Household Financial Assets in Japan: 2007 in Retrospect

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I. Household Financial Assets in Japan May Enter a Medium- to Long-Term Downtrend

According to the Bank of Japan's "Flow of Funds Accounts" (released on 21 March 2008), Japanese household financial assets amounted to 1,545 trillion yen as of end-December 2007 (a y-y decline of 0.5%). This is the first time since end-2002 that the figure has declined on a year-end basis. If we divide the changes during the course of 2007 into capital flows and valuation gains/losses, we can see that the decline was the result of net inflows amounting to ¥26.9 trillion and valuation losses amounting to ¥36.0 trillion, mainly as a result of the stock market downturn. (¥32.3 trillion of these losses was on equities (both public and private), while ¥2.2 trillion was on investment trusts.)

Although the stock market downturn was the main cause of the decline in 2007, we see the level of savings as a more important factor for the level of household financial assets in the medium to long term. We expect the savings rate to decline in the years to come as the Japanese population ages and an increasing number of older people draw down their savings. The rate, which was 10%-plus in the 1990s, had declined to 3.3% by 2006, the latest year for which figures are available. Assuming that the savings rate can be explained solely in terms of the dependent population ratio[1], we should be prepared for the savings rate to turn negative in 2009 (Figure 1). After ranging between ¥30 and ¥40 trillion/year in the 1990s, Japanese net household savings (disposable income – final consumption expenditure)[2] then declined along with the savings rate and have been hovering around ¥10 trillion/year since 2003 (Figure 2). We expect net savings to turn negative in the years to come and to exert downward pressure on financial assets.

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1 The "dependent population ratio" is the percentage of under-15s and over-64s in the population as a whole.

2 Strictly speaking, it includes changes in the pension fund reserves. Also, because of differences in the way net savings and acquisitions/disposals of financial/real assets in the national accounts, and financial surpluses/deficits in flow of funds accounts are calculated, the two amounts differ.

Figure 1: Japan's Savings Rate: Actual and Estimated

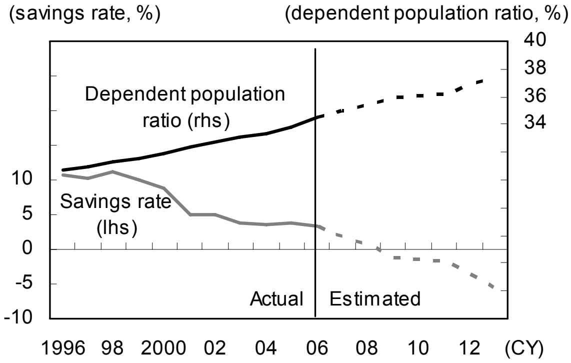
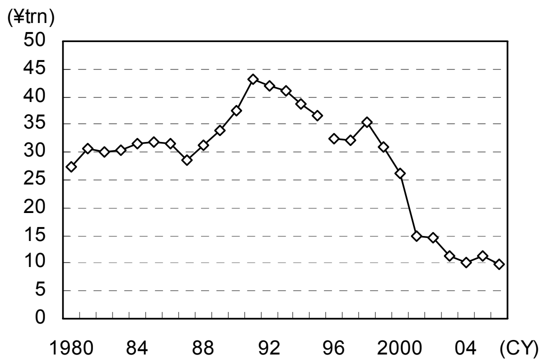


Figure 2: Net Savings



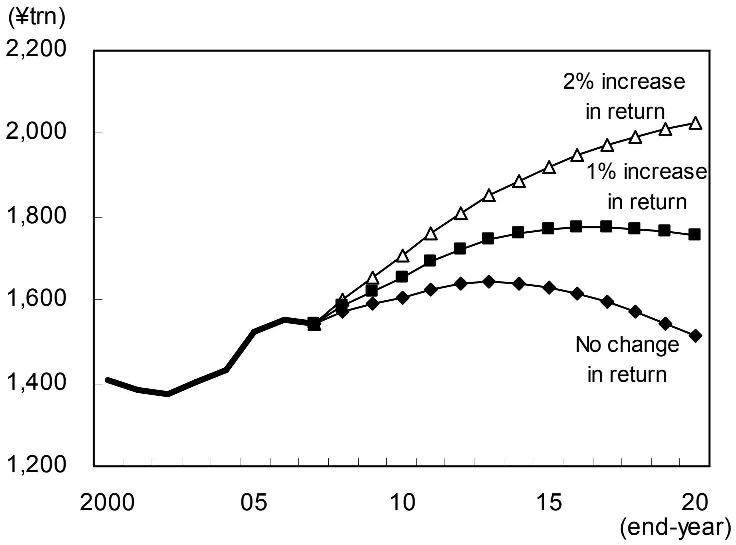
Notes: 1. We have used the medium variant estimate of the dependent population ratio for 2007 and later years.
2. In the case of the savings rate, we have done a regression analysis using the dependent population ratio as our sole explanatory variable.
3. In the case of net savings, the series through and after 1995 are discontinuous.

