

Current Situation, Challenges and Future of Regional Finance in Japan



Hisashi Ono

Deputy Director-General, Supervisory Bureau, JFSA

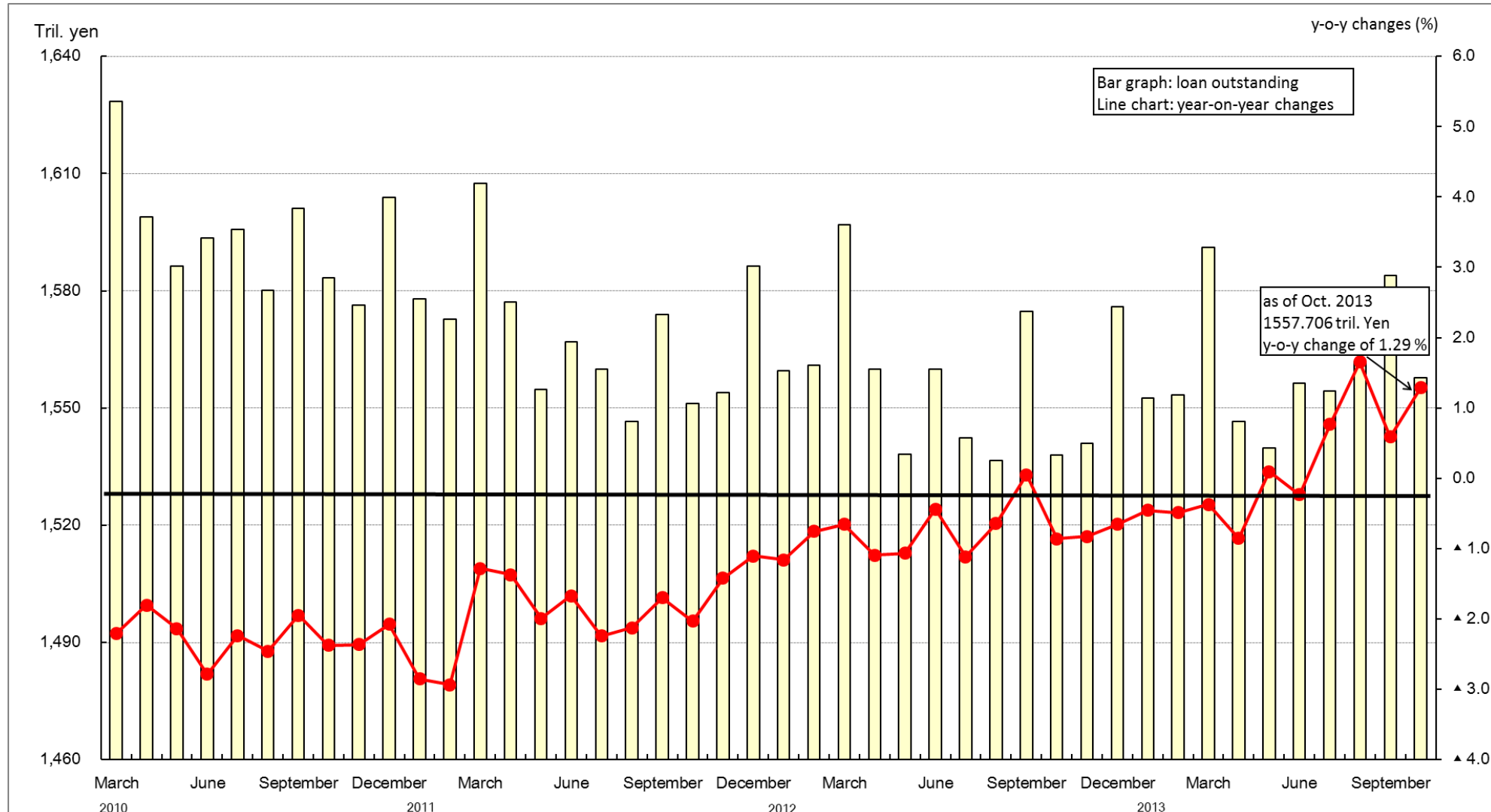
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I. Current Situation of Regional Finance

Banks' Loans to SMEs

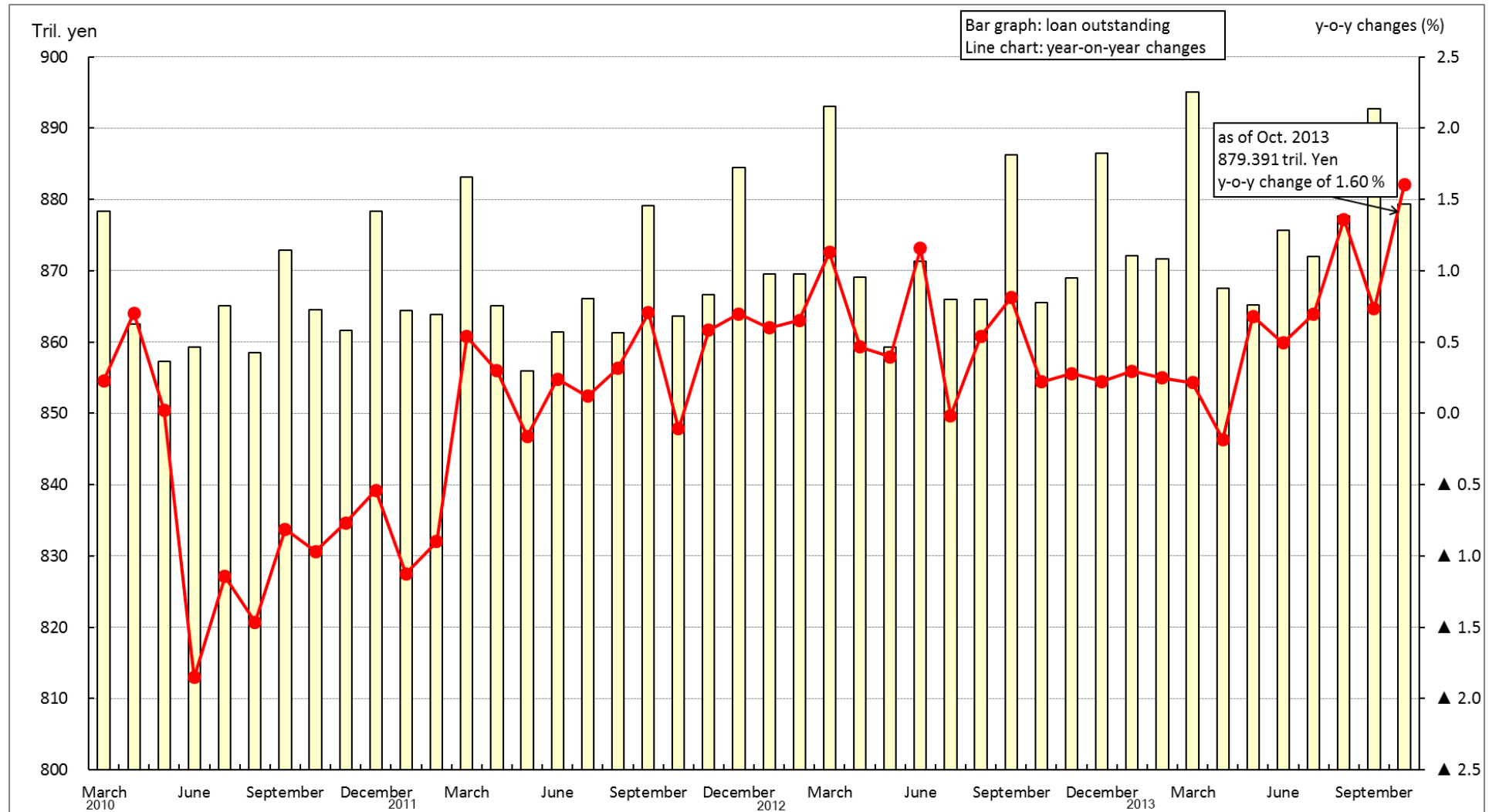
Outstanding amount of banks' loans to SMEs had been decreasing year on year for some time, but it increased in July 2013, with year-on-year change of 1.29 % in October 2013.



Source: Amount outstanding of loans is calculated from the total of loans to SMEs by “city banks,” “regional banks” and “regional banks II” in Bank of Japan’s statistics “Deposits, Vault Cash, and Loans and Bills Discounted.”

