Developing a New Type of Financial Intermediation: A Blueprint for the Post-Banking Era

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Need for the Concept of a Multi-Tier Financial System

One of the main reasons why Japan's bad debt problem became so serious in the 1990s is that the banking system had become overloaded with risk, and it is this realization that has led to the reform of the debt and equity markets, beginning, in June 2001, with the government-approved policy document of the Council on Economic and Fiscal Policy ("Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management") and continuing with the slogan "Save less and invest more" as part of an effort to make the country's securities markets play a more important role in the financial system.

As the aim of these efforts has not been to abolish the role of banks as financial intermediaries, what is being proposed is a kind of two-track financial system where banks continue to negotiate deals with their corporate and other customers while a market-based type of finance gradually becomes the principal channel for the flow of money.[1]

This concept of a market-based type of finance includes not only the securities markets as we know them but also bank loans where the risk is borne not by individual banks but dispersed by means of bank syndicates ("syndicated loans"), securitization, and credit derivatives—market mechanisms that enable risks to be transferred. Some of these mechanisms are also referred to as "market-based indirect finance."

While the author is very much in favor of the concept of a two-track financial system that seeks to disperse the risks that have traditionally been loaded on the

[1] "Blueprint for Reforming Japan's Financial System and Financial Administration," July 2002.

banking system,[2] he also believes that we should not forget the need for lateral thinking.

First, before we even consider how to disperse the risk that has been loaded on the banking system, we surely need to ask to what extent, in this day and age, we need financial intermediaries like banks. If, for example, banks are no longer as indispensable as they once were, we have the option to devise policies that will directly reduce the role that banks play. If banks are no longer as indispensable as they once were and there is something that is preventing the banking system from downsizing in a natural way, that obstacle needs to be removed.

Second, it is probably an oversimplification to label all the different types of financial intermediation other than traditional banking as "market-based finance." The world of the securities industry, where securities companies sell shares that have been traded on highly liquid securities markets, has traditionally been seen as a different planet from the one inhabited by banks. However, today's debt and equity markets have ceased to be a two-planet universe with only either traditional deposit-taking and lending or traditional stockbroking. Alternative types of intermediation such as hedge funds and private equity funds have in a very short space of time become a major force to be reckoned with. Private equity funds are different from both market-based finance, which requires highly liquid markets, and the kind of negotiated transactions found in traditional banking.

Third, we need to consider the important role played in many countries by personal investment accounts as an alternative type of financial intermediation that enables governments and companies to help individuals to accumulate financial assets. This new type of financial intermediation is also different—not only from traditional banking and stockbroking but also traditional insurance and pensions.

Fourth, we need to consider the fact that financial intermediation, whether it be via the banking system or the markets, has become increasingly specialized, with some players focusing on product creation, and others on sales, advice, processing (execution, delivery and settlement) or custody, to name only a few. Even sales, for example, can either be combined with advice or performed automatically.

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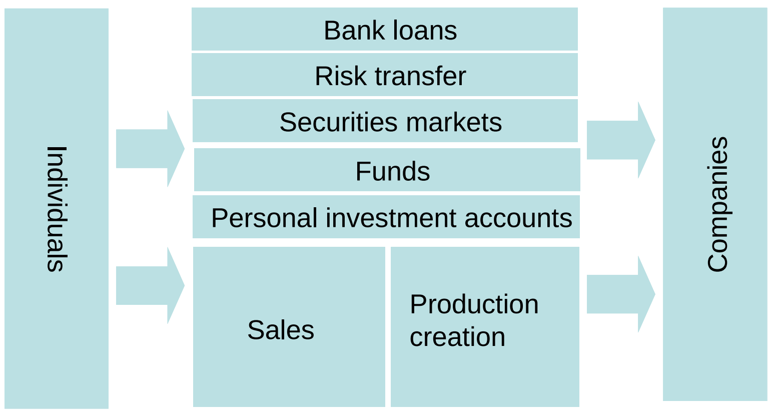
[2] Yasuyuki Fuchita, "Fukusengata Kin'yu Shisutemu ni Yoru Mane Furo Kozo Kaikaku o" [Reforming the Flow of Money in the Economy by Means of a Two-Track Financial System], Shukan Kin'yu Zaisei Jijo [Financial and Fiscal Affairs], Kinzai Institute for Financial Affairs, 1 December 2003, and "Fukusenteki Kin'yu Shisutemu Kochiku e no Mittsu no Wakugumi" [Three Plans for Building a Two-Track Financial System], Shukan Kin'yu Zaisei Jijo [Financial and Fiscal Affairs], Kinzai Institute for Financial Affairs, 29 November 2004.

Therefore, while it can be convenient to think in terms of a two-track financial system, the reality has become more like a multi-tier financial system where different layers intersect both horizontally and vertically (see diagram). After considering whether there is any need for banks, the rest of this report goes on to look at the different elements that go to make up this multi-tier financial system (funds, personal investment accounts and the separation of product creation and sales).

Multi-Tier Financial System



Source: NICMR.

The Concept of a Post-Banking Era

Japanese banks continue to accumulate ever more government bonds. As of end-November 2004, they owned more than ¥100 trillion worth. With the government continuing to issue large amounts of debt, companies continuing to run a surplus and banks seeing relatively little demand for loans, their holdings of government bonds continue to increase.

At the same time, there is strong demand from retail investors for the new type of 10-year variable-rate government bonds aimed at the retail market. Whereas one-year term deposits pay only 0.03% and even five-year term deposits only 0.1-0.2%, the most recently issued government bonds aimed at retail investors (the #9 bond issued in January 2005) pay 0.67%. Although the interest rate is variable, a minimum rate of 0.05% is guaranteed.

With the blanket guarantee on demand deposits due to end in April, retail investors are likely to find these bonds increasingly attractive as they offer not only higher interest rates but also a higher credit rating. However, it is difficult to imagine that the process by which retail investors deposit their money with banks and banks use that money to buy government bonds will suddenly stop.

One reason for this is that bank deposits enable depositors to settle transactions (e.g., by means of transfers and direct debits). In addition, deposits are covered by a deposit insurance scheme, and banks are subject to tough inspections by the financial authorities. Indeed, in some cases, banks may even receive injections of taxpayers' money, so it is hardly surprising if they are not perceived as being riskier than the state.

As for retail investors, they may be quite rational in some respects but reluctant to change in others. Even the state may be wedded to the idea that banks are important and continue to mollycoddle them when it is no longer necessary.

Deposit insurance schemes and checks by the financial authorities are all predicated on the assumption that banks perform a funds transfer function and are an important link in the flow of money through the economy. However, with the spread of information technology it is now increasingly possible to settle transactions without having to use a traditional bank. In spite of this, the system for protecting depositors and supervising banks has become ever bigger and more complex. As a result, the supply of banking services may have been maintained at an artificially high level when it should have been allowed to decline.

Why should the state spend vast sums of public money on inspecting and regulating a type of financial intermediation that accumulates liabilities in the form of deposits and invests them in government bonds? Why should households own government bonds indirectly through a pool that offers no tax advantages? Similarly, why should the state spend taxpayers' money on inspecting and regulating banks that invest depositors' money in risky alternative investments simply because no one wants to borrow from them, and why should households have to worry whether banks are financially sound?

If investors want a risk-free investment, all that is needed is to make it easier for them to invest in government bonds—either directly or indirectly (via a fund). If consumers need a reliable system for making payments, all that is needed is to make it easier for them to have access to a narrow bank or to open a cash management account. Needless to say, this would be both cheaper and more transparent than the existing type of financial intermediation.

So long as people continue to believe that banks are more important than other types of financial intermediation, the development of a more rational financial system will only be delayed. At the very least, there should be a mechanism by which banks, big or small, that have made fatal mistakes should be allowed to make an easy exit.

One option would be to allow the word "bank" to refer to a wider range of activities. In its Program for Further Financial Reform, due to be implemented over a two-year period, starting in April 2005, the Financial Services Agency talks about the possibility of allowing new types of bank to be formed. Similarly, it talks about the need to consider creating a regulatory framework for electronic settlement and payment as well as for online financial transactions.

A narrow bank or an investment trust run along the lines of a narrow bank could be classified as a type of bank but regulated and inspected according to a completely different system from a traditional bank. Alternatively, it could be subject to a much lower rate of deposit protection insurance. Or it could be given conduit (i.e., tax-exempt) status. Similarly, there is much to be said for creating a regulatory framework that would encourage the use of an electronic settlement or electronic money scheme.

Adam S. Posen of the Institute for International Economics has also advocated a downsized banking sector.[3] Taking as his starting point the fact that many economic and financial crises have been caused by problems with the banking system, he emphasizes the need to reduce dependency on such a risky system. He also criticizes public opposition to closing down a bank. Similarly, he describes the widely held view that developing countries need to develop a banking system first and can wait until later to develop a securities market (because they will not be able to develop properly unless the banking system can absorb domestic savings) as outdated in an age when capital is increasingly able to flow unhindered across international borders.

Now may be the time, both in Japan and the rest of the world, to question the wisdom of continuing to spend a great deal of time and money on accommodating such a troublesome creature and to welcome the beginning of a new post-banking era.

[3] Adam S. Posen, "A Strategy to Prevent Future Crises: Safely Shrink the Banking Sector," 12 June 2001.

Kings of Capitalism

Last year the Economist published a special feature on private equity firms entitled "Capitalism's new kings," [4] while the Nihon Keizai Shimbun ran a series of articles entitled "Fund capitalism" from June to December.

In a report published in this journal in February 1999 the author expressed his opinion that Japan would be saved by utilizing alternative funds and that hedge funds, venture capital, buyout funds and distressed funds are part of the answer to some of Japan's problems such as the lack of attractive investment opportunities, the need to develop venture businesses, the three "excesses" (excess capital, excess employment and excess debt) and corporate turnaround.[5]

Six years later and it is now no longer unusual for banks and pension funds to invest in hedge funds. Vulture funds apply the discipline of the market to the governance of companies that have been taking it easy, while recovery funds have become a focus of interest as the main players in the corporate recovery business. Both in Japan and the rest of the world, hedge and other funds are no longer simply alternatives: they are now the main type of financial intermediation.

Although there are various reasons for this, it is probably fair to say that they have come to the fore at a time when the traditional type of financial intermediation was beginning to suffer from system fatigue while the existing framework was no longer able to keep pace with technological changes and the changing needs of users.

One example of this is X-efficiency—the friction, communication costs and other inefficiencies that arise within large financial conglomerates. X-efficiency makes it difficult to develop businesses involved in venture incubation, corporate recovery and sophisticated trading techniques since these demand high levels of individual skill. This has led to the creation of boutique funds, some of which have been able to attract enormous amounts of money from investors such as pension funds on the basis of their performance.

Advances in information technology have made it easier for boutique funds to outsource noncore skills such as back office operations to vendors or other financial institutions, and this has, in turn, made it easier for such funds to be established.

[4] "Capitalism's new kings," Economist, 27 November 2004.

[5] Yasuyuki Fuchita, "Reconstruction of Functions of Financial Intermediaries in Japan," Capital Research Journal, Spring 1999.

There is no doubt that one of the reasons for the explosive development of such funds has been the desire to avoid regulation. Even so, this raises the question whether existing types of financial intermediation were not handicapped by too much regulation.

There comes a point at which no amount of regulation can prevent every possible problem occurring. However, history shows that, when major problems have occurred, regulations have tended to be tightened. Sometimes deregulation occurs once a problem is resolved; but, in a world where radical changes are occurring all the time, problems tend to occur frequently, with the result that regulations tend to follow suit. Also, even when the root of a problem may lie elsewhere, subjecting the banking system to greater regulation is often the response. Those economic agents that are easiest to regulate tend to be regulated most.

It is not always appropriate to criticize the development of new types of financial intermediation that seek to escape the burden of increased regulation to which existing financial institutions are subjected as "regulatory avoidance."

In the United States there was a heated debate last year about the regulations the Securities and Exchange Commission was proposing to apply to hedge funds. Even the Chairman of the Federal Reserve, Alan Greenspan, voiced concern about the impact these regulations might have on what he considered an important source of market liquidity. Similarly, there are those who point out that regulation has its limits and that tightening domestic regulations will only lead businesses to move overseas.