Source: NICMR, from the Cabinet Office's "System of National Accounts" and National Institute of Population and Social Security Research statistics.

In view of the impact of aging on financial assets, the return on these assets is likely to become increasingly important. Figure 3 shows a projection of household financial assets' likely level until 2020, assuming that the return in terms of capital gain[3] stays at the level of the past five years and that other factors remain unchanged. If the current rate of return remains constant, Japanese household financial assets will peak in 2013 and then decline as the Japanese population ages. However, if the return increases by 1%, they will not peak until 2017. Moreover, if the return increases by 2%, we estimate that they will continue to increase even after 2020. In view of the fact that households in the US and the UK, where investments account for a higher proportion of financial assets, have achieved a higher return on their financial assets than households in Japan (Figure 4), we think that it will become increasingly important to encourage Japanese households to invest more.

[3] The annual rate of capital gain on household financial assets in 2003–07 was 1.46%.

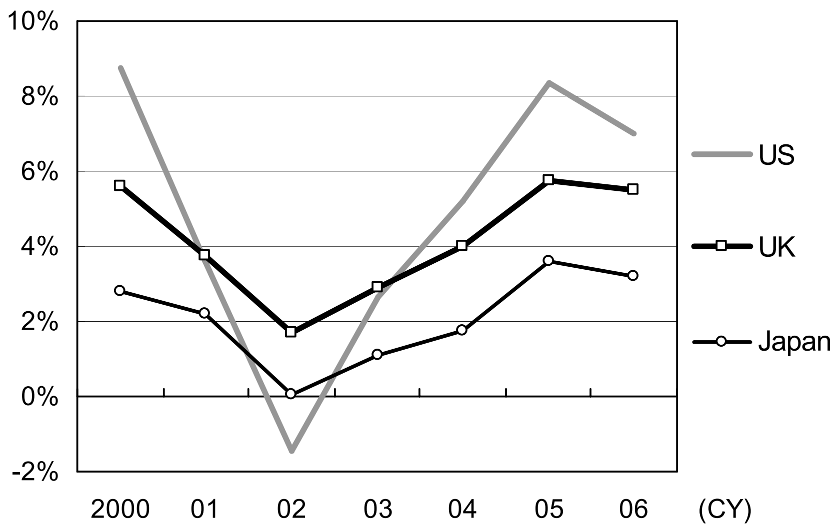
Figure 3: Projections of Household Financial Assets



Note: The projections assume the savings rates in Figure 1 and that the annual rate of capital gain on household assets remains 1.46%.

Source: NICMR, from the Cabinet Office's "System of National Accounts," National Institute of Population and Social Security Research statistics, and the Bank of Japan's "Flow of Funds Accounts."

Figure 4: Rate of Return on Household Financial Assets in the US, UK and Japan



Note: Data are plotted as a three-year moving average using interest and dividend income together with capital gains on shareholdings.

Source: NICMR, from Japan's Cabinet Office, US Department of Commerce, Bank of Japan, UK Office of National Statistics and Bloomberg data.

As we will see later in this report, the flow of capital in 2007 shows that the "Shift from savings to investments" continued. However, since last October in particular, this tendency has lost some of its momentum as (1) sales of investment trusts by regional financial institutions have shrunk as the Financial Instruments and Exchange Law has come into effect and as (2) inflows to investments have slowed as issuance of JGBs for individual investors has declined. In this report we take a closer look at the current situation, particularly with regard to investment assets, in the light of the flows in and out of different assets in 2007.

II. Trends in Financial Assets in 2007

1. Net inflows to financial assets

Figure 5 shows net inflows to different types of financial assets on a calendar-year basis.

An analysis of net inflows to different types of financial assets in 2007 reveals that, at ¥12.7 trillion, net inflows to investment trusts in 2007 were the highest in 10 years. In particular, net inflows in Apr–Jun 2007 (¥5.9 trillion) were the highest ever for any quarter (the previous record was for Apr–Jun 1987 (¥4.1 trillion)[4]). Net inflows to Japanese government bonds were also at a high level (¥3.1 trillion), reflecting the issuance in July 2007 of nearly ¥2 trillion in JGBs for individual investors. However, net outflows from listed stocks (¥2.7 trillion) continued. If we group these three types of financial asset as "investment assets," inflows to investment assets amounted to ¥13.1 trillion over 12 months. Investment assets accounted for 12.8% of outstanding financial assets. This is nearly twice the proportion in the year to March 2003 (6.8%), which was the lowest in recent years.

