conference)

The Fourth Financial Research and Training Center International Conference, entitled ‘Regional Finance in the Recent Period and the Way Forward’, was held on Friday January 18, 2008. This conference was jointly organized by the Financial Research and Training Center and the Keio University Graduate School of Economics and Graduate School of Business and Commerce Alliance for the 21st Century COE Program. Employing the principles of relationship banking, each regional financial institution throughout Japan has implemented a variety of measures aimed at revitalizing small and medium sized enterprises (SMEs) and invigorating regional economies. Collectively, these efforts have steadily produced results, evident, for example, in the number and variety of measures being implemented and in the increase in funding being made available. But despite the progress made, many voices can still be heard stating that these efforts have been insufficient from the standpoint of business revitalization, of financing that is not excessively reliant on collateral and guarantees, and regional contributions. Based on this situation, the conference compared the current situation in Japan with that in Germany, which has seen financing efforts successfully stimulate regional economies, and in Asia, where financing is flourishing for regional businesses and SMEs. In addition, the future direction of regional financing in Japan was discussed. Approximately 200 people participated in the conference, including domestic and overseas researchers, embassy staff from a variety of countries stationed in Tokyo, and from financial institutions.

Opening Remarks

Mr. Takafumi Sato, Commissioner, Financial Services Agency

(Read by：Mr. Junichi Maruyama, Deputy Commissioner for International Affairs, Financial Services Agency）

Commissioner Sato’s opening remarks addressed the significance of the conference theme – regional finance in Japan in the recent period and the way forward. (Due to urgent business, Commissioner Sato was unable to attend and his opening remarks were read by his colleague, Deputy Commissioner Maruyama.)Below is a summary of his opening remarks.

To strengthen the relationship banking function, the Financial Services Agency began a four-year, two-stage action program from 2003, implementing a variety of measures for SME and regional financial institutions. The evaluation conducted on its completion found that as a whole and to a certain degree the action program was successful, but that problem areas clearly existed. Positive evaluations were exceeded by negative evaluations in some areas such as for business revitalization. On the basis of the action plan and its evaluation, the Financial System Council Second Subcommittee published its report in April 2007. It outlined the three main areas such as Strengthening Support for Partner Companies According to Life-cycles etc in which measures directed by SMEs and regional financial institutions needed to continue.

In August 2007, the Financial Services Agency incorporated these relationship banking measures into supervisory guidelines for SME and regional financial institutions, and will follow-up its efforts from within the framework of these guidelines in the future. From this standpoint, holding a conference with the theme ‘Regional Finance in the Recent Period and the Way Forward’, and providing an opportunity for participants to discuss experience and current status as well as future direction of SME and regional finance in all countries, including Japan, is extremely significant.

Session1: Experience and current status of regional finance in Japan

Chair：Mr. Nobuyoshi Chihara, Deputy Commissioner for International Affairs, FSA, Japan

The theme of Session 1 was the experience and current status of regional finance in Japan. Speakers were: Mr. Akira Watanabe, Director of Cooperative Financial Institutions Office, Supervisory Bureau, FSA, Japan; Mr. Osamu Tsukahara, Senior Executive Director of JASME(Japan Finance Corporation for Small and Medium Enterprise); and Mr. Atsushi Abe, President of North Japan Maritime Corporation.

Mr. Watanabe spoke comprehensively on regional financing measures implemented by the current financial administration. Below is a summary of his speech.

Approaches to relationship banking measures in Japan have moved ahead within the 2002 Financial Revitalization Program framework as methods for dealing with the non-performing loan problem held by SME and regional financial institutions. The FSA implemented a two-stage action program based on the 2003 report by the Financial System Council Second Subcommittee and the 2007 status report evaluating the progress of these relationship banking measures. These action program measures were highly evaluated as to exceed initial targets such as the number of measures implemented and total funding provided. However, the report highlighted a number of problem areas, such as the continued reliance on collateral and guarantees, and the shortage of staff with sufficient judgment capabilities.

Based on this situation, the FSA incorporated relationship banking measures into the supervisory guidelines, and continues to promote relationship banking from within this permanent framework. The FSA has reviewed past uniform and all-round measures, and has placed greater importance on independent measures by all financial institutions that utilize the characteristics of each region, and on measures demonstrating originality and innovation. The FSA considers responding appropriately to the specific financial needs of each region and gaining the trust of customers sufficiently will contribute to the profitability of financial institutions and increase the soundness of their management. Therefore, it has encouraged all financial institutions to actively and independently implement relationship banking measures.

