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The Japanese Financial Industry:

Desirable State in the Medium- and Long-Term

(Present State and Future Outlook)†

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

Financial System Council

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Introduction

The Japanese government has made successive efforts to revitalize Japan's financial and capital markets, and its financial industry. In 2007, the Financial Services Agency (FSA) formulated *Plan for Strengthening the Competitiveness of Japan's Financial and Capital Markets*, examining the development of the environment, including measures for revitalizing the capital market, and measures for improving financial regulation (Better Regulation) and nurturing financial experts.

The Financial System Council's *Report by the Roundtable Committee on Fundamental Issues*, which was formulated in 2009 immediately following the Lehman Shock, confirmed the significance of building a two-track financial system. At the same time, it also emphasized the need to enhance the Japanese financial industry, and above all, the importance of value-creation-orientated financing, and it discussed the response to immediate financial crises originating in the markets.

Then, in December 2010, in response to the Japanese government's *New Growth Strategy* (June 2010), the FSA formulated *Action Plan for the New Growth Strategy*. The plan regards the roles of the financial sector as those to "support the real economy" and to "lead the economy as a growing industry itself," and it presents a package of various measures for fulfilling these roles. Subsequently, in light of such events as the Great East Japan Earthquake and the European debt crisis, the Japanese government put together *Strategy for Rebirth of Japan* (December 2011). Measures adopted by the strategy for the financial sector include expanding the supply of funds used to induce economic growth through public-private cooperation; and, strengthening the financial intermediary functions of banks, securities companies, etc.

Amid such circumstances, in March 2011, the Minister of State for Financial Services requested the Financial System Council to investigate "the medium and long-term agenda for developing Japanese economy and finance by enhancing the international competitiveness of Japanese financial institutions, improving financial functions in regional economies, and combining these two." In response to this request, the Financial System Council launched the Working Group on the Medium- and Long-Term Modalities of the Japanese Financial Industry (hereinafter referred to as the "Working Group"), which subsequently met 14 times to deliberate on the matter. This report is a compilation of the results of those deliberations.

The medium- and long-term future of the Japanese financial industry discussed in this report is conditional as it is based on the current situation. The Working Group expects that further discussions will be made at the Financial System Council and other relevant bodies, reflecting changes in the financial environment in Japan and overseas.

Chapter 1 Towards a New Financial Industry

The roles presently required of the Japanese financial industry are to support the real economy and to lead the economy as a growing industry itself. To this end, the financial industry is required to get an accurate grasp of customer needs, and to create new customers and new markets. Financing has a variety of functions, and the funding and settlement functions represent its partial aspects. There are two functions that support the provision of funds: the function of ascertaining, assuming or transferring risk (the risk conversion function), and the function of producing, accumulating and providing information (the information production function). These are both intrinsic functions of finance. The Japanese financial industry is being asked to fully mobilize these functions and create value that wins the admiration of customers.

(1) A new phase for the Japanese economy

(i) Economic and social trends in Japan

(a) The Japanese economy is entering a difficult era. There has long been a deflationary gap—meaning aggregate demand is below aggregate supply—and in recent times, the gap has even shown signs of expanding. This trend has been especially conspicuous in regional economies. One of the reasons for this has been declining income levels, particularly among the younger age groups, as a result of the declining birthrate, aging population and subsequent population decrease proceeding at a rapid rate, and stiffer competition on the back of economic globalization, coupled with a strong yen, increasing pressure to reduce costs. Thus, the excess supply capacity and the shortage of demand have created a difficult situation, with the Great East Japan Earthquake aggravating it further.

This imbalance in the real economy is reflected in the flow of funds. Both the household sector and the corporate sector have a surplus of funds, which has been mobilized to finance the fiscal deficit in the government sector. As a result, in the financial sector, while deposits have been built up, loans have been made sluggishly. This trend is particularly noticeable in regional economies, especially in loans businesses for small and medium-sized enterprises (SME's). As a result of surplus funds being diverted to investment in government bonds, interest rate risk is piled up in the banking sector, whose profitability remains low. The fact of the matter is that, in such an environment, the financial sector works hard to continue to provide struggling SME's with versatile succours mainly those related to their corporate finance and business revitalization.

(b) However, viewed from a different angle, perhaps this also suggests that the Japanese economy and society are poised to enter a new phase. Indeed, there are definitely indications of new markets. In addition to demand for healthcare services from the elderly, the declining birthrate and aging population are creating demand for childcare support as more and more women enter the workforce. The decrease in population necessitates New Town Planning characterized, for instance, by combined living and working spaces. And the heightened awareness of the environment is stirring up action to explore the possibilities of renewable energy. Values, especially those held by consumers, are definitely becoming more diverse. Amid these diversifying values, Japan is a world-leading front-runner, as it enters an unprecedented phase of a decreasing and aging population with a declining birthrate.

On reflection, even supposing that Japan's supply capacity is in excess, some part of the excess capacity would just generate in the mass-consumption, mass-production supply system that has provided products and services intended for average companies and households. That might also be described as an impasse in the supplier-led production and sales system. Such a supply system is not fully developed that generates products and services in response to the situation where consumers diversify their sense of value and they change their preferences in reflection of the demographic changes and the increased awareness of the environment. If suppliers can look at things from a true customer perspective, it will open up a lot of possibilities for stimulating potential demand. This applies not only to industry, but also to the financial industry. It is expected that the financial industry will play the role of actively supplying funds to support the development of new industries and new markets. The financial industry is also expected to supply meticulous products and services in reflection of the diversification of values among individuals, including the elderly. There have been so far attempts to shift away from the supplier-led production and sales system in the financial industry, and now such attempts need to be promoted further.

(ii) Economic and social trends overseas

(a) When it comes to economic growth, the world is becoming polarized. Whereas emerging countries in Asia and other regions continue to experience remarkable economic growth, following the collapse of the Lehman Brothers (the so-called Lehman Shock), developed countries in Europe and North America continue to be driven to low growth as their private sectors, including their financial sectors, continue to go through a process of balance sheet adjustments. The government debt crisis in Europe adds yet another element of uncertainty.

Looking at Japan's external balance, the country has long maintained a saving surplus in its domestic savings-investment balance and has sustained a surplus in its current account. However, since 2005, Japan's income surplus has been larger than its trade surplus. Japan has already embarked on the path to becoming a mature creditor nation. It is spreading its wings from an all-out trading nation, making money from imports, to an investing nation, also able to make money from financing and investment overseas. That is to say, Japan is harnessing the growth of emerging countries in Asia and other regions in the form of external investment, or increases in net income received from overseas.

(b) There are two types of external investment: direct investment and securities investment. Increasing foreign direct investment involves accelerating the international expansion of Japanese firms, and this means transferring some of the surplus mass-consumption, mass-production supply system to overseas markets in Asia or other regions. Supporting the overseas expansion of Japanese firms is a role expected to be performed by the Japanese financial industry. Increasing securities investment involves taking some of the surplus funds held by the corporate sector and some of the financial assets held by the household sector, which amounts to 1,400 trillion yen, and then investing them in overseas assets, such as bonds and investment trusts. It is another role expected to be played by the Japanese financial industry to build up the overseas investment into a stable and profitable financial investment that targets many different kinds of financial assets, including not only bonds but also equities. To achieve this, it is also imperative that there be sound macroeconomic management so as not to give rise to volatile fluctuations in foreign exchange rates.

(c) It is also important that Japan’s financial and capital markets provide an investment infrastructure befitting Japan as an investing nation. Japan needs such efficient financial markets as to enable its abundant domestic funds, mainly personal financial assets amounting to 1,400 trillion yen, to be invested in overseas assets and yield profits which will come back home in order to be managed stably. This kind of markets will be able to attract surplus funds both domestically and internationally, especially those from Asia, and then will be able to supply them as new money both at home and abroad. The Japanese financial and capital markets need to be improved so as to serve as the hub of such a global virtuous cycle of funds.

(d) In this way, the contemporary missions of the financial industry would be to give more affluence and stability to Japan’s journey to becoming a mature creditor nation.

(2) A new phase for the financial regulatory environment

Since the Lehman Shock, restoring stability to financial systems has been a matter of urgency in developed countries in Europe and North America. Financial authorities in these regions must place the priority of their policy management on restoring stability. The dominant discussion has been about strengthening financial regulations, and this trend is also having an influence on more recent moves for the international tightening of regulations.

In Japan, on the other hand, the stability of the financial system has been relatively secured, even following the Lehman Shock. Because Japan had previously experienced a financial crisis, it has the adequate institutional safety net which had been prepared in the crisis. In some respects, Japan can be positioned as a kind of front-runner when it comes to financial regulations as well.

The risk tolerance of Japanese financial institutions is also generally higher than that of financial institutions in Europe and North America. Furthermore, since the Lehman Shock, increasing profits based on the investment bank model has proven difficult, whilst there have been notable moves to positively reassess the business model based on commercial banking, like that of many Japanese financial institutions. Moreover, amid the government debt crisis, European and North American financial institutions have rushed to sell their overseas assets as falling government bond prices has led to a deterioration in their financial circumstances; whereas Japanese financial institutions have increased their external purchasing power, backed by the soundness of their balance sheets and the upward trend of the yen. Japanese financial institutions are being presented with an internationally favorable opportunity.

In this way, with the stability of the financial system secured, Japan's financial authorities are in a situation where they can implement policy management designed to improve or revitalize financial functions.

(3) Towards a financial industry creating value that wins the admiration of customers

(i) As the Japanese economy and society embark on a new phase as a front-runner of maturing capitalist economies, the financial industry is expected to respond actively to new demands emerging both at home and abroad. This means that it is expected to facilitate finance, or improve and revitalize financial functions. Meeting the new demand and thereby contributing to the development of the Japanese economy is both the mission and a business chance for the financial industry.

(ii) To achieve this, first, both the indirect financing sector and the direct financing sector need to work in harmony to effectively connect the users and suppliers of financial services. The Japanese government have long promoted a policy called "from savings to investment," with the aim of building a two-track financial system. However, mainly because of macroeconomic conditions, such as the lengthy deflation and low interest rates, as well as financial market conditions which are sluggish both at home and abroad, it would be likely that all of the funds needed for encouraging Japanese economic growth will not be supplied through direct financing channel only. Thus, it can be viewed that Japan is approaching a phase where both savings and investment must be fully mobilized.

(iii) Financing has a variety of functions. The funding function and the settlement function are two that are often cited, and what underlie these functions are the risk conversion function and the information production function. In order to supply funds, it is necessary to ascertain, assume and transfer risk related to the investment or loan target. At the same time, fulfilling this function is impossible without the function of producing, accumulating and providing information related to the credit and business risk of the investment or loan target. In this way, both of the two functions should be described as primary financial functions. The financial industry is being asked to fully mobilize these functions and create value that wins the admiration of customers while ensuring the efficiency of management.

(iv) To accomplish this, Japanese financial institutions need to formulate management strategies with a greater emphasis on the customer perspective than ever before. After doing that, they will need to implement the selection and concentration in line with those strategies and building a business foundation for strategy execution, and to develop human resources and enhance the capacity to develop and sell financial products and services for which customers are willing to pay a price. Creating value that wins the admiration of customers is equal to creating markets. Succeeding in this will provide Japanese financial institutions with strong support for making profits, thereby forming a foundation for their growth. It will then make it possible to envision that the financial industry will reach a stage of development in which it consists of financial institutions with business models enabling the industry itself to become a driving force for Japanese economic growth.

(v) Individual financial institutions are placed in a variety of environments, and they encounter a variety of customer needs. They also exist in an infinite variety of sizes, characteristics, strengths and weaknesses. Because of these, a variety of developments will be possible for their business models. Such different business models would share key success factors. One factor would be that financial institutions conduct agile and tough management in order to shoulder the expected roles and missions and address them flexibly. Another factor would be that the financial authorities adopt approaches towards supporting such management of financial institutions.