Regional Banks' Loans to SMEs

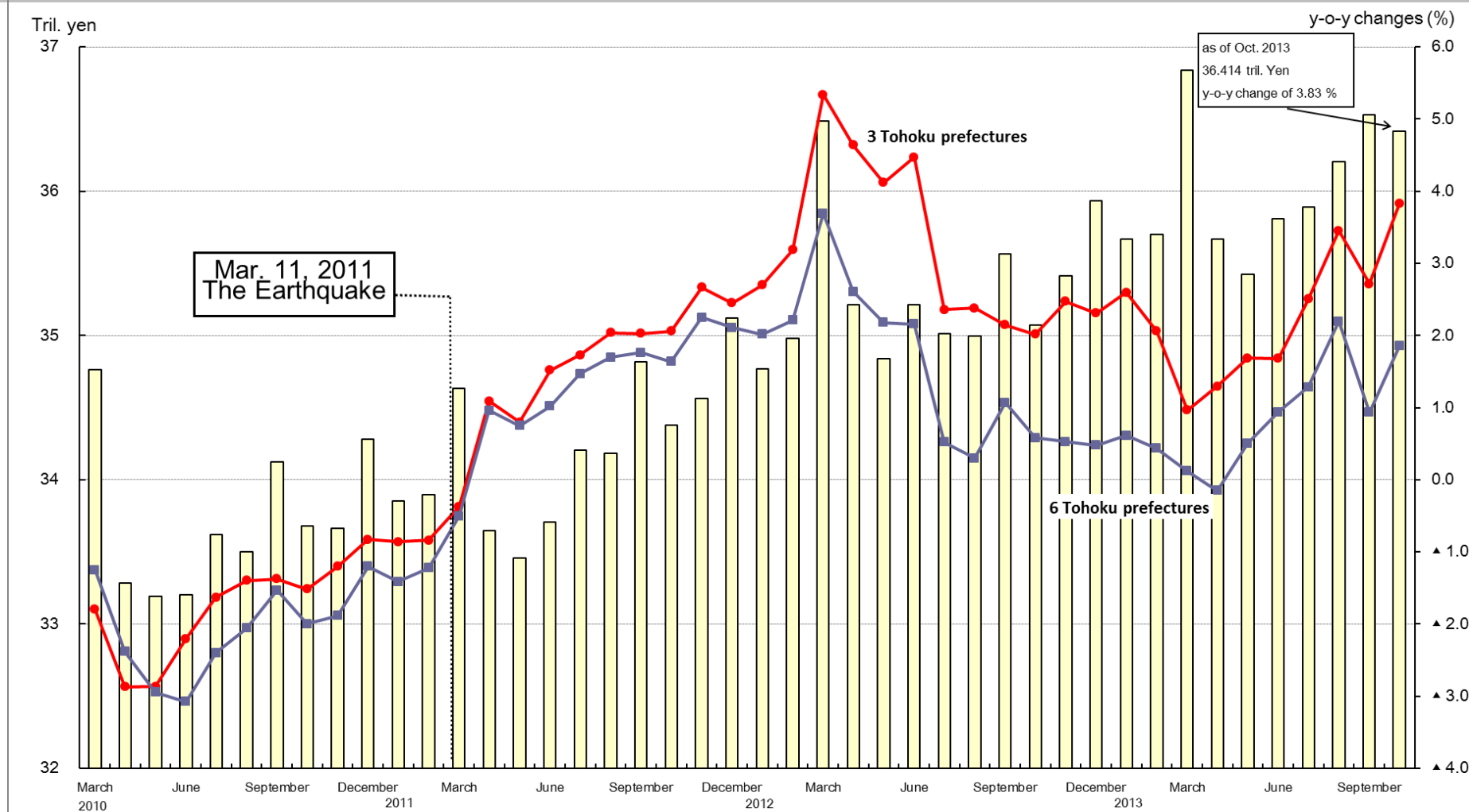
Outstanding amount of regional banks' loans to SMEs have been increasing year on year.
In October 2013, the loans increased by 1.60 % year on year.



Source: Amount outstanding of loans is calculated from the total of loans to SMEs by “regional banks” and “regional banks II” in Bank of Japan’s statistics “Deposits, Vault Cash, and Loans and Bills Discounted.”

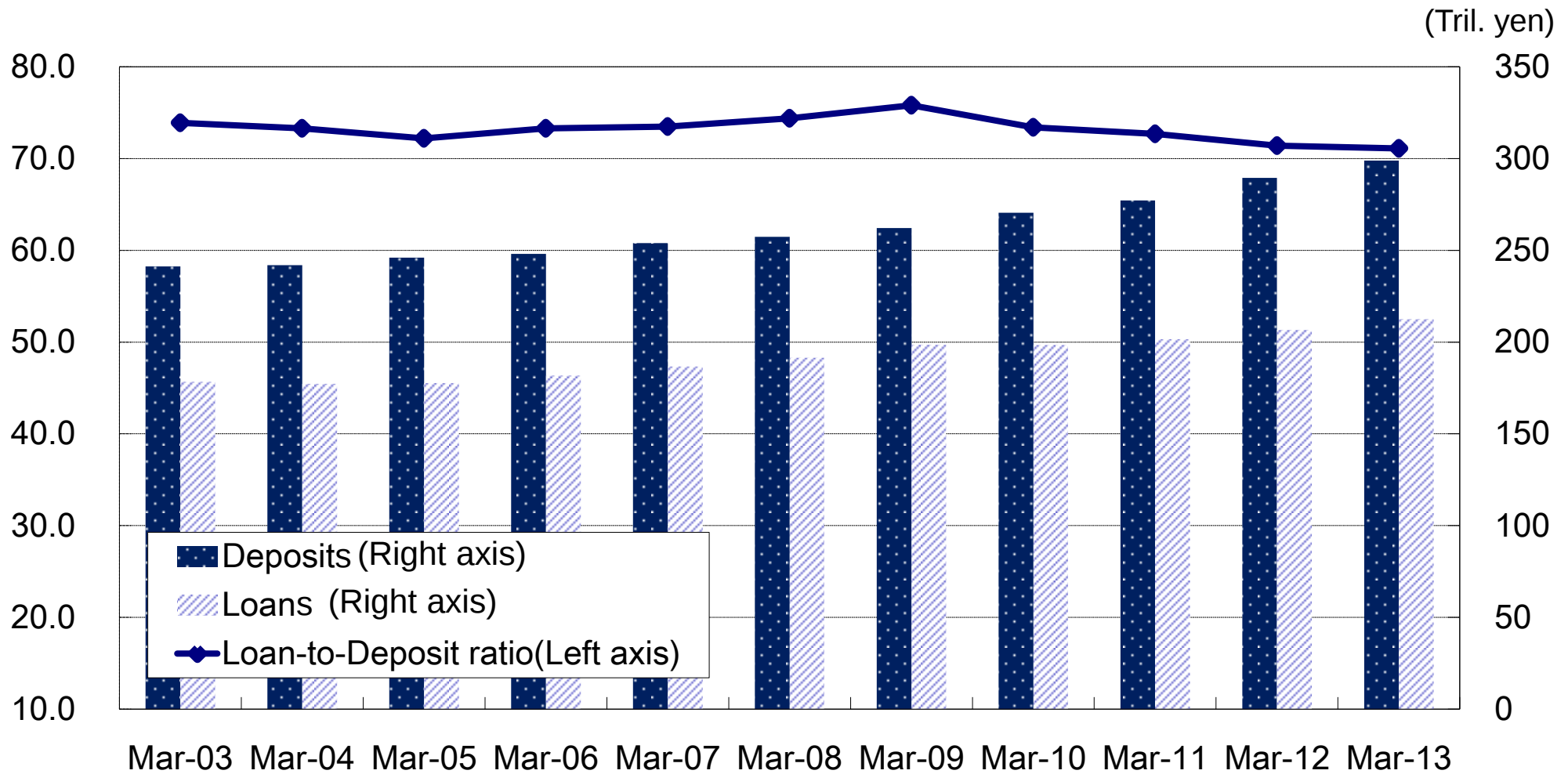
Regional Banks' Loans to SMEs in the Area Struck by the Great Earthquake

Outstanding amount of regional banks' loans to SMEs in the three prefectures hit by the Great East Japan Earthquake (Iwate, Miyagi and Fukushima) are increasing after the earthquake. In October 2013, the loans increased by 3.83% year on year.



Note: (1) Charts are prepared based on figures from the Bank of Japan's statistics "Deposits, Vault Cash, and Loans and Bills Discounted." (2) Figures for "3 Tohoku prefectures" are total of loans of regional banks whose headquarters are located in Iwate, Miyagi and Fukushima prefectures. Figures for "6 Tohoku prefectures" are the total of loans of regional banks whose headquarters are located in Aomori, Akita and Yamagata, in addition to the 3 Tohoku prefectures. (3) "Nationwide total" is the total of loans to SMEs by "regional banks" and "regional banks II" in Bank of Japan's statistics "Deposits, Vault Cash, and Loans and Bills Discounted."

