The Outlook for Japan's Financial Services Industry and Some Strategies for Survival
Certain Change and Uncertain Challenges

Yasuyuki Fuchita

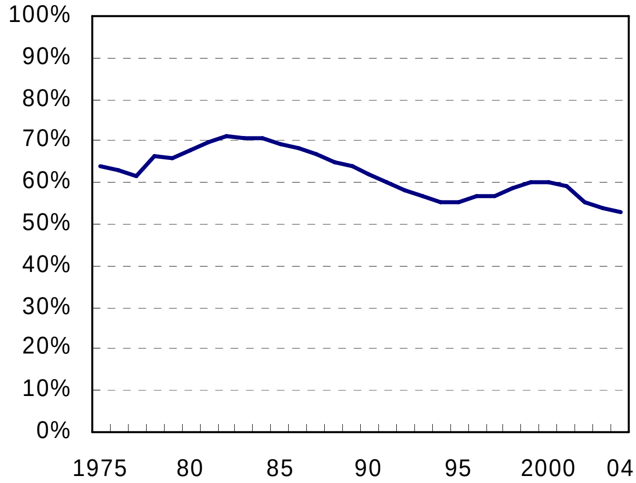
Traditional and Standard Financial Products Will Inevitably Become a Commodity

As a result of Japan's economic recovery, the country's financial services industry is now in much better shape than just a few years ago. While this optimism should continue in the near term, the real question is what will happen after that. Now that Japanese financial institutions no longer have to spend all their time trying to sort out the negative legacy of the 1980s' asset boom, they should be assessing the medium- to long-term outlook for their industry and planning how to meet future challenges. General considerations, such as whether the future is likely to be bright or gloomy and whether the industry is likely to expand or contract, matter little. Whether the economy is in an uptrend or a downtrend, there will inevitably be both winners and losers. However, if individual institutions misjudge the changing situation and make the wrong decisions, they are more likely to end up as losers. This report therefore tries to identify some of the trends in financial services and what individual institutions need to do if they are to be winners rather than losers.

One trend which is fairly clear is that traditional and standard financial products are likely to become a commodity. This process of commoditization has already occurred in the United States, the global trendsetter in financial services.

A good example is corporate loans. As the return that US banks can earn on traditional corporate loans has proved increasingly unattractive, such loans have come to account for an increasingly small share of their loan portfolios (Figure 1).

Figure 1 Corporate Loans as a Proportion of Lending by US Banks



Note: Corporate loans = Total loans and leases (gross) - mortgages - personal loans.
Source: NICMR, from Federal Deposit Insurance Corporation data.

Although syndicated loans are one type of corporate loan for which demand is still rising, the market for such loans has become an oligopoly, and even the handful of major banks that dominate the market have had to incorporate their loan syndication operations in their investment banking arms because they have been unable to earn a satisfactory return on such loans. In other words, loan syndication has ceased to be a profitable business on its own.[1]