Chapter 2 How Financial Institutions Should Be

(Looking towards financial institutions that create value and drive growth)

Structural changes of the Japanese economy and society, as well as the globalization of the economy, are opening up new possibilities for financial services. Japan's declining birthrate and aging population, and the heightened awareness of the environment are generating new demand. It is hoped that Japan's financial institutions will grasp this demand inclusively and create value that wins the admiration of customers. Creating markets and driving Japanese economic growth continue to be an important role of the financial industry.

Furthermore, the global flow of funds expands and accelerates in response to the progress of economic globalization and advances in technological innovation. This opens up possibilities for the global asset management businesses which assess the cross-border flows of funds among individuals and companies, and redistribute resources by directing these flows of funds from regions with surplus funds to those with the potential for high investment returns.

1. Global expansion of corporate financial services

(1) Perception of current reality

As Japanese companies shift into full swing in their expansion overseas, they are seeking meticulous financial services overseas, which are on par with what are available in Japan; for example, the provision of local information, loans in local currency, mediation for M&As, and transaction banking, such as efficient local and cross-border fund management and remittances. These services are also provided by local or non-Japanese financial institutions operating there, but there are high expectations for the services to be provided by Japanese financial institutions, utilizing the strong relationships that they have formed with Japanese companies at home.

(i) From the 1990s to the first half of the 2000s, Japan's financial institutions proceeded to reduce their international businesses in order to overcome the problem of non-performing loans and to deal with international standards, such as capital adequacy requirements. In the second half of the 2000s, Japanese financial institutions shifted to expanding international banking assets, and they are now on their way to rebuilding their international businesses. Meanwhile, Japanese companies expand their businesses overseas at a rate faster than Japanese financial institutions set up their overseas bases. In terms of the current number of overseas bases and the current amount of local-currency loans, Japanese financial institutions do not fully satisfy Japanese companies' needs at present. Supporting the overseas expansion of Japanese companies is also needed in order to make Japan's foreign direct investment more efficient and more fruitful, thereby ensuring Japan's journey to a mature creditor nation.

(ii) Amid such circumstances, what to be done in the Japanese financial industry is not an overly aggressive supply of funds to foreign countries like in the 1980s. Instead, the financial industry is required to perform its primary roles on the global stage: that is, the risk conversion function of improving financial functions, ascertaining risk and taking risks effectively, and the information production function of producing necessary information for customers and supplying consulting services to them.

In terms of the provision of funds, recent Japanese financial institutions have admittedly come to the fore as prominent providers of funds for project finance and syndicated loans, utilizing the abundant domestic funds and assisted by government-affiliated financial institutions. However, from the viewpoint of providing the same level of meticulous financial services as available in Japan—which is in demand by Japanese companies—the financial institutions should enhance the capacity to provide traditional commercial banking services, such as loans, settlement, and debt collection, in local currency. Particularly with regard to settlement services, there are growing calls among Japanese companies for improvements in quality, such as making systems easier to use. In the insurance sector as well, Japanese financial institutions are required to actively provide a diverse range of financial instruments designed to control the various risks that are faced by Japanese companies expanding operations overseas, including the risk of disaster.

In terms of the information production function, Japanese companies, including SME's, expect Japanese financial institutions to provide them with information. It is not just general information on the local macroeconomic situation and institutional backgrounds and circumstances, but also practical and specialized information directly benefitting their international business expansion. Against the backdrop of a rising yen, the companies are faced with the problem of how to properly manage foreign exchange risk. Therefore, they place increasing expectations on Japanese financial institutions' providing hedging instruments and, more importantly, consulting services that link to specific measures regarding the currency composition of assets and liabilities as well as global fund management and settlement. Japanese companies expect support for all aspects of finance encompassing their corporate activities, but Japanese financial institutions cannot address all of these needs. Some SME's have unique production techniques and expertise, and such SME's sometime need outside support related to managerial and/or financial affairs when they proceed with international expansion by taking advantage of those strengths.

(iii) The insufficient global networks of Japanese financial institutions make it difficult for them to compete with foreign financial institutions in intermediary and advisory services for global companies that procure funds in international capital markets or conduct international M&As. On the other hand, with regard to M&As by Japanese companies, including those by SME's, there is further scope to utilize the virtues of Japanese financial institutions, which are familiar with Japanese corporate conditions and industry trends. Furthermore, despite some Japanese financial institutions gaining prominence in the international banking market, the challenge is whether they can make the most of this development and link it to expanding arranger services and other fee-based businesses.

(2) Direction of efforts in the financial industry

Given such a situation, the Japanese financial industry needs to promote outward globalization and inward globalization.

(i) Outward globalization

(a) For individual financial institutions, the question of how they should expand their operations overseas is the matter of their management strategies, and therefore, naturally, there could be diverse and flexible ways to achieve such operational expansions. On that basis, Japanese financial institutions are expected to expand globally to an adequate breadth and depth in order to provide support for the international expansion of Japanese companies.

The geographical breadth of the international expansion of Japanese financial institutions needs to keep up with that of Japanese companies. It is imperative that the financial institutions develop a varied network of overseas bases and a network of settlement systems and so forth, based on how Japanese companies are expanding overseas. A depth equal to that of Japanese companies is also required with regard to the localization of the international expansion.

- With regard to commercial banking, the provision of financial services deeply rooted in specific foreign places is becoming increasingly important. This includes the smooth lending in local currencies, the provision of practical and specialized local information, and efficient settlement services. In acknowledgement of these, individual financial institutions are already actively promoting expansion of their customer bases, cooperation with local banks, and improvements in their ability to procure local currencies from the market. Furthermore, enhancing the ability to collect local currency deposits through the expansion of retail banking could also be effective. Expanding retail banking in local areas overseas not only helps Japanese financial institutions to support Japanese companies operating there, but also potentially enables the financial institutions to increase their profitability by capturing the latent demand from the rapidly growing middle classes in Asia. However, it should be kept in mind that developing retail banking in local areas overseas into lucrative businesses is premised on a management strategy formulated from a medium- and long-term standpoint as well as the continuous devotion of management resources.
- With regard to investment banking, Japanese securities firms are required to build up the capacity to supply financial services in the global marketplace (in particular, to expand functions in major international financial centers), and each of the leading

firms is moving ahead to acquire divisions of European and North American investment banks and to secure personnel from the investment banks. Furthermore, overseas M&As by Japanese manufacturers are becoming more active in an effort to harness the strong economic growth in foreign countries, including that in emerging countries. Amid such circumstances, by continuously expanding their local networks overseas, Japanese investment banks are strongly expected to enhance their information production capacity in terms of both quality and quantity, thereby playing a role in supporting the sustained growth of Japanese companies.

- With regard to insurance services, internationalization has progressed in a way that harnesses the demand for insurance from Japanese companies expanding their operations overseas. More recently, Japanese insurance companies have begun localization in their own ways that incorporate Japanese characteristics, such as expanding automobile insurance and motorcycle insurance under the favour of the international competitiveness of Japanese manufacturers. In life insurance and nonlife insurance as well, examples can be seen of Japanese companies actively involved in the acquisition of or equity investment in local insurance companies engaged in retail business. Still, their localization is underway on the whole. With the recent amendment of the Insurance Business Act resulting in revisions being made to regulations on the scope of business activities of subsidiary companies relating to the acquisition of foreign insurance companies, it is expected that there will be even more international expansion in the future.

(b) Japanese financial institutions need to build a broader customer base overseas, consisting of local, non-Japanese-owned companies as well, in order to provide better support for Japanese corporate customers in foreign places where they actually operate. Such a globalization might lead to transforming some Japanese financial institutions into truly global players. This is a business model that will satisfy the demand for financial services from global companies, including non-Japanese-owned companies, and could also be described as a form of the financial industry that will drive growth in the Japanese economy in the global dimension. Profits that Japanese financial institutions make overseas by satisfying the demand for financial services from global companies and other foreign companies will be additional Japanese national incomes. Furthermore, Japanese financial institutions can enhance their risk management through the expansion of services rooted in specific areas overseas, mainly because it can help diversify risks that they take on a company-wide basis.

(ii) Inward globalization

In order to support Japan's growth as well as Japanese companies' investment activities and financing activities in foreign countries, Japan's financial and capital markets must first fulfill the function of a reliable base. In other words, the markets need to enable

Japanese companies and individuals to procure funds for overseas investments and to bring the fruits yielded back to Japan so as to manage them in a stable and efficient manner. Moreover, in terms of corporate finance, the markets should be able to execute trade settlement and short-term fund transactions in a variety of currencies, including Asian currencies.

In addition, Japan must aim at gaining home markets which can serve as the hub of the global flow of funds, attracting surplus funds from emerging countries, especially those in Asia where tend to have excess savings, and supplying them as new funding both in Japan and abroad. To this end, such a market environment needs to be built in Japan as to promote the accumulation of advanced financial technologies, human resources, and know-how, and also as to encourage players both at home and abroad to compete with each other with looking at things through the eyes of their customers, thereby generating financial innovations. This is indispensable for addressing the need to enhance the international appeal of the Japanese financial markets, so as to maintain their position as a central international market which enables interactions with other parts of Asia and the involvement of their dynamism.

(3) Challenges for financial institutions

Japanese financial institutions have an edge mainly in terms of the depth of their relationship with Japanese companies, such as potential to provide meticulous service, and the availability of low-cost ample funds at home. Furthermore, the soundness and growth potential of the financial business model based on commercial banking has been positively reappraised since the Lehman Shock. In reflection of this, the Japanese banks have generally come to have a higher creditworthiness and fund-raising capacity than major foreign financial institutions do in Europe and North America.

On the other hand, challenges facing Japanese financial institutions expanding their corporate financial services globally include how to improve tangible (global networks of overseas bases and information systems) and intangible (expertise and human resources) management resources, and how to strengthen management strategies and capabilities so as to develop and establish the management resources in the medium- and long-term. In relation to intangible management resources, there are indications that the personnel rotations at Japanese financial institutions could be an issue as they may be too frequent.

(4) Addressing the challenges

(i) Outward globalization

(a) In order to capitalize on the strengths whilst making up for deficiencies in tangible and intangible management resources, Japanese financial institutions need international management strategies that are sustainable in the medium- and long-term. Of course, such strategies should be formulated and put into practice independently by each financial institution in light of its own strengths and weaknesses. However, having experienced the collapse of the bubble economy and the disposal of non-performing loans, Japanese financial institutions have not so far maintained well the consistency and continuity in their international expansions and have made very little cross-border business integration. Given this, Japanese financial institutions can find some room in their overseas operations for a further expansion, although they have insufficiently accumulated experiences relevant for the expansion. Recent Japanese financial institutions make steady efforts in to make up for lost time, and now they need to formulate and execute sustainable strategies.

(b) Broadly speaking, there are two methods of international expansion: organic strategies, where the company expands its own branch network and local subsidiaries; and inorganic strategies (M&A), such as equity investment in, or acquisition in entire, or in divisions of, local financial institutions in each foreign country. Generally, organic strategies envisage orderly growth under the control of the head office, but they lack a sense of speed because it takes time to develop human resources and establish new branch offices in each country. On the other hand, an inorganic strategy can be described as a strategy of buying time. However, it is difficult to gauge the size of a premium for acquisition before the execution of an M&A, whereas it is possible that unexpected risks will emerge after the execution of the M&A. In addition, bargaining power and the ability to collect information on the target business need to be established. Adding to the difficulty is the problem of post-merger integration (PMI). There are a number of difficult management-related challenges following the acquisition, such as how to enforce the head office's policies; how to secure capable employees; how much discretion should be given to the local management team; how to maintain motivations for local management teams and employees; and, how to ensure global risk management.

(c) Regardless of which strategy, as the size of international businesses increases, the ratio of local employees will also rise. This creates a need to organically fuse the global and local strategies, such as securing capable employees locally and promoting local employees to positions in the head office management team. That also creates a need for new approaches to operation within the organization, such as the standardization of the language used internally, and the provision of incentives and maintenance of motivation for local management teams and employees. Opting for such approaches has the potential to lead to reexamining and rebuilding the organizational identity per se.