However, there is a need for a certain minimum amount of regulation—even of funds. In Western countries a wide range of investment services are regulated in order to protect investors. In Japan, on the other hand, there is currently a boom in moneymaking schemes, many of which describe themselves as "funds" and are aimed at the man in the street. If funds are to develop as a new but healthy form of financial intermediation, there is clearly an urgent need for an investment services law.

The Importance of Personal Investment Accounts: Visualizing How Investors Can Be Encouraged to "Save Less and Invest More"

President Bush has won a second term in office, and it will be particularly interesting to see what becomes of his program to reform Social Security, especially the proposed introduction of personal investment accounts.

The US Social Security Program is similar to the National Pension Insurance Scheme in Japan in that every citizen is a member of the program. Currently, anyone with an income is required to pay a social security tax, which entitles him or her to receive benefits in the future. As the program is operated on a pay-as-you-go basis, increasing longevity is expected to make it unworkable. It has therefore been proposed that the program should be partly funded and that this part of the program should be run on an individual basis.

There already exist a number of schemes designed to encourage individuals to accumulate financial assets. These include 401(k) and 529 plans as well as IRA accounts. However, what President Bush is proposing is a new account, which would involve a new scheme with greater incentives for individuals to accumulate financial assets. Existing schemes would be gradually wound up.

There are similar schemes in Europe. In the United Kingdom, for example, there are so-called individual savings accounts (ISAs), in which individuals can hold shares or savings free of tax. From April 2005 there will also be so-called child trust funds (CTFs), which are a tax-free savings scheme designed to encourage parents to save for their children. In addition to their tax-exempt status, accountholders receive a voucher from the state: once when a child is born and once on his or her seventh birthday. In France there are so-called equity savings schemes (plans d'épargne en action or PEAs), where reinvested dividends from shares and investment funds are tax-free—as are capital gains if the assets have been held for at least five years.

The move away from pay-as-you-go to funded schemes and from defined benefit to defined contribution schemes, whether it be by state pension schemes or occupational pension schemes, has been criticized as shifting the risk to the individual. However, demographic changes and growing global competition mean that the idea that either the state or an employer can provide all that an individual needs for his or her retirement is intellectually virtually bankrupt. As a result, individuals face all sorts of unimaginable risks, including the possibility that their pension benefits may be cut or that they will have to pay more tax. Therefore governments worldwide are in the process of devising schemes that offer a basic safety net and tax incentives for individuals to accumulate financial assets that will pay additional benefits. However, it is up to individuals to understand the risks involved and to choose financial products that match their risk preferences.

In Japan, on the other hand, people have become increasingly skeptical about the public pension scheme. As far as occupational pension schemes are concerned, legislation has been passed to allow 401(k) schemes, but Japanese 401(k) schemes are 401(k) schemes in name only as there is no provision for employee contributions even though the name of the scheme comes from Section 401(k) of the US International Revenue Code, which sets out the tax benefits.

In addition to the above schemes, where the state offers tax incentives to encourage individuals to open personal accounts to save for their retirement, it is also important to have schemes that enable companies to encourage their employees to save for their retirement. One such scheme is the employee share ownership plans (or ESOPs) common in the United States. Other schemes include dividend reinvestment plans (or DRIPs) and direct stock purchase plans, in both of which investors receive their shares directly from the company concerned. This enables investors to purchase shares directly without having to pay commission to a stockbroker. For their part, companies are able to increase their retail investor base and avoid the kind of market impact and cost that normally accompany a capital increase. About 3,000 US companies have adopted this scheme, including Microsoft, which resumed paying a dividend in 2003.

In Japan public opinion surveys show that, in spite of the campaign to encourage people to save less and invest more, there is still considerable reluctance to invest in traditional securities. Although there are tax incentives and Japan's securities markets have been reformed, it is doubtful whether the composition of personal financial assets in Japan, which are much more heavily weighted towards bank deposits, will change without the kind of schemes introduced in Western countries and described above.

In the United States, one of the reasons why securities investment has become popular is the growth of ESOPs and 401(k) plans. Schemes such as these have a number of advantages, including the fact that they save investors the bother of having to go along to a securities company, tend to improve the performance of an investor's portfolio as a result of their emphasis on long-term investment, and also make provision for investor education.

