April, 2013

Opportunities and Risks for Japan's Financial Industry to Ensure Growth — Financing for Global Competition, Fiscal, and Socio-Environmental Issues —

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This report is a digest of eleven reports released by the JCER Financial Research Team during fiscal year 2012 (April 2012 - March 2013), offering our policy and strategy recommendations on how Japanese financial institutions should deal with four issues facing Japan, namely (1) government finances, (2) social problems, (3) the earthquake disaster and regional reconstruction, and (4) the shifting of manufacturing offshore, as well as what financial framework would be most desirable.

Part 1 investigates ways in which financial institutions have dealt with Japan's sovereign risk. We analyze why Japanese financial institutions continue to purchase Japanese government bonds regardless of the Japan's largest outstanding sovereign debt (as a share of nominal GDP) in the world, and examine how Japanese financial institutions might best guard against risk and the extent to which deposit flight which might occur in the event of a future Japanese sovereign debt crisis with reference to the example of the global sovereign debt crisis.

In Part 2, we consider the financial framework that would be best to achieve sustained growth amid rising fiscal constraints in Japan as society increasingly ages, and we then propose an orientation for such a framework. We also propose that promising strategies might be found toward this end, as through the establishment of a public-private investment fund to enhance the added value of pro-environment real estate, the promotion of social finance as a framework to support financing of business firms grappling with social issues, and creation of a system to incentivize investment in education.

In Part 3, we overview feasible exit strategies from the Small and Medium Enterprise Financing Facilitation Act passed to help business firms cope with the Lehman Shock and the earthquake disaster. After interviewing persons actually working at organizations in the areas affected by the Great East Japan Earthquake, including government organizations, financial institutions, credit guarantee associations and investment funds, we have identified bottlenecks at the scene and suggested policy measures to cope with risks and other issues.

In Part 4, we discuss how Japanese banks might pursue survival strategies overseas as prospects for growth remain limited within Japan. There is rising debate in advanced nations concerning the danger that the bloated financial sector may undermine growth, and we suggest that important considerations for Japanese financial institutions will be not just increasing market share but building strategies and corporate cultures in line with the global and local standards.

The above analysis and proposals represent our attempt to move beyond a purely historical approach and instead look forward to the shape which Japan ought to take in the future. If our proposals can help point the way to greater economic growth for Japan and better earnings for Japanese financial institutions, our efforts will have been worthwhile.

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List of Report Summary

Report 1-1.

Why have Japanese Government Bond Prices been Stubbornly High?

– Coordinated Move by Investors, Rapid Breakdown Possible –

Financial Research Team:

Shohei Terada

Even though markets are concerned about the government debt and fiscal balance, yields on Japanese government bonds (JGBs), instead of moving higher, if anything keeps drifting lower. This report lays out factors underlying this trend and examines the risk of a collapse. For Japanese financial institutions, which already hold massive amounts of Japanese government debt, the cost of withdrawing from the market could be substantial, but there is mounting concern that the bloated government debt and the rising share of government bonds held by foreigners could lead to failures in coordination and a possible of a sharp decline in the Japanese government securities market. Such a prediction is a difficult one to make, and the best prescription would be to improve government finances.

Key Points

• An analysis of changes in yields on Japanese government securities shows that, gauged by the standard deviation and also by statistical skewness and kurtosis, the market remains stable compared to other countries. A principal component analysis of changes in the yield curve also shows stable influence at all maturities across the curve.

• The absence of alternative assets is one factor supporting the stability of JGBs. With the Japanese economy continuing to grow slowly under deflationary conditions, the Japanese stock market has remained weak over the long term. And as indirect finance is the norm in Japan, the corporate bond market is small, so the risk premium is not priced into the market as effectively as in the United States. This has served as a rationale leading domestic financial institutions to prefer Japanese government securities in their investment portfolios.

• The demand for government securities as risk-free assets is ingrained, and demand from foreign investors has also been rising of late owing to the short supply of risk-free assets. Under present financial regulations, government securities held by Japanese financial institutions may be treated as risk-free assets, so increasing holdings causes no deterioration in capital adequacy ratios for banks or solvency margins for life insurance companies.