(d) As for regional financial institutions, in order to provide both information and financing support to SME's engaged in overseas expansion, it has become imperative that they look to cooperate with major financial institutions and government-affiliated institutions, form alliances with local banks overseas, and cooperate and form alliances with other regional financial institutions (i.e., setting up joint branches). Once again, ways of thinking about organizational affairs, such as the degree of the management team's commitment to the customer perspective and to international expansion strategies, and the relative merits of personnel procurement and management, will significantly influence the outcome.

(e) Thus, the key to promoting this kind of international expansion is the leadership and judgment of the management team. This is because investigation into how an organization ought to be, both in terms of size and function, is a job that involves making decisions and implementing them amid an intricate intertwining of such factors as the manner of international expansion, the process of internal decision-making, and the modality of internal management.

(ii) Inward globalization

From the perspective of developing Japan's financial and capital markets into a financial market which serves as the hub of the global flow of funds, more efforts than ever before are needed to improve the market infrastructure. With an aim of building a two-track financial system, Japan has made effort after effort to improve market rules, introduce a financial ADR system, and improve exchanges and so forth in light of examples in other developed nations. These efforts have resulted in the development of a market infrastructure of a remarkably better quality than before.

Nevertheless, it would still be difficult to state that Japan's financial and capital markets have rapidly developed into a vibrant market that contributes significantly to the growth of the Japanese economy and is at the hub of Asia. As viewed from the perspective of individuals investors, companies delisting would be problematic because it narrows the range of choice for investment.

It is necessary to make further investigations into Japan's financial and capital markets in terms of how to lead revitalizing the markets to benefiting the macroeconomic growth. The aim must be for a vibrant market in which players from emerging countries in Asia and other regions can participate, and through which funds flow freely in and out. For this reason as well, Japan needs to continue to pursue highly transparent and internationally consistent market rules, as well as efficient and stable exchanges and settlement and clearing functions. It is necessary to develop an infrastructure that is strong and attractive, in terms of usability and cost, and that is capable of continuing to attract players, entities raising funds, and investors at home and abroad. The idea is for the comprehensive exchange plan and the Asian bond market should also be positioned within this context. On reflection, further action is needed for insurance too, including the improvement and utilization of reinsurance markets and systems in order to meet the demand from customers in Japan and overseas for insurance services which address the risk of natural disasters, such as the Thai floods and the Great East Japan Earthquake.

2. Local expansion of corporate financial services

(1) Perception of current reality

In local communities, corporate challenges to new businesses and generations of new industries appear, whereas economies continue to be battered mainly due to decreasing population; the difficult situation faced by tiny, small and medium enterprises in particular is becoming worse. Most local companies are confronted with the shrinking of their home markets and the reduction of their sales. In addition to the difficulty in short-term financing, they are faced with the long-term problem of sluggish performance occurring as their competitiveness tends to decline. No other areas are in as much need of contributions by the financial industry. Already, it is no longer good enough just to supply funds. Japanese financial institutions are expected to fulfill the risk conversion function of taking risks for promising projects, without relying on the conventional use of real estate as collateral. For this, the information production function is essential. What are needed for exercising the function include the ability to discern the business risk and potential of customer companies, and the ability to utilize the information to supply consulting services to the companies. It is no longer enough just to have abstract policy debates, such as a dualistic debate of savings versus investment regarding the allocation of household financial assets. With the help of both direct and indirect financing, the financial sector needs to enhance its capacity to supply funds in ways conducive to economic growth.

(i) For the rehabilitation of local enterprises and the general revitalization of individual rural communities, the essential aspects of the fund provision in regional economies include supporting local enterprises with funding difficulties, and giving continuous assistance to those that formulate exit strategies for improving and restoring the soundness of management. At the same time, it is fundamental to local communities that the capacity to accommodate demand for finance from new industries emerging there will be expanded. The function of supplying funds in ways conducive to economic growth needs to be expanded, and the types of players to perform this function need to be increased. With regard to the financing of high-risk, high-return projects, the expansion of investment and loans made by various kinds of investment funds, including venture capital, private equity (PE), corporation reconstruction funds, and region-based funds, will be one beneficial option. Furthermore, it is imperative that deposit-taking institutions will supply funds in more active ways. With the help of both direct fund provision by financial institutions and indirect provision through several kinds of investment funds, the capacity to supply funds in ways conducive to economic growth needs to be improved. Whilst making loans in the sphere of commercial banking will continue to be the main channel of fund provision by deposit-taking institutions, providing capital or quasi-capital will be an effective alternative in their portfolio selection. With respect to risks that cannot be fully taken by private-sector players only, the status of government-affiliated financial institutions should be examined from several viewpoints, mainly from that of supplementing the private sector.

(ii) Related to the information production function, financial institutions are required to provide consulting services that contribute to customer companies' various efforts, such as those to promote the corporate revitalization, including changing business categories, and those to launch new businesses. In providing such services, financial institutions will, firstly, draw fully on their own capacity to produce, accumulate, and provide information for their customer companies, and then will share the same recognition with the companies, regarding their business purposes, the means necessary for carrying them out, and their management strategies. Based on such a common recognition, financial institutions will deploy their risk conversion function. The financial industry has the strength of occupying a position to build long-term business relationships with companies belonging to wide-ranging types of industries, and individual financial institutions need to capitalize on this strength further in their own fashion.

As well as improving the ability to collect and analyze information, utilizing outside experts will be beneficial for financial institutions. More generally, it is fundamental to local communities that the frontiers of business deployments will be explored with the help of knowledge accumulated through "industry, academia, and finance" associations. Such attempts are actually made now. Projects for the promotion of the general revitalization of individual communities need to involve the public sector, such as local governments, and new supporters of public service, such as NPO's.

Strengthening the ability of financial institutions to discern the business potential of customer local enterprises is essential. This ability is made up of both backward-looking analytical capacity to evaluate risks with a focus on customer enterprises' historical performance, such as their cash positions and financial soundness, and forward-looking analytical capacity to look into customer enterprises' future performance, such as business risks and profitability. Discerning the business potential of customer local enterprises is, ultimately, assessing their management power, and this requires financial institutions to acquire broad-ranging knowledge and accumulate experiences.

(2) Direction of efforts in the financial industry

Towards expanding corporate financial services in local communities, basic directions can be outlined for the financial industry as follows.

(i) The first direction is to improve the function of SME financing. There is a high possibility that many regions will be forced to scale back their economic activity, given the escalation of the declining birthrate and aging population, as well as the acceleration of corporate overseas expansion in response to globalization. In tackling various issues, this must be presupposed by SME's and financial institutions, whose businesses are based in local communities.

Local SME's have contributed to local communities by offering job opportunities there. They also have made significant contributions not only to regional economies, but also to the Japanese economy as a whole through the creation of innovation. Their financial situation, however, is harsh. Their net-worth is too small, looking at the balance of their assets and liabilities. Their cash positions are damaged by low profitability, looking at their cash flows. Such high-risk, low-return companies need to be converted by fund provisions to either high-risk, high-return companies with improved profitability, or low-risk, low-return companies with enhanced financial position. Therefore, fund providers to such companies need to make a long-term commitment to their corporate management. This calls for financial institutions which have the capability to differentiate newly-created companies with future potential and troubled companies with viability from inefficient companies without viability, and the capability to provide funds to the differentiated companies from a long-term perspective but lead the rest smoothly to restructuring, including voluntary closures. Furthermore, against the backdrop of the demographic changes, the difficulty of finding successors emerges among local SME's in which hereditary transfer is normally found. Taking this into account, it can be viewed that financial institutions are required to address demand from local SME's for financial services related to their business successions, by use of several financial means, including the injection of capital and quasi-capital, the provision of loans, and the application of trusts.

Seeing that local SME's have the profile of high-risk, low-return in general, their demand for funds cannot be fully satisfied by a provision of loans collateralized by real estate. The types of funds to be provided to local SME's would include capital, quasi-capital, and loans based on collateral other than real estate, such as Asset Based Lending, or ABL. The role of providing capital to local SME's can be assumed by regional financial institutions and several kinds of investment funds, including those established in collaboration with government-affiliated financial institutions. The role of providing quasi-capital to local SME's has been long assumed by regional financial institutions in the form of making *neyuki* loans. *Neyuki* literally means snow that remains unmelted until spring, and *neyuki* loans are short-term loans that are rolled over repeatedly, being regarded as "long-term working capital" in effect. The situation is happening more and more in recent years that regional financial institutions provide quasi-capital in the form of Debt Default Swaps (DDS) to local SME's at the stage of corporate revival. Last November, measures were implemented to clarify the application of financial inspection manuals for the purpose of promoting the active use of loans with capital characteristics. With regard to loans backed by assets other than real estate, how to increase the availability of ABL's using inventory or accounts receivable as collateral has been recently explored by financial institutions, including government-affiliated ones, as well as the central bank.

Furthermore, electronic monetary claims that manage and settle accounts receivable based on electronic data are useful. As a consequence of the Electronically Recorded Monetary Claims Act coming into effect, institutional infrastructure was developed that utilizes electronic commercial bills and electronic nominative claims of accounts receivable for settlement and financing activities. Among financial institutions and industry organizations, there has been a succession of moves to establish electronic monetary claim recording institutions. Looking forward, many regional financial institutions are expected to participate in Densai Net, which is scheduled to soon commence service, thereby opening the way for commercial credits among local SMEs to be fully incorporated into an electronic monetary claims network.

(ii) The second direction of efforts to be made in the financial industry is to assist the promotion of new industries in regional economies and to participate in public utilities, such as New Town Planning.

Challenging new endeavours in local communities in such fields as medical and geriatric care, the environment and biotechnology, and agriculture has the potential to trigger recovery of sluggish local economies. Challenging them will also contribute to the economic growth of Japan, which has entered into a new phase due to the demographic changes. Supporting such challenges to new endeavours is the mission of the financial industry, and regional financial institutions are expected to be actively engaged in performing the mission.

There are new advancements of public utilities, including New Town Planning, in local communities. Regional public utilities are required to flexibly deal with several socio-economic changes, including the declining birthrate and aging population, population diminishment and depopulation, and changes in industrial structure. Combined with the heightened awareness of the environment, increases in the elderly population enhance the social need for New Town Planning, such as making towns more compact. Water supply and sewerage systems in local communities need to be renewed in response to their decrepitude, as well as to be realigned in response to the shifting and decaying of commercial and residential areas. Amid such circumstances, in view of the fiscal conditions of the central and local governments, utilizing the vitality of the private sector with the help of, for instance, private finance initiatives (PFI's), is beneficial. This makes it important to diversify methods to raise funds from private-sector investors and lenders, and one option for this is to issue revenue bonds. Regional financial institutions are expected to make contributions to the formulation of plans for community revitalization and to the new advancements of public utilities, by fulfilling their financing and consulting functions.

(3) Challenges for financial institutions

A challenge to be pointed out first for financial institutions carrying out the local expansion of financial services is to enhance the capacity to supply funds in ways conducive to economic growth. Another challenge is to supply consulting services with the practicality and technicality which satisfy customer firms in terms of usefulness.

Seeing that the loan-deposit ratio of regional financial institutions is low, it is not as if there is an absolute shortage of funds. The fundamental challenge is to compensate for the lack of management foundations so as to take risks on providing funds in ways conducive to economic growth through the exertion of consulting functions.

With declining loan-deposit ratios, lending rates of interest, which can be viewed as compensation paid by borrowers for financial services supplied by regional financial institutions, have also been declining. Regional financial institutions secure profits mainly by taking interest-rate risks on investing in government bonds. This suggests a necessity for them to enhance their profitability by performing a consulting function that will be appreciated by customers, and by leading this to increasing lending rates of interest to the level in a fine balance with the risks contained in loan businesses.

One more important challenge for financial institutions is to do an adequate management of risks. To take more risks in local communities on providing funds in ways conducive to economic growth means for an individual financial institution that it will bear risks peculiar to its own home community. How to diversify this kind of area-specific risks should be within the scope of the adequate risk-management.