Mr. Tsukuhara spoke on the role of JASME in relationship banking and on tie-ups between regional financial institutions. Below is a summary of his speech.

Tie-ups between JASME and regional financial institutions are being conducted into the following areas: support for start-ups and new businesses, support for early business revitalization, support for securitization, management consultations, support for improvement proposals, and collaboration in personnel training. Practically JASME exchange memorandums (MOU) with all regional financial institutions. Support is provided for financing proposals with societal significance or contribution to the development of regional economies. In these instances, support and subsequent assistance in forms other than financing is provided. As a result, cooperative financing with regional banks has steadily increased. In 2006, cooperative financing was realized for 99% of proposals for a total of more than ¥300 million in financing.

Also, support for securitization for SMEs so as to allow for the smoother raising of funds through the diversification of risk has steadily produced by completing purchase-type and guarantee-type frameworks. However, in comparison to mortgage-centered real estate securitization, the current scale of SME finance securitization is small. Therefore, the role of securitization as a method of SME financing during the future transition period from indirect to direct financing has been reconsidered, and measures are being implemented to address the problems faced by the SME securitization market, such as the asymmetry of information. As a result, by fiscal 2006, JASME's share of the asset-backed securities market pertaining to lending for SMEs had reached 26%.

Mr. Abe spoke about the experience and current status of regional financing in Japan from the point of view of the borrowing company. Below is a summary of his speech.

Regional economy vitalization is conducted not only within the context of regional (micro) economies, but is also dependent on macroeconomic trends. Consequently, the policy line for finance and financial administration (taxation and infrastructure improvement) must ensure harmonization between micro and macro considerations. Considering this, the government's 'Regional Revitalization Strategy' formulated across its ministries and departments is worthy of praise. By observing the positive developments in regional economies that have resulted from this strategy; regional entrepreneurs have stimulated the desire to start-up new businesses. First, a policy aimed at stimulating the entrepreneurial spirit should be implemented prior to implementing a corporate financing (cash-flow) policy.

I think the role of regional financial institutions should be to anticipate the company's future, participate in its growth stage, and contribute to its development, not providing financing once the management situation at the borrowing company has improved. Some people have said that small-scale regional financial institutions lack the financial strength to provide high risk financing. If this is the case, then it is my view that these institutions need to merge with other institutions. In addition, I have the impression that the excessive human resources of regional financial institutions are allocated to handling of the financial inspection. I would like to see more personnel allocated to the front line, such as the corporate management advisory services.

During the free discussion, problems inherent to business succession for SMEs in regional economies and the issue of mergers for SME and regional financial institutions were debated. Below is a summary of the discussion.

Business succession is becoming an increasingly serious problem in Japan due to the effects of the low birth rate. However, it seems the owners of Japanese companies are prepared to pass on their businesses not only to their children, but also to relatives or employees if they possess the necessary business skills. However, in case that the buyer (regardless of whether the buyer is from Japan or overseas) doesn't have any business skills, they won't sell their company even if a high price are offered.

Mergers of SME and regional financial institutions can be expected to produce benefits such as expansions of scale and rationalization. But it is a complicated issue, and fears were expressed that it would reduce competition in regional financing and that post-merger financial institutions could lose their regional identity.

Session 2: Experience and current status of regional finance in Germany

Chair: Professor Naoyuki Yoshino, Professor, Keio University, and Director of the Financial Research and Training Center, FSA

The theme of the second session was the experience and current status of regional finance in Germany. Dr. Thomas Keidel – Director of the Financial Market Relations Department at the German Savings Bank Finance Group– was the speaker on this topic. Below is a summary of his speech.

The German Savings Bank Group is a financial group with 640 financial institution members. The group has total assets of 3.4 trillion euros, more than double the scale of European and US financial groups such as UBS and the Citi Group. It has the most extensive network of branches in Germany, and in a majority of regions maintains a population to branch ratio of less than 4000 people per branch. In addition to our relationship with the regions, awareness of the importance of relationship with SMEs began to spread through the German banking system at the start of 2000 when the shock occurred. As a result, in 2006 the Group Savings Bank held a 44% share of the German lending market for SMEs.

The Savings Bank provides customized corporate financial services for SMEs, such as IPO, enabling its customers to access venture capital and the capital markets, or M&A-related services such as MBO and provides funding for half of Germany's start-up companies. Further, as a management policy, the Savings Bank provides business advice to its customers, aiming to strengthen customer loyalty through actively providing advice and support. It has earned the trust of its customers through establishing strong regional bases and also for the quality of both its products and support services.

Mr. Nobuo Yamamura, Associate Professor of Takushoku University and Special Research Fellow of the Financial Research and Training Center, had comments and questions regarding this speech. Below is a summary of his remarks.

It is often said that German SMEs are highly independent and are able to sell their in-house products to a wide range of customers. The establishment of the EU has meant that, in terms of economic activity, country borders have ceased to exist within the European region. German SMEs are leveraging their strengths and conducting operating activities that target global development. To support these kinds of SMEs, German regional financial institutions do not simply offer financing, but also provide a wide range of financial services.

According to Dr. Keidel, the broad range of financial services provided by the Savings Bank includes investment banking. What is the reason behind this? Is it because there is high demand for this service from SMEs, do financial institutions have a sense of social responsibility to provide services to SMEs and to support regional economies, or is it because this is a profitable area of business?

Dr. Keidel's answer to Mr. Yamamura's question is below.

There is demand for both investment banking services for SMEs and management advisory services. But it is possible to say that major financial institutions are not motivated to enter this area because of the small transaction sums involved. However, via these transactions, each bank within the Savings Bank Group is able to acquire detailed information on their regional economy, such as information on whether it is feasible to open a new branch in a certain region (based on the presence of competitors etc.). This in turn enables banks to provide services that meet their customer's needs.

Session 3: Experience and current status of regional finance in Asia

Chair：Mr. Osamu Tsukahara, Senior Executive Director of JASME

Session 3 speakers were: Mr. Pongsak Chewcharat, President of the SME Development Bank of Thailand; and Mr. Byung-Sun Cho, Head of the Industrial Bank of Korea Economic Research Institute.

Mr. Pongsak talked about the experience and current status of regional finance in Thailand. A summary of his speech is below.

Irrespective of the fact that 99% of all companies in Thailand are of a medium to small scale, commercial banks have not necessarily provided funding to SMEs proactively. Also, as the majority of the owners of SMEs are from the medium-to-low income bracket, they have been unable to provide collateral to secure financing from official banking channels. As a result, they have been forced to raise funds from the black market which can sometimes develop into situations where their business becomes unsustainable. The Small and Medium Enterprise Development Bank of Thailand was established in 2002 as a government financing institution tasked with eradicating this problem.

The SME Development Bank of Thailand started its 'One Village, One Product Financing Program' in 2003 to promote business start-ups in farming villages and to increase their product sales both domestically and internationally. It has provided funding to 22,000 villages and 1.3 million people. In addition, under the auspices of its 'Capitalization of Assets' program, it conducts assessments aimed at ascertaining whether the borrower has assets that can be utilized as collateral for financing. Moreover, the SME Development Bank of Thailand does not merely provide funding to SMEs, but also plays the role of business advisor and aims to contribute to the creation of a society rooted in a spirit of entrepreneurship.

Mr. Cho talked about the experience and current status of SMEs and regional finance in Korea. Below is a summary of his speech.

As financing for SMEs is characterized by high risk, low return, and asymmetrical information, it is incontrovertible that SME borrows are at a disadvantage in terms of interest rates and repayment periods. The Korean government has implemented financial policies to support SMEs as it recognizes their necessity and importance. For example, the central bank has set recommended SME borrowing ratios for all banks to expand the provision of funding available to SMEs, and has also established the SME Promotion Fund. Concurrently, it is attempting to enhance the credit guarantee and export guarantee systems to strengthen SMEs’ credit availability expantion function.

Further, the government has established various financial institutions, such as Industrial Bank of Korea founded in 1961, to provide financial support for Korean SME and regional finance. During the 1997 financial crisis and the 2004-2005 economic recession, private banks reduced theie financing to SMEs in order to maintain their BIS ratios. The Industrial Bank of Korea responded to this credit crunch by actively supporting financing for SMEs. As a result, it was responsible for 74% and 55.5% respectively of the net increase in lending to SMEs in 2004 and 2005, and has become the bank most trusted by SMEs. In the future, it plans to bolster its management consulting function in order to strengthen its relationship banking role.

Mr. Tsuguo Fujino, Professor, Yokohama City University and Adviser of Shinkin Central Bank Research Institute, had comments on these speech, which are summarized below.

We can consider relationship banking for SMEs and regions to be an effective business model for regional financial institutions. However, if we consider relationship banking from a long term perspective, it may sometimes lead to a decline in profitability and postpone efforts at dealing with non-performing loan problems. Carrying out greater relationship banking measures, financial institutions are being confronted with a problem of which should take priority, their risk management and profitability, or their own financial soundness. For regional economies, this means a choice between prioritizing the smooth supply of funds to regions and SMEs or financial institutions’ financial soundness.

We have heard about the positive results achieved in Thailand and Korea thanks to their active implementation of financing measures for regions and SMEs. In Japan, to a certain extent we can also point to some positive results, as the two stages action programs achieved some of its numerical targets. However, the extent to which financial institutions, SMEs, and regional economies have benefited from the plan has yet to be determined. I believe that verifying this is the next issue we need to address.

Mr. Hiroshi Hayakawa, Deputy President (Representative Director), The Bank of Yokohama, Ltd also commented on Mr. Pongsak’s and Mr. Cho’s speeches based on the situation of regional banking in Japan.

A key issue for regional banks that provide finance for SMEs and regions is how to train bank employees so as to be capable of making good judgments. Banks are required to meet customer needs management support more than merely providing financing. They must address the diverse issues faced by all managers and provide optimal solutions to individual problems. To do this, their employees must have sound judgment abilities. Also, banks are forming tie-ups with other financial institutions as, from the perspective of the allocation of management resources, it would be inefficient for each individual bank to address the specific needs of all of its customers. Within this tie-up framework, banks' ability to address the latent needs of their customers is inevitably dependent on the judgment abilities of their employees. Also, the nature of retail banking means that such operations are expensive to conduct.

To reduce these costs, regional banks are aiming to establish joint ventures via the nationwide banking organization, the Regional Banks Association of Japan. An example of joint ventures is the development of a system to quantify credit risk. Currently, information relating to 650,000 customers, (SME borrowers), has been stored in a shared database. For regional financial institutions coherent to region, it may be said that the local intensive risk of the financing is the risk that is hard to avoid. In the future, they will be able to utilize the data stored on the credit risk quantifying system to alleviate risk through greater use of securitization while at the same time fulfilling their role of providing financing to regions.

In the free debate, the topics discussed were the business model for financing for SMEs and regions, and credit guarantees and borrower moral hazards. Below is a summary of the discussion.

In Thailand, loans from private banks are companies that posess sufficient collateral. Therefore the SME Development Bank of Thailand provides funding to those SMEs and start-up companies unable to secure the necessary collateral to obtain loans from private sector. Also, based on the belief that the development of SMEs connects to the development of the country as a whole, it has not stopped simply at providing financing, but has also aimed to provide guidance to companies so they can develop their businesses. It offers advice based on its management expertise in fields such as marketing and accounting.

The initial credit guarantee ratio in Korea was 100%, and there were a number of examples of borrower moral hazards. At present, the credit guarantee ratio has fallen to 80% and it is hoped this will serve as a controlling effect for moral hazard.

Session 4 (Panel Discussion): Challenges going forward

Moderator: Mr. Junichi Maruyama, Deputy Commissioner for International Affairs, FSA, Japan

Session 4 was a panel discussion on the theme of challenges going forward. Mr. Yasushi Hasegawa, (Director of Banks Division Ⅱ, Supervisory Bureau, FSA, Japan), spoke prior to the discussion.

He addressed the current situation of relationship banking in Japan and problems faced. Below is a summary of his speech.

For the 2002 Program for Financial Revival, it was determined that off-balance sheet methods were not appropriate for SME and regional financial institutions with regional borrowers to deal with the non-performing loan problems that they faced. This led to relationship banking being examined as an alternative. The implementation of the two stages action programs produced some positive results, for example, we exceed numerical targets for the number of measures implemented and funding provided. However, results in some areas were determined to be inadequate, such as business revitalizations, financing that relied excessively on asset collateral or individual guarantees, or the area of regional contributions.