Figure 5: Breakdown of Net Inflows by Financial Asset (CY-basis)

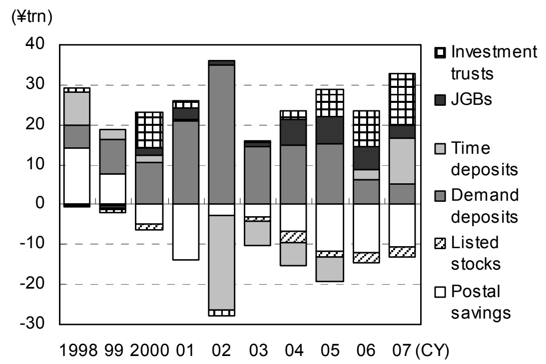
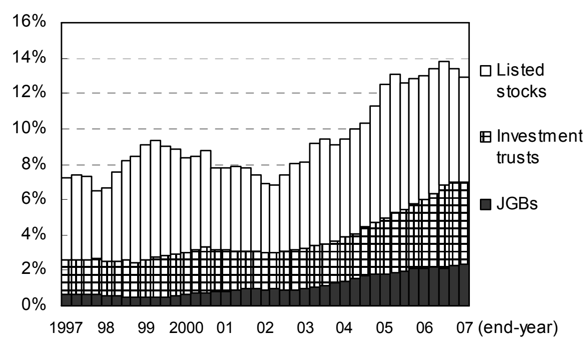


Figure 6: Investment Assets as Percentage of Financial Assets



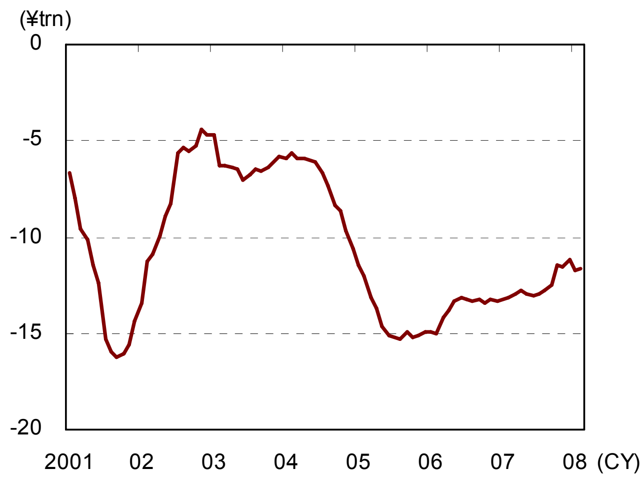
Source: NICMR, from Bank of Japan's "Flow of Funds Accounts" and Japan Post Bank statistics.

[4] Statistics based on the old (68SNA) flow of funds accounts.

At the other extreme are postal savings deposits, which have seen net outflows of more than ¥10 trillion every year since 2005. In 2007 these amounted to ¥10.4 trillion. However, these outflows have diminished since Japan Post was privatized in October 2007 (Figure 7), and it will be interesting to see whether this affects inflows to investment assets.

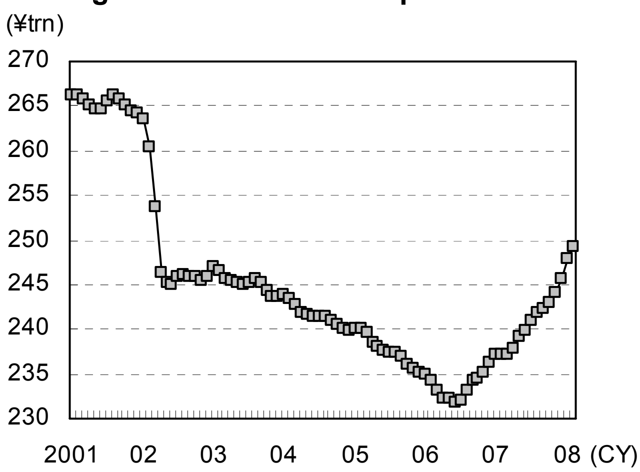
Another increasingly marked trend has been net inflows to bank time deposits[5] since 2007. In July 2006, when the Bank of Japan abandoned its policy of zero interest rates, household balances of time deposits, which had been declining, began to rise. Net inflows in 2007 totaled ¥11.6 trillion, the highest on an annual basis in 10 years. As a result, total balances have recovered to the same level as in 2002, when the blanket guarantees on time deposits were partially ended (Figure 8).