(4) Addressing the challenges

In addressing these challenges, it is essential for financial institutions to expand their business foundations both in terms of size and function. The question of what specific efforts each financial institution makes is basically a question of its own management judgment. Different financial institutions are confronted with different economic trends in their home communities as well as with different corporate clients, and have their own different comparative advantages: strengths and weaknesses. Because of this, they cannot find uniform solutions, and different financial institutions need to find different solutions by exercising their own originality and ingenuity. Although the stagnation of economic activity and the decline in the business base of financial institutions have long been pointed out in local communities, it does not appear that financial institutions have made steady progress towards sorting out these problems. Behind this fact, financial institutions are expected to share the customer perspective and properly perform the risk conversion function through information production activities. To meet this expectation, financial institutions need to formulate management strategies and expand their business foundations.

(i) What to be done by financial institutions for their human resources and expertise include stipulating the focus areas of their consulting work, and promoting the cultivation of human resources and the accumulation of information, both of which must contribute to building up their consulting capacity to evaluate and improve the future potential, business risks, and management capability of client companies. Financial institutions should also join “industry, academia, finance + government” projects in local communities as well as utilize outside experts. Furthermore, they are required to make steady and prolonged efforts to cultivate their human resources, including efforts related to enhancing internal systems of personnel rotation and performance evaluation.

(ii) What to be done by financial institutions with respect to financial affairs is to enhance their own capital so that they will be able to maintain the soundness even if risks taken by them materialize. This is inextricably associated with the necessity for financial institutions to improve their medium- and long-term profitability. Financial institutions can do so by taking risks on the basis of their own distinctive consulting activities, thereby creating value that wins the admiration of customers. Financial institutions' provision of the same old services in diminishing local economies will never lead to improving their medium- and long-term profitability. It is indispensable for financial institutions to be prepared to promptly make possible the provision of new-type financial services, and to put such service provisions into practice.

(iii) What to be done by financial institutions with respect to their organizational capability is to utilize outsourcing in non-focus areas and in knowledge-poor areas in order to use their limited management resources efficiently.

Furthermore, promoting integration and realignments, as well as cooperation and alliances with other financial institutions, can be an effective option for a financial institution that attempts to strengthen its own capability more fundamentally.

(a) Generally speaking, when a financial institution faces difficulty in fully accommodating customers' demand for financial services due to a deficiency of some management resources, advancing integration or realignments is an effective means for the financial institution. This is because integration and realignments enable a financial institution to make up the deficit of specific resources from other financial institutions, and to create value that wins the admiration of its customers. The appropriateness of integration and realignments for individual financial institutions is, of course, a matter to be investigated in line with their own business judgment. The diversification of business lines thanks to integration of management could end up with increasing management risks or reducing the locality in which regional financial institutions have an edge. The integration and realignments conducted by financial institutions operating in the same area, on the other hand, will make it possible for an integrated or realigned institution to enjoy an economy of scale resulting from the subsequent proper rearrangement of branch offices and personnel. In addition, the integration and realignments conducted by financial institutions with focus on specific business lines will make it possible for an integrated or realigned institution to enhance the competitiveness in the business lines. Moreover, advancing integration or realignments can help an integrated or realigned institution to diversify the above-mentioned area-specific risks, because it causes an expansion of business area for original institutions.

(b) With regard to cooperation and alliances, it is beneficial for regional financial institutions to strengthen business relationships with unfamiliar areas, and measures for this include the utilization of regional Collateralized Loan Obligations (CLO's) in addition to ordinary business tie-ups. For cooperative financial institutions, risk diversification by use of a central organization is also worthy of consideration.

(iv) The growth potential and profitability of regional financial institutions have been sluggish, and this occurs in the context of the slump of regional economies and regional SME's. However, an additional assessment is offered in the discussions of the Working Group that attributes the sluggish growth potential and profitability to problems of internal governance and problems caused by financial institutions' own preoccupations. For example, it was pointed out that the development of financial products which meet customer needs is hindered by the fact that internal opinions in financial institutions tend to be biased because they have a generally homogenous staff. To tackle this problem, it is important for financial institutions to develop products and formulate strategies on the basis of objective verification, such as data mining. It was also pointed out that, while the management team is insufficiently incentivized to achieve profits, it has a strong fear of failure, and this possibly brings about an overly conformist mentality. It was suggested for joint-stock financial institutions that one of the reasons for this is that crossholding of shares among local financial institutions and companies might be weakening the discipline of the management team of financial institutions. There was also the suggestion that another reason could be that there is a tendency to overemphasize compliance with various regulations and rules. It is hoped that regional financial institutions will take these indications seriously and use them as reference for their own management reforms.

Measures designed to overcome challenges can only be implemented with the leadership and judgment of the management team. An indication that has been raised for financial institutions in general is that they have overly the mentality that puts avoiding risks before taking risks to make profits in their business. There is also a chance in the long run that management headed towards holding the status quo will make a financial institution fail to maintain continuity as a private enterprise as well as to accomplish its public mission of contributing to the local economy. In fact, partly as a consequence of the slump in regional economies, the loan-deposit ratio has been falling, the profit margin on funds has been contracting, and profitability has been declining, and there are views that the medium- and long-term business continuity of regional financial institutions is under threat. Holding the status quo will definitely involve risk.

3. Personal financial services

(1) Perception of current reality

(i) As the Japanese economy and society undergo considerable structural changes mainly due to the declining birthrate and aging population, personal financial services are becoming the most important segment for the financial industry. This is because personal financial services are becoming an important source of earnings for all kinds of financial institutions, including insurance companies, banks, and securities firms. That is also because how to effectively utilize household financial assets, which have been accumulated over the years and now amount to 1,400 trillion yen, is a topic of great significance for Japan's future. It is the very role of the financial industry to link the household financial assets to Japanese economic growth by executing the risk conversion function. Japan is in the process of becoming a mature creditor nation, and therefore the financial industry will have another role of giving more stability and profitability to the household sector's investment in foreign securities. Thus, it is necessary to strengthen financial intermediaries' functioning and expand their categories.

(ii) Individuals are financial services users who expect financial intermediaries to provide them with higher quality services. Given the increasing diversity in individual lifestyles and values, financial intermediaries are required to supply meticulous services in response. Individual customers have needs related to managing their investment assets, and the financial industry needs to provide an efficient environment in which such individuals can make investments with a sense of security. Individual customers go about their everyday lives with several needs for financial products and services other than those related to managing their investment assets. As borrowers of housing loans, reverse mortgages, consumer loans, and also users of settlement services, individual customers expect the financial industry to create value and accommodate needs that they generate through living their everyday lives.

Generally speaking, it is not as if Japanese financial institutions are lagging far behind financial institutions in Europe and North America in terms of the ability to develop personal financial services and products. However, Japan is the first country to be entering such an unprecedented phase of an aging society with a declining birthrate, and therefore the financial sector is required to display even more originality and ingenuity. Conversely, if Japanese financial institutions succeed in creating markets in which they ensure the satisfaction of customers leading lives in a society with a declining birthrate and aging population, then the financial institutions will gain the potential to become a front-runner leading financial services business in foreign countries whose societies will have shown similarities to Japanese society in terms of population structure.

(iii) To enhance the functions of financial intermediaries in the context of building the two-track financial system, various institutional reforms and environmental improvements have been advanced, mainly with deregulation regarding the scope and openness of the financial services industry, as well as the merchantability of financial products and services to be provided. Thanks to this, several suppliers originating in non-financial sectors have entered financial markets and become new financial intermediaries, and financial institutions have gained increasing discretion in developing and selling services and products. However, these have not resulted in creating a grand trend advocated in the slogan of “from savings to investment.”

With uncertainty over future prospects for the public pension system, the continuous deterioration of employment and income environments as a result of the economic slump makes it reasonable to admit the difficulty for Japanese households to expand their investment in risk assets. Such evasive behavior is also attributable to their buttoned-down safety-orientated attitude in their family finances and asset management, as well as to market trends of the protracted decline of stock prices and the continued low interest rates.

At the same time, there are indications that financial intermediaries have not made enough efforts to closely reflect the properties of individual investors and characteristics of the generation when they develop and sell investment products. For example, one of the concerns raised is that the line-up of insurance products and investment trusts available to individual customers is largely determined on the grounds of distribution firms, including banks, thereby providing the customers with insufficient choices. Such concern is based on the view that margins on commissions on the sale of stocks and securities become extremely narrow on account of the spread of online sales and increased competition due to liberalization, while selling insurance products and investment trusts to individual customers becomes a considerably profitable business line for the distributors.

(2) Direction of efforts in the financial industry

Towards providing financial services that meet the needs of the people, basic directions can be outlined for the financial industry as follows.

(i) The first direction is to improve the ability to develop and sell financial products and services for individual investors. Reflecting their differences in amounts of income and assets, those in levels of financial literacy, and those in life stages and other generational characteristics, individual investors’ needs in managing their financial assets are diverse. Such diversity calls for detailed responses from the financial industry.

For example, in light of the deteriorating financial condition of Japan’s pension system and the steadily aging society, younger age groups have to build their assets over a long time by their self-reliant efforts, and therefore they need to be provided with the most wide-ranging menu of investment products. However, there are not many investment products now that are actually used for long-term investment, apart from personal pension insurance products. Instead, there are indications that short-lived investment trusts have been massively offered for sale against the background of product developments and commercial policies with a focus on the quickly-repeated acquisition of sales commissions. Older age groups, on the other hand, tend to possess their financial assets as a preparation for future sickness and some sort of emergencies, and prefer financial products that enable them to maintain the liquidity and ensure the principle. Still, such a preference is mostly met by bank deposits and postal savings.

There is no doubt that improving the financial literacy of the public is desirable, and this can be said too in the context of the principle of self-responsibility in investment. Efforts for that have been made so far, and they need to be continued in the future. At the same time, it is necessary to prepare the capacity to provide individual customers with investment products which are developed and sold on the assumption that the customers lack financial literacy, in order to enable them to manage their assets with a sense of security. Due consideration also needs to be given to how information ought to be provided to individual customers, including information-provision through online advertising.

(ii) The second direction of efforts to be made in the financial industry is to expand the function to link the financial assets of individuals to economic growth via the investment management by institutional investors. As a matter of course, there is a limit to direct risk taking by individuals. Most of the financial assets of individuals have been accumulated as bank deposits, postal savings, insurance, and pensions other than securities. These financial products are offered by institutional investors who reallocate the funds collected from individuals through their portfolio selections. This function needs to be enhanced in order to reallocate the collected funds in ways conducive to economic growth. It is also effective to open up new fund mediation channels like PE funds with consideration to investor protection. In addition, individuals have the potential to take risks on investing in projects with which they empathize because of the motivation based on a sense of public duty or local patriotism rather than the desire for profits. To catch such inclination, microfinance-based funds are emerging, in which individuals support their favorite projects through their fund-contributing and consumption activities.

(iii) The third direction of efforts to be made in the financial industry is to enhance the ability to develop and sell financial products and services that accommodate needs that individuals generate through living their lives. The demographic changes and other socio-economic changes require the evolution of personal financial services. What are needed for meeting this requirement include the diversification of types of personal loan products, the expansion of insurance products and services for, primarily, medical and nursing care, and the development of various advice and agency services, including trust business

(3) Challenges for financial institutions

To provide financial services that meet the needs of the people, financial institutions are required to conduct sale operations and marketing with an emphasis on the customer perspective, thereby improving the design of financial products and services as well as their sales techniques.

Individual consumers rarely recognize their own needs explicitly in retail markets of financial products and services. This creates an expectation for financial institutions to do what suppliers of consumer products usually do. That is, financial institutions have to hypothesize about customer needs based on ongoing socio-economic changes, and to verify them through market surveys. Financial institutions are also expected to produce unprecedented innovative products and services, thereby creating new markets likely to genuinely satisfy customers.

(i) Regarding investment tools provided to individual investors, a challenge for financial institutions is to build an environment in which individual investors are able to make efficient asset management by investing in financial assets at home and abroad with a sense of security. Financial institutions are required to enhance the capacity to develop and sell financial products in accordance with different individual investors' different needs in their asset management. For example, it would be necessary for investment management companies to improve the capacity to capture individual investors' needs and make more independent-minded active contributions to the development of investment trusts. Financial institutions, in addition, would find it important to make more transparent the breakdown of costs incurred by individual investors, such as sales commissions.