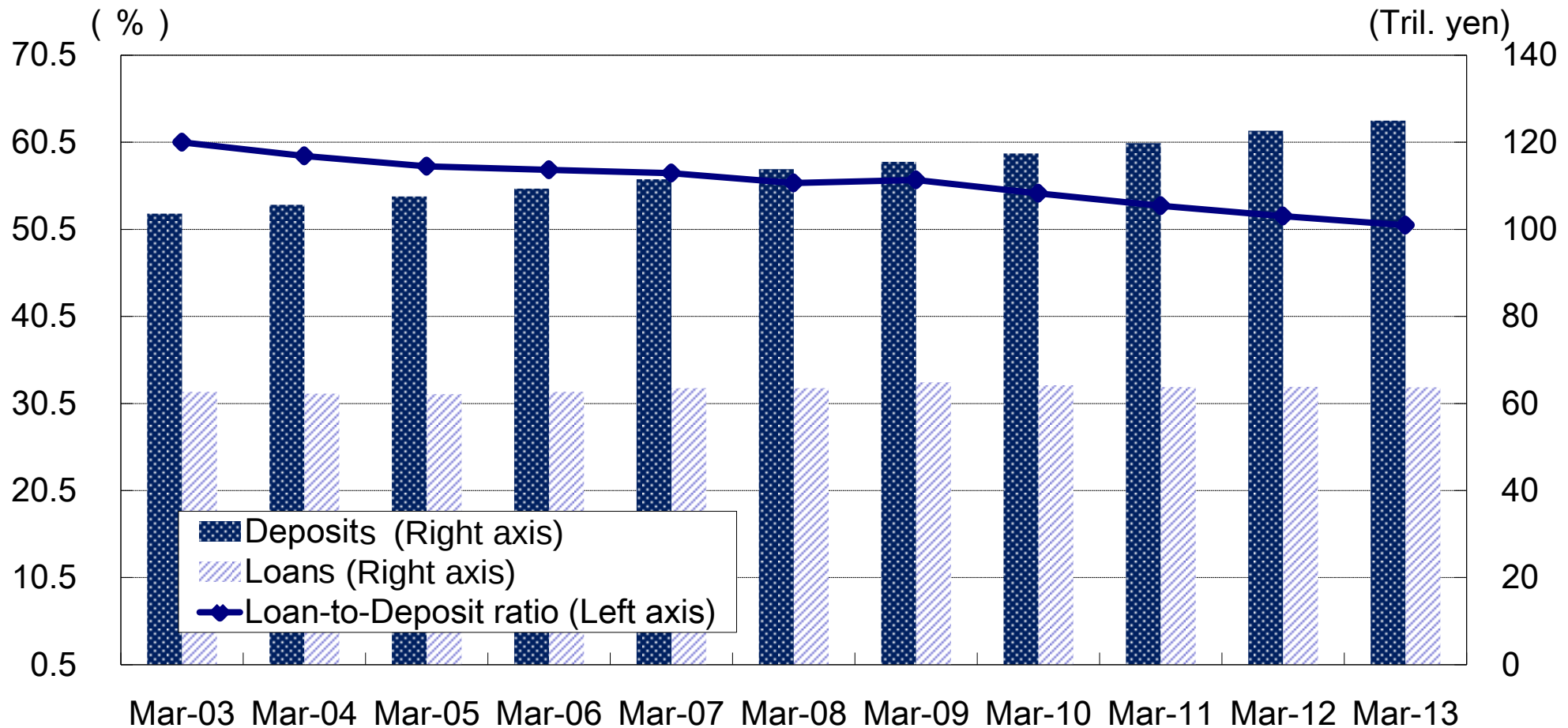
Deposits, Loans and Loan-Deposit Ratios of Regional Banks



Deposits (Right axis)	241.2	241.8	246.0	248.0	254.0	257.3	262.1	270.4	277.2	289.5	298.9
Loans (Right axis)	178.3	177.2	177.7	181.7	186.6	191.4	198.6	198.4	201.5	206.6	212.5
Loan-to-Deposit ratio (Left axis)	73.9	73.3	72.2	73.3	73.5	74.4	75.8	73.4	72.7	71.4	71.1

Source: Figures are calculated based on the statistics of the Japanese Bankers Association

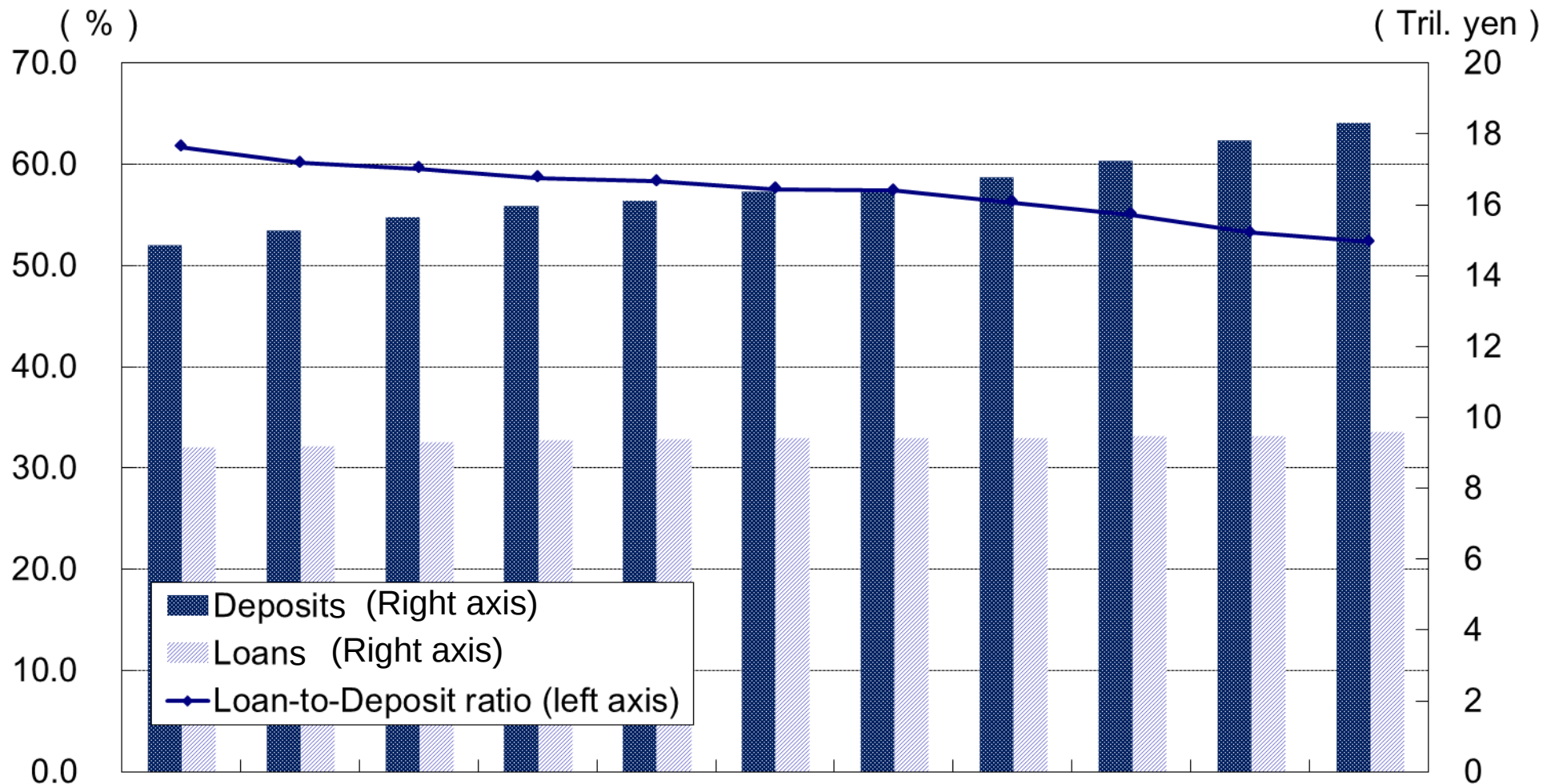
Deposits, Loans and Loan-Deposit Ratios of Credit Associations



Deposits (Right axis)	103.5	105.5	107.5	109.3	111.4	113.8	115.5	117.4	119.7	122.6	124.8
Loans (Right axis)	62.6	62.2	62.0	62.6	63.4	63.5	64.8	64.1	63.7	63.7	63.6
Loan-to-Deposit ratio (Left axis)	60.5	58.9	57.7	57.3	57.0	55.8	56.2	54.6	53.2	52.0	51.0

Source: Figures are calculated based on the statistics of the Shinkin Central Bank.