Figure 7: Year-on-Year Percentage Change in Postal Savings Balances (as of month-end)



Source: NICMR, from Japan Post Bank and Japan Post data.

Figure 8: Retail Time Deposit Balances



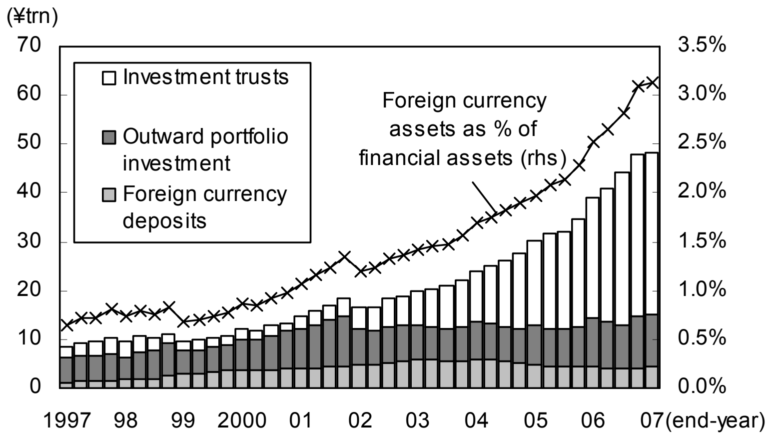
Note: Total for domestic branches of Japanese banks and shinkin banks. Latest data as of end-February 2008.
Source: NICMR, from Bank of Japan data.

5 This excludes Japan Post Bank.

2. Investment in foreign currency assets continues to increase

As investment in investment trusts has increased, so has households' exposure to foreign currency assets. As of end-2007, household holdings of foreign currency assets totaled ¥48.2 trillion, 3.2% of financial assets, the highest proportion ever (Figure 9). Traditionally, households have held foreign currency assets mainly in the form of either overseas securities (e.g., overseas-registered investment trusts) or foreign currency deposits. In recent years, however, the proportion of investment trusts has risen to more than 70% as the investment trust market has expanded.

Figure 9: Household Holdings of Foreign Currency Assets



Note: The data on foreign currency assets held in the form of investment trusts are estimated using data on the foreign currency assets of publicly offered investment trusts.

Source: NICMR, from Bank of Japan's "Flow of Funds Accounts" and Investment Trusts Association, Japan data.

A breakdown of foreign currency assets held in the form of investment trusts reveals that, although bonds have traditionally accounted for the lion's share, 2007 saw an 84% increase in equity holdings. As a result, they accounted for 27% of foreign currency assets by the end of 2007 (Figure 10). This is not only because the net assets of global equity funds[6] increased from ¥5.4 trillion as of end-2006 to ¥9.8 trillion as of end-2007, but also because households invested more in overseas equities via balanced funds.

Furthermore, a breakdown by currency reveals that holdings of US dollar assets declined in relative terms while those of assets denominated in Australian dollars and "other currencies" increased (Figure 11). We think this is partly because of an increase in the number of funds that invest in high-yielding currencies and partly because of an increase in demand for funds that invest in emerging markets such as India and Brazil.

Just as households have increased their holdings of foreign currency assets in the form of investment trusts, investment trusts themselves have widened their scope as

6 Net assets of global open-end equity investment trusts according to the Investment Trusts Association, Japan.

the range of their products has also widened. To put it rather simply: whereas Japanese households have traditionally held foreign currency assets in the form of investment trusts that tended to invest mainly in US dollars and bonds, the tendency now is to diversify currency exposure and increase exposure to equities.

Figure 10: Breakdown of Foreign Currency Assets of Publicly Offered Investment Trusts