• The possibility exists that this stability in the prices of JGBs may collapse due to a coordination failure among domestic financial institutions (the "Tokyo whales"), which hold but are unable to unload their huge holdings. Several factors could contribute to such an event: (1) changes in macroeconomic or monetary policies abroad (such as changes in market expectations or portfolio rebalancing); (2) surfacing of fiscal problems (such as a rise in Japan's sovereign risk premium); (3) an increase in the share of Japanese government debt held by foreigners (leading to higher volatility); and (4) exhaustion of capital gains opportunities as the potential for further upside in Japanese government securities prices disappears.

• It will be difficult for financial markets to anticipate and avoid a rise in yields following from a coordination failure. For this reason, the government should proceed with prompt fiscal reform before any erosion in the factors stabilizing the market.

Report 1-2.

Massive Deposit Flight during Financial Crisis

– Strengthen Surveillance and Capital Adequacy Ahead of Rapid Interest Rate Rise –

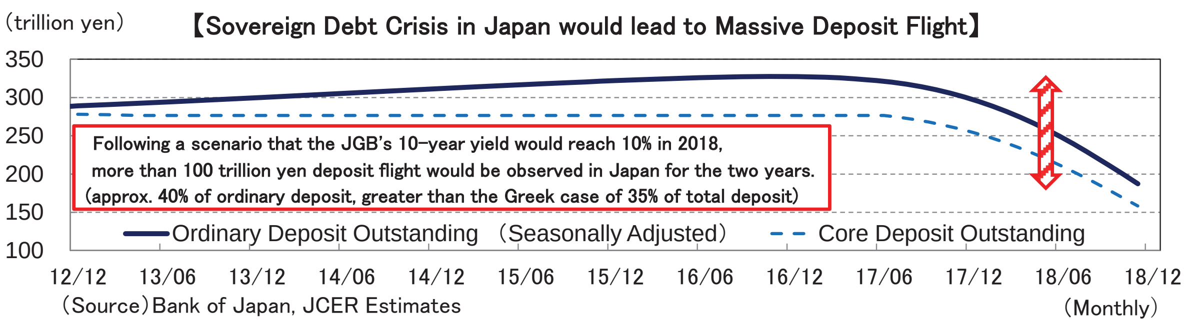
Financial Research Team:

Shohei Terada

Thus far, the expected impact from a spike in yields on Japanese government securities owing to a sovereign debt crisis in Japan has focused on the impairment risk to assets held by Japanese financial institutions. However, a look at the experience of other nations shows that the damage has not been limited to the impairment of asset values but has also come in the form of deposit flight. Efforts to contain the flight through deposit insurance and other measures of government protection have been effective, but given Japan's concerns about expanding the government debt further, it would be difficult to regard this as an effective option for the future. We have therefore simulated such a deposit flight in order to determine how financial institutions might best respond in a crisis.

Key Points

- During the sovereign debt crises in Greece, Argentina and South Korea, there was a severe flight of deposits from financial institutions. Government efforts to stem the outflows by guaranteeing the deposits met with only limited success, as in Sweden.
- In recent years, deposits at financial institutions in Japan have been rising steadily, with no occurrence of deposit flight. A previous analysis of by the present writer found that Japanese government security yields would jump by about 10% if the government were substantially less able to rely on private savings to finance the deficit, and estimates based on that scenario of rising yields indicate that about 40% of savings could be pulled from financial institutions in that case.
- And since the absolute amount of liabilities will decline as interest rates rise, in view of the economic value of the banks' balance sheet overall, the declines in the value of their assets and liabilities would cancel each other out. For this reason, it would be possible for banks to control the extent of their interest rate risk to some degree by matching the term structures of their assets and liabilities.
- Changes in the structure of liabilities will be influenced by changes in the behavior of depositors and insurance policyholders and would thus be difficult to predict. In order to cope with this risk, it would be necessary to boost monitoring in order to detect early signs of a crisis and to increase capital above that amount of capital required for quantitative purposes. In implementing such a move, it would be important for management to be actively involved.