Deposits, Loans and Loan-Deposit Ratios of Credit Unions



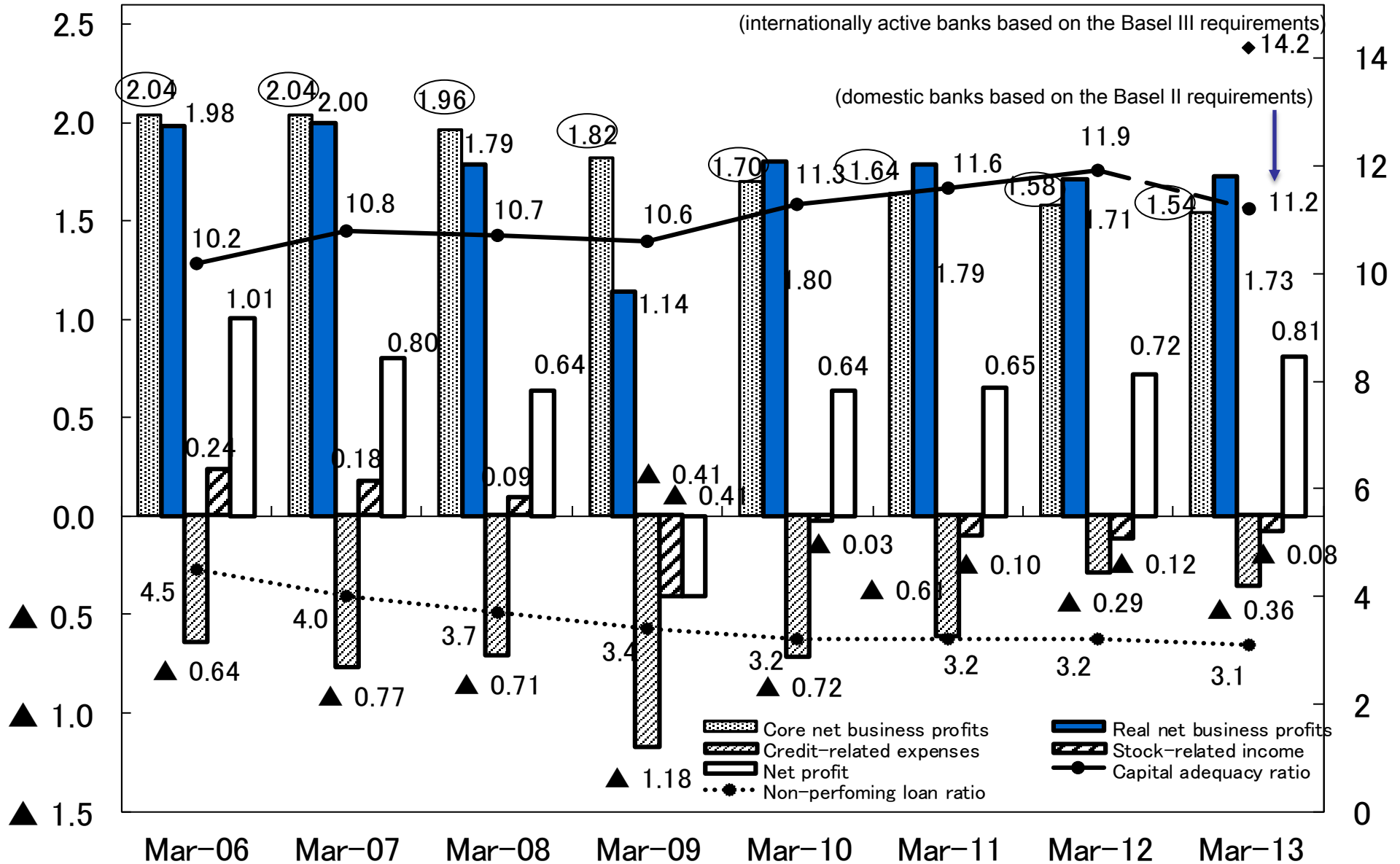
	Mar-03	Mar-04	Mar-05	Mar-06	Mar-07	Mar-08	Mar-09	Mar-10	Mar-11	Mar-12	Mar-13
Deposits (Right axis)	14.8	15.2	15.6	15.9	16.0	16.3	16.3	16.7	17.2	17.7	18.2
Loans (Right axis)	9.1	9.1	9.1	9.3	9.3	9.3	9.4	9.4	9.4	9.4	9.5
Loan-to-Deposit ratio (Left axis)	61.7	59.8	58.8	58.3	58.2	57.4	57.4	56.1	54.7	53.3	52.4

Source: Figures are calculated based on the statistics of the Shinkumi Federation Bank.

Regional Banks' Financial Statements

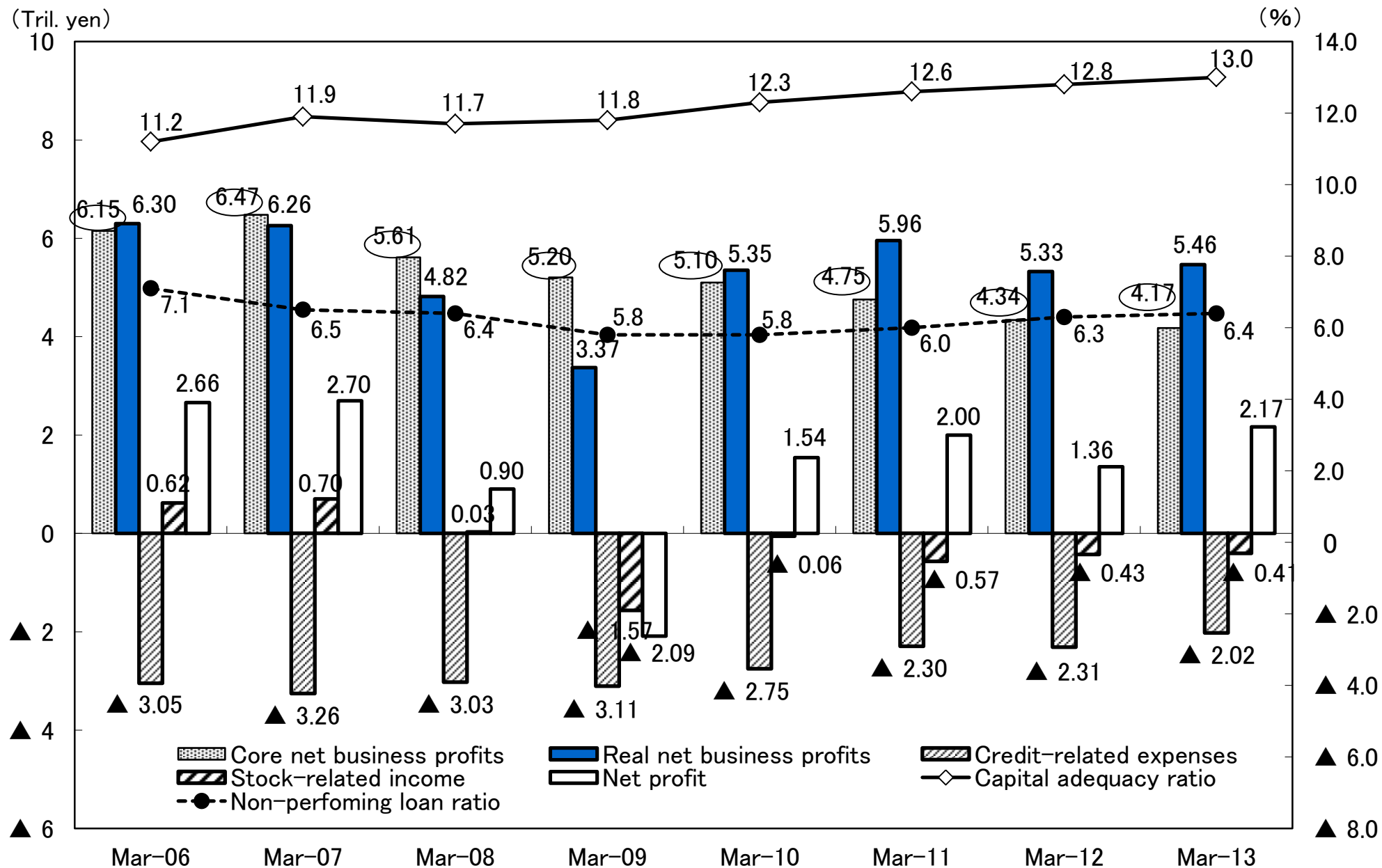
(Tril. yen)

(%)



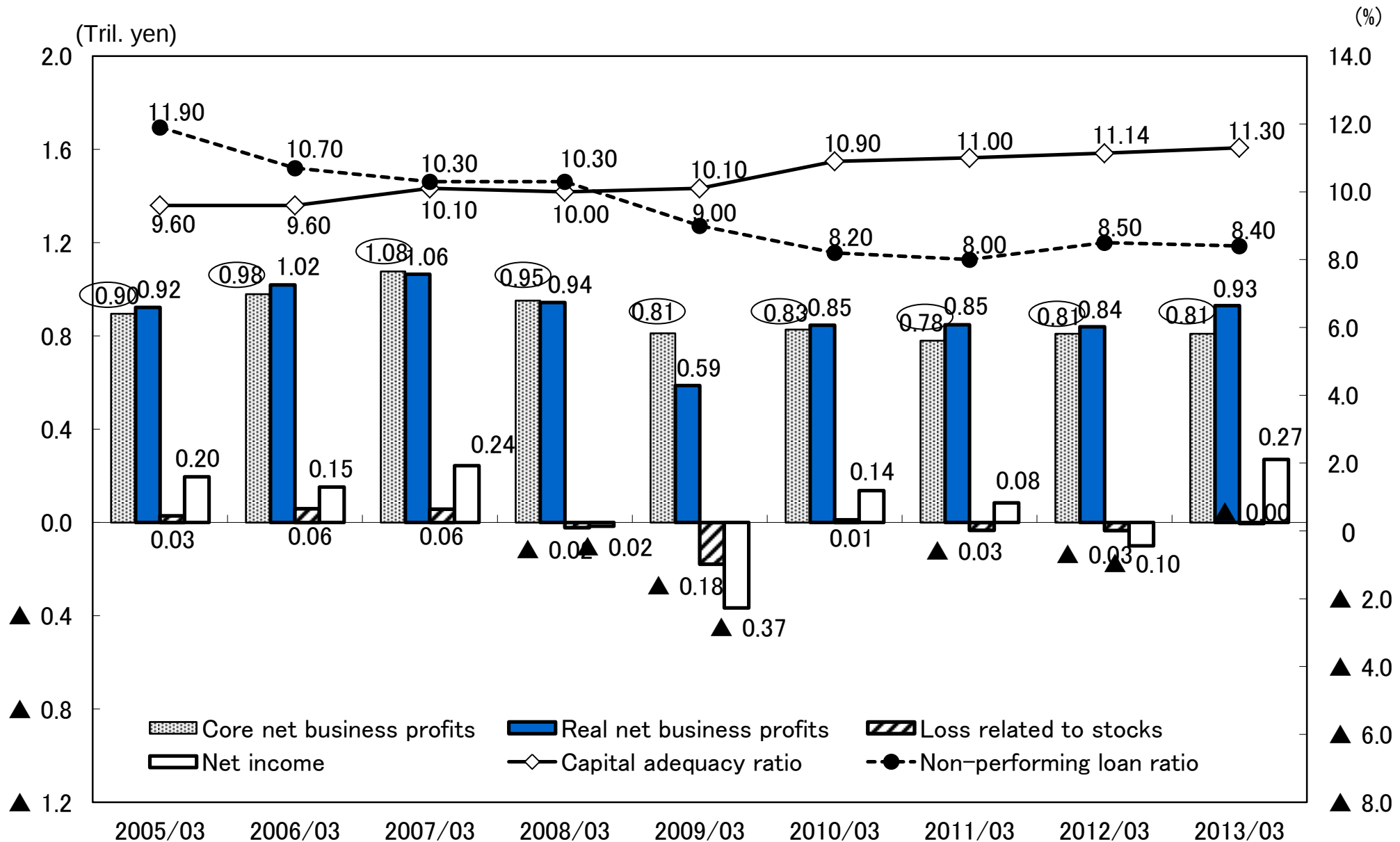
Note: (1) Capital adequacy ratios from March 2006 to March 2009 do not include Ashikaga Bank, which was under special public management during that period. (2) Operating profits from core business is equal to operating profits excluding realized gains/losses on JGB holdings.