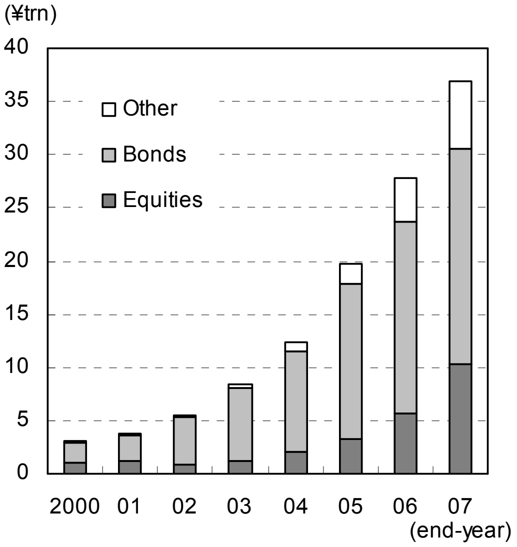
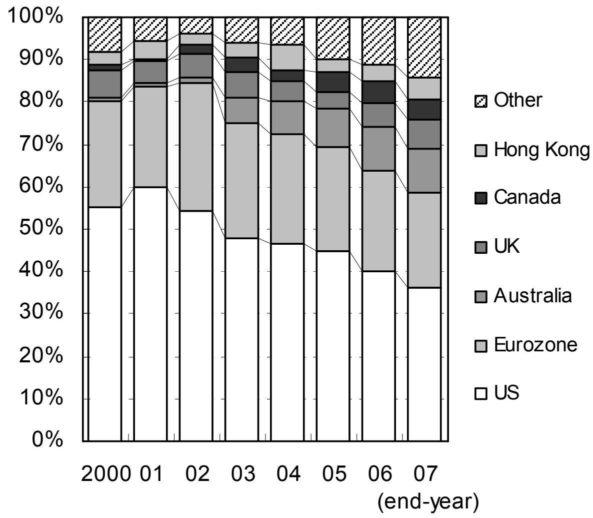


Figure 11: Breakdown of Foreign Currency Assets by Currency



Note: "Other" includes mortgage-backed securities and deposits. However, some of the real estate owned directly by investment trusts is included in "equities."
Source: NICMR, from Investment Trusts Association, Japan data (both charts).

III. Change of Direction since October 2007

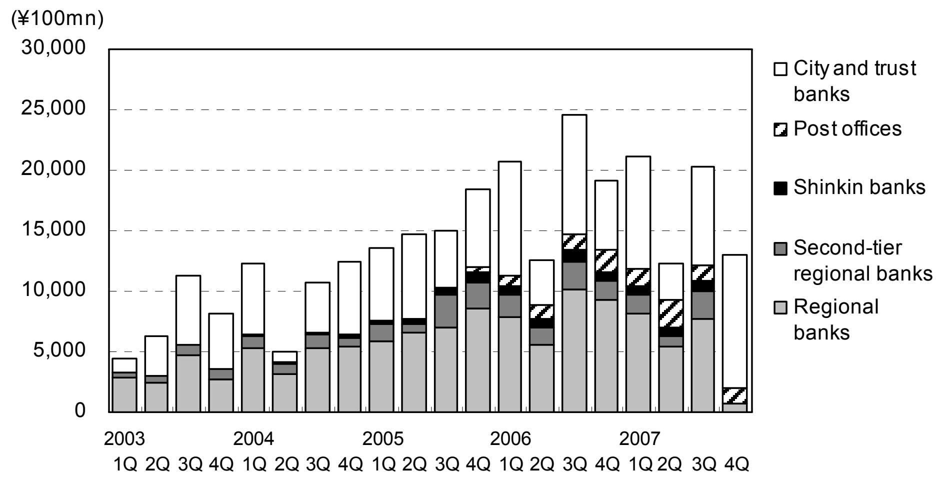
In 2007, investments by households increased, both in terms of amount and range, as shown by the inflows to investment trusts. However, since last October in particular, this tendency has lost some of its momentum—not only as a result of the stock market downturn but also as the Financial Instruments and Exchange Law has come into effect and the issuance of JGBs for individual investors has declined.

1. Impact of Financial Instruments and Exchange Law on bank investment trust sales

The Financial Instruments and Exchange Law, which came into effect on 30 September 2007, has put a damper on sales of investment assets (especially investment trusts). In order to comply with the Law's specific and detailed accountability requirements, financial institutions have to give customers a simple yet thorough explanation in writing (even before a contract is signed) to ensure that they have understood properly what is involved[7]. In order to comply with these new requirements, financial institutions now also have to explain in writing many of the things that they used to be able to explain verbally; and, in order to demonstrate that they are satisfying the suitability principle, they have had to start using documents such as interview sheets. One result of this has been a sharp fall in sales of investment trusts by regional financial institutions since last October as they struggle to cope with the new requirements.

Figure 12 estimates sales of investment trusts by different types of financial institution (on a net quarterly basis). According to these calculations, sales of investment trusts by regional and second-tier regional banks and shinkin banks fell sharply in 2007 Q4 while those by city and trust banks were largely unchanged. We think the main reasons for this are (1) that it now takes financial advisers an average of roughly two hours (i.e., nearly twice as long as before) to explain the products they are recommending[8] and (2) concerns about what the Law requires them to do to comply with the suitability principle[9].