(Source) Bank of Japan, JCER Estimates

Report 2-1.

Investment in Prime-Environment Real Estate Could Add ¥18 Trillion to Value

- Creation of Government-Private Sector Fund and J-REIT Market Growth Key -

Financial Research Team:

Yuki Ishizaki, Tsubasa Ueda, Kentaro Sugimoto

Even as Japan's real estate market has been mired in a long-term slump, a market for Japanese real estate investment trusts (J-REITs) was created in 2001. However, market values of J-REITs have failed to grow, and the sector has not attracted investments proportional to the size of the real estate market. The present report proposes a scheme under which quake-proofing and energy-saving investments in prime-environment real estate through J-REITs could add ¥18 trillion to real estate values and revitalize the J-REIT market. Key to enhancing the value of real estate will be creation of a environment promotion fund backed by the government and the private sector, certification of prime-environment real estate and international standardization of investor principles for responsible investment (PRI).

Key Points

- Expanding J-REITs will require bringing out the potential value of real estate and attracting funds from investors through the promotion of investment in prime-environment real estate with quake-proofing and green enhancements. Appropriate valuation of prime-environment real estate will require objective valuation criteria and creation of assessing institutions.
- Improved information dissemination capabilities would serve to popularize PRI to improve returns based on the environmental and social qualities of real estate. The adoption of this principle, which is generally accepted in the West, could not only attract investors from overseas but could boost awareness of prime-environment real estate investment on the part of domestic pension funds and individual investors. This could then set the stage for a sustainable cycle of fund inflows from investors and rising values of real estate.
- We estimate that real estate assets valued at ¥64.7 trillion could expect to benefit from prime-environment investment. If such investments were made, an additional ¥18.2 trillion could be added to the value of such assets, with the relevant real estate reaching a total market value of ¥82.9 trillion. In order to promote investment in prime-environment real estate in this way, one critical component would be building a framework effectively linking the investors on the supply side and the J-REITs and developers on the demand side.
- As for the form for this framework, we would propose a scheme combining the following: (1) establishment of a government-private sector fund for promoting investment in prime-environment real estate, (2) granting of preferential tax measures for investors, (3) creation of a body to assess environmental value, and (4) creation of J-REITs for investment in prime-environment real estate. The steady investment of funds in prime-environment real estate in conjunction with the creation of a framework to enhance the potential value of real estate would also likely help eliminate the expectation of continued deflation.

Report 2-2.

Create Framework to Solve Social Problems with Private-Sector Capital

– Issues Include Earnings and Risk Assessment–

Financial Research Team:

Yuki Ishizaki, Yutaka Ishido, Tsubasa Ueda

Japan faces an increasing number of social problems which require solutions, including support for childrearing, the wealth gap, and the need to revitalize local areas. As the liabilities of the central and local governments grow, these problems should be addressed through the use of private capital rather than through expanded fiscal spending. As the business of investment banks shrinks in the wake of tighter international regulation, there is a trend among foreign financial institutions to improve their business through social investment. The adoption of a social finance and a framework to provide financial support to private companies grappling with social issues would be one promising growth strategy.

Key Points

- The commercialization of social businesses which could solve social problems through private enterprise will require fixed returns and innovation. The provision of funding to nurture such enterprises would likely improve the international competitiveness of Japanese companies and NPOs.
- Assessing the social benefit and risk of social investment is not easy, however, so financial institutions in many cases hesitate to set aside funds for socially beneficial ventures having only modest potential for returns. One new method for assessing the social benefit of such ventures is “social return on investment” (SROI), and there is a growing move toward standardizing the manner in which such ventures are assessed.
- “Social impact bonds” have been issued in Britain as a financial instrument in the field of social investment. With social impact bonds, NPOs and other entrepreneurial organizations aiming to resolve certain social problems step in to take over social policy which in the past might have been conducted by government organizations, with the funds required for the operations being invested by private investors. Using SROI, the returns to investors are thus gauged in terms of social benefits as well as investment returns.
- The size of the Japanese market for social-benefit funds is small compared to Western countries, and the framework for such a market is not yet adequately in place. A consideration of the framework for supplying capital to social ventures which could be pursued in Japan shows a market with the potential value of no less than ¥2.9 trillion, which includes a total of about ¥2.1 trillion in government spending cuts on medical care, nursing care and public assistance and about another ¥800 billion in social value created. If just one such venture can succeed in Japan, it would likely be possible to package such ventures and bring them to emerging nations.

Report 2-3.

Support Education with New Type of Savings Account

– Kick Start with Tax and Bonus Incentives –

Financial Research Team:

Yuki Endo, Akira Shoda, Kentaro Sugimoto

As wages remain weak, the cost of education is rising, and households with college students in particular are struggling to make ends meet. Although there is demand for state educational loans and scholarships, the delinquency rate is rising, so it will be difficult to expand such assistance. Efforts should therefore be made to encourage households to save early. Based on similar efforts in the U.S. and Britain, we would propose the adoption of individual educational-expense savings accounts aimed at young people featuring tax and bonus benefits.

Key Points

- As households spend more and more on education, the household savings rate is falling in the face of stagnating income. Among young people and the childrearing generation, this trend is particularly marked for low-income households. Moreover, state assistance for educational expenses is shrinking due to government fiscal constraints.
- The loan-loss ratio for state educational loans has been rising, and a framework is needed not just for loans to pay for school but for encouraging early saving as well. Modalities for saving for education by the childrearing generations in the U.S. and Britain are well developed, and combined with tax and bonus incentives, they serve to encourage saving.
- From 2014, a Japanese "individual savings account" (ISA) will be launched. Based on this development, we would propose the creation of an educational ISA linked with child-assistance measures as a framework to help households save for school expenses. Adopting such a system would increase the balance of savings by about ¥3 million as of the time a child entered college without any additional burden on state finances, and the economic impact could be expected to be about ¥1.7 trillion annually.
- It would also be worth considering the use of business sector retained earnings for education. For example, not only could company loans and scholarships be provided directly to students but government assistance could be used to encourage business firms to provide funds to colleges, while dormant deposit accounts could be used as well. With a view to nurturing human resources over the long term, discussion is needed regarding use in the educational field of growth capital with contributions from business firms.

Report 3-1.

Analysis of FY2011 Bank Results

– Capital Adequacy Ratios up Marginally, Potential Risks Warrant Caution –

Financial Research Team:

Junichi Ando, Yutaka Ishido, Yuki Endo, Maki Kikuchi, Akira Shoda, Masashi Yanagita

The financial results for FY2011 appears to show that Japanese banks are relatively sound financially and risk tolerant in comparison with their Western counterparts. However, they still have difficulty obtaining a good return on domestic portfolio investments. There are three relevant issues for the future. The first is whether the growing move, particularly among city banks, to extend credit to overseas borrowers can be developed into a new source of revenue. The second is when banks stop investing in JGBs, given high government debt. The third is whether loan assets in danger of becoming impaired will actually do so after the removal of the financing facilitation legislation in March of 2013.

Key Points

• Revenues for 120 domestic banks for FY2011 rose modestly[†]. Following last fiscal year, banks saw an improvement in credit charges and a rise in net gains on investments in Japanese government and other debt securities, which contributed positively to revenues. On the other hand, the lowering of the normal effective tax rate that accompanied the overhaul of the corporate income tax system, which was an extraordinary factor in FY2011, resulted in an increase in deferred income taxes, which in turn became a factor in lowering profit[‡].

• As a result, the capital-asset ratio (under Bank of International Settlements criteria) for the major bank groups rose marginally compared to FY2010. Looking by type of bank (major banks, regional banks and Second Association regional banks) also shows that, on the whole, real capital adequacy ratios were higher compared to FY2010.

• Even as net interest income continues on a declining trend, room for further reduction in credit costs is gradually narrowing, making for a severe environment for earnings. Demand for money within Japan is weak, and as margins continue to narrow, major banks in particular have been seeking borrowers abroad, which are becoming a new source of revenue.

• Banks' outstanding balance of impaired assets rose marginally compared to FY2010. Reviewing the terms of restructured loans is serving to hold down loans under watch, and it is impossible to determine the extent of the impact of the earthquake disaster. Our estimates indicate that the amount of potential impaired bank loan assets is somewhere between ¥5 trillion and ¥10 trillion.

• While deposits are rising steadily, the deposit-loan gap has been widening owing to the sluggish demand for money, and the rising interest risk arising from the tendency for banks to rotate funds into Japanese government securities is a cause of concern. However, improved financial positions have eased some of this interest rate risk as well as the potential impaired asset risk.

[†] Our analysis focuses on all banks nationwide as published by the Japanese Bankers Association. In FY2011, these include six thity banks (Bank of Tokyo-Mitsubishi UFJ, Sumitomo-Mitsui Bank, Mizuho Bank, Mizuho Corporate Bank, Resona Bank, and Saitama Resona Bank), six trust banks, the former long-term credit banks (the present Shinsei Bank and Aozora Bank), sixty-three first-tier regional banks, forty-two second-tier regional banks, for a total of 120 banks. There were 123 banks in FY2008, 120 in FY2009 and 119 in FY2010.

[‡] Since the December 2, 2011 Corporation Tax Act and the Recovery Funding Act have become law, the Special Corporation Tax for Recovery will be applied from FY2012 through FY2014 in conjunction with a reduction of the Corporation Tax rate from FY2012. In FY2011, the reduction of the effective statutory tax rate resulted in an increase in deferred income taxes as banks amortized deferred assets, in turn pushing down net income. From and after FY2012, moreover, the reduction of tax rates will contribute positively to net income by reducing the burden of paying corporate taxes.

Report 3-2.

Still Room to Devise Ways for Loans to Disaster-Affected Firms

– Ease Double-Loan Burden with New Lending Methods –

Financial Research Team:

Junichi Ando, Akira Shoda, Masashi Yanagita

Loans to disaster-affected areas have been growing thanks to a variety of financial aid measures, but it is difficult to say that sufficient money has been provided to small and medium-sized enterprises (SMEs) struggling with the double-loan problem. Thus as a means to satisfy the demand for funds from companies facing difficult circumstances, we would propose the use of debt-debt swaps with banks unable to extend asset-backed loans (not collateralized by real estate) to borrowers lacking real estate as collateral and unable to have the loans purchased by the debt-buying institutions set up by the government.

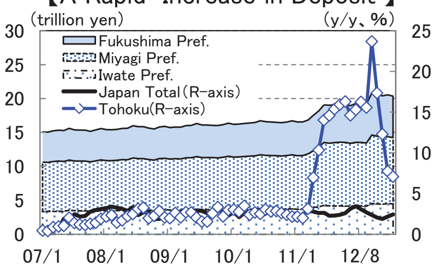
Key Points

• On the whole, deposits and outstanding loans are on the rise in the disaster-affected areas of Tohoku. However, in areas damaged by the tsunami or the nuclear power plant accident, companies are making loan requests which banks cannot respond positively to even if the disaster credit line is used under the credit guarantee system. Meanwhile, other companies are struggling with the double loan problem, under which they are unable to get new financing because they are still in the process of repaying loans from before the disaster. Disaster-affected companies are still not adequately able to secure adequate recovery funds.

• The re-enforced credit guarantee system intended to ease the impact of the Lehman Shock and the Great East Japan Earthquake on business firms will expire in March of 2013, and the number of SMEs having cash flow difficulties is expected to increase from the next fiscal year and after. These companies do not necessarily have real estate which they can pledge as collateral. Thus, use should be made of asset backed loans, which can be extended to companies able to pledge collateral other than real estate, such as accounts receivables or stock. Loans covered by guarantees could be possible under separate credit lines made possible through the use of ABL guarantees.

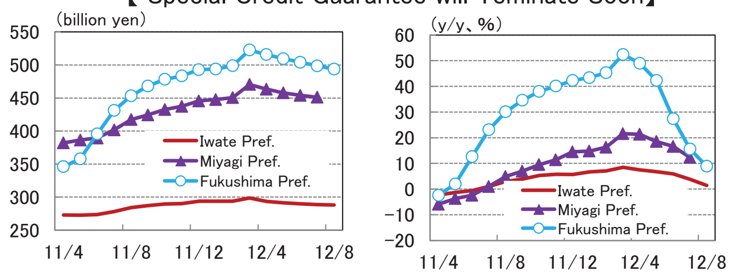
• With the establishment of debt-buying institutions by the government, efforts to address the overlapping loan problem affecting disaster-affected companies are steadily moving forward, but the process of purchasing the loans is not advancing smoothly. One reason is that the scheme will force banks to realize losses, which they are reluctant to do. Thus, one promising solution would be using debt-debt swaps (DDS), which are borrowings and can be treated as capital instead of liabilities. Using the DDS method would make it possible to support the cash needs of businesses over the long term, and once they recovered, the banks could recoup their capital as well.

【A Rapid Increase in Deposit】



(Source) Bank of Japan

【Special Credit Guarantee will Teminate Soon】



(Source) Credit Guarantee Association Website

Report 3-3.

Regional Financial Institutions, Financing Facilitation Act Exit Strategy

– Use Fund for Venture Recovery and Succession –

Financial Research Team:

Junichi Ando, Maki Kikuchi, Masashi Yanagita

Regional financial institutions are finding themselves in an increasingly severe business environment. They have managed to maintain revenues by investing in Japanese government securities and by extending loans outside of their home prefectures, but the population decline has been concentrated in regional areas, so any strategy of offsetting narrowing margins by raising volume will be of limited effectiveness. Improving revenues over the long run will require taking a business approach to solving the issues faced by regional companies. The number of SMEs filing for bankruptcy is expected to rise following the expiration of the SME Financing Facilitation Act, but one exist strategy to be considered would be a framework ensuring the succession and recovery of business ventures through the use of a investment fund.

Key Points

- The earning power of Japanese banks has been following a decline trend[§].Given the declining population and stubbornly low interest rates, the core business revenues of these banks is expected by 2050 to fall to about 60% of present levels. They have almost reached the limit to which they can boost revenue by increasing the volume of loans and expanding investment in government securities, so they are hard pressed to secure new sources of revenue and to diversify their business.
- A basic cause of falling bank revenues has been their inability to set lending rates at levels which would be profitable given their credit costs. In the background of this situation are structural factors, including the excess supply capacity in the banking market, the relationship-based banking model and the growth of public guarantees.
- The SME Financing Facilitation Act is scheduled to expire in March of 2013. Since the more relaxed criteria for classifying impaired loan assets will be perpetual, there is little chance of an immediate increase in impaired loan assets, but they will remain a potential factor threatening revenues. As one strategy to cope with the expiration of the legislation, we would propose a recovery fund financed through equity investments.
- Regional economies and regional financial institutions sharing a common destiny can not turn their attention away from the local areas which are their home business territories. Unless assistance is provided which imposes self-discipline and unless the competitiveness of the SMEs which are their customers is strengthened, it will remain difficult for these banks to improve their revenues and restore sound finances.

[§] Our analysis focuses on all banks nationwide as published by the Japanese Bankers Association. In FY2011, these include six city banks (Bank of Tokyo-Mitsubishi UFJ, Sumitomo-Mitsui Bank, Mizuho Bank, Mizuho Corporate Bank, Resona Bank, and Saitama Resona Bank), six trust banks, the former long-term credit banks (the present Shinsei Bank and Aozora Bank), sixty-three first-tier regional banks, forty-two second-tier regional banks, for a total of 120 banks. Major banks include all city banks, trust banks and the former long term credit banks.

Report 4-1.

Credit Expansion Could Hurt Growth for Advanced Economies

– Room for Growth in Emerging Nations –

Financial Research Team:
Kazuhiro Kida

The financial institutions of the major advanced nations face a severe business environment owing to the drastic decline in interest rates and the weak demand for loans. One background factor is the fact that expansion in the size of financial markets is no longer contributing to economic growth. Financial regulators are also groping for direction with a view to using regulation to shrink the size of mammoth financial institutions. Financial institutions need to seek new sources of revenue in order to improve their margins, but the question is what sort of opportunities exist in emerging nations. Given the relationship of financial depth and economic growth, one rule of thumb is that opportunities to boost lending in emerging nations exist when domestic private credit relative to GDP is less than 80%.

Key Points

• With the maturation of financial markets and the erosion of economic growth rates, the intermediary role of financial institutions in the major advanced nations has declined, and in some countries the high level of debt is beginning to have a negative impact on economic growth. Early research has indicated that if the outstanding debt of the corporate or household sector exceeds 85% to 90% as a share of GDP, it could cause an erosion in GDP.

• On the other hand, financial depth, which indicates the diversity of financing and the liquidity of financial markets, is only developed to a limited extent in emerging countries, so the financial sector has a lot of growth potential. For this reason, the expansion of credit to domestic borrowers in such countries can stimulate economic growth. In advanced nations, the excessive development of financial depth exerts a negative impact in times such as financial crises, and thus the need for deleveraging is increasingly urgent. As far as the financial institutions in advanced nations are concerned, extending loans in emerging nations would have the effect of offsetting the decline in revenues associated with the need to reduce credit at home.

• Our present analysis indicates that if private-sector debt in emerging nations exceeds around 80% to 100% of GDP, it no longer contributes to economic growth. The level of private debt is high in some of these nations, including China and Malaysia, but leeway remains in other nations, such as Indonesia and the Philippines, to raise the level of private debt.

• As Western financial institutions proceed with deleveraging, there are attractive opportunities for Japanese financial institution to grow revenues through expansion of loans from this macroeconomic perspective in the emerging nations of Asia, which are regarded as growth markets. However, Western financial institutions will also be stressing emerging nation markets, so competition is bound to intensify in the future.

Report 4-2.

Japanese Banks: Move Offshore an Issue for Revenues

– Growth of Loans in Asia Still Lags Western Banks –

Financial Research Team:

Yutaka Ishido, Yuki Endo, Maki Kikuchi

As lending operations by Japanese banks fails to grow amid sluggish economic conditions at home, they are looking for new opportunities in the fast-growing markets of Asia. However, even as Western and local financial institutions enjoy superior profitability, Western institutions are once again stepping up lending in Asian countries after a period of retrenchment to cut back outstanding credit. To successfully compete in Asian markets and achieve high margins, Japanese banks will have to expand their operations extensively in Asian countries, lending in local currencies and entering into joint ventures with local banks.

Key Points

• As the rapid growth of Asian nations draws worldwide attention, Japanese banks have been boosting the extension of credit mainly to these countries. Although Japanese banks enjoy higher margins in these countries than they do in their domestic credit business, margins are still lower than those of non-Japanese banks, and their profitability remains low.

• Since the European sovereign debt crisis, European financial institutions have been engaged in deleveraging, but they have made only limited cutbacks in credit extension to Asia. Competition is intensifying in Asian markets not only among Western financial institutions themselves but with the rising presence of Asian financial institutions as well. In an effort to cope with the financial crisis, banks have expanded lending in local currencies, but Japanese banks have continued to lend for the most part in foreign currency.

• As for the best mode of entering the local market, a comparison of past instances studied indicates that, among three alternatives, namely establishing a local branch, buying a local institution outright or entering into a joint venture with a local institution, the joint venture option is comparatively advantageous in light of the synergy generated between the debt management technology which the foreign bank brings and the superior local information which the local partner brings to the partnership.

Report 4-3.

Japanese Banks Should Lead Asian Regional Financial Integration

– Issues Include Focus Strategy and Corporate Culture –

Financial Research Team:
Kazuhiro Kida

Owing to the slumping demand for money within Japan, Japanese banks are endeavoring to expand the scope of their operations in Asia. Asian nations are strengthening their economic links, and in the future, it will be necessary for them to move toward regional financial integration as well. Major financial institutions in Asia are gradually broadening their base of operations in the Association of South East Asian Nations (ASEAN) region and East Asia, but they have not reached the point of leading in the regional integration of the region. It is therefore important for Japanese banks to seize this opportunity and raise their profile in the Asian region.