(ii) Another challenge in the context of linking the financial assets of individuals to economic growth is to expand the asset management of institutional investors, such as deposit-taking institutions, insurance companies, and pension funds as well.

The use of defined contribution pension plans is steadily increasing, but it is still not enough. PE fund investments have secured a firm position as an alternative product in developed countries in Europe and North America, but not so in Japan. Even microfinance-based funds have reached only the embryonic stage.

(iii) In accommodating demand for financial services from individuals living their day-to-day lives, a challenge for financial institutions is to promote such product design and sales as to be able to respond to individual customers' diversifying demand. In particular, there is a prospect that the elderly will become a principal customer segment due to the demographic changes. This raises the necessity for financial institutions to accommodate financial services demand peculiar to aged individuals by expanding, for example, medical and nursing care insurance.

(iv) The last challenge for financial institutions is to maintain the provision of financial services to individuals living in rural areas, which suffer from rapid depopulation with fewer children and the further aging of society. Such demographic changes require financial institutions to reconsider how they provide basic financial services, such as the depositary and settlement services, in local communities.

(4) Addressing the challenges

(i) In addressing these challenges, it is essential for financial institutions to conduct such management as to weigh heavily and grasp accurately customer needs. To achieve this, financial institutions need to reinforce their management resources, reform their internal decision-making processes, and improve the transparency of the information provided to customers.

With regard to reinforcement of management resources, the development of human resources is important. To supply such financial products and services as to win the admiration of customers, financial institutions need to prepare personnel who possess financial knowledge and attach importance to the customer perspective. Financial institutions' sales attitude should be orientated not to the acquisition of sales commissions but to the accomplishment of genuine customer satisfaction. The sales attitude orientated to just satisfying the principle of suitability falls short. Financial institutions need to make sales efforts based on consulting activities that enable them to specify financial products and services matching customers' genuine needs and wants. Eventually, these suggest that the appropriateness of sales activity will not be secured without the enhancement of sales people's mindsets. What are needed for fostering and maintaining such sales people include changing the mode of personnel rotations, shifting the emphasis of employee evaluation systems, setting a new goal in internal company training, and investigating reform on the structure of industry qualifying examinations.

Internal decision-making processes have room for improvement. Business chances discovered by sales people who succeed in an accurate grasp of customer needs have to be taken and turned into the commercialization of products and services under the leadership of the management team. This requires building internal decision-making processes which enable quick implementations of countermeasures.

Realizing a situation where financial products and services responding appropriately to customer needs are on sale is premised on the ability of customers to make purchase decisions based on cost-effectiveness. This requires financial institutions' own efforts, such as exercising their ingenuity to making it easier for customers to understand the details of fees and other costs they will bear. In particular, meeting different individual customers' needs is accompanied with diversifying financial products and services through unbundling and rebundling, and this makes it more important to ensure the transparency of fees being charged.

(ii) To strengthen the capacity to supply funds in ways conducive to economic growth, a review is needed on how institutional investors, who are entrusted with funds from individuals, ought to manage those assets. They should expand their investment and lending to areas of growth by either independently or via investing in outside investment funds. As for securities investment, rather than being entirely-focused on index investing, institutional investors are required to make contributions to the growth of specific companies in which they invest, through their investment in companies on the base of independent research and analysis. Regarding pensions, the huge amount of funds are managed in the public pension system, and utilizing a part of them in ways conducive to economic growth will contribute enormously to Japanese economic growth, whilst the long-term stability of managing public pension funds needs to be maintained. What should be considered for defined contribution pension plans include environmental developments and awareness-building activities designed to increase their use, as well as the development and sale of investment trusts that have similar product characteristics to the plans.

To open up new fund mediation channels, it is one option to mobilize the funds of the wealthy through feeder funds that act as an intermediary for PE fund investments. Another option is to develop wholesome microfinance-based funds while being mindful of the need for investor protection.

(iii) To accommodate needs that individual customers have in their daily lives, it is imperative that managerial efforts are made with regard to the development of products and services.

As for insurance products, financial institutions are required to deal with the diversification of people’s values and lifestyles, which is in progress due to the declining birthrate as well as the decreasing and aging population. For example, financial institutions would find it necessary to explore how they develop and offer insurance products and services, such as insurance products that flexibly combine medical and nursing care insurance and private pension insurance, as well as new types of insurance products, and various services to be provided beyond the present business interface in association with insurance services.

A well-rounded characteristic for the financial circumstances of the elderly is that they possess considerable assets, such as bank deposits, postal savings, rights to receive pension benefits, and real estate, whereas they do not own a sufficient amount of liquid assets. This suggests that the elderly have a need for financial ways and means that make it possible for them to gain cash by use of their assets, in addition to a need for financial products and services for the expansion and disposal of their assets, such as those related to asset management as well as those related to trusts and inheritance. Moreover, it is becoming increasingly important for financial institutions to explore new financial ways and means for the elderly from such an angle as to exercise the flexible nature of trusts; mainly, their property management function.

Apart from the business lines mentioned above, financial institutions would find it important to make efforts in their product development for a wide range of business lines linked with people’s lives. Demand for personal financial services is diversifying not only because of inter-generational and intra-generational differences, but also because of the diversification of work styles and mindsets. For example, as a result of the drift towards non-regular employment patterns, there are rising needs for consumer loans and credit-card loans to cope with temporary cash positions. Therefore, it is important to continue to make efforts to form sound consumer finance markets.

(iv) Strengthening the capacity of the financial industry to develop and sell financial products and services is premised on the creation of the situation where customers are able to get a clear understanding of their own needs and to make purchase decisions based on sufficient information and plentiful options.

What are needed for meeting such a premise include fostering independent investment managers, and building up an environment in which insurance brokers can function properly. At the same time, it is important to secure their soundness and reliability. With regard to trusts, it is also worth considering the creation of an environment in which small, specialized players can play an active part in new trusts, like welfare-type trusts for instance, in order to let customers enjoy the expanded merchantability and availability of trust products after the implementation of the new Trust Act.

Moreover, it is essential to bring up financial advisors who hold a neutral position. The financial sector has now a large number of qualified financial planners. However, most of them are employed by specific financial institutions, and they are able to give advice to their customers only with reference to specific menus consisting of financial products and services provided by their employers. It is desirable for individual customers to receive financial services and products in a situation where providing independent advice to them is a business in its own right; that is, such an environment needs to be created as to encourage neutral financial advisors to strike out on helping individual customers to clarify their master plans for life and to appropriately select financial services and products from expanded menus consisting of items provided by different financial institutions.

It is also important to review the production and sales separation for financial services. In the financial industry, product development and sales for investment trusts and insurance have been separated from each other and assumed by different types of financial institutions. More recently, some trust banks have begun to sell their trust products by utilizing the sales channels of their group companies. Such a separation can help financial institutions to increase their efficiency. Generally speaking, however, if the industrial structure for the development and sale of goods and services becomes immobilized, a distribution firm with strong sales force will be able to have the power to incorporate its inclination into its client makers' development of goods and services. This can result in generating a tendency that the near-term availability of sale commissions for the distributor is put before the long-term maintenance of customer satisfaction.

It is important to reinvestigate the present production and sales separation for financial services from the perspective of whether or not financial products and services truly necessary for individual customers are actually on sale. In particular, both cooperation between investment trust companies and distribution firms, such as securities companies and banks, and cooperation between insurance companies and insurance agents, call for unceasing investigations.

(v) How to establish sales channels is a topic of importance in the provision of personal financial services. In light of the progress of the demographic changes, developments in information technology, and advances in the formation of financial groups, the industry will be forced to make major reforms to the size and structure of sales channels in each of the financial business categories, such as the securities, banking, and insurance business categories. The growing presence of online securities companies has been already observed in the securities business. There is growing investment in the building of sales channels other than staffed branches in the banking business. Momentum is gathering for the diversification of sales channels in the insurance business from those centered on sales staff and agents to those based on direct sales. Financial institutions are expected to make efforts to establish sales channels most suitable for the accommodation of needs that individual customers generate through living their lives.

As for the sales channels in rural communities, which suffer from the progress of depopulation, the economically and socially disadvantaged people in such communities must be prevented from losing access to basic financial services. For this purpose, financial institutions need to give due consideration from the viewpoint of fulfilling the public nature of the financial industry. In this regard, effective steps to be taken by financial institutions would include expanding the network of agents through alliances and other forms of alignments, as well as diversifying sales channels with the provision of financial services through the Internet and electronic money in accord with the progress of information technology.

Chapter 3 The Roles of Government

(Towards public-private collaboration efforts)

As Japanese financial institutions carry on their businesses with a greater emphasis on the customer perspective, Japanese financial authorities will be required to make a further development in their financial administration, in which they are basically given a number of objectives and are able to employ several approaches corresponding to the objectives. The first objective is to ensure the stability and appropriateness of financial functions. On the basis of the achievement of this, the second is to seek improvements and revitalization of financial functions. These two objectives can be regarded as immediate objectives needed to be met in the financial administration in order to encourage the financial industry to make the utmost contributions to the economy through its creation of value that wins the admiration of the users of financial services.

To achieve the first objective, it is obvious that the financial authorities are required to fulfill important roles by ensuring the stability of financial functions and the fairness of markets, and also by protecting the users of financial services, as they always have been. This is all the more true when the excessive activation of finance ends up causing an external diseconomy, namely the instability of the financial system, as seen in Europe and North America recently. In addition, the financial authorities are expected to perform a certain function when the risk that some financial institutions may abuse the information gap to harm the interests of customers is found.

Ensuring the stability of financial functions is nothing more than a necessary condition for the financial industry to perform its contemporary roles of supporting the real economy and becoming a growing industry to lead it. When the necessary condition is satisfied, the perspective of improving and revitalizing financial functions is required in the financial administration. It is the perspective aspiring for improving the financial functions, revitalizing financial markets, and maximizing user convenience. In a situation like that seen recently in Japan, where it is required to exploit new markets at home and abroad in response to slackening in economic activity and sluggish demand for funds, finance is expected to fulfill its functions more actively, and supporting this is the role of financial administration.

For example, it is difficult to understand correctly the growth potential and risk profile of tiny, small and medium enterprises, new industries, and new markets, even for financial institutions. This can make individual financial institutions become overly risk averse, thereby generating the risk that the provision of funds will fall short as a whole. It is sometimes necessary for financial institutions to take risks collectively in places where relevant information is insufficiently available and market size, primarily, is limited, like new markets at home and abroad. Some foreign markets are difficult for Japanese financial institutions to enter due to institutional barriers made by foreign authorities. The general revitalization of individual rural communities is literally the public goods for individual financial institutions in regional economies, and therefore it calls for public sector involvement. Furthermore, improving the infrastructure of Japanese capital and financial markets takes on the meaning of the establishment of international public goods. Thus, it is the role of financial authorities to support the realization of an optimal state that the market mechanism cannot create with the risk conversion and information production functions executed by individual financial institutions.

To revitalize financial functions, the financial administration has to have a perspective aiming at inducing spontaneous initiatives from private financial institutions and complementing them. Such a perspective will be accompanied with employing an approach that can be described as an evolved form of the Better Regulation.

Japanese financial authorities have so far worked through the Better Regulation and accomplished certain results by making continuous efforts with an emphasis on financial institutions' own efforts and incentives. When the financial authorities place the focus of their policy maneuvers on stabilizing financial functions or protecting users, they are sometimes driven to employ an approach that can bring about a sense of tension between the financial authorities and institutions. On the other hand, when the financial authorities place the focus of their policy maneuvers on improving and revitalizing financial functions, they will need to employ an additional approach that has the perspective of promoting public-private collaboration initiatives through dialogues and concerted explorations of solutions by the financial authorities and institutions.

Specifically, to gain financial institutions that improve and revitalize their financial functions and meet customer needs fully, financial institutions themselves, firstly, need to build and strengthen their own management strategies. Following such attempts made by the financial institutions, the financial authorities will be required to fill their role by removing impeding-factors for those attempts as well as fostering an environment encouraging them. The scope of such reforms to be made by the financial authorities should include both domestic and foreign regulations, both institutional and operational affairs, finance-related law, and the tax system.

