Japan's Regional Financial Institutions: Is a Synergistic Model Possible?

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I. Introduction

On 24 December 2004 the Financial Services Agency published its "Program for Further Financial Reform: Japan's Challenge—Moving towards a Financial Services Nation." One of the document's main themes is how regional financial institutions could contribute more to their local economies. It therefore contains proposals for creating vibrant local communities where regional financial institutions compete with one another and cooperate with local and central government agencies to help revitalize their local economies and do more to help local businesses, thereby creating a financial services industry that is more in touch with the needs of local communities.

With more than ¥1,400 trillion in personal financial assets, the Japanese need to save less and invest more. In order to achieve this, a wide range of high-quality financial products and services is needed in which people can invest when- and wherever they want. Regional financial institutions, for example, have a key role to play in creating a financial services industry that can help to create such vibrant local communities.

However, Japan's declining birthrate, the increasing longevity of its population and the increasing concentration of business in the big cities have not helped local economies, some of which are falling behind. At the same time, many regional financial institutions are having to struggle to maintain their independence. Since 1998, nearly 100 shinkin banks have either merged or been taken over.[1] Local businesses need a dynamic local financial services industry if they are to recover from the post-bubble slump; otherwise, local economies will continue to fall behind. How exactly this can be achieved is one of the key issues facing Japan's financial services industry.

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1 According to Shinkin Central Bank Research Institute's "Statistics of Shinkin Banks," there were 401 shinkin banks as of end-March 1998. Since then, however, the number has declined—to 396 (end-March 1999), 386 (end-March 2000), 371 (end-March 2001), 349 (end-March 2002) and 326 (end-March 2003)—as consolidation has gathered momentum since March 2001.

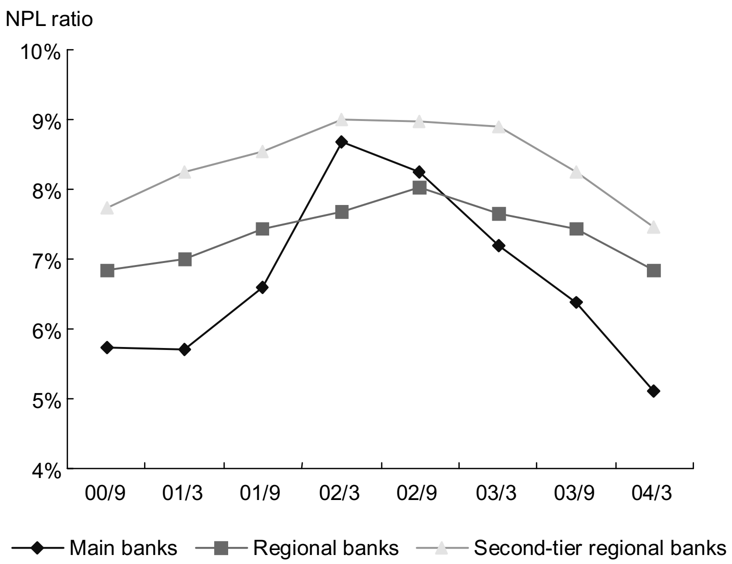
Many financial institutions, ranging from the big city banks to regional banks and cooperative financial institutions such as shinkin banks, are involved in local economies. However, this report deals mainly with the situation in which regional financial institutions find themselves and the challenges they face (e.g., in the field of relationship banking). It also looks at the Financial Services Agency's Program for Further Financial Reform. Finally, it considers whether a synergistic model can be built to help regional financial institutions achieve these goals.

II. Japan's Local Economies and Regional Financial Institutions

1. Short-term improvement in performance

Japan's 89 regional and second-tier regional banks recorded a net profit for the first time in four years when they reported their results for fiscal 2003 (the year ended March 2004). This improvement was the result of their efforts on various fronts to become more efficient and was also reflected in a reduction in the ratio of nonperforming loans for regional financial institutions as a whole. Although not as substantial a reduction as that achieved by the big banks, the trend is nevertheless clearly downwards (Figure 1).

Figure 1 Nonperforming Loan Ratios of Main, Regional and Second-Tier regional banks



Note: "Main banks" here refers to city, long-term credit and trust banks collectively.
Source: NICMR.

2. Structural problems facing local economies

Although Japan's regional financial institutions now appear to be out of the woods, they still face a number of structural problems. One of these is the increasing concentration of business in big cities such as Tokyo—a trend that has become all too clear in the past 10 years.

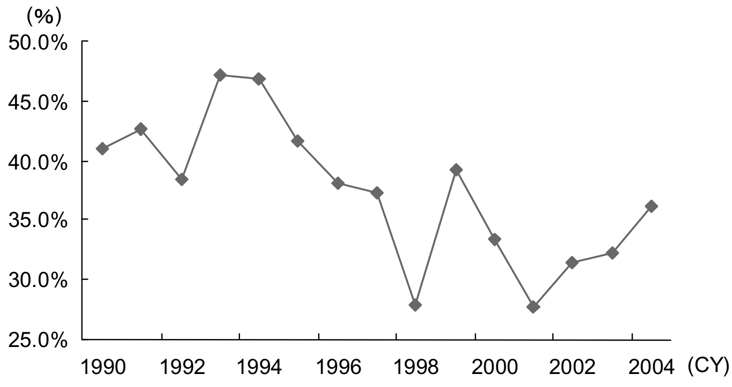
Of the 3,800 or so companies listed on the country's stock exchanges and the JASDAQ,[2] more than 1,700 are based in Tokyo.[3]

A similar trend can also be observed in the number of new listings: the vast majority are by companies based in the big cities.

Most of Japan's main regionally based companies were listed or went public during the "first listing boom" of 1987–1991, which followed a relaxation of the listing rules in 1983. Since then, however, 70% or so of new listings have been by companies based in or near Tokyo, Osaka or one of the big cities in the prefectures of Kanagawa, Aichi and Hyogo.

During this period, the number of new listings by companies not based in Tokyo has fallen by nearly 20% (Figure 2).

Figure 2 New Listings by Companies Not Based in Tokyo, Osaka or Nagoya



Source: NICMR.

2 Japan Company Handbook, Spring 2005.
3 No less than 85% of listed companies are based in or near large cities such as Tokyo, Osaka and Nagoya.

There are wide variations among prefectures, with 25 prefectures having fewer than 10 new listings, and 11 prefectures fewer than five. Most of these listings have been by companies in services such as distribution and retailing, and some of these have since merged with or taken over companies based elsewhere. The current situation is therefore not one where the kind of dynamic medium-sized companies that should be driving local economies are being founded all the time.

Nor have efforts to establish markets for venture businesses that could help to revitalize local economies been as successful as was hoped. Most venture businesses have listed on the Mothers market set up by the Tokyo Stock Exchange, while the regional stock exchanges have tended to be ignored.

The big cities have therefore also tended to be seen as the best source of new equity capital.

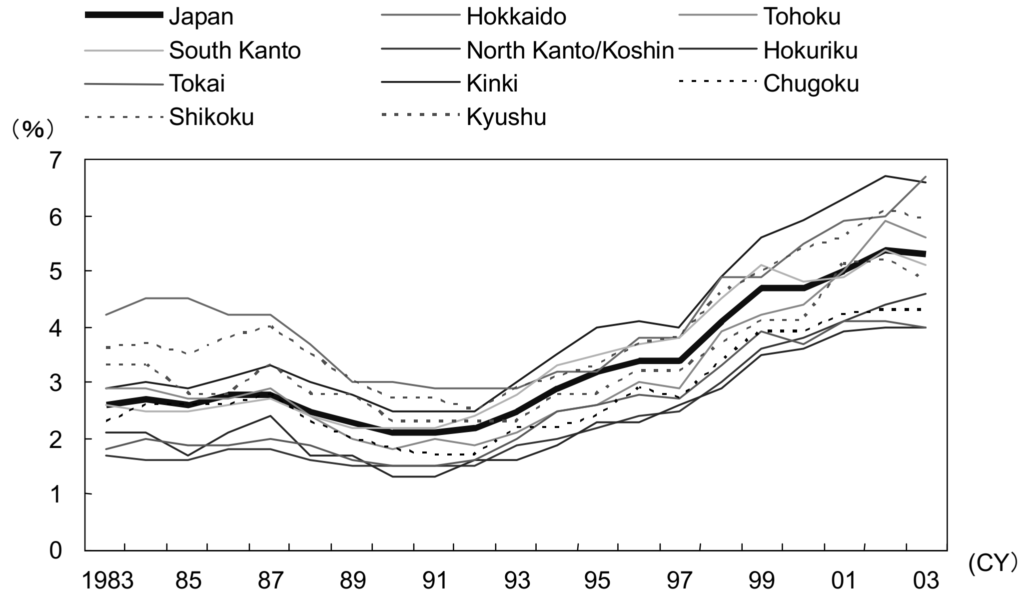
3. Growing economic disparities among the regions

As well as this tendency for new businesses to be concentrated in the big cities, there have been growing economic disparities even among the regions.

Some idea of these disparities is given by the employment data for the various regions.[4] In 2003, for example, the unemployment rates for Hokkaido and Kinki (the prefectures of Shiga, Kyoto, Osaka, Hyogo, Nara and Wakayama) were 6.7% and 6.6%, respectively, compared with 5.3% for the country as a whole. In contrast, the rate for Hokuriku (the prefectures of Niigata, Toyama, Ishikawa and Fukui) and Tokai (the prefectures of Shizuoka, Aichi and Mie) was only 4.0%, while the rates for North Kanto/Koshin (the prefectures of Ibaraki, Tochigi and Gunma), Chugoku (the prefectures of Tottori, Shimane, Okayama, Hiroshima and Yamaguchi), and Shikoku (the prefectures of Tokushima, Kagawa, Ehime and Kochi) were all less than 5%. Similarly, while the unemployment rate for the country as a whole recently declined (by 0.1%) for the first time in 13 years, the rate for Hokkaido rose sharply year on year. Thus, while the unemployment rates for Hokkaido, Tohoku (the prefectures of Aomori, Iwate, Miyagi, Akita, Yamagata and Fukushima), Kinki and Kyushu (the prefectures of Fukuoka, Saga, Nagasaki, Kumamoto, Oita, Miyazaki, Kagoshima and Okinawa) are higher than the national average, those for Hokuriku, North Kanto/Koshin, Tokai and Chugoku are lower (Figure 3).

4 Ministry of Health, Labour and Welfare, "White Paper on the Labour Economy 2004," Chapter 1: Employment and Unemployment Trends.

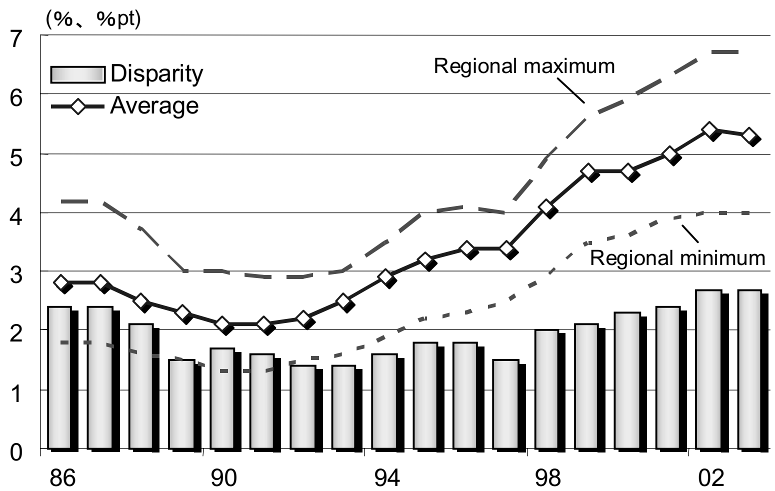
Figure 3 Regional Unemployment Rates



Note: The data are seasonally adjusted.
Source: NICMR, from Ministry of Health, Labour and Welfare's "Report on Employment Service" and Ministry of Internal Affairs and Communications' "Labour Force Survey."

Also, while the unemployment rate has generally been rising since 1990, the difference between the regions with the highest and lowest rates has also been rising since 1997 (Figure 4).

Figure 4 Unemployment Rate Disparities



Note: The data are seasonally adjusted.
Source: NICMR, from Ministry of Health, Labour and Welfare's "Report on Employment Service" and Ministry of Internal Affairs and Communications' "Labour Force Survey."

The ratio of job vacancies to applicants shows a similar picture. Although the figure for the country as a whole increased from 0.54 to 0.83 between 2002 and August 2004, the improvement in Kinki, Tokai, Kanto and Hokuriku was even greater while that in Hokkaido, Shikoku, Chugoku, Kyushu and Tohoku was less. The rate of improvement has therefore varied from region to region (Figure 5).

Figure 5 Ratio of Job Vacancies to Applicants

(Times)

	Japan	Hokkaido	Tohoku	Kanto	Hokuriku	Tokai	Kinki	Chugoku	Shikoku	Kyusyu	Okinawa
2002	0.54	0.47	0.44	0.58	0.64	0.74	0.45	0.66	0.61	0.44	0.30
2003	0.64	0.49	0.54	0.69	0.75	0.90	0.57	0.78	0.66	0.52	0.36
03/7-9	0.64	0.50	0.53	0.70	0.77	0.89	0.57	0.77	0.66	0.52	0.36
10-12	0.73	0.52	0.60	0.79	0.87	1.03	0.67	0.89	0.73	0.57	0.38
04/1-3	0.77	0.50	0.60	0.85	0.90	1.12	0.72	0.94	0.76	0.59	0.37
4-6	0.80	0.51	0.60	0.88	0.94	1.18	0.77	0.97	0.77	0.60	0.39
04/3	0.77	0.48	0.58	0.86	0.87	1.13	0.73	0.94	0.76	0.59	0.36
4	0.77	0.50	0.58	0.87	0.90	1.15	0.75	0.95	0.75	0.58	0.36
5	0.80	0.52	0.60	0.87	0.94	1.17	0.76	0.97	0.77	0.61	0.39
6	0.82	0.52	0.62	0.89	0.98	1.22	0.80	0.99	0.80	0.62	0.41
7	0.83	0.55	0.63	0.90	1.03	1.21	0.79	0.96	0.82	0.65	0.42
8	0.83	0.56	0.66		1.01	1.20	0.77		0.78	0.65	0.40
Comparison with 02	153.70	119.15	150.00	160.34	157.81	162.16	171.11	139.39	127.87	147.73	133.33

Note: The data are seasonally adjusted.
Source: NICMR, from Ministry of Health, Labour and Welfare's "Report on Employment Service" and Ministry of Internal Affairs and Communications' "Labour Force Survey."

According to the Cabinet Office's Annual Report on Prefectural Accounts, the construction industry accounts for some 10% of the gross prefectural product of Hokkaido, Tohoku, Hokuriku and Shikoku. Any reduction in unemployment in these regions is therefore likely to have been delayed as a result of the government's efforts in recent years to cut its spending on public works.

Although the overall picture is one of falling unemployment, regional disparities in the unemployment rate and the ratio of job vacancies to job applicants have increased—probably as a result of the different rates at which the (un)employment situation has been improving.

For this improvement in the (un)employment situation to be sustained and for regional financial institutions to help to revitalize their local economies, the current economic recovery will also have to be sustained. This will then have to feed through to a recovery in consumer spending that, in turn, leads to a broad-based recovery involving local businesses.

4. Problems faced by regional financial institutions

Although the results of Japan's regional banks (see above) indicate that their situation is better than it was a year earlier, with 20 of them reporting a ratio of nonperforming loans of 6% or less as of March 2004 (compared with 11 banks as of March 2003) and 23 reporting a ratio of 10% or more (compared with 28 as of March 2003), there are big disparities between individual banks.

The situation regarding bank deposits and savings accounts is similar: 40.0% (or ¥397 trillion) of these are held in the Kanto region (Tokyo and the six surrounding prefectures),[5] and the double-digit rate at which they have accumulated in Saitama and Kanagawa (two of the prefectures in the Kanto region) is much higher than that of the other regions. Similarly, 49.4% (or ¥250 trillion) of bank loans were made in the Kanto region, and 35.7% (or ¥178 trillion) in Tokyo alone.

These regional disparities and the concentration of business in Tokyo and other big cities are likely to have influenced the business models used by regional financial institutions.

There are big disparities between the biggest and the smallest regional financial institutions, with the disparities among the smaller institutions being greater among the shinkin banks than among the regional banks. While the key business ratios of some of the smaller institutions are on a par with those of the larger institutions, any business model for a regional financial institution needs to take into account the kind of regional disparities mentioned above.

Japan's 306 shinkin banks can be divided into three groups according to the amount of funds they hold on deposit:[6] those with ¥100 billion or less (81 banks), those with between ¥100 billion and ¥500 billion (181 banks), and those with ¥500 billion or more (44 banks) (Figure 6).

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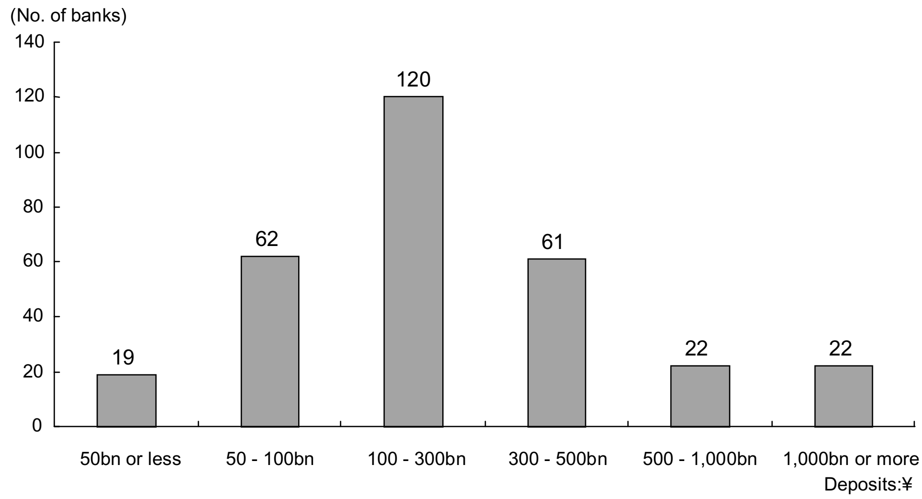
5 Kin'yu Janaru [Financial Journal], December 2004.

6 As of end-March 2004. As of end-October 2004, the number of shinkin banks had declined to 303.

Figure 6 Funds Held on Deposit with Shinkin Banks



Source: NICMR.

Even the largest shinkin banks with more than ¥1 trillion in deposits and head offices in Tokyo, Osaka or Nagoya exhibit considerable disparities in their overhead ratios,[7] which demonstrates that banks are not necessarily efficient just because their deposit-taking and lending operations are on a large scale. In fact, many of the smaller shinkin banks are highly efficient. One of the main reasons for this state of affairs is probably that the largest shinkin banks face stiff competition from rivals such as the big city banks. They therefore need to boost their profit margins and develop new markets as soon as possible.

The regional disparities among the smaller shinkin banks are quite extreme. Many of those based in areas where the population is both declining and aging can see their customer bases being eroded and have to operate in conditions that are generally unfavorable (e.g., a chronic lack of demand for funds).

Financial services are supposed to be an industry where economies of scale are possible. Indeed, in recent years there has been a wave of mergers by shinkin banks in the same region aimed at achieving some of those economies. Nor are shinkin banks located in big cities an exception. Such is the threat to smaller institutions that the number of shinkin banks in Tokyo has declined since the mid-1990s from 58 (the level at which it stood for a long time) as one big merger has followed another and is set to reach 23 (less then half the original number) by January 2006, when Tama Chuo

7 The overhead ratio (OHR) indicates how much it costs a company to produce a certain profit and is an important measure of a bank's efficiency. It is usually calculated by dividing a company's operating expenses by its net interest income and other operating income. The underlying idea is that the lower the number, the more efficient the company and that the more highly rated a bank in terms of its overhead ratio, the greater the effort it is making to cut costs and increase profit.

Shinkin, Hachioji Shinkin and Taihei Shinkin will merge to form Tama Shinkin Bank. This restructuring is likely to continue nationwide as shinkin banks seek to rightsize.

As the disparities among shinkin banks are greater than those among regional banks, it would be wrong to apply the same logic as has been applied to larger institutions. What shinkin banks need to do is make sure where their own strengths lie in relation to the various characteristics of their local market and set about differentiating themselves from other types of financial institutions, including the big banks. The fact that the Program for Further Financial Reform does not set regional financial institutions targets for cutting their nonperforming loans may well have been because a "one size fits all" solution would not have been appropriate for institutions that will have to tailor their services to the needs of their local communities if these are to recover from the post-bubble slump.

III. Where Regional Financial Institutions Need to Direct Their Efforts

1. Relationship banking

As we have already seen, the regional financial institutions are gradually getting to grips with their nonperforming loans, and their earnings are showing signs of improvement. However, the picture varies considerably, depending on the size of the institution. In March 2003, as part of its efforts to help small businesses and local economies recover from the post-bubble slump during the so-called "intensive improvement period" of fiscal 2003 and 2004, the Financial Services Agency published an "Action Program Concerning the Enhancement of Relationship Banking Functions," which required regional financial institutions to submit a "plan for enhancing the functions of relationship banking" by August 2003. These plans were meant to serve as "a business model of lending by obtaining information (e.g., on the qualities of the management and the future prospects of a debtor company) based on a long-term relationship."

In their plans institutions were asked to deal with two main issues: first, how they could help small businesses to recover from the post-bubble slump; and, second, how they proposed to make their own operations less risky and more profitable. They were also asked to try to implement their proposals as far as possible by the end of fiscal 2004.

The main developments in the implementation of these plans between April 2003 and September 2004 are set out in Figure 7.[8]

Figure 7 Findings of Survey of Results of Action Program Concerning the Enhancement of Relationship Banking Functions

Main findings	Fiscal 2004 (first half)		Fiscal 2003	
	Number	Amount	Number	Amount
(1) Improved support for new companies and businesses				
Number of staff attending personal development courses	176,283	-	111,706	-
Number of staff attending courses designed to improve their ability to support small businesses	187,266	-	121,339	-
Support loans for industrial clusters	64	13	31	6
Loans to support new companies	3,574	331	2,274	230
Syndicated loans with government financial institutions	704	668	331	330
Number of corporate development funds (or institutions investing in such funds) and size of investment	88	165	80	104
(2) Improved advice and support for corporate customers; action to achieve early recovery				
Number of corporate recovery funds (or institutions investing in such funds) and size of investment	75	158	39	100
Number of successful business matches	12,519	-	7,334	-
Use of SME revitalization support councils	1,062	-	666	-
Debt-for-equity swaps	39	219	29	175
Debt-for-debt swaps	19	126	6	55
DIP finance	330	708	216	603
(3) Improved action to develop new sources of finance for small businesses				
Loans involving scoring models	222,362	20,118	132,067	11,403
Loans involving restrictive financial covenants	3,383	1,089	2,264	482
Private placements	4,396	6,433	2,816	4,146
Loan sales/securitizations	3,357	3,167	1,279	1,833
of which, collateralized loan obligations	2,335	796	828	414
Participation in syndicated loans (as arranger)	412	4,882	220	2,530
Loans secured against receivables	18,305	1,559	9,268	895
Loans to small businesses with high disclosure standards	24,542	2,671	8,893	982

Source: NICMR, from Financial Services Agency data.

1) Measures to improve financial services to small businesses

There are clear signs of progress. Most regional and shinkin banks have organized in-house training courses to help their staff better serve the needs of their small business customers. Also, local authorities, universities and government financial institutions have been increasingly involved in arranging loans.

8 For further details, see a December 2004 progress report on the Financial Services Agency's "Action Program Concerning the Enhancement of Relationship Banking Functions" at http://www.fsa.go.jp/news/newsj/16/ginkou/f-20041227-2.html (in Japanese).

There have also been cases (albeit still small in number) where debt-for-equity swaps, debt-for-debt swaps and debtor-in-possession finance have been used successfully.

Similarly, regional financial institutions are making progress in reducing their dependence on collateral and guarantees. All the different types of institution are in the process of adopting scoring models for assessing loan applications, and more than half of all the institutions now have a loan monitoring manual and conduct regular loan reviews. A growing number of institutions also rely less on third-party guarantees. This process of helping local businesses and economies to recover from the post-bubble slump will also help the institutions themselves to build a new business model.

Some regional financial institutions have also reaped rich rewards from this type of business, whether it be in the form of (1) dividends from corporate recovery funds, (2) fees for M&A advice to companies that have taken over businesses sold as part of the recovery process, (3) interest income from new business with such companies (e.g., loans or loan recovery), or (4) a reduction in the risk of making a profit from a corporate recovery fund as a result of these different types of business.

Although local investment banking has been branded as uneconomical and unprofitable, it does give institutions the opportunity to engage in a wide range of business provided they discuss the likely outcome of any business plan properly with the company concerned.

It is also interesting to note the growing number of cases where financial institutions from the same prefecture have cooperated with rivals in traditional areas such as deposit-taking and lending. If attempts to help small businesses to recover are to be successful, it is clearly important to collect as much local information as possible; and institutions can pool the wide range of expertise they have acquired in this area by investing in the same recovery fund.

2) Measures to reduce the risk to both individual institutions and local financial systems

In order to improve disclosure, even those regional financial institutions that are not public companies all now publish their results every quarter. In addition, many cooperative financial institutions (more than 90% of the shinkin banks and more than 30% of the credit cooperatives) have made an effort to improve their governance (e.g., by giving details of their annual delegate meetings and how delegates are elected).

The central organizations of the cooperative financial institutions now also play a greater role in trying to reduce the risk to local financial systems (e.g., by underwriting preferential participations in individual institutions that need to recapitalize in order to restructure). As of the end of March 2004, for example, Shinkin Central Bank had underwritten ¥223.9 billion of such participations, while the Shinkumi Federation Bank had underwritten ¥22.4 billion.

2. Progress report and issues outstanding

In a report on the progress made during the past two years towards creating a financial services industry in tune with the needs of local communities, the Financial Services Agency has identified the following three areas where progress has been made from the point of view of both the financial institutions and their customers.

First, the Agency noted that a significant number of financial institutions had made progress in putting in place the basic systems necessary for helping local businesses and cooperating with local and central government financial institutions.

Second, the Agency noted that, as of the end of September 2004, some progress had been made in reducing the credit risk borne by the regional banks, with the credit rating of some 20% of the companies that they had helped to restructure being upgraded and the ratio of their nonperforming loans being reduced.

Third, the Agency expressed its hope that small and regional financial institutions would adopt a similar attitude and play a key role in helping local economies and businesses.

At the same time, the Agency identified the following three issues that need to be addressed.

(1) Need for continuity

In many cases (e.g., where a new company or business is being established, or where a business needs to recover as soon as possible), it will be some time before the benefits of any action begin to appear. Institutions therefore need to be patient and persistent.

(2) Need for an individual approach

Any attempt to tailor financial services to the needs of a local community should really depend on the judgment of individual financial institutions as to how best they can do this in line with the plans they have submitted to the Financial Services Agency. However, a significant number of institutions appear to regard this as a mere formality and try to please everyone.

These institutions need to bear the particular needs of their local communities in mind as well as their own limits, and seek to offer a tailor-made and efficient service.

(3) Need for an effective approach that produces quick results

Different financial institutions will adopt different approaches, with some able to achieve visible results while others will still be in the process of acquiring the necessary expertise. Similarly, some institutions will still rely on customer collateral when extending loans and still lack the expertise needed to judge a business's prospects. Such institutions need to acquire this expertise. As well as training staff to understand the needs of their customers and the strengths and weaknesses of their own institutions, they need to work more closely with other organizations and outside experts. In addition, they need to improve their disclosure. In short, they need to adopt an effective approach that produces quick results.

3. The Program for Further Financial Reform and local financial services

Building on the progress that has been made during the past two years and taking into account the improvements in relationship banking that still need to be made, the Program for Further Financial Reform calls on regional financial institutions to redouble their efforts to help local economies and businesses to recover from the post-bubble slump by offering them a better service. This will involve submitting new plans in addition to the ones already submitted to the Agency and summarized in the Program.

Each institution will have to submit more detailed proposals for (1) helping businesses to recover and offering them a better service, (2) making its own operations more efficient, and (3) offering a service that is more tailor-made to the needs of customers and the local community.

In order to ensure that regional financial institutions make their own operations more efficient, there will be incentives for them to improve their governance by submitting to the discipline of disclosure while making the most of the distinctive characteristics of regional financial services, and to achieve higher risk-adjusted returns by means of better risk management, business analysis and profit control.

By encouraging small and regional financial institutions to diversify their business portfolios in line with local needs, the Program aims to stimulate healthy competition.

IV. Regional Financial Services at the Dawn of a New Era

1. Is reform of Japan's regional financial institutions possible?

We have looked at the current state of regional financial services in Japan in the light of the tendency for business to migrate to the big cities (with an inevitably negative knock-on effect on local economies) and the disparities that have developed among different regions. We have also considered some of the measures taken by government to remedy this situation as well as some of the issues that need to be addressed. Just as even Japan's biggest banks cannot afford to stand still, so its regional financial institutions face some tough decisions if they are to service the needs of their local economies and still make a profit.

The Program for Further Financial Reform, which builds on the earlier Action Program Concerning the Enhancement of Relationship Banking Functions, is the Financial Services Agency's response to this situation and these issues. The question, however, is whether this response will succeed in helping local economies to recover and in creating a more effective regional financial services industry.

If reform of Japan's regional financial institutions is to succeed, they will need to devise a strategy to deal with the following three issues.

(1) Need for a clearly defined role

Whereas Western financial institutions devise business models that analyze their own strengths and weaknesses and emphasize distinctive choices and areas of specialization in their customer bases, products/services and distribution channels, Japanese financial institutions tend to try to please everyone by offering the same comprehensive range of products and services to as many different types of customer as possible. By their very nature, financial institutions should offer something distinctive according to what type of institution they are.

However, as the gap between the regions and the big cities has widened, the competition between commercial banks and cooperative institutions such as shinkin banks has become increasingly fierce, and the resulting cost pressures have squeezed the margins of all the institutions. Regional financial institutions need to decide where their strengths lie and to define a role for themselves on that basis.

(2) Shortage of talented managers

Local economies will not recover and employment will not be created without small and medium-sized local businesses with the necessary growth potential. These in turn, cannot continue to grow without a financially sound and stable regional financial services industry. However, an issue of equal importance is the need for talented managers.