Credit Associations' Financial Statements



Note: Total of net profits do not include the total net loss of 10.1 billion yen for those credit associations that used measures under Act on Special Measures for Strengthening Financial Functions.

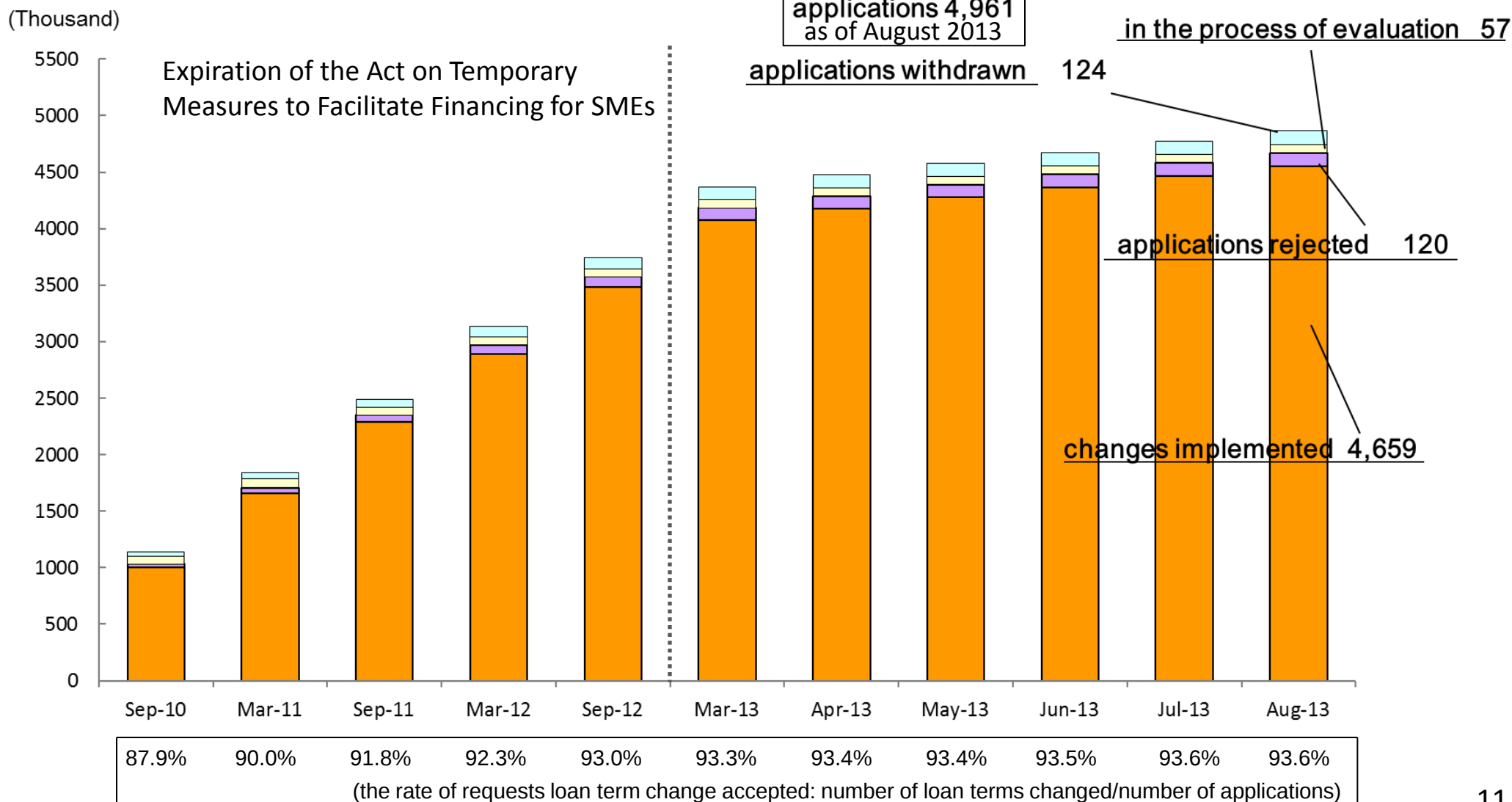
Credit Unions' Financial Statements



Note: Total of net profits do not include the total net loss of 21 billion yen for those credit unions that used measures under Act on Special Measures for Strengthening Financial Functions.

Financial Institutions' Response to SMEs' Requests for Loan Term Change

Even after the expiration of the Act on Temporary Measures to Facilitate Financing for Small and Medium-Sized Enterprises, more than 90 % of applications for changes in loan terms are accepted by financial institutions.

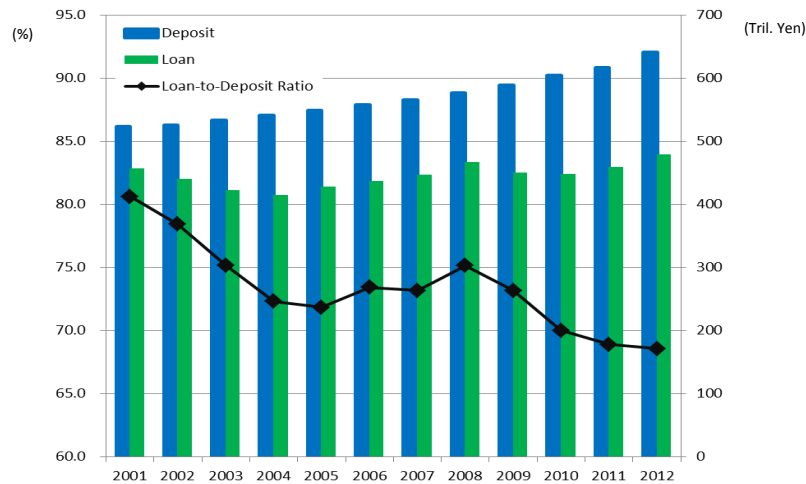


II. Challenges of Regional Finance

Financial Institutions' Situation and Challenges

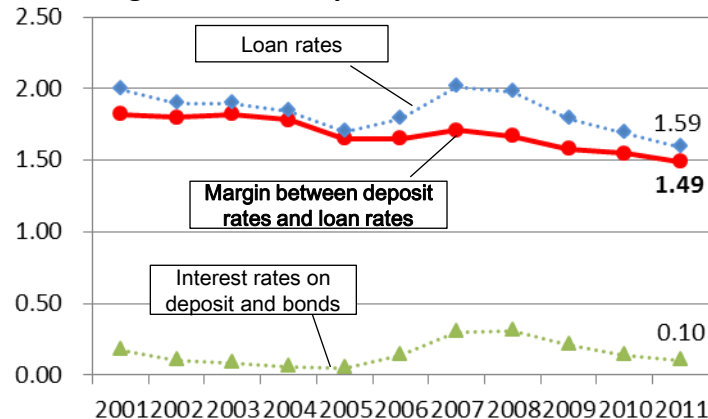
Financial institutions' loan-deposit ratios and profitability

- Deposits have been increasing but lending has been flat. As deposits are not used for lending, loan-deposit ratio has declined.
- Interest margin is diminishing due mainly to a decline in loan rates. Profits from lending have also decreased.