Moreover, the financial authorities will be required to work in close cooperation with a wide range of players. To encourage and support the management of financial institutions which weigh heavily the customer perspective, the financial authorities need to expand cooperative relationships across a variety of entities, which include not only traditional counterparts, such as self-regulatory organizations and other financial industry organizations, but also the government-affiliated financial institutions and local governments, and relevant authorities at home and abroad. The financial authorities also need to work together in the "industry, academia, finance + government" collaboration.

Furthermore, revitalizing the Japanese financial and capital markets is a precondition to ensuring the fulfillment of financial functions, and therefore it is vital to make efforts for that. Through *Action Plan for the New Growth Strategy* (December 2010) and other policies, the

FSA has so far promoted institutional developments and regulatory reforms from such perspectives as the appropriate provision of funds according to the size and growth stage of the company, finance which links Asia and Japan, and the development of an environment in which the people can use their assets effectively and with a sense of security. In doing so, arrangements have been made for investigation by self-regulatory organizations and other relevant bodies for the purpose of promoting specific policies, such as institutional developments for rights offerings, revitalization of the corporate bond market, and development of the English language disclosure system. Going forward, it will be important to further promote these endeavours, expanding both the coverage of relevant bodies and the scope of the examination.

1. For the development of corporate financial services

(1) Global expansion of corporate financial services

(Outward globalization)

(i) The international expansion of Japanese financial institutions is affected by regulations and institutions in Japan and overseas. When the financial institutions promote the international expansion, they are sometimes confronted with problems in overseas markets that are difficult for private-sector players to sort out and therefore impede their international expansion. The financial institutions find it useful to obtain outside support in some cases, especially that from Japanese financial authorities. Together with Japanese financial institutions, the financial authorities need to collect information internationally and work on foreign authorities to reform their regulations that constitute obstacles to the international expansion of Japanese financial institutions. For this, Japanese financial authorities should actively harness opportunities, including bilateral discussions, negotiations for the liberalization of financial services at the WTO and economic partnership agreement (EPA) negotiations, as well as international frameworks of financial cooperation in Asia, such as that in ASEAN+3 countries. Moreover, as the Japanese financial system is equipped with progressive institutional arrangements which have gained a certain degree of recognition, such as the system to protect investors in a cross-sectional fashion, and the system of calculation and provision of reference loss cost rates and standard full rates for plain nonlife insurance products, it should be investigated to introduce such institutional arrangements overseas through public-private collaboration in light of the circumstances of each foreign country.

On the other hand, there could be occasions where the rules and execution of financial regulations at home interfere with the international expansion of Japanese financial institutions due to the balance with financial regulations abroad. It should be investigated to reform such domestic regulations as appropriate, after taking into account their purposes and effects well.

Regarding international financial regulations applied widely to financial institutions at home and abroad, Japanese financial authorities need to actively participate in the rule-making and to put effort into building a regulatory environment that encourages Japanese financial institutions and markets to exercise their functions fully. Japanese financial authorities have so far worked hard with the Financial Stability Board (FSB) and in other places that build new international regulatory frameworks following the Lehman Shock, in order to realize such frameworks as to enhance the medium- to long-term robustness in financial systems, and to pay much attention, in parallel, to impacts that new regulations will have on real economies. The financial authorities should continue such efforts.

(ii) In supporting the international expansion of Japanese financial institutions, it is beneficial for Japanese financial authorities and institutions to cultivate strategic cooperative relationships with third parties, mainly Japanese government-affiliated financial institutions. When Japanese financial institutions exploit new markets in foreign countries, it is effective for them to take risks collectively. The government-affiliated financial institutions have so far supported Japanese companies' corporate finance with respect to their cash management in foreign operations, M&A activities, and investment in natural resources. It should be explored whether there is scope for them to go further by supporting Japanese financial institutions' international expansion. When Japanese SME's advance their businesses internationally, they find it useful to obtain outside support regarding the acquisition of local currency and the collection of local information, especially support from regional financial institutions operating in their hometowns. Also in this context, it is one option to establish strategic cooperative relationships between Japanese private and government-affiliated financial institutions, taking care not to let the latter overreach the principle that their mission is to supplement the private sector.

(Inward globalization)

(iii) It is required to build up the infrastructure of Japan's financial and capital markets in terms of their robustness and attractiveness, in order to encourage the markets to exercise functions to serve as the base for Japanese internationally-active companies and Japanese investors, and also as the hub of the global flow of funds, especially in Asia. For the Japanese financial and capital markets to gain the capability to perform a central role in Asia, both public and private sectors need to tackle jointly tasks for ensuring the consistency with global market rules and maintaining the institutional progressiveness. A financial market which is easy to use, efficient, and cost-free is needed.

On top of this, it is another perspective of importance to explore how Japan's financial and capital markets gain their own distinctiveness which will be appraised by Asian investors and fund-raisers. The Japanese markets are required to prepare the capacity to attract funds from Asia. To this end, the Working Group members suggested the following directions of efforts to be made: (a) nurturing of a market which provides functions that are well developed in Europe and North America but yet undeveloped within Asia, like the reinsurance function and the custodian function; (b) nurturing of a market which provides functions that are yet undeveloped even in Europe and North America, like intraregional local currency transactions in Asia; (c) promotion of standardization for the practical aspects of financial transactions based on how things really are in Asia; and (d) utilization of Japan's unique electronically recorded monetary claims system.

(iv) For the Japanese financial and capital markets to develop into the infrastructure benefiting investors in Japan as an investing nation, it is necessary for corporate and individual investments in foreign financial assets to yield greater fruits and bring them back to Japan, where the fruits can be managed both stably and efficiently. In this respect, the foreign exchange rates with large fluctuations will worsen the investment environment surrounding Japanese investors. This is why the government and the central bank need to soundly manage the macro-economy, which will contribute to stabilizing the foreign exchange rates. Expanding overseas financial transactions denominated in Japanese yen is beneficial too, because it helps reduce foreign exchange risks to be taken by Japanese investors upon investing in foreign financial assets. It is of great significance to promote efforts for the internationalization of the yen, like the Asian bond market concept.

(2) Local expansion of corporate financial services

To support the revitalization and restructuring of industry and the emergence of new industries through exercising own functions, the financial institutions need to address challenges in a number of areas, including human resources and expertise, financial affairs, organizational affairs, and corporate culture. At the same time, the financial authorities are required to eliminate factors, including regulatory factors, which impede financial institutions' exercising of their functions, and to develop an environment which encourages their endeavours.

(i) If there are any institutional or operational factors that are preventing financial institutions from fulfilling their risk conversion function and supplying funds in ways conducive to economic growth, then the financial authorities should examine measures to reform them.

(a) It would be needed to review whether or not several rules derived mainly from laws and official guidelines are exerting strong constraining influence over financial institutions that attempt to exercise the risk conversion function, even if the underlying laws and official guidelines are basically introduced for proper purposes, such as the maintenance of the soundness of financial institutions.

For example, when companies in a phase of business revitalization, especially SME's, attempt to accept an investment from financial institutions, they could end up acquiring a small amount of capital, because of the so-called 5% Rule stipulating banks' acquisition of companies' voting rights. There could be cases in which relaxing the rule will contribute to improving regional finance. It would be reasonable to deepen discussion further on the degree and conditions if the rule was to be relaxed, whilst its original purposes, including the maintenance of sound banking operation, need to be taken into account.

Looking at financial institutions' risk management from the perspective of the demonstration of risk conversion function, it is insufficient to build the capacity to make backward-looking analyses of risks of customer companies with a focus on their historical performance. Such a forward-looking viewpoint is important for financial institutions as to enable them to comprehensively grasp the future growth potential and business risks from many sides of customer companies and the entire region in which they operate. The financial authorities are required to improve the environment to encourage financial institutions to promote the preparation of such capacity.

(b) Mobilizing all available resources in "industry, academia, finance + government" is indispensable for promoting the general revitalization of individual communities. As areas expected to generate new industries and markets in local communities relate to medical and geriatric care, the environment and biotechnology, and agriculture, etc., efforts to be made in these areas require the involvement of the entire government working as one. To specify a growth field in each local community, it is beneficial to deepen "industry, academia, finance + government" collaboration, including local governments. Regulations imposed in such growth areas by relevant authorities could obstruct private-sector firms mainly by preventing them from entering into new markets and developing their businesses, while the authorities have imposed such regulations from their own administrative perspectives regarding assigned areas, such as medical cares and environment. This outcome is increasing difficulty for the financial institutions to provide funds to the growth areas. If the situation calls for it, the financial authorities will work with financial institutions and encourage the relevant authorities to review the regulations in question.

(ii) The financial authorities need to develop an environment which encourages financial institutions to actively exercise their risk conversion and information production functions.

(a) It is indispensable for financial institutions to expand their ability to discern the business potential of customer local enterprises, in order to supply funds conducive to economic growth. To this end, financial institutions have so far made their own efforts and promoted "industry, academia, finance" cooperation. Local governments and relevant authorities should explore how to support the private-sector endeavours for the accumulation of knowledge and information.

(b) It is also important to broaden financial institutions' means of taking risks that do not depend on traditional collateral, mainly real estate. Regarding ABL, there is legal vulnerability in relation to the requirement for claiming rights against a third party, and it costs much to measure asset value. To address these challenges, it would be beneficial to make relevant efforts, including the sharing of know-how with the help of the advice of outside experts and through industry organizations, and the promotion of making institutional improvements. In addition, it is important for the financial institutions to actively support the spread of electronic monetary claims. Moreover, it is needed to diversify financing methods, mainly a method for the provision of quasi-equity, such as the use of DDSs.

(iii) It is necessary for financial institutions to expand and reinforce their business foundations based on solid management strategies, in order to let them exercise their functions and contribute to the growth of regional economies. The leadership of their management is indispensable for this, and the financial authorities are required to provide them with necessary support.

(a) It can be an important option for financial institutions to promote integration and realignments or to organize extended associations over a wide area among them, in order to expand and reinforce their business foundations. It has long been pointed out that the so-called overbanking occurs in regional economies. Looking at such future trends as the demographic changes as well as structural changes and industrial restructuring in regional economies, the point was also raised in the Working Group that financial institutions are required to expand and reinforce their business foundations more actively than before. If financial institutions share such an awareness of the issue and aim to promote integration and realignments or organize extended associations over a wide area, then financial authorities will be required in some cases to provide them with a variety of support, such as information-provision and relevant coordination.

(b) It is pointed out in general that effective disciplines on corporate managers include market competition, governance by shareholders, and supervisory authorities. In the Working Group, the importance was pointed out of investigating the reality and mechanics of the competitive environment surrounding regional financial institutions. In connection to this, a view was presented there that regional financial institutions compete severely for the sales of existing products and services while they compete insufficiently for developing their businesses in new directions so as to create value that wins the admiration of customers. Additionally, in the Working Group, it was indicated on shareholders' governance of the management of joint-stock regional financial institutions that discipline on management could be weakened due to the shareholder composition of local borrower companies becoming major shareholders. Regarding the supervision and inspection by the financial authorities, it was pointed out in the Working Group that the managers of financial institutions are so fearful of the materialization of reputational risks or compliance risks that they are apt to avoid independently trying new challenges. The financial authorities need to address reviewing and improving as necessary the competitive environment surrounding financial institutions, the governance for them, and financial regulations, in order to create an environment that disciplines financial institutions adequately and encourages them to try new challenges.

(iv) It is also important to expand financiers with the capability to take risks.

(a) Financial institutions do not always take all the risks contained in projects to be financed with their loans or capital subscription. The fund-provision by financial institutions in ways conducive to economic growth can be of any type, such as direct provision by financial institutions as well as indirect provision through several investment funds; for example, venture capital, corporation reconstruction funds, and region-based funds. In addition, when financial institutions change their business models due to integration and realignments, their customers could lose access to some specific financial products and services according to suppliers' convenience, thereby generating unsatiated financial needs. This can lead to broadening the reach of deposit-taking institutions by inviting new entrants. It is important that various types of players engage in business start-ups and business revitalization in cooperation, and it would be effective if the financial authorities make environmental developments with an aim at expanding networks for this.