In Japan action to promote the growth of securities investment has included the introduction of a system of securities intermediaries (i.e., stockbroker agents) and allowing banks to offer this service if they want. However, there is a limit to what can be achieved by simply increasing the number of distribution channels. With the safety net traditionally provided by the state and employers beginning to show signs of wear and tear, more needs to be done to set up a system of personal investment accounts like those already introduced in Western countries and to show people the kind of thing that they should do when they are encouraged to save less and invest more.

One of the items included in the Program for Further Financial Reform is "further reform of financial taxation to encourage better use of financial assets, including reform of securities taxation to encourage more long-term investment." With so much public concern about the effects of the country's declining birthrate and increasing longevity as well as the growing budget deficit, the Financial Services Agency (the body responsible for the campaign to encourage people to save less and invest more) as well as the Ministry of Health, Labour and Welfare should seek to address people's concerns about what they should do to provide for their futures.

Specialization of Financial Services

In this day and age it is no longer true to say that the best thing that a government can do for its people is to try to develop and maintain a sound and competitive banking system. This is not only because we need to speed the arrival of a post-banking era, but also because people have very different needs and therefore require access to a wide variety of financial products—something that cannot be achieved by having only a banking system.

Nor is the optimum solution necessarily to encourage competition within the banking system and allow banks to form conglomerates that can offer a wide range of financial products. It may be that the best fund products can only be produced by the kind of boutiques mentioned above. If a bank has subsidiaries such as investment trusts, funds and insurance underwriters that are capable of producing a wide range of products, it is likely to favor them over rival products. What society perhaps needs is providers who can see things from the point of view of retail investors and recommend to them the best investment products and opportunities for their needs from all over the world.

Generally speaking, an organization that combines every possible function is unlikely to know whether each is being performed to the highest standard. There may be an external provider that can do the job better. Also, some functions may lose their objectivity or neutrality and cease to perform properly when they form part of a single institution. Financial services are therefore likely to become increasingly specialized.

Of course, this is not to say that specialization has not been possible in the past. Just as there are cases where insurance companies tie up with insurance brokers, so there are cases where, within the same group, one securities company may specialize in wholesale business, another in retail, another in online broking, and so on.

Recently, however, the trend has been away from vertically integrated structures towards a setup that recognizes new service providers as part of the system and encourages specialization. One example of this is servicing. Another example is banks that specialize in custody services. Similarly, when the Government Housing Loan Corporation was allowed to engage in asset securitization, the aim was not that it should offer a full range of services from origination to loan management but that banks should be allowed to specialize in origination and servicing.

However, a bigger change has taken place in the way financial products are sold to retail investors. What this means is that, instead of each type of financial institution having its own sales outlets, deregulation now permits securities, insurance products and, once the legislation has cleared the current session of the Diet, banking services to be offered through other intermediaries. For example, it will eventually be possible to obtain a wide range of financial products in one's local convenience store.

Moreover, the fact that the Program for Further Financial Reform clearly advocates one-stop shopping and the separation of sales from product creation means that this trend is set to increase.

Nor is that the end of the story. If, as planned, Japan Post is privatized in April 2007, local post offices will take on a new lease of life as part of a huge network of retail outlets. As well as acting as sales agents for the new Japan Postal Savings Bank and Japan Postal Insurance, these outlets can be expected to sell the products of many other private-sector financial institutions, including investment trusts.

The public will suddenly have access to a trusted and extremely familiar nationwide network of independent financial sales outlets. This is likely to have a major impact on the product creation and sales strategies of existing private-sector financial institutions as well as on the choice of products available to retail investors.

Reform of the postal savings bank could therefore act as a catalyst in hastening the arrival of the post-banking era.

Conclusion

Too much concern about policies aimed at reviving the banking sector and restoring it to financial health coupled with an emphasis on policies aimed at encouraging people to invest rather than save will not create new channels of financial intermediation or help the intermediaries to develop. What is needed is to forget the status quo and to foster the development of new intermediaries that will service consumers' needs.

Fortunately, as this report has mentioned, the Program for Further Financial Reform includes a number of measures designed to achieve this. Privatizing Japan Post, the legislation for which could even be passed during the current session of the Diet, could therefore help to bring about the kind of changes that are needed. 2005 promises to be an interesting year.