

## The Vision for the Future of the Financial System and Policy (Summary)

- Foundation for Japan with prosperity and diversity -

### Part I: The Vision for the Future

#### 1. Ongoing Changes

Industrial Financing Model	= Financing mainly through intermediation based on bank deposits and lending
Market Financing Model	= Financing through market-based intermediation which the pricing mechanism functions

The existing financial system, which is principally dependent upon the industrial financing model, is not fully capable of bearing the increasing risks stemming from the economy. While the industrial financing model will continue to be viable in the future as well, the role of the market financing model will become all the more important to detect, manage and allocate the risks. Therefore, it is necessary to construct a financial system in which both industrial financing and market financing are utilized with the market function set as its core.

Towards the new financial system, basic direction for financial intermediation can be summarized as follows;

- (i) Financial intermediaries should clearly recognize costs of funds (interest rate plus a risk premium) and ask for a borrower to cover such costs. (This needs to be emphasized for loans negotiated bilaterally, since, in the case of financial intermediation through market, a price commensurate with the would be found as part of market's own function.)
- (ii) Financial intermediaries should proceed with disaggregation of and specialization in

functions (in the case of banks, a shift from relationship banking based on the premise of long-term relationship to disaggregation of and/or specialization in functions, such as loan construction function, loan securitization function, or office operational function required for securitized products; in the case of financial intermediation through market, expansion of the role of institutional investors who connect individuals with the market and the market with enterprises).

(iii) Financial intermediaries should offer, according to the risk preference or life cycle of individuals who supply funds, a wide variety of different financial products through a single sales channel.

(ii) and (iii) mean the shift from a division of business operations of financial intermediaries by types of financial products offered to a division based on types of functions provided. Also, (iii) and (i) are interrelated, because securitization is essential to offer variety of products, and rational loan pricing is a prerequisite for securitization.

## 2. Roles of Different Players Under A New System

### (1) Financial Intermediaries

In the field of wholesale, the trend will be basically in a shift from lending to securitization but the differences between the two are expected to be further reduced as a result of expansion of project financing and syndicate loans. Investment banking services, which involve corporate balance sheet analysis and cash flow restructuring, will become more important as well. Even if traditional lending operations were to remain, they would supplement short-term credit, or accompany credit risk transfer or securitization in the case of long-term lending. Therefore, the degree of financial intermediaries' dependency on deposits as fund sources will decline. Furthermore, incentive to detach their office operational function will increase as well.

In the field of retail, it is suggestive that division of operation among institutions is observed in the U.S. For example, major banks serve small- and medium-sized enterprises

and individual customers in an mechanical fashion, at low cost and on a large scale by utilizing a scoring system while many regional banks and securities companies operate soundly based on their community-based service offerings. While major Japanese banks are inevitably moving towards the market financing model, the effectiveness of relationships in regional financial services would be recognized anew.

## (2) Companies

Looking at the corporate sector as a whole, the needs for companies to rely on external financing will shrink further. At major companies, the needs for investment banking services, such as assistance in organizational restructuring, will increase. On the other hand, small- and medium-sized enterprises that cannot be expected to attain growth substantial enough for venture capital investors to become interested in them will continue to be primarily served by banks. However, the relationship between each small- or medium-sized enterprises and its financing bank will likely be increasingly fluid and, accordingly, management assistance offered by banks, such as through shareholding and personnel dispatches, will probably become more limited.

## (3) Individuals

As products and services offered by financial intermediaries start to be differentiated, individual customers will begin to shift from one intermediary to another based on their own judgment, which will lead to expediting reorganization of financial intermediaries. As individual customers' needs for higher returns grow with the further aging of society, the shift from bank deposits to investments in financial markets will have to be supported by public policies.

## (4) Government

The government is required to facilitate, while also taking into account risk characteristics and differences in the degree of public involvement of each sector, financial intermediaries to disaggregate and specialize in functions. The principal axis of public administration needs to shift further from the one based on type of business to the one based on functions

offered. Needless to say, addressing systemic risks, protecting users and leading financial technology innovation will continue to be important roles of the government into the future.

### 3. The Vision for the Future of Public Financing

In moving towards a new financial system, it is essential to review the extraordinarily large share of public financing currently observed, with Postal Savings and Postal Life Insurance serving as a way in and government-affiliated financial institutions as a way out.

Postal services continues to make utmost efforts to operate on an equal footing with private financial businesses also after the transformation into a public corporation scheduled in 2003. In conjunction with the management reform, it is also necessary to examine the possibility to utilize the post office network as a sales channel of private financial products.