(b) Collective risk taking by several types of financiers would be effective in advancing new forms of public utilities, such as New Town Planning. This is partly because the scale of such a project is too large for an individual financier to take all the risks contained therein. In this case, institutional investors are expected to take some risks through their investments in relevant funds, while government-affiliated financial institutions are expected to exercise the function of supplementing private sector's risk taking. The government also needs to continue to promote the utilization of private-sector vitality through, for example PFI's, and the diversification of methods to raise funds from private-sector investors and lenders, such as the active use of revenue bonds.

2. For the development of personal financial services

(1) Provision of financial products and services from the customer perspective

The role to be played in the financial industry through providing personal financial services is to contribute to Japanese economic growth by letting the financial assets of individuals be used in ways conducive to it. The individual customers have needs related to managing their investment assets, while they go about their everyday lives with several needs for financial products and services. The role of the financial industry will be fulfilled by responding more sensitively to the diversifying needs of individual customers and exercising the risk conversion function. This requires financial intermediaries to perform their functions even more, and expects new entrants to appear. These should be encouraged in an environment improved by the financial authorities.

(i) It often happens in personal financial services that individual customers can neither identify their own needs nor select financial products and services suitable for them, partly because individual customers lack sufficient financial literacy. Financial institutions need to understand such a situation fully and improve the capacity to develop and sell financial products and services in accurate response to customers' characteristics. The financial authorities need to adequately incentivise the financial institutions to promote such efforts.

(a) The financial authorities need to work together with self-regulatory organizations and explore the establishment of self-determined rules, expanding the content of qualifying examinations, and implementing various training programs. For example, as far as the qualifying examinations, especially the Securities Sales Representative Examination, are concerned, more attention should be paid to how to sell financial products and services in accurate response to customer needs, as well as to acquiring specialized financial knowledge and compliance with laws and regulations. An emphasis should be placed on fostering the consulting function of sales people. The function is to introduce individual customers financial products and services suitable for their needs that sales people clarify to the customers by supplementing their lack in financial literacy, based on autonomous professional responsibility backed by specialist knowledge.

(b) It is important that individual customers become able to understand costs, such as commissions on the sale of financial products and services, in order to enable them to make selections that match their needs. This should be achieved by financial institutions' own ingenious attempts, and the financial authorities need to improve the environment to encourage their efforts.

(c) With regard to investment trusts which are expected to become a main investment vehicle for individual investors, financial institutions are expected to establish the capacity to develop and sell them in accurate response to customer needs. Especially, investment trust companies are expected to be more actively involved with the development and selling process of investment trusts. The financial authorities need to promote the establishment of an environment that enables investment trust companies to display their ability to develop investment trusts accommodating the true needs of customers. When the financial authorities do so, they should place focus on whether investment trust companies ascertain the true needs of individual investors and develop investment trusts in response to them, without being captive to the sales policies of major distribution firms with strong sales force. The financial authorities should place focus also on whether independent, small and medium-sized investment trust companies are allowed to sell their products widely through several channels, including direct selling.

(d) It is a challenge to improve financial services in response to needs that individuals have in their everyday lives, and this should be addressed by the private-public collaboration. Various types of financial services, such as banking, insurance, trusts, consumer loans, and settlement services, will be required to transform in light of socio-economic changes, including the demographic changes as well as structural economic changes in local communities. The financial authorities should make the environment more helpful for financial institutions to develop and sell new services in flexible responses to those changes. In doing so, attention should also be paid to the maintenance of financial service provision in rural areas on the basis of the public nature of finance.

(e) Improving the financial literacy of customers will also continue to be important. Financial and economic education has been advanced by such bodies as the FSA, the Central Council for Financial Services Information, and by industry organizations. Going forward, the effectiveness of this education will need to be further enhanced, with greater cooperation with private financial institutions. In doing so, the financial and economic education needs to aim at going beyond just the technical acquisition of financial knowledge, and to aspire for learning which allows individuals to acquire the ability to take the initiative in making financial investments through positioning them adequately within their own life plans and on the basis of macro-economic trends. The point was raised in the Working Group that consideration should also be given to taking up financial and economic education at primary and secondary school from the perspective of fostering young people's zest for living in society.

(ii) It will also be important for the financial authorities to support the entry and development of new players. Although there are many qualified financial planners, at present, most of them are employed by specific financial institutions. However, in the medium- and long-term, the environment will have to be improved to allow customers to receive advice from experts holding neutral positions. Independent financial intermediaries and neutral financial advisors need to be nurtured. There are calls for mechanisms to be built which provide individual customers with a rich line-up of investment trusts, insurance and other financial products and services, and allow the customers to make selections and purchases while receiving professional, neutral advice.

(2) Transformation of personal funds into capital inducing economic growth

The financial assets of individuals have been accumulated mainly as bank deposits, postal savings, insurance, and pensions. It is hoped that these funds will be further utilized for the growth of the Japanese economy through the asset management of institutional investors offering those products. There is a limit to direct risk taking by individuals. The expansion of the risk conversion function performed by institutional investors through their asset management has an extremely important implication for supporting the Japanese economic growth. The role of insurance companies and cooperative financial institutions is important, both of which already have a certain presence as capital suppliers to investment funds.

It is necessary to expand further the capacity to supply funds in ways conducive to economic growth through institutional investors' investing activities. In this regard, it would be a counterplan for financial intermediaries to develop investment tools, such as investment funds for SME start-ups and revitalization or the promotion of new industries, and to sell them more actively to institutional investors. At the same time, institutional investors are required to flexibly examine the use of newly developed investment tools, without setting investment targets rigidly. The creation of such a relationship between financial intermediaries and institutional investors should be encouraged by environmental improvements made by the financial authorities.

Regarding pensions, the financial condition of public pensions, for which the government is responsible, is expected to deteriorate further due to the demographic changes, and therefore maintaining the long-term stability of managing public pension funds needs to be put first. Thus, when fund investments or other non-traditional investments are made by use of public pension funds in order to improve the efficiency of public pension investments, additional preparations need to be made, such as fostering human resources and enhancing the capacity to manage risks. As for defined contribution pension plans, governmental efforts to encourage the use of the plans should be explored.

It would be beneficial in the medium- and long-term to nurture new financiers that supply funds in ways conducive to economic growth. To open up new fund mediation channels, it is desirable to develop investment tools that contribute to the mobilization of the funds of wealthy people. It is necessary to create an environment that encourages the sound development of microfinance-based funds, which mediate small contributions by ordinary people in empathy with investment projects, while being mindful of the need for investor protection.

Consequently, endeavours of various players, including institutional investors, to manage their assets more efficiently and actively will lead to discovering the sources of higher returns, thereby enabling the financial assets of individuals, who are the original providers of funds, to be diverted eventually to areas of greater growth potential.

Chapter 4 Future Efforts

The medium- and long-term future of the Japanese financial industry depends on the active creation of diverse values that win the admiration of customers at home and abroad. Through such a value-creation, the financial industry will be able to play the role of supporting the real economy and that of leading the economy as a growing industry itself.

To this end, the modality of financial institutions' management strategies is of foremost importance. The management of a financial institution is required to provide leadership in formulating its own management strategy with a greater emphasis on the customer perspective, and in expanding the business foundations necessary for strategy execution. Next, each financial institution needs to continue to enrich its business foundations in order to respond to customer needs. In this respect, Japanese financial institutions are required to strengthen their organizational structures so that they will be able to develop their businesses either horizontally or vertically at home and abroad in accordance with customer needs. The financial institutions are also required to achieve improvements in their profitability and capital adequacy by creating markets appreciated by their customers. To meet these requirements, Japanese financial institutions will find it necessary to nurture more advanced experts in finance. In this connection, the financial institutions need to promote the accumulation of knowledge and information in finance, mainly with the help of "industry, academia, finance + government" collaborations and self-regulatory organizations' contributions. The financial institutions also need to make efforts to steadily cultivate specialized, internationally minded, professionally ethical, and richly experienced human resources.

These endeavours made in the private sector will be assisted by the financial authorities whose supportive measures include environmental improvements and regulatory reforms. Environmental improvements need to be made by the authorities with respect to the industrial organization as well, and include those encouraging the integration and realignments of financial institutions, the entry of new players, and the nurturing of independent financial intermediaries and neutral financial advisors.

Thus, it would be beneficial to establish a platform for sustained dialogue, where the financial industry and financial authorities set tasks and goals from a shared point of view, and then they collaborate towards achieving the goals by performing the tasks. The FSA has so far set up this kind of platform for public-private collaborative discussion when implementing various policies, including *Action Plan for the New Growth Strategy*. As a way of expanding this, consideration needs to be given to establishing a public-private roundtable. In doing so, it is also worth considering the expansion of membership, such as adding financial services users to the public and private sectors.

(i) Shared codes of conduct (principles)

At the public-private roundtable, it would be useful to explore and develop codes of conduct which can be shared by the users of financial services in addition to financial institutions and authorities. The FSA formulated *Principles in the Financial Services Industry* (April 18, 2008), and made them the guidelines for financial administration. Going forward, financial institutions and authorities could further develop the principles and share them in a sustained manner.

In doing so, the first step would be to confirm that the role currently being asked of the financial industry is to support the real economy and to lead the economy as a growing industry itself. For this purpose, Japanese financial institutions need to create new value and new markets by getting an accurate grasp of customer needs, thereby raising the profitability of financial industry sustainably. To be more specific, a code of conduct that requires the financial institutions to maximize customer interests and lead this to their own profits would be included as one of the basic standards. In personal financial services, the code of conduct could guide the financial institutions to concentrate on getting an accurate grasp of customer needs and leading this to the establishment of a sustained business relationship (including the principle of suitability, ban on conflicts of interest, fiduciary responsibility, etc.), and also guide them to foster individual staffs' professional responsibility for this purpose. In corporate financial services, on the other hand, codes of conduct for financial institutions could include working on sharing the same recognition of customer companies' business objectives and strategies; fulfilling the risk conversion and information production functions, thereby achieving mainly a smooth provision of funds; and, linking this achievement to the establishment of their own profit base. In both personal and corporate financial services, the code of conduct could guide the financial institutions to expand and strengthen their business foundations and improve their corporate governance in order to meet the expectations of their customers.

(ii) Formulation and sharing of action plans

In promoting public-private collaboration efforts, financial institutions and industry organizations, firstly, will be required to assess the current situation and specify concrete tasks. Of such tasks, some ought to be performed by financial institutions, and they will need to commit themselves to do this. Others require the involvement of the financial authorities, such as the reform of domestic and foreign regulations, and improvements to markets, and the authorities will need to commit themselves to investigate these efforts.

To ensure the effectiveness of efforts to be made by financial institutions and authorities, it would be beneficial for the two groups to make their own action plans and review the performance of their tasks with each other after a certain period of time. It could also be beneficial to investigate the setting of deadlines for finishing tasks as well as qualitative indicators to measure the accomplishment of goals. In doing so, however, the necessity and feasibility of deadlines and qualitative indicators must be investigated fully, and the diverse developments of financial institutions' management strategies must not be impeded. At the same time, consideration will also be required so as not to inhibit the flexible response to any changes in the external environment. Furthermore, it will also be important to conduct ex-post evaluations of the outcomes of efforts made by financial institutions and authorities, including the investigation of whether or not unintended negative consequences occur. In giving shape to the action plans, as a matter of course, it is essential that there be a close exchange of views among financial institutions and authorities.

The following are some examples of possible matters to be addressed in the action plans.

(Global expansion of corporate financial services)

[Outward globalization]

- Strategies related to expanding the breadth and depth of the globalization of Japanese financial institutions (development of networks of overseas bases, provision of local information and local currency, settlement and remittance services, etc.).
- Response to regulations at home and abroad that impede the overseas expansion of Japanese financial institutions.
- Strengthening of cooperation with government-affiliated financial institutions and other relevant institutions.
- Active participation in the rule-making for international finance.