Figure 12: Net Inflows to Investment Trusts via Banks (quarterly basis)



Note: We calculated net inflows using the data on sales by each type of financial institution in Japan Financial News Co's "Nikkin Toshin Nenkin Joho" [Information on Investment Trusts and Pensions], stripping out fluctuations in stock market prices and exchange rates. Although the sample consists mainly of publicly offered investment trusts, some privately placed trusts are included. As a result, the data differ from those of the Investment Trusts Association, Japan.

Source: NICMR, from Japan Financial News Co.'s "Nikkin Toshin Nenkin Joho" [Information on Investment Trusts and Pensions].

7 For further details, see Kei Kodachi, *Kin'yu Shohin Torihikiho ga Ginko ni Ataeru Kiseijo no Eikyo* (Regulatory Impact of the Financial Instruments and Exchange Law on Japanese Banks), Capital Market Quarterly, Spring 2007 issue (in Japanese)

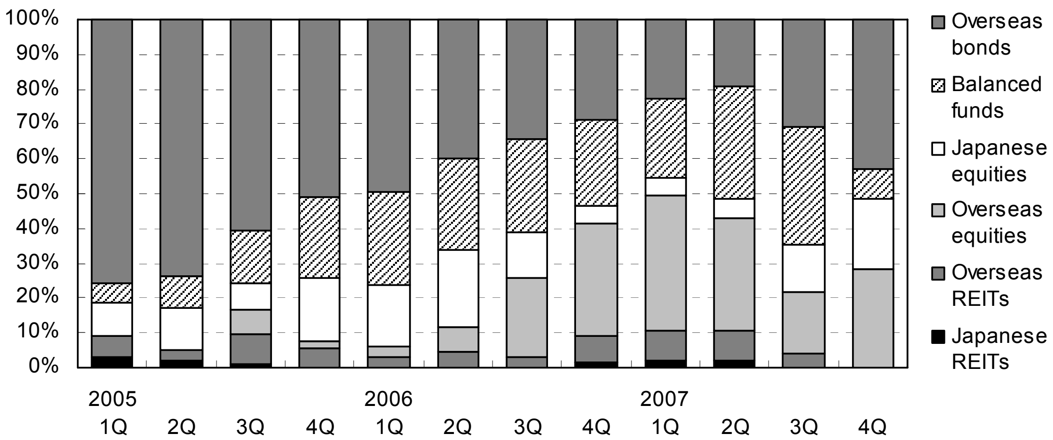
8 "Toshin Hanbai Kyugeki ni Donka—Ginko no Madohan, Kanshii 'Shuchu Kensa' Iri, Kinshoho no Junshu Taisei Tenken" [Sharp Drop in Investment Trust Sales as the Securities and Exchange Surveillance Commission Inspects Banks to See Whether They Are Selling Investment Trusts in Accordance with the Financial Instruments and Exchange Law], Nihon Keizai Shimbun (morning edition), 8 November 2007.

9 "Kin'yu Shohin Torihikiho, Shiko kara 1kagetsuhan—'Kinshi Kitei' Ginko Yurusaburu" [Financial Instruments and Exchange Law Six Weeks on: Prohibitions Shake Banking Industry], Nihon Keizai Shimbun (morning edition), 19 November 2007.

We have also noted recent changes in the types of investment trusts that financial institutions have been selling (Figure 13). From 2005 to 2007 Q2, demand for investment trusts sold by financial institutions shifted away from those specializing in overseas bonds to balanced funds and funds specializing in overseas equities. In 2007 Q3 (i.e., just before the Financial Instruments and Exchange Law came into effect in October), demand began to shift back to funds specializing in overseas bonds, and this shift intensified in Q4. We think this was probably the result of changes in the way financial institutions sold investment trusts in anticipation of the Law's introduction. For example, balanced funds may have been avoided because of the time required to explain the different types of assets of which they are composed, while overseas bond funds may have been favored because they are relatively easy to explain. Given the aims of the Law, such an approach is the very opposite of what financial service companies should be doing (i.e., encouraging customers to diversify their portfolios)[10]. The sooner they mend their ways, the better it will be for the financial services industry in the long run.

As city and trust banks have focused their sales efforts on variable annuities since 2005, regional financial institutions have become the main retail outlets for investment trusts. Given that the introduction of the Law had relatively little impact on the sales of city and trust banks, we hope that their sales will recover as their staff become more familiar with these sales approaches. However, we expect that during this recovery process new investment preferences will develop and that differences in sales performance among the regional financial institutions will become more marked.