Source: the Japanese Bankers Association

Margin between deposit rates and loan rates

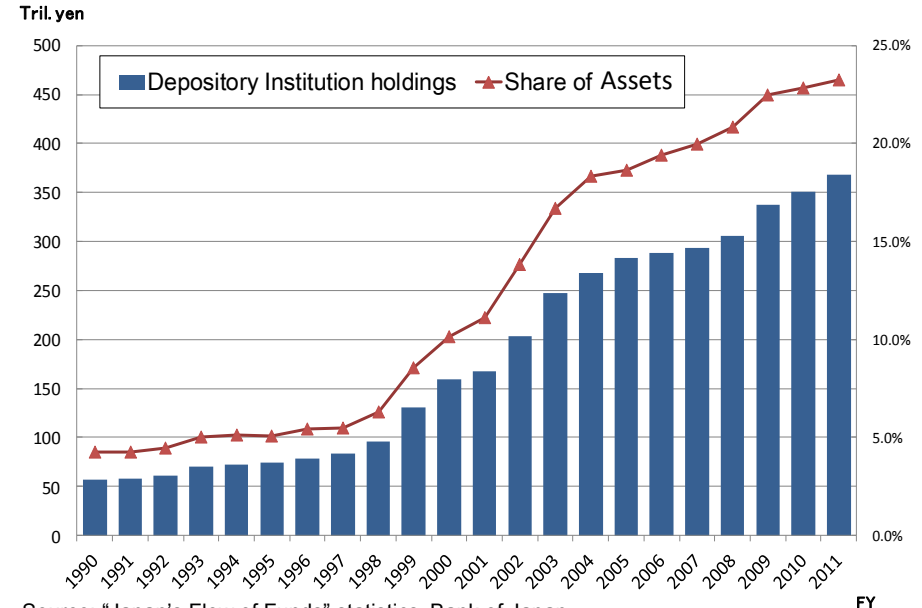


*Margin between deposit rates and loan rates = loan rates – interest rates on deposits and bonds

Source: the Japanese Bankers Association

Banks' JGB holdings

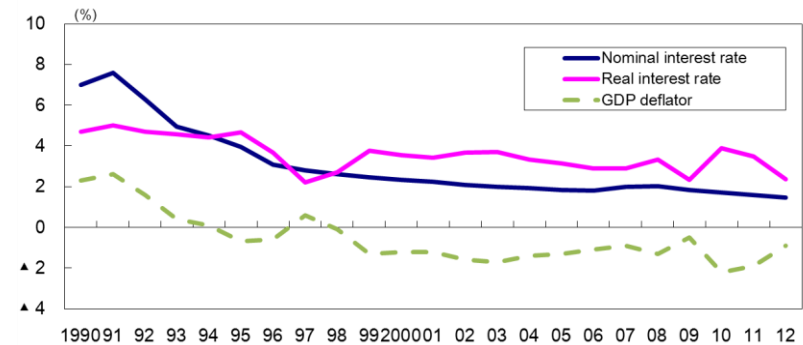
Banks' JGB holdings have been increasing.



Source: "Japan's Flow of Funds" statistics, Bank of Japan.

Nominal interest rates and real interest rates in deflation

In the last 20 years, although nominal interest rates (contracted loan rates) have been declining, the level of real interest rates have not declined due to deflation.



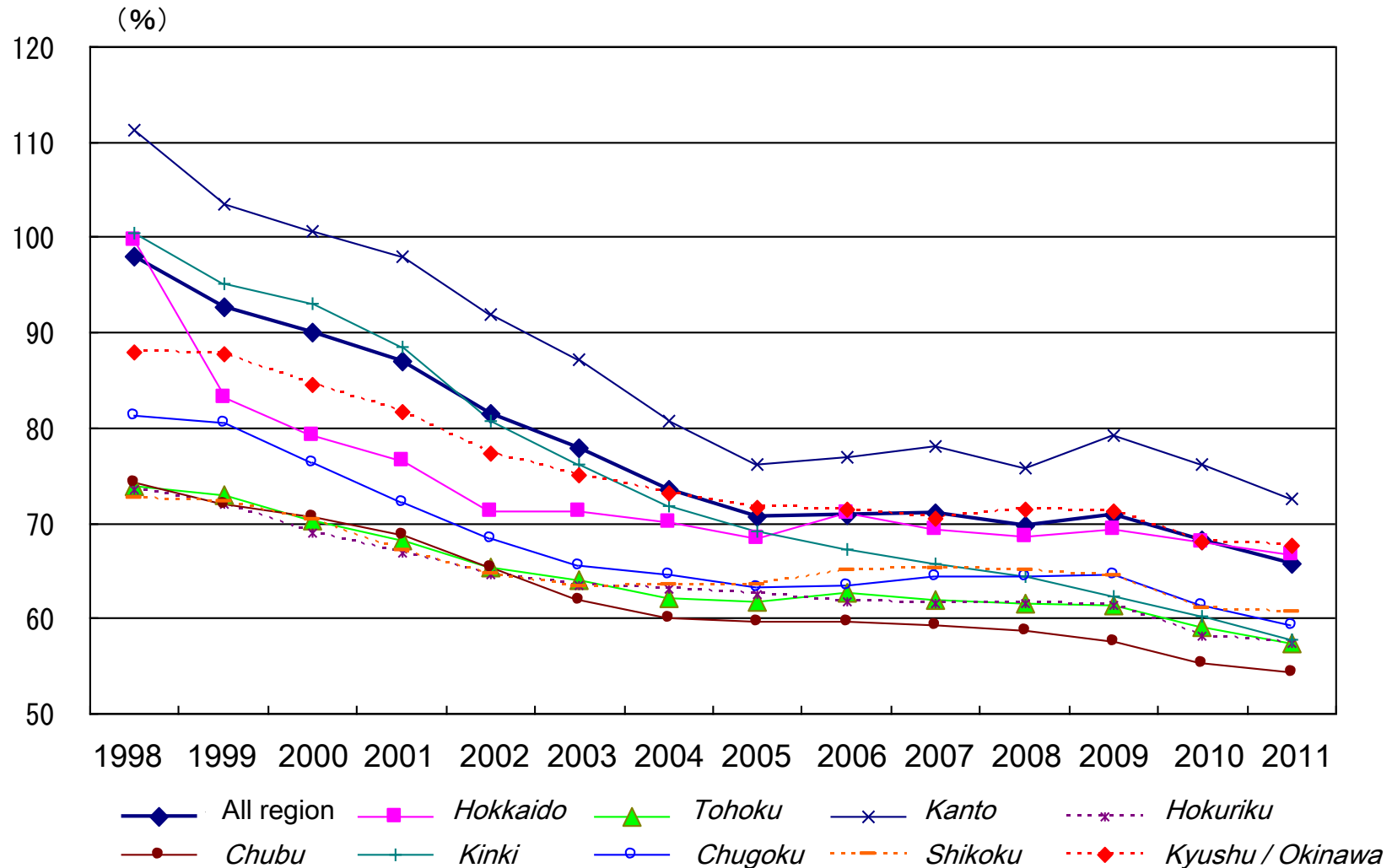
Real interest rates = contracted loan rates – rate of inflation (GDP deflator)

Loan interest rates are rates for long-term loans, calculated for all banks.

Source: Bank of Japan, Cabinet Office.

Declining Trend of Banks' Loan-to-Deposit Ratio

Loan-to-deposit ratios of domestic banks by areas

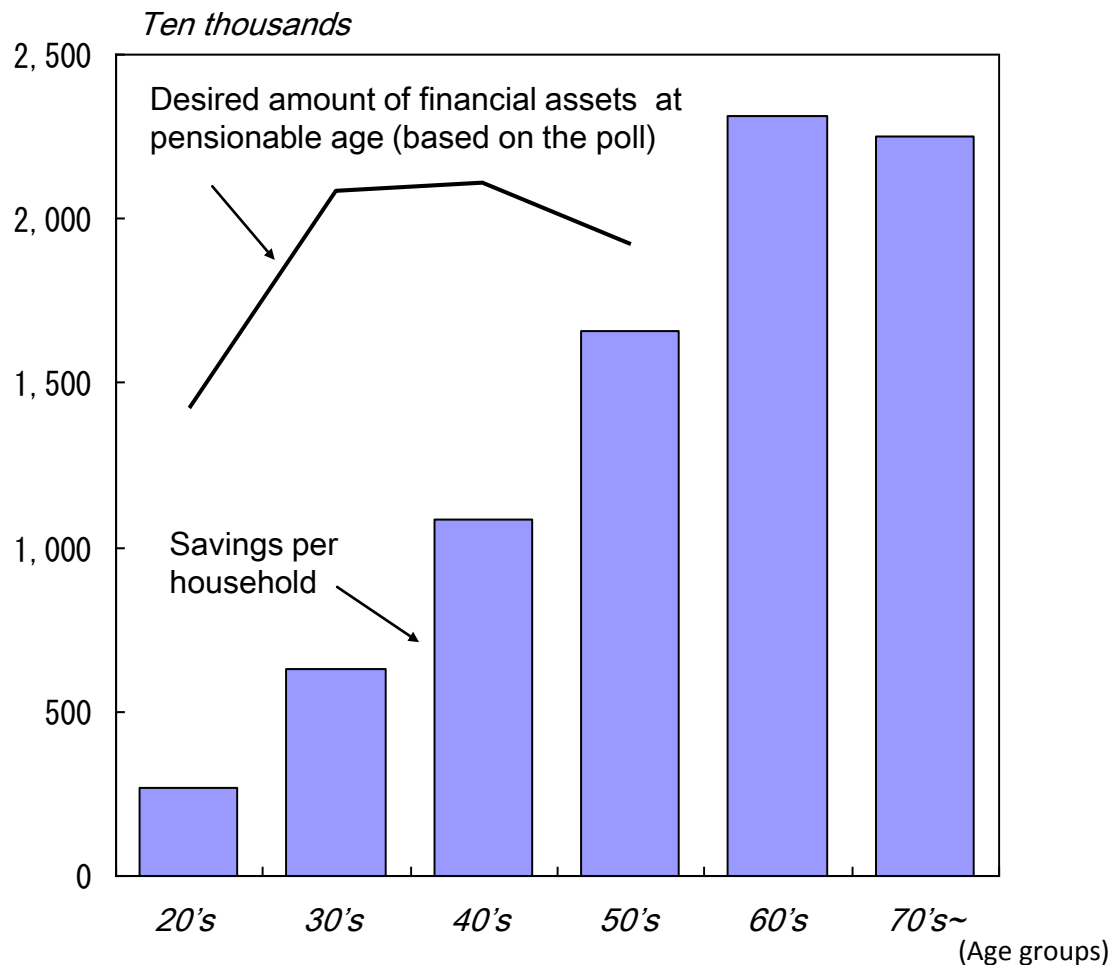


Figures at end-March, except for 1998 for which figures at end-April are used. Loan-deposit ratios are calculated as loans divided by deposits (including negotiable deposits) and multiplied by 100.

Source: "Deposits, Vault Cash, Loans and Bills Discounted by Prefecture (Domestically Licensed Banks)," Bank of Japan.

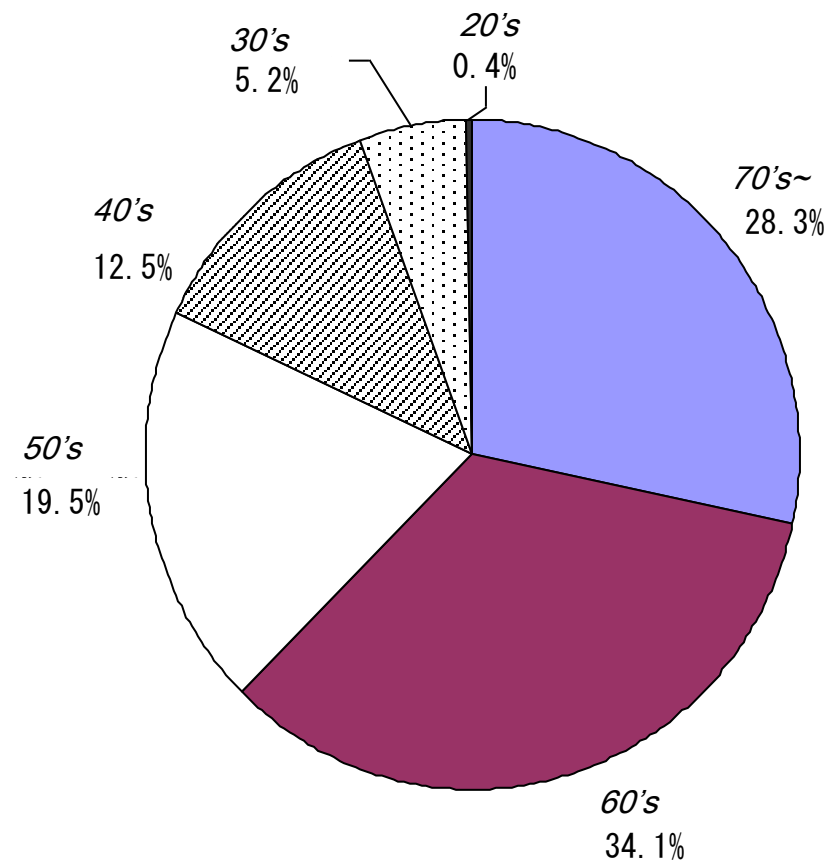
Increasing Importance of Management of Financial Assets in Aging Japan

Savings of households by different age groups



Source: "Family Income and Expenditure Survey (Savings and Liabilities) (2010)," Ministry of Internal Affairs and Communications; "Public Opinion Survey on Household Financial Assets and Liabilities (2010)," Bank of Japan.

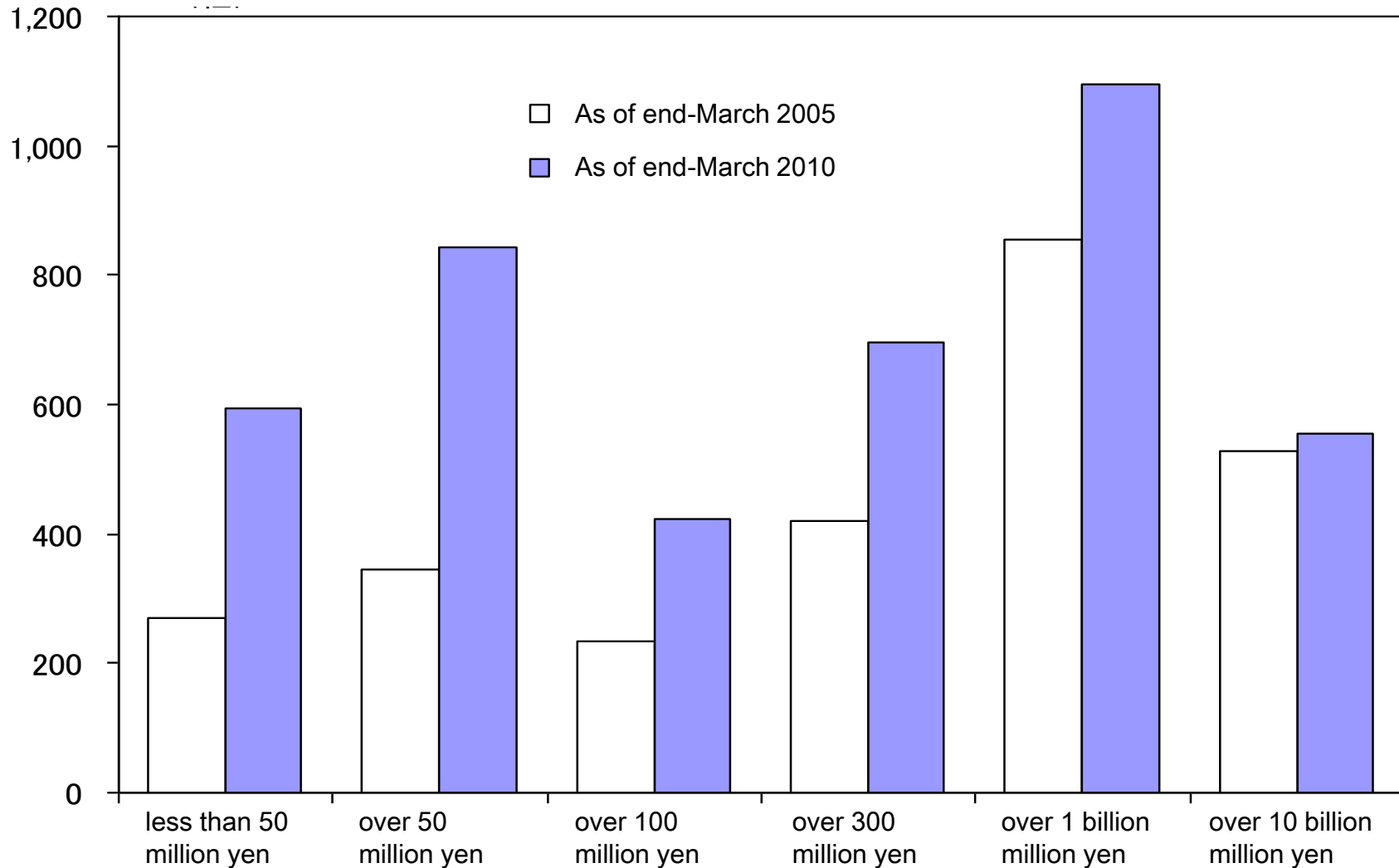
Share of households' savings by different age groups



Source: "Family Income and Expenditure Survey (Savings and Liabilities) (2010)," Ministry of Internal Affairs and Communications.

Japanese SMEs Going Overseas

Number of firms with overseas affiliated companies by size of equity capital



Source: "Survey of Overseas Business Activities," Ministry of Economy, Trade and Industry.

Financial System Council: Working Group on the Medium- and Long-Term Modalities of the Japanese Financial Industry

- In March 2011, the Minister of State for Financial Services requested the Council to investigate:

“the medium- and long-term agenda for developing the Japanese economy and financial industry, by enhancing the international competitiveness of Japanese financial institutions, improving financial functions in regional economies, and combining these two.”
- In June 2011, the Financial System Council: Working Group on the Medium- and Long-Term Modalities of the Japanese Financial Industry was established.
- On May 28, 2012, the Working Group compiled and released the report titled “The Japanese Financial Industry: Desirable State in the Medium- and Long-Term (Present State and Future Outlook).”

The report focused on three challenges:

- **Enhancement of the international competitiveness of the Japanese Financial Industry**
- **Improvement of the financial functions in regional economies**
- **Provision of financial services that meet the needs of the people**

The report is available here: http://www.fsa.go.jp/en/refer/councils/singie_kinyu/reports/20120831.html

Towards a New Financial Industry

“The roles of the financial industry”

- (1) To support the real economy
- (2) To lead the economy as a growing industry itself

Towards a financial industry creating values that meet the needs of customers

Financial institutions are required to play roles such as;

- Fulfillment of the risk conversion function
- Function of the information transmission
- Execution of management strategies with a greater emphasis on the customer perspective
- Development and expansion of business foundations
- Nurturing of experts in finance

How Financial Institutions Should Be – Local corporate financial services

- Urgent issues faced by regional economies
 - (1) Rehabilitation and revival of local SMEs
 - (2) General revitalization of individual rural communities
 - (3) Promotion of new industries and New Town Planning (“compact-city projects”)
- Broadening financial institutions’ means of taking risks
 - (1) Strengthening of the risk conversion function
 - Making loans and investment without depending on real estate for collateral (utilization of Asset Based Lending [ABL], etc.)
 - Utilization of investment funds (venture capital, business turnaround funds, and region-based funds, etc.)
 - (2) Expansion of the function of information production and transmission
 - “Industry, academia, finance + government” collaboration (“accumulation of knowledge and information in finance”)
 - Development of human resources with the ability to discern the sustainable business potential of companies and industries; utilization of outside experts
 - (3) Reforms on human resources and know-how, financial affairs, and organizational affairs
 - Implementation of integration/realignments and cooperation/alliances among different financial institutions, etc.