[Inward globalization]

- Greater overseas investment of domestic funds.
- Attraction of funds from Asia and other regions overseas, greater provision of funds both domestically and abroad.
- Accumulation of financial technologies, human resources and know-how.
- Strengthening of the infrastructure of Japan’s financial and capital markets.

(Local expansion of corporate financial services)

- Improvement of the SME finance function.
- Provision of funds to new industries and New Town Planning (reinforcement of public-private collaboration contributing to stronger supply systems, responses to institutional impediments, etc.).
- Support for cooperation and alliances among financial institutions.

(Personal financial services)

- Improvement in the capacity to develop and sell financial products and services to individual customers.
- Expansion of institutional investors’ investment and lending to areas of growth.
- Strengthening of financial products and services to accommodate demand that individuals generate through their daily lives.

Concluding Remarks

A number of challenges lie ahead for the Japanese financial industry, and there are also many uncertainties in the long-term macroeconomic environment. With innumerable courses of action possible, future prospects are hard to anticipate. Aware that it presents too much of an almost pre-established harmony, if we were to venture to sketch a vision for the medium and long-term future of the financial industry, perhaps it would look like the following.

In this future, individuals, who are the users of financial services, can receive a range of financial services in a number of aspects according to their values, lifestyle, asset position and so on, as well as aspects according to the sources of their demand, whether it be managing their investment assets or living their day-to-day lives. A varied product line-up has been developed without any perceived barriers like banks, securities firms and insurance companies, and the reach of those responsible for financial services has broadened. New services are also provided which go beyond the traditional framework of financial transactions. All players in the financial industry have completely embraced the stance of developing and selling products and services from the perspective of individual customers. Furthermore, there has also been an increase in the number of neutral brokers who provide advice on the best combination of products from a broad range of financial products and players, as well as in the number of financial experts who can provide advice from a wider perspective of life plans. Meanwhile, many new sales channels have emerged which provide standard, commoditized financial products in a way that users can make comparisons. Although sales channels, including online sites, are steadily diversifying, face-to-face sales channels are providing meticulous financial services in which the needs of each and every customer are accurately identified. Moreover, personal asset management has been very fruitful for Japan, going beyond its domestic borders and capturing the growth potential of emerging countries in Asia and other regions. Many foreign products denominated in Japanese yen or in a basket of currencies have also emerged, and the line-up of financial products that limit foreign exchange risk has begun to develop substantially. Japan is on the road to becoming a mature creditor nation.

Near where these individuals are living, there are new towns, in which new industries rise. Japan has strived for corporate turnarounds and reorganizations in regional areas, and there is a general revitalization of individual rural communities underway. Japan is forging ahead with New Town Planning, such as more compact cities, in order to address the issues unique to the global front-runner, such as a declining birthrate and aging population, and a heightened awareness of the environment. New industries, such as nursing care, medical care, childcare, and renewable energy are also rising. Amid such circumstances, Japanese financial institutions are playing their part in the “industry, academia, finance + government” collaboration, and are making an active contribution to regional revitalization, mainly through the supply of funds. The financial institutions are fulfilling both the risk conversion and information production functions by cultivating and mobilizing human resources with the ability to discern the sustainable business potential of companies and industries and to actively provide financial instruments. Funds are being allocated in ways conducive to economic growth through a variety of channels, not just a channel of deposit-taking institutions. For instance, there is financing through a channel of institutional investors that invest in investment funds, as well as a channel of PE funds and microfinance-based funds. On the other hand, deposit-taking institutions have bolstered their business foundations so as to meet customer expectations. There has been an emergence of broad-based regional finance confederations and super regional banks. Through cooperation and alliances, as well as integration and realignments, they serve increasingly large regions while maintaining their community-based nature, and they succeed in achieving a balance between risk taking and risk diversification. Such regional financial institutions realize a virtuous cycle; that is, their risk taking results in increasing their profitability and capital strength, thereby allowing their further risk taking.

This trend of cooperation and integration among financial institutions will also be expanded beyond borders. With the progress of globalization, Japanese financial institutions are proceeding to expand overseas while deepening their cooperation and integration with other domestic and foreign financial institutions. They are meeting the needs of Japanese companies, and capturing the growth potential of emerging economies. There is multi-fold demand: (i) Demand from Japanese companies expanding internationally: the provision of funds, including local currencies, the provision of high-quality settlement services, practical and specialized information directly linked with business expansion, and a risk management function for insurance; (ii) Demand from global foreign companies and of local companies in regions targeted for expansion: supply of funds, settlement services, investment banking services, such as arranger services, and advice during M&As; and (iii) Demand from the middle classes living in emerging countries that are experiencing rapid growth: accurate and meticulous retail services related to commercial banking and insurance services. In order to accommodate such demand, Japanese financial institutions are developing various business models. Among them, there will be some financial institutions that are transforming into truly global players, expanding business globally and establishing their own corporate identity. These are financial institutions that will recognize the accelerating and expanding global flow of funds and manage the flow.

Japan is a country in which these global players are headquartered, and therefore the strength of the infrastructure of Japan's financial and capital markets is also an important support for them. Steady environmental improvements have been made to the Japanese financial and capital markets in order to efficiently manage the 1,400 trillion yen of financial assets. Consequently, those markets have become the most advanced and stable markets in Asia, boasting transparency and fairness. They also completely satisfy the rules matching the funding needs of Asia, and so are positioned as the nucleus of the flow of funds in Asia. Japan’s markets will attract the surplus funds of individual investors and others from Japan and abroad, and will supply them as new funding to industries both at home and abroad. Furthermore, some improvements have also made on reinsurance markets and systems to address large risks such as the risk of natural disasters, and this leads to the establishment of a market which can satisfy the insurance service needs both at home and abroad. Such financial and capital markets have built up specialized, professionally ethical, and internationally minded financial human resources and expertise, and both domestic and foreign players are competing to manage the abundant financial assets of Asia and beyond. The image of Japan’s financial and capital markets is one of forging ahead with its insatiable accumulation of knowledge, and remaining at the center of Asia’s flow of funds.

Finally, this report describes the outlook for the medium- and long-term state of the Japanese financial industry based on current conditions. Of course, individual financial institutions are responsible for establishing their own management strategies, and therefore their management strategies should be wide and varied across financial institutions. However, with regard to such an outlook, it is meaningful for the public and private sectors to deepen their common understanding, and to think together about the roles of the financial industry and the mode of financial functions, and about how financial administration and regulation ought to be. It is hoped that this report will serve as the guidelines for such efforts, and be used in the management of financial institutions and in the financial administration.

(Appendix Table)

Meetings of the Working Group

	Date	Agendas	Presenters* & Presentation Topics**
1st	June 24, 2011	General remarks	WG secretariat: “Preliminary Consideration on the Medium- and Long-Term Modalities of the Japanese Financial Industry,” etc.
2nd	July 29, 2011	Enhancement of the international competitiveness of the Japanese Financial Industry	Banking industry: “Strengthening the International Competitiveness of the Japanese Financial Industry” Nonlife Insurance Industry: “Overseas Expansion of the Tokio Marine Group and Associated Challenges” Securities Industry: “Towards Strengthening the International Competitiveness of the Japanese Financial Industry”
3rd	September 2, 2011	As above	Japan Center for International Finance (JCIF): “Current State of Foreign Banks Operating in Local Areas, and the Future of the Emerging Economies of Asia” Sumitomo Chemical Company, Ltd.: “Our Business Expansion and Corporate Finance in Overseas" Mitsubishi Corporation: “Our Financing Activities and Medium- and Long-Term Issues” The Hongkong and Shanghai Banking Corporation, Ltd.: “Our Global Strategy”
4th	September 30, 2011	As above	J.P. Morgan: “J.P. Morgan’s Global Corporate Banking Strategies” Goldman Sachs Japan Co., Ltd.: “The Strategies of Goldman Sachs” WG secretariat: “Examination of the Enhancement of the International Competitiveness of the Japanese Financial Industry from a Medium- and Long-Term Viewpoint” (Discussion Summary)
5th	October 14, 2011	Improvement of the financial functions in regional economies	Bank of Japan: “The Status Quo of Regional Finance” HARIMAYA, Associate Professor, Ritsumeikan University: “Efficiency Analysis of Regional Financial Institutions: Survey of and Challenges in Major Research Topics” ONO, WG member: “Economic Analysis of Loans to SME’s: Theory and Reality” Financial Services Agency (Supervisory Bureau): “Background of the Promotion of Region-Based Relationship Banking, etc.”

6th	October 28, 2011	As above	Inspire Corporation: "Our Recognition of Financial Services from the Eyes of a Business Company that is Engaged in Managing Venture Capital Funds and is Involved with Managing Start-up Companies" Fuji Seira. Co., Ltd.: "Improving the Financial Functions in Regional Economies" High Performance Motion System Development Co., Ltd.: "Expectations for Japan's Financial Services" NOZAKI, Managing Director, Citigroup Global Markets Japan, Inc.: "Challenges in Regional Finance and Countermeasures"
7th	November 18, 2011	As above	DOGAN Advisors, Inc.: "New Attempts in Regional Economies and Their Accomplishments" The Kagoshima Bank, Ltd.: "Towards Improving the Financial Functions in Regional Economies" WG secretariat: "Examination of the Improvement of the Financial Functions in Regional Economies from a Medium- and Long-Term Viewpoint" (Discussion Summary)
8th	December 2, 2011	Financial services meeting the needs of the people	TAKUMORI, Chief Economist, Sumitomo Mitsui Asset Management Co., Ltd.: "Personal Investment in Risk Assets: The Environment Surrounding Japan's Household Sector" Japan Association for Financial Planners: "The Needs of Personal Investment in Risk Assets as Viewed by Financial Planners (FP)" IWAISAKO, Associate Professor, Hitotsubashi University: "Portfolio Selection Theory and the Asset Holdings by the Japanese Households" IGATA, WG member: "Developments in Market-Based Finance in the United States: Economic and Institutional Backgrounds and Their Significance"
9th	December 16, 2011	As above	Morningstar Japan K.K.: "Japanese Investment Trusts: Challenges and Solutions" MITSUI and OTSUKA, Managing Director and Director respectively, The Carlyle Group: "Use of PE Funds in Japan" Music Securities, Inc.: "The Status Quo of Micro Investment"

10th	January 11, 2012	As above	YABUKI, Partner, A.T. Kearney: "Challenges in Personal Financial Services" SUGIURA, Professor, Chuo University Graduate School of Strategic Management: "Considering the Future of the Personal Trusts Business" OGAKI, WG member: "Provision of Financial Services that Meet the Needs of the People" WG secretariat: "Examination of the Provision of Financial Services Meeting the Needs of the People from a Medium- and Long-Term Viewpoint " (Discussion Summary)
11th	February 15, 2012	Presentation of research commissioned by the Financial Services Agency Discussions for preparation of the report	Nomura Research Institute, Ltd.: "Research on the Enhancement of the International Competitiveness of the Japanese Financial Industry" Mizuho Research Institute, Ltd.: "Research on the Improvement of the Financial Functions in Regional Economies" WG secretariat: "Structure of the Report" (Draft Proposal)
12th	March 12, 2012	Discussions for preparation of the report	YAMADA, WG member: "Corporate Financial Services of the Japanese Financial Industry (Global Expansion) ONO, WG member: "Corporate Financial Services of the Japanese Financial Industry (Local Expansion)" OGAKI, WG member: "Personal Financial Services of the Japanese Financial Industry" WG secretariat: Chapters 1 and 2 of the Report (Draft)
13th	April 18, 2012	As above	WG secretariat: Chapters 1 and 2 (Second Draft), Chapters 3 and 4 (Draft) of the Report
14th	May 15, 2012	As above	WG secretariat: "The Japanese Financial Industry: Desirable State in the Medium- and Long-Term (Present State and Future Outlook)" (Draft)

*: Honorifics omitted.

**: The presentation topics are originally in Japanese, and they are translated into English on the responsibility of the WG secretariat.