In order to turn a company around, talented managers are needed who are also specialists in areas such as law and taxation. Only recently have the services of such specialists become more generally available in Japan. Generally speaking, the most talented specialists are snapped up immediately, and there is a risk that there may not be enough to go round.

Therefore, although there have already been reports of successful recoveries,[9] it is not always possible to do this within a fund.

(3) Competing with the big battalions

Generally speaking, it is the big banks that are the first to develop new financial schemes. These schemes also tend to become commodity products. This means that regional financial institutions eventually find themselves competing with the big banks to cut costs. As a result, their profit margins are squeezed, and they find themselves driven into a corner.

In the retail market, competition has become increasingly severe, with regional financial institutions competing with one another while the big city banks are also keen to carve out a share for themselves. Similarly, in the regional investment banking business, the big banks, which have no local customer base, have made investment banking just as much a strategic priority for their local branches as retail banking, thereby limiting the scope for regional financial institutions to develop a strategy of their own. However, if they simply try to copy the big banks, there is no way that they will develop the kind of new business model that the Financial Services Agency has

9 See "Saisei Fando Kaishu Kyuzo" [Recovery Rate of Corporate Recovery Funds Improves Dramatically], Nihon Keizai Shimbun, 12 January 2005.

been urging them to do. Instead, they must come up with some radically new ideas that allow for the fact that they will have to compete with the big battalions.

2. Division of labor with central organization

In big cities such as Tokyo it is actually difficult for different types of competing financial institutions to achieve synergies, while, in the regions, the harsh reality is that, unless a locally based regional bank, shinkin bank or credit cooperative is able to generate a profit that matches its commitment to that area, it will not survive. This is not the case with the big city banks, which can afford to devise a radical regional strategy. They have already written off their nonperforming loans and formed themselves into four huge financial groups with their own securities, trust banking and consumer loan arms and are therefore capable of offering full-service banking.[10]

It would be unrealistic for regional financial institutions to try to compete head on with such behemoths. This is particularly true of retail banking, where they find it difficult to differentiate themselves from the big city banks and where, the more deposits they take in, the more likely they are to be unable to invest the money because of the low demand for funds from their customers.

A further point is that, although one would think that there would be increasing business opportunities for regional financial institutions to cooperate, it has become difficult for banks and cooperative financial institutions such as shinkin banks to coexist. This suggests that cooperative financial institutions need to decide where their future lies and how best they can organize the division of labor between themselves and their central organization.

In many countries, regulatory reforms have often led to the blurring of traditional demarcation lines between banks and cooperative financial institutions as the latter have entered new areas of business and are now often the responsibility of the same regulator. These reforms can take a variety of forms, depending on the situation on the ground, but include mergers by institutions of the same type, demutualization, and the creation of financial groups (consisting of a central organization, individual cooperative institutions and specialized subsidiaries) to offer a wider range of financial services and improve risk management.[11]

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[10] For further details on the big banks, see Yasuyuki Fuchita, "The Risks and Rewards of the Pursuit of Size and Complexity by Japan's Megabanks," Capital Research Journal, Winter 2004.

[11] See "Kaigai ni Okeru Kyodo Soshiki Kin'yu Kikan no Genjo" [The Overseas Operations of Japan's Cooperative Financial Institutions], Nihon Ginko Chosa Kiho [Bank of Japan Research Bulletin], October 2004.

In Japan, Shinkin Central Bank acts as the central organization for the country's shinkin banks, investing surplus funds efficiently and providing a centralized payment and settlement system as well as other services such as foreign exchange that it would be impracticable for individual institutions to offer. In addition, it plays a key role in helping institutions to stay solvent (e.g., by providing capital injections) and to merge or restructure.[12]

As a central organization, Shinkin Central Bank has a conservative investment policy and a very high equity ratio (16.6% on a consolidated basis).

Compared with normal commercial banks, Shinkin Central Bank has a low overhead ratio, but its return on assets (on a net operating profit basis) is also low (only 0.2%). However, it can offer a full range of financial services as a financial institution in its own right as well as venture capital and investment advisory services through its subsidiaries. In addition, it is involved as a lender, through its network of 12 branches, with local authorities and companies (e.g., in PFI projects). However, this could bring it into conflict with local shinkin banks.

As well as restructuring their networks more radically, Japan's cooperative financial institutions, each of which has a central organization similar to Shinkin Central Bank, will need to decide how to allocate responsibility between the central organization and individual institutions more effectively (e.g., by offering the services of the central organization to small and medium-sized local businesses) in order to compete against regional and city banks.

This may also mean that some of the regulations governing shinkin banks (e.g., restrictions on lending to non-members) may need to be relaxed to allow large and medium-sized shinkin banks to compete with regional banks.

3. Implementing a strategy for diversifying cooperation

We have seen how regional financial institutions need to devise a radical strategy (e.g., for diversifying away from their core deposit and loan business into areas such as investment management or for specializing in loans to small businesses). However,

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12 Other types of cooperative financial institution in Japan include credit cooperatives (National Central Society of Credit Cooperatives), labor credit associations (National Society of Labor Credit Associations), and agricultural and fishery cooperatives (Norinchukin Bank). The name of the central organization of each type of institution is given in parentheses. The roles of Shinkin Central Bank and Norinchukin Bank are likely to become particularly important.

any strategy based solely on short-term criteria such as profit margins and capitalization will fail to achieve the goal of long-term regional development.