How Financial Institutions Should Be – Personal financial services

- Challenge for Japanese financial institutions: Enhancement of their capacity to develop and sell investment products in response to a wide variety of needs of financial services users
- Development of human resources (personnel who possess financial knowledge and attach importance to the customer perspective, cultivation of sales people assuming the professional responsibility [autonomous professional responsibility backed by specialist knowledge], etc.); and, improvement of the transparency of financial products and services
- Reviewing the state of institutional investors' asset management (including the development of microfinance-based funds, which mediate small contributions by ordinary people in empathy with investment projects)
- Managerial efforts for the development of products and services in appropriate response to a wide variety of needs of services users
- Fostering of independent financial intermediaries and neutral financial advisors; and, reviewing the state of the production and sales separation for financial services
- Reviewing the state of distributors' sales channels

Public-Private Collaboration Efforts – Local corporate financial services

- Correction of factors that are preventing financial institutions from supplying funds in ways conducive to economic growth
- Development of promising new industries and markets related to medical and geriatric care, environment and biotechnology, and agriculture in local communities through the “Industry, academia, finance + government” collaboration efforts
- Development of an environment which encourages financial institutions to actively exercise their risk conversion and function of information production and transmission.

For example, (1) institutional improvement for ABL, (2) spread and promotion of electronic monetary claims, and (3) diversification of financing methods, mainly a method for the provision of quasi-equity, such as the use of Debt Debt Swaps (DDSs).

- Support for financial institutions to expand and reinforce their business foundations

Public-Private Collaboration Efforts - Personal financial services

- Strengthening human resources for the enhancement of personal financial services
- Promoting financial and economic education to improve financial literacy of customers
- Supporting the entry and development of new players (independent financial intermediaries and neutral financial advisors, etc.)
- Creating environments helpful for developing and providing financial services in flexible response to changes in the needs of individuals
- Transformation of personal funds into capital inducing economic growth
 - Expansion of the capacity to supply funds in ways conducive to economic growth through institutional investors' risk conversion function
 - Opening up of new fund mediation channels
(For example, nurturing of microfinance-based funds)

III. Future of Financial Institution

1. Summary of Financial Monitoring Policy for Fiscal Year 2013

Current situation

- Financial inspections have generally been aimed at ensuring the financial soundness and legal compliance of financial institutions

Future challenges

- (1) Monitor timely and address appropriately economic and market changes within/outside Japan
- (2) Contribute to the current economic policy to overcome deflation, leading to the following positive cycle

Effective financial intermediation with appropriate risk management by financial institutions

Sustainable safety and soundness of each financial institution and the entire financial system

Complete end of deflation and contribute to sustainable economic growth and business expansion

Past financial inspection

- Fixed point observations of each financial institution
- Focus on the examination of whether financial institutions meet the criteria set in laws, regulations and inspection manuals (minimum standards)

New financial inspection (New financial monitoring)

- Identify developments within financial institutions and markets on a real-time basis and address potential risks.
- Identify and analyze important issues across the industry, identify challenges, examine remedies, and develop policy responses.
- As a general rule, major financial institutions are subject to the monitoring from the viewpoint of better business operations (best practice).

New framework

→ The Inspection Bureau and the Supervisory Bureau shall work together to deeply understand the actual conditions of financial institutions and systems. (*The FSA will review its organizational structure as necessary.)

• Monitoring of financial systems (with macro-prudential perspectives)

- The FSA continuously monitors what is happening in the financial system, and identifies and addresses potential threats against the financial system at an early stage.

• Introduction of horizontal review (three mega financial groups, some regional banks, and major insurance companies, etc.)

- The FSA selects important issues for examination which are common to multiple financial institutions and examines the efforts for such issues across institutions from a unified viewpoint.
- The FSA improves the quality of financial institutions management and raises the level of the financial industry through the review.

Review and challenges of the monitoring method:

- (1) Analyze the sustainability of financial institutions' earnings structure, (2) focus on customers' business potential in credit screening, and (3) respect the financial institutions' assessment for small assets, etc.

2. Outline of the Annual Supervisory Policy for Regional Financial Institutions for Fiscal Year 2013

Areas to Be Emphasized in Supervision

1. Performing an Active Financial Intermediary Function, including Management Support for SMEs

2. Risk Management and Regional Financial Systems Stability

3. Improvement of Customer Protection and Convenience for Users

• To pull Japan out of deflation and achieve powerful growth, financial institutions are expected not only to support business improvement and recovery of customer enterprises, but also to play their primary role more effectively and give strong support for the development and growth of their customer enterprises, by actively providing funds including new loans, while controlling risk appropriately.

• As such, it is important to encourage regional financial institutions to become actively involved in the provision of new loans that will likely result in business improvement and recovery, development and growth of customer enterprises, taking into consideration the “Japan Revitalization Strategy” adopted by the Cabinet in June 2013.

Considering the above, in this fiscal year, the FSA will supervise the performance of financial intermediary functions by regional financial institutions from the following viewpoints.

(1) Promotion of Initiatives of New Loans by Financial Institutions which Emphasize Growth Potential

(2) Deepen Region-based Relationship Banking

(3) Support for Business Improvement, etc., to SMEs

3. Viewpoints for Supervising the Performance of Financial Intermediary Functions

(1) Promotion of Initiatives of New Loans by Financial Institutions which Emphasize Growth Potential

The FSA will encourage the active involvement of regional financial institutions in the provision of new loans, by intensively verifying their efforts to promote new loans that will likely result in business improvement, business recovery, development and growth of their customer enterprises.

(2) Deepen Region-based Relationship Banking

Regional financial institutions should continue and reinforce the efforts to promote region-based relationship banking involving an entire organization, by setting up a business model looking ahead to the future, recognizing that region-based relationship banking is a way to contribute to users, the economy, and society in the relevant region, as well as improving their own financial profiles.

(3) Support for Business Improvement, etc., to SMEs

This fiscal year is considered crucial for financial institutions to start their full scale support for improvement of SMEs' business profiles, and reinforcement of business structure.

Each financial institution should work towards real improvement of SMEs' business profiles, by providing greater support for business improvement and recovery, such as support for devising highly effective business rehabilitation plans through performing an active consulting function while coordinating and cooperating with outside experts and other financial institutions.

4. Outline of the Regional Economy Vitalization Corporation of Japan

- On March 18, 2013, the Enterprise Turnaround Initiative Corporation of Japan was fundamentally reorganized and initiated operations with expanded functions as the “**Regional Economy Vitalization Corporation of Japan (REVIC).**”
- The objective of **REVIC** is to vitalize regional economies through the formation of groups of healthy companies and the securing/creation of jobs by providing support for business turnaround based on selection and concentration of business and business restructuring; and support for starting up new business/implementing business change, and regional revitalization projects.
- Main Functions
 - (1) Direct support for business turnaround
 - Deadline for deciding support: End of March 2018
 - Support period: “Less than five years”
 - In the case of a large company, the name of the company will be publicly announced.
 - (2) Enhancement of regional revitalization ability
 - Enhancement of cooperation such as dispatching experts to the SME Business Rehabilitation Support Cooperatives and to regional financial institutions
 - Dispatch of experts to, and capital injection/loans to, subsidiaries for business turnaround
 - Dispatch of experts and capital injection for business turnaround funds
 - (3) Support for regional revitalization
 - Dispatch of experts to regional financial institutions
 - Dispatch of experts and capital injection for regional revitalization funds

5. Casebook for the Provision of New Loans and Support for Business Improvement/Business Turnaround

Purpose:

- The casebook collects examples of pioneering initiatives or cases that should be widely practiced with regards to: providing new loans, improving profits in the main business, supporting business and turnaround, and support for initiating business.
- These cases are promulgated and published in order to encourage financial institutions to take voluntary action while also serving as a reference for other parties supporting business improvements.

Main structure:

1: Providing New loans

- Efforts to provide new loans to start new businesses/ companies
- Efforts to support business improvement
- Efforts to provide loans that don't rely excessively on mortgage collateral, etc.



- New loans and support for the commercialization of projects to solve regional problems
- Support for business turnaround through the utilization of “management support funds”
- Upgrading actions for ABL: “Development Manual for ABL Business” and the introduction of “Assessment System for Movable Properties”

2: Improving profits in the main business (support for expanding sales)

- Efforts to expand sales channels
- Efforts to expand business, etc.



- Matching business demands and supplies through the utilization of databases
- Support for new product development and the development of sales channels in order to increase sales

3: Support for business improvement/business turnaround, etc.

- Active efforts for business turnaround
- Efforts in cooperation with outside organizations
- Efforts through the utilization of investment funds, etc.



- Examples of business improvements led by second-tier main banks
- Consultation and information provision in cooperation with the Federation of Small Business Associations
- Support for business turnaround through the utilization of regional revitalization funds and the conversion of debt into “equity-like debt” (DDS)

4: Support for initiating business

- Efforts for identifying customers aiming to start new businesses
- Efforts through “industry, government, academia, finance” collaboration, etc.



- Support for business start-ups through regional “industries, government, academia” collaboration (management of support facilities established by cities)
- Support for the establishment of public-private joint entities through project finance

Thank you for your attention.