Figure 13: Breakdown of Bank Sales of Investment Trusts by Fund Type



Note: We have grouped the top 30 funds by sales via banks and insurance companies.
Source: NICMR, from Japan Financial News Co.'s "Nikkin Toshin Nenkin Joho" [Information on Investment Trusts and Pensions].

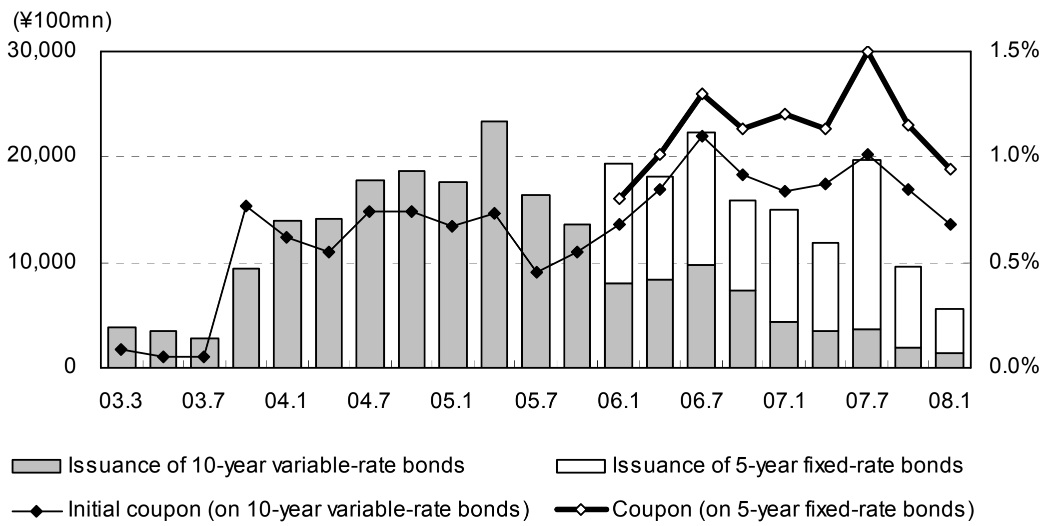
10 "08nen Kin'yu Toppu Senryaku o Kiku (3) Nomura Asetto Shacho Shibata Takumishi" [Senior Managers of Leading Japanese Financial Service Companies Talk about Their Strategy for 2008: (3) Takumi Shibata, President of Nomura Asset Management], Nihon Keizai Shimbun (morning edition), 10 January 2008.

2. Decline in issuance of JGBs for individual investors

In recent years the volume of issuance of JGBs for individual investors has, to all intents and purposes, determined retail investment in bonds. Between March 2003, when they were first issued, and October 2007, ¥28.6 trillion of these bonds were issued. During the same period, households purchased a cumulative net ¥23.4 trillion of JGBs[11]. We calculate that during the same period sales of these bonds led to an annual shift in household financial assets of 0.4% in favor of investment assets.

Despite the role these bonds have played in encouraging households' "Shift from savings to investments," issuance has been declining since the second half of 2007. Issuance in October 2007 was less than ¥1 trillion—the first month in which this has occurred since these bonds were first issued in 2003. Furthermore, sales of these bonds declined to only ¥551.1 billion in January of this year (Figure 14).

Figure 14: Issuance and Yield of JGBs for Individual Investors



Source: NICMR, from Ministry of Finance data.

11 Net inflows are according to Bank of Japan's Flow of Funds Accounts. Other possible factors include redemptions of JGBs for individual investors and net sales of other JGBs by households.

The main reason for the sharp decline in issuance is believed to be the decline in the yield on these bonds[12]. The yield on the January 2008 issue of five-year fixed-rate bonds, which tend to be issued in larger amounts, was 0.94%—a level that was probably considered unattractive after two years (2006–07) in which the yield was more than 1%. Comments by participants in the Ministry of Finance's meetings of JGB top retailers[13] indicate that they are concerned not only by the difficulty of attracting more customer interest but also that low interest rates could lead to a decline in issuance.

Despite these criticisms, JGBs for individual investors still have the potential to induce households to shift money out of bank deposits and still offer a more attractive yield than large time deposits with the same maturity. The need to increase investor awareness of this product is evermore increasing.

IV. Household Sensitivity to Yield as a Key Factor

As we have seen, the tendency of the "Shift from savings to investments" remained intact in 2007. In particular, the tendency for holders of foreign currency assets (especially investment trusts) to diversify their assets intensified.