Key Points

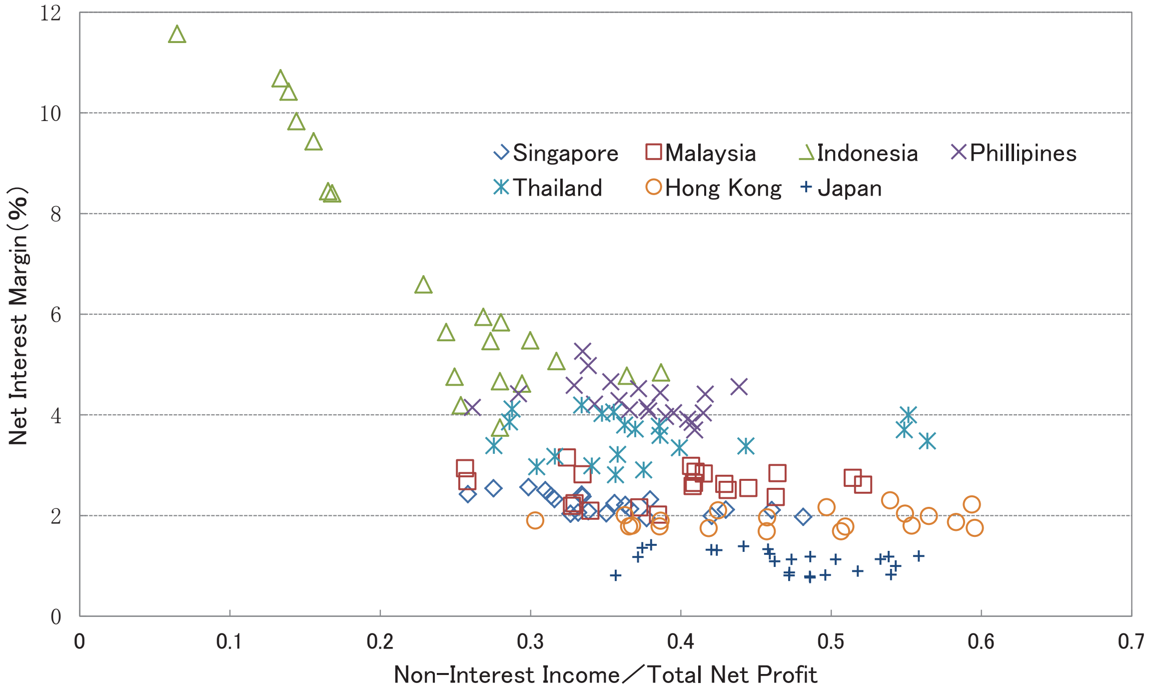
• Asian economies are becoming increasingly regionally integrated through trade and direct investment within the area. The role which financial centers play in the move toward economic integration is considerable, and Japanese banks must act strategically in order to respond to financing needs within the region.

• The net interest margin is a gauge of profitability in commercial banking operations, and it is higher for banks in the financial centers of Asia than in the major advanced nations. In some countries, the share of non-interest income in net operating income has been increasing, and the financial institutions of Singapore and Malaysia have begun to move into regional offshore markets as their domestic markets have matured.

• Regulatory trends differ in each country with regard to equity investments in local banks by foreign banks. In Indonesia, such regulations are being tightened, while in Malaysia they are increasingly being eased. Japanese banks face a high hurdle in purchasing local financial institutions, and it will be important for them to consider entering into local operations in fields other than commercial banking. Another issue deals with how Japanese banks, in order to respond to rising demand for trade settlement and other transaction banking, might establish leadership in the Asian settlement system.

• A comparison of the offshore operations of Japanese and Western financial institutions indicates that, while Japanese banks have a similar earnings structure, Western banks develop unique local strategies. As financial integration in the region moves forward, Japanese banks will have to blend into the local corporate culture even as they commit business resources to particular areas in force.

【Promoting Asian Financial Integration Leads to Higher Profit Opportunity for Japanese Banks due to Low Net Interest Margin in Japan】



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