With regard to government-affiliated financial institutions, what is considered to be realistic and effective in order to facilitate the process of disaggregation of functions within the Japanese financial system will be to review their interest rates and to focus on the measures to assist in securitization of both public and private loans.

### 4. Cooperation with Other Asian Countries

With the acceleration of the regional integration of the EU, it will be even more important than ever for Japan to assume, as a member of the Asian region, a pivotal role for the cooperation in the region in both financial and actual economic aspects. As the industrial financing model and the market financing model can coexist in the vision for the future of the Japanese financial system, it is necessary to adopt finely-tuned ways of managing funds in Asian countries depending on the development stage of each country. Efforts will also need to be made to augment the incentive of Asian companies to list them in the Tokyo market.

## Part II: A Bridge to the Envisioned Future

### 1. Non-Performing Loan Problems and the Current Measures to be Taken by the Government

Opting out of overdependence on the industrial financing model and striving to shift into business models intended for higher profitability will provide financial resources for non-performing loan disposal. Promoting the process of securitization will provide tools for non-performing loan disposal. We hope that these visions for the future will be shared by all the parties concerned with the financial sector and will become a driving force of awareness and action towards the reform.

It is pointed out that non-performing loan problems are caused by several factors, such as overborrowing by companies, weak profitability of banks and overdependence on industrial financing model. As a premise to solve them, macroeconomic policies for overcoming deflation have a significant role. In addition, considering that a corporate loan disposal framework that could be trusted and shared by Japanese public is yet to be fully established, it is important to accumulate actual cases of disposal in a steady manner even if such disposal may accompany pain.

The authorities are required to promote the process of non-performing loan disposal through rigorous inspections that check financial institutions' self-assessments as well as through appropriate supervision.

### 2. Key Points in Business Model Shifting

#### (1) Lending Rate Setting Commensurate with Risk

Setting a lending rate that is commensurate with risk will enable a bank not only to improve its profitability but also expand the range of enterprises to lend to. Since the state of a borrower enterprise's management needs to be continuously monitored by the bank, the

management will be urged to conduct management reform in response to changes in its business environment.

## (2) Improvement of Retail Business

In order to make profits in the business with small- to mid-sized enterprises and individual customers, it is necessary to change drastically the traditional mindset to seek certainty of profits with regard to each customer, relying upon collateral. It is also imperative to thoroughly review existing services in the light of cost-effectiveness and lay down rules concerning financial services having elements of public goods, such as banking account with no commission.

## (3) Disaggregation of Functions of Financial Intermediaries

Bearing in mind the fact that loan construction and securitization are mutually complementary in providing funds, a framework for policy measures need to be established to facilitate disaggregation of intermediary functions. On the part of financial intermediaries, it is also necessary to set up a personnel and organizational structure in accordance with the applicable function.

## 3. Challenges in Capital Markets

Reflecting the outcomes from what is called Japan's Big Bang, and considering the importance of sales channels through which individual customers access capital markets, it is necessary to take measures to enable intermediaries to provide one-stop services. In addition, both public and private sectors need to make further efforts to change individuals' preference towards securities investment.

The infrastructure of the financial system, including the foundation for transactions such as settlement systems for funds and securities and securities exchanges, as well as tax system and accounting system etc., must be improved constantly from coherent perspectives to ensure security and efficiency of the financial system and protect users. In particular, revision of taxation on financial and securities products is strongly desired as a part of the

reforms towards simplified taxation.

Although the concepts that have hitherto been seen as symbols of the soundness and strength of American capital markets, such as disclosure, corporate governance, accounting and audits, have been shaken significantly since the Enron case broke out. However, we should not simply deny the American system but, instead, carefully observe and learn from the speed of the reform that both their public and private sectors are implementing.

#### 4. Role of the Government in Delivering the Vision

##### (1) Regulatory Framework

In order to promote innovation in the financial system, the government needs to respond actively to new entry of institutions, including non-financial ones, into financial businesses and also to examine regulations of business operations in a coherent manner with the direction of disaggregation of financial intermediary functions.

##### (2) What the Organization of the Financial Services Agency ought to be

While it is necessary for the agency, to be reorganized towards the future in a way to be adapted to the framework for the regulation of financial intermediaries, an immediate challenge is to strengthen the market surveillance system. For that purpose, efforts to strengthen the capacity of the Securities and Exchange Surveillance Commission needs to be made, and these efforts are expected to be met by continuous operational improvements on the side of the SESC.