However, as a result of flagging sales of investment trusts by regional financial institutions and the decline in sales of JGBs for individual investors, the two main products that have driven the "Shift from savings to investments" have lost some of their impetus. If this remains the case, the outflows from postal savings accounts could simply be redirected to join the continuing inflows to bank time deposits, and the "Shift from savings to investments" could end up being no more than a transfer of time deposits from one type of financial institution to another. Household financial assets could then easily begin to decline in the next few years because of their low medium- to long-term return.

In that case, money market funds could have an important role to play in convincing households of the benefits of ordinary investment. Since 2006, these products have achieved a consistently higher return than either three- or one-year time deposits (Figure 15) and still have the advantage that they can be cashed at short notice. However, the net assets of these funds (Figure 16) indicates that they have not seen any significant inflows.

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[12] "Kojinmuke Kokusai, Hanbaigaku, Saitei ni, 1gatsu Hakkobun Kinri Teika de, 07nendo wa Keikakuware" [Sales of JGBs for Individual Investors Hit Record Low, Sales Target for Fiscal 2007 Unlikely to Be Met because of Drop in January Coupon], Nihon Keizai Shimbun (morning edition), 12 January 2008.

[13] From the summary of the minutes of the second meeting of JGB top retailers, 9 September 2007.

Figure 15: Yield on Various Financial Products

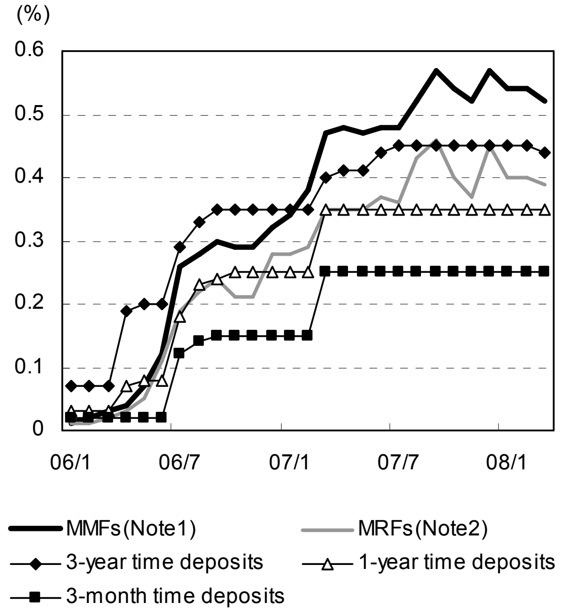
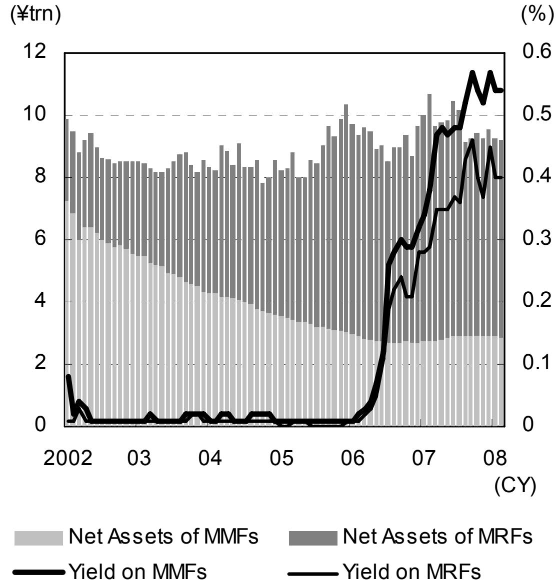


Figure 16: Yield and Net Assets of Money Market Funds



Note: 1. Money market funds with early cancellation penalty
2. Money market funds with no early cancellation penalty
3. Fund yields are from funds managed by Nomura Asset Management.

Source: NICMR, from Bank of Japan and Investment Trusts Association, Japan data.

The higher returns on money market funds can be publicized by encouraging people to use schemes such as the credit card payment facilities offered by cash management accounts[14]. Pointing out the returns that individuals can earn on their investments and encouraging them to take greater risks will, in our view, continue to be important for the future of the financial services industry.

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14 In the US, cash management accounts have become increasingly sophisticated, offering, amongst other things, both payment and credit facilities. Companies such as Merrill Lynch now offer credit cards to small businesses and nonprofit organizations as well as individuals. For further details, see Yuko Numata, *Shinka Shitsuzukeru Beikoku no Shoken Sogo Koza—Kadohen* (Recent Developments in US Cash Management Accounts: Credit Cards), Capital Market Quarterly, Spring 2008 issue (in Japanese).