Considering the situation of intensifying competition in the SME and regional financing markets, merely providing financing is not enough to bolster the profitability of SMEs and regional financial institutions. It is vital that they provide high value-added services that fully address the needs of their customers. Future relationship banking efforts will aim to three key areas, namely strengthening support for borrower companies in accordance with life-cycles, focus on thoroughly implementing those funding methods that are most appropriate for SMEs, and contributing to the achievement of sustainable regional economies. In August 2007, the FSA incorporated these relationship banking efforts to supervisory guidelines. In the future, it will continue to promote the independent initiatives of financial institutions from within this permanent framework, and as a regulatory organization will regularly seek to meet and exchange opinions with institutions regarding their initiatives. We want to take appropriate steps to keep track of these initiatives as part of our routine supervisory activities.

Mr. Takashi Yoshikai, (Director & Managing Executive Officer, The Bank of Fukuoka, Ltd) commented on Mr. Hasegawa’s speech based on the experience of regional banking in Japan. Below is a summary of his comments.

Considering the Bank of Fukuoka’s relationship banking measures until the present day, we can divide them into two main areas – the territory of traditional commercial banking and new territories. The traditional commercial banking territory has been constructed of the following areas. The first constitutes relationship banking measures that strengthen and accumulate a company's competitive capabilities (namely, information capabilities) to dispatch personnel to start-up companies, and so on. The second constitutes the provision of these relationship banking measures so as to add value to management by individually offering solutions in response to the management issues facing customers. The third constitutes the development of retail banking through the provision of new types of financial commodities, such as asset-backed financing. However, at the stage where asset-backed financing and other innovations became technologically feasible, we can see that some time must pass before they begin to become profitable.

An example of the new territory is the creation of various types of funds. In 2003, the Bank of Fukuoka created a regional business revitalization fund to deal with the non-performing loan problem and to support business revitalization. Meanwhile, shifting the non-performing loans off-balance sheet, we aimed to maintain relationship banking with our customers by establishing a subsidiary company with a debt collection service (servicer) and the temporary transfer of specialist staff. Further, in 2006 we created a regional contribution fund to support the development of venture companies and business succession. However, due to the fact that as a commercial bank we mainly provide financing from customers' deposits, the fund-managed framework did not reach the level where it could fully function. This is a problem we must address.

Professor Yoshino reviewed the comments made prior to the discussion. Below is a summary of his remarks.

Until the present, regional disparities have existed in terms of income and productivity. However, these disparities have been addressed through an income transfer from the central government and investment in public works projects. However, as the central government's financial situation becomes increasingly serious, we cannot expect it to sustain this over-reliance on this kind of framework. As a result, it is urgent issue that how to unearth investment demands in regional economies, and how to provide financing for these demands.

Stimulating regional economies and SMEs necessitates risk taking, so it is not necessarily preferable that all of these funding demands are met solely by a single financing method, namely bank lending. Accordingly, it is necessary to place a variety of financial institutions under the umbrella of a financial holding company, ensure multiple supply financing scheme, as to lending, investment trusts, and investment funds in proportion to project risk. It is essential that the profitability of an investment project in the market be evaluated, regardless of whether it is intended for private or public sector investment.

Participants then discussed the application of investment funds by regional financial institutions. Below is a summary of the discussion.

It is true that there are limits to the extent bank deposits can be used to finance high risk projects, and it is not the case that using funds as an alternative financing method enables high risk investment in any kind of field. High risk, non-performing loan funds have succeeded in attracting capital from institutional investors, who are hoping to achieve an expected rate of return of between 15 and 20%. However, the reality is that other funds, such as venture funds, have failed to attract capital even from institutional investors.

The supply of risk-money in Japan is low, as household (individual) financial assets have tended to flow into bank deposits. This reason would reflect the wide scope of application for deposit insurance. As insurance premiums are necessary even for deposit insurance, costs must be borne in order to enable bank deposits to be risk-free. However, safety-orientated individuals have resulted in a situation where financial assets do not flow into the risk-money supply. It is necessary to continuously maintain a policy that encourages assets to flow from savings to investment.

Closing Remarks

Professor Naoyuki Yoshino, Professor, Keio University
and Director of the Financial Research and Training Center, FSA

The conference was closed by Professor Yoshino, who expressed his thanks to all of the participants of the event.