With the ending of restrictions on "securities intermediaries" (i.e., stockbroker agents) last December and the growth of trust and commercial banking agencies, cooperation among different types of financial institution is likely to increase. As a result, a growing number of regional banks can also be expected to offer full-service banking.

However, banks will not be able to differentiate themselves simply by offering full-service banking. Regional financial institutions will have to develop their relations with as many stakeholders in the local economy as possible—not just with local businesses. These wider contacts will help them to identify local strengths and characteristics, and to develop a new synergistic business model. There are many options open to regional financial institutions seeking greater cooperation, including cooperating with their central organization (see above), cooperating with organizations outside their local area, and cooperating with other types of financial institution. However, the following are four such options.

(1) Cooperation in issuing collateralized loan obligations

There has been considerable interest in collective investment schemes such as collateralized loan obligations (CLOs) as one of the principal means by which financial institutions can free up their credit risk and thereby reduce their risky assets and improve their capital adequacy ratios. They have already been used in Japan (e.g., by the Tokyo Metropolitan Government in association with Kanagawa Prefecture and the cities of Yokohama and Kawasaki in July 2004), and are an example of how financial institutions from different regions can cooperate, albeit at the initiative of local authorities.[13] There have since been examples from other parts of Japan, including a collateralized loan obligation organized at the initiative of the Chubu Bureau of Economy, Trade and Industry and involving financial institutions from neighboring prefectures as well as one involving institutions from four non-neighboring prefectures (Wakayama, Miyagi, Tottori and Saga).

Another possible example of cooperation by financial institutions from different regions would be for regional financial institutions under the auspices of the Regional Banks Association to set up a national pool of regional relationship banking experts trained at seminars organized as part of the Financial Services Agency's Action

[13] The collateralized loan obligation involving the Tokyo Metropolitan Government, Kanagawa Prefecture, and the cities of Yokohama and Kawasaki was sold through branches of UFJ Bank, Bank of Yokohama, Kanagawa Bank, Hachiyo Bank, Yokohama Shinkin Bank and Tokyo Tomin Bank.

Program Concerning the Enhancement of Relationship Banking Functions (see above). These experts could be seconded to other regions as necessary. Similarly, corporate recovery funds from different regions could be amalgamated as one possible exit strategy for small business recovery funds.

(2) Cooperation with other types of business (healthcare)

All over Japan, local authorities are in the process of drawing up regional healthcare plans. With major regional hospitals and healthcare "units" (themselves comprising many local clinics) probably covering similar geographical areas to those covered by regional financial institutions, many of the latter's customers are likely to be patients—either now or at some time in the future. Also, with Japan's birthrate declining and the longevity of its population increasing, the number of single-person households is set to increase. As a result, a growing number of people are likely to become concerned about whether they will receive the quality of healthcare they would like. Regional financial institutions also have extensive local branch networks and are in a much better position than their rivals to develop face-to-face relationships with their customers. All this suggests that there will be growing opportunities for them to cooperate with local health authorities—even to the extent of developing a business model that makes more of such opportunities than simply acting as intermediaries, as they have done in the past.

(3) Cooperation with universities and colleges

In the past, regional financial institutions have had relatively few opportunities to do business with universities and junior colleges. As a result, they have had very few opportunities to interact with them. Most universities and junior colleges have tended to do business mainly with the big city banks and the biggest regional banks. However, many of them see regional financial institutions as some of the best prospective employers of their graduates. Many also want to give their students more work experience opportunities and would like to open up the channels of communication with regional financial institutions as one way of doing this.

(4) Cooperation aimed at improving the service to corporate customers

In recent years many regional financial institutions have had to rely on their central organizations (e.g., the Regional Banks Association or Shinkin Central Bank) for specialist advice for small and medium-sized corporate customers looking to set up operations in other parts of East Asia. This is because, in many cases, the training that local staff have received is inadequate for their customers' business needs. Exactly how regional financial institutions should cooperate with their customers to address their needs, of which advice on overseas expansion is only an example, should be left to the initiative of individual institutions. Whatever options institutions decide to go for, briefings for institutional investors should increasingly serve as a new forum for those involved to exchange ideas.

As we have seen, there are ample opportunities for regional financial institutions to service the needs of the various stakeholders in their local economies, who include local citizens, small and medium-sized local businesses, local authorities, universities, hospitals, Shinto shrines, Buddhist temples, nonprofit organizations and local communities. The growth of information technology such as the Internet has made it increasingly inappropriate for such stakeholders to act alone, and financial institutions will find it increasingly difficult to do business with their customers in isolation, whether they be companies or universities.

Although most regional financial institutions have opportunities to interact with most of their customers through their deposit-taking and lending operations, they have failed to make the most of these opportunities in their traditional approach to business.

By developing their relationships with as many stakeholders in the local economy as possible (and not just with local companies) and using these wide-ranging contacts to identify local strengths and characteristics, regional financial institutions have the opportunity to develop a new synergistic business model that should enable them to enhance their relationship banking function in the true sense of the term.