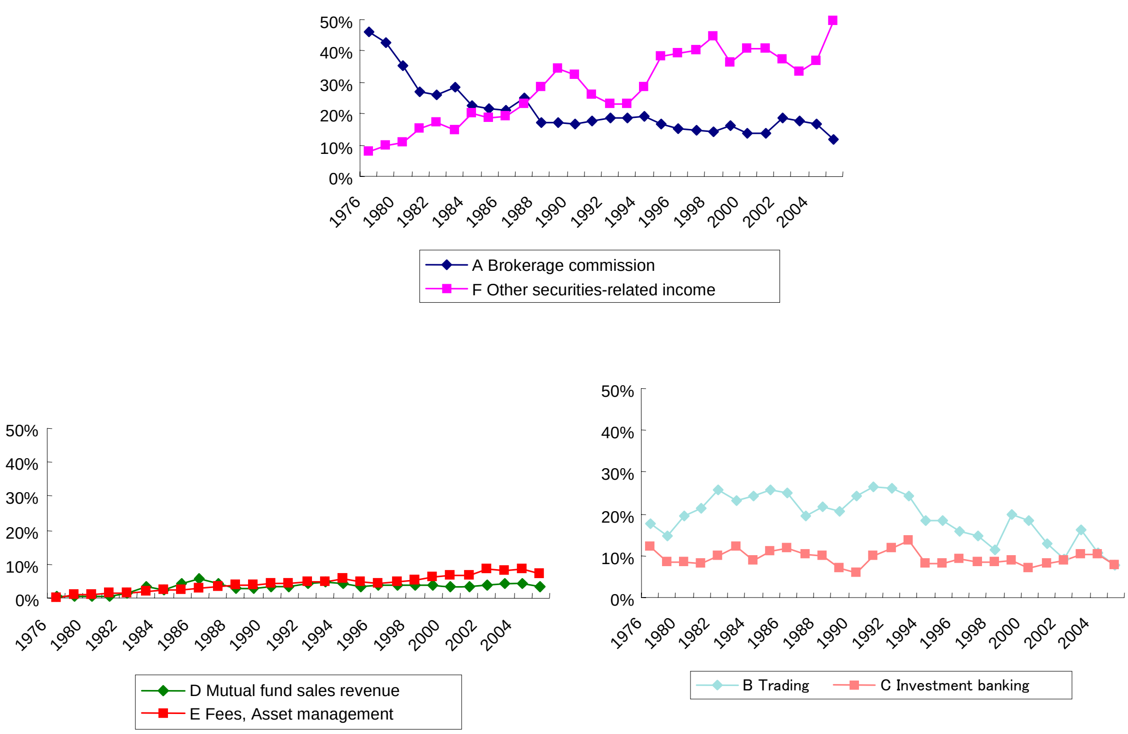
The picture in retail banking is similar. Even in areas such as credit cards and mortgages, where customers' creditworthiness can easily be assessed using automated credit scoring systems and small loans can be pooled using securitization, most banks earn only a meager return. As a result, this market has become increasingly dominated by a handful of banks big enough to achieve economies of scale.

The process whereby financial products have become a standard commodity has also occurred in the securities industry. Following May Day (1 May 1975, when brokerage commission rates were deregulated in the United States), the proportion of broker-dealers' revenues from brokerage commission declined sharply (Figure 2). Although the decline leveled off in the late 1980s, it has resumed in recent years—probably as a result of competition for business from online traders. In contrast, the proportion of revenues from asset management (e.g., mutual funds and wrap accounts) has gradually increased as broker-dealers have diversified into this area. As a result, combined revenues from mutual fund sales and asset management fees in

[1] See Yuta Seki, "Beikoku Rebarejjido Ron no Hatten to Shijogata Kansetsu Kin'yu" [Market-Oriented Indirect Finance and the Development of Leveraged Loans in the United States], Zaikai Kansoku [Financial World Observations], Autumn 2004, Nomura Securities Financial Research Center and Nomura Institute of Capital Markets Research.

2005 accounted for 11% of revenues—roughly the same proportion as brokerage commission.[2]

Figure 2 Breakdown of Earnings of NYSE Member Broker-Dealers



Source: NICMR, from Securities Industry Association data.

The same process of commoditization has occurred in the life insurance industry. As the US life insurance market has matured, competition has become increasingly fierce. As a result, term insurance premiums have halved in just over 10 years, while the number of insurance companies has halved in about 15 years.[3]

This process of commoditization in the financial services industry is described in a recent survey of stockbroking and asset management by the IBM Institute for Business Value. According to the survey, the margins on both types of business are set to decline by an average of 1.21% a year between 2004 and 2015.[4]

2 See Yuko Numata, "Hen'yo Suru Beikoku Shoken Gaisha" [Changes in the US Securities Industry], Shihon Shijo Kuwotari [Capital Market Quarterly], Spring 2006, Nomura Institute of Capital Markets Research.

3 See Takeshi Inoue, "Seimei Hoken Shijo no Maruchichaneruka to Nenkin Jigyo no Kakudai" [The Expansion of the Pension Industry and the Development of New Channels in the Life Insurance Market], Shihon Shijo Kuwotari [Capital Market Quarterly], Spring 2006, Nomura Institute of Capital Markets Research.

4 See IBM Institute for Business Value, *The trader is dead, long live the trader! A financial markets renaissance*, April 2006.

Not that there is anything unusual about an industry where companies are forced to exit if they can no longer earn a satisfactory return from selling the same standard products as many of their rivals.

In the past, however, financial service providers were, to a certain extent, protected by regulatory requirements such as licenses and permits. What has happened in the financial services industry is that regulators have at long last realized that their job is to protect service users (rather than providers) and ensure that they receive a better service. As a result, restrictions on new entrants and products have been eased, and the industry has found itself subject to the same pressure to commoditize as other industries. For example, banks that offer deposits and loans on the same terms as their rivals should not really expect to make a profit on the spread between the two interest rates.

In fact, it is easier for companies in other industries to differentiate their goods and services in terms of quality and brand as well as more difficult for them to conduct instant arbitrage. When all is said and done, finance is simply a combination of cash flows, while, at a global level, digital information flows permit instant arbitrage. One should therefore expect financial products to be more liable to commoditization than products in other industries.

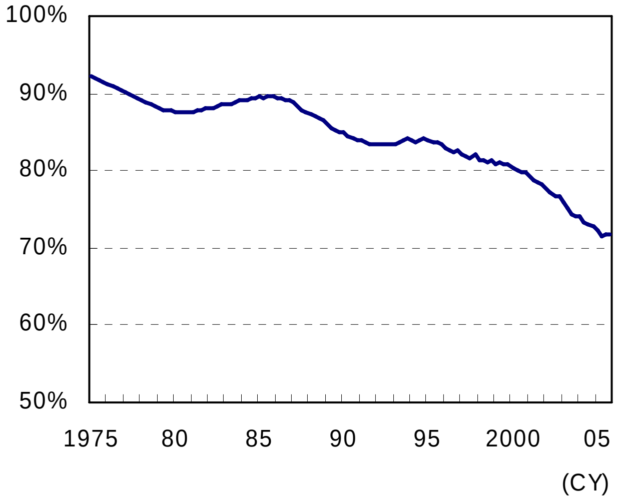
It used to take at least 10-20 years for manufactured products such as consumer electronics to become commodities. Now, however, this process takes only a few years. The main factors behind this are said to be globalization, deregulation, digitization and the rapid spread of information technology (especially, the Internet).[5] Since the financial services industry is particularly sensitive to such factors, it should not be surprising that it now finds itself subject to the same process of commoditization.

Japan Faces Even Greater Changes Than the United States

The process of commoditization is already well under way in Japan's financial services industry. Corporate loans account for a declining proportion of bank lending in Japan (Figure 3). However, it is still a higher proportion than in the United States (Figure 1). That this should be the case, even though corporate loan rates in Japan are generally considered not to reflect the risk involved and it should be more difficult for Japanese banks to make a return on these loans than for US banks, suggests that Japanese banks will continue to see their margins squeezed.

5 See Ken Kusunoki, "Datsu Komoditi Senryaku" [A Strategy for Avoiding Commoditization], Hitotsubashi Business Review, Spring 2006, Toyo Keizai.

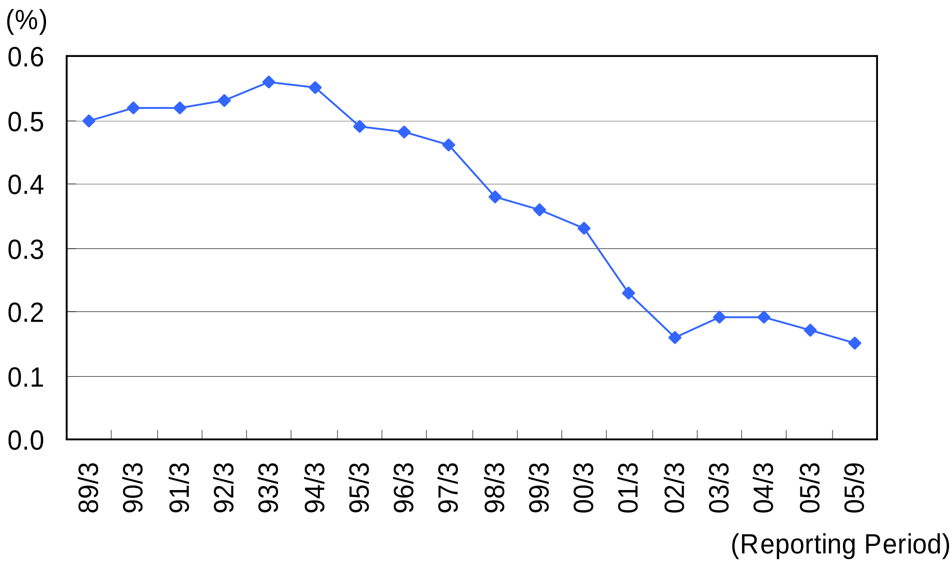
Figure 3 Corporate Loans as a Proportion of Lending by Japanese Banks



Note: Corporate loans = Total lending - personal loans.
Source: NICMR, from Bank of Japan data.

Similarly, Japanese securities companies have seen their brokerage commission rates decline sharply since commissions were deregulated at about the same time as online trading became popular (Figure 4), while the Japanese life insurance market is even more mature than the US market, with 90% of households (compared with 70% in the United States) covered by one type of policy or another (including postal life insurance).

Figure 4 Equity Brokerage Commission Rates in Japan



Note: Brokerage commission rate = equity brokerage commission ÷ value of agency transactions.
Source: Tokyo Stock Exchange.

Traditional and standard financial products are therefore subject to the same process of commoditization in Japan as in the United States. However, margins are likely to be squeezed even more, and financial service companies are likely to face even greater pressure to restructure. This is because of the economic and structural changes facing Japan's financial services industry.

First, let us consider the economic changes—namely, the prospect that the industry can no longer expect the market for financial services to continue to grow. Japan's population has already begun to decline, so the total volume of business will also inevitably decline.

As far as corporate finance support services are concerned, there have been reports of a recovery in corporate demand for capital. However, much of this recovery appears to be have been in the demand for mortgages (as competition has forced mortgage providers to accept narrower margins) and in partly speculative demand for property (as the price of land has risen). In the medium to long term, the historical trend is for companies to rely increasingly on internal finance. Although it is debatable how long shareholders will be prepared to allow companies to sit on their cash piles, it can be argued that it has never been more important for companies to demonstrate expertise and flexibility, and that shareholders are prepared to give companies a free hand.[6] At any rate, it is difficult to see why Japanese companies should depart from the trend towards internal financing and significantly increase their external funding ratios.

As far as asset management support services are concerned, a gradual decline in the savings ratio is likely to slow the rate of growth in personal financial assets. Although the sharp decline in the savings ratio is probably partly the result of people drawing down their savings as their earnings growth slowed during the recession, the ratio should pick up again, at least in the short term, as their earnings growth recovers. However, the medium to long-term trend is for the savings ratio to decline as Japan's population ages.

Although Japan's financial services industry can no longer expect the market for financial services to continue to grow, it faces the prospect of more new entrants. This is because the structural changes currently taking place in the industry are dominated by two main developments: a shift from "public to private" (in line with the Koizumi government's program of structural reform) and a drive to improve service (in line with the Program for Further Financial Reform) (Figure 5).

6 See Allen, Franklin & Douglas Gale, *Comparing Financial Systems*, MIT press, 2000.

Figure 5 Structural Changes Due to Take Place in Japan's Financial Services Industry

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Financial regulation	Depositor Protection Law came into force (February); use of tax-deferred assets initially restricted to 40% of core capital (year ending March); amendments to Banking Law came into force; nonfinancial institutions allowed to offer services on behalf of banks (April); Financial Instruments and Exchange Law passed; amendments to Trust Law passed (spring); Financial Inspection Rating System to be introduced (July).	Financial Instruments and Exchange Law comes into force; use of tax-deferred assets to be restricted to 30% of core capital (year ending March); Basel II to be implemented (April); remaining restrictions on sales of insurance products by banks to be lifted (December); Law on Electronic Receivables.	Use of tax-deferred assets to be restricted to 20% of core capital (year ending March).									
Privatization of Japan Post	Japan Post Co. established (January); Postal Privatization Committee set up (April).	Japan Post Co. to become a holding company (1 October). (30 September)		Transitional period (government involvement to be reduced by selling off shares, and business to be gradually deregulated)								Government to complete sale of shares in postal savings and postal insurance operations by 30 September. (30 September)
Reform of public-sector financial institutions	Regulatory Reform Law enacted (spring); Public-Sector Financial Institution Reform Law to be enacted (autumn).	Government Housing Loan Corporation to be replaced by a new independent administrative body that will also provide securitization support services (April).	Existing public-sector financial institutions to be amalgamated in new institution; Development Bank of Japan and Shoko Chukin Bank to be privatized; Japan Finance Corporation for Municipal Enterprises to cease operation.				Okinawa Development Finance Corporation to become part of new public-sector financial institution established in 2008.	Government to sell off stake in Development Bank of Japan and Shoko Chukin Bank in fiscal 2013-2015.				
Company law, etc.	New Company Law came into force (May).	Triangular merger provisions of new Company Law to come into force (May).	Temporary tax incentives for investment in equities and equity investment trusts expire (March); quarterly disclosure and auditing to become a regulatory requirement; internal assessment and independent auditing of internal controls for financial reporting (year starting 1 April); Social Insurance Agency to be replaced by a new government body that will manage public pension programs (October).	Share certificates to be dematerialized (by June).								

Source: NICMR.

One of the consequences of the privatization of Japan Post, Development Bank of Japan and Shoko Chukin Bank as part of this shift is that institutions that have turned a profit because they could ultimately count on taxes and sovereign credit ratings will have to compete on the same terms as other private-sector institutions for a share of the same market. Although, under the old rules, private-sector financial institutions faced pressure from public-sector institutions, the game did not require public-sector institutions to make the same returns as private-sector institutions. Under the new rules, however, all these institutions will have to compete on a level playing field for the same opportunities.

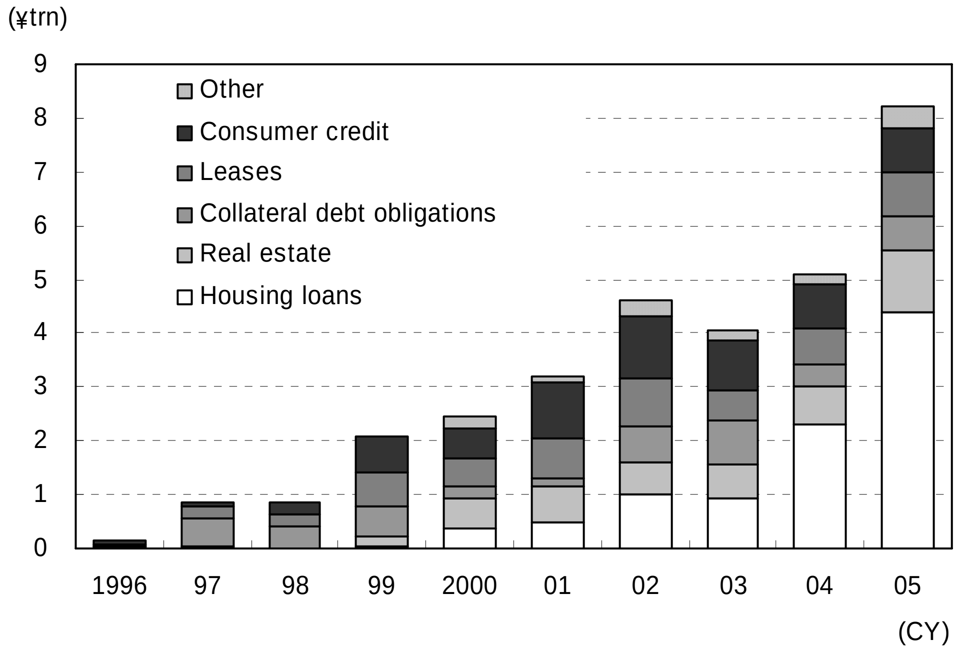
Although Japan Post's savings and life insurance operations will not be permitted to engage in any new activities until they are fully privatized in 2017, they will presumably need to expand at some stage. The postal savings operation will find it particularly difficult to survive because the deposits in the Fiscal Loan Fund, which have yielded a higher return than the market rate and helped it to make ends meet, will cease to exist as a result of the reforms of 2001. With interest rates still at rock bottom, outstanding postal savings deposits have been declining—a trend that looks set to continue. Moreover, obliged as it is to invest more than the equivalent of past outstanding deposits in risk-free assets, the postal savings operation has little opportunity to make a profit within the scope of its current operations. While the post office is expected to increase sales of investment trusts through its network, this is unlikely to be enough to offset the loss of revenue.

Although the Postal Privatization Committee, which began work in April, has apparently proposed that the post office should be allowed to expand its operations as its shares are gradually sold to the private sector, this would fly in the face of market principles. This is because it will be difficult to find buyers unless it is clear when the post office will be allowed to do what and to what extent this will boost future earnings. Also, while many observers have commented that the timetable for full privatization (10 years) is too long, those who have been involved with previous privatizations of large public-sector organizations (e.g., JNR and NTT) are well aware of just how long it takes to sell such shares. The restrictions on what kind of business the post office can engage in therefore need to be lifted as a matter of urgency if privatization is to proceed as planned. One result of this is will be to increase the competition among existing private-sector financial institutions. In particular, the postal savings operation will face stiff competition from regional banks that have tried to capitalize on their local connections if it wants to project an image of itself as a "family-friendly bank."

On the other hand, while there is no denying that the pressure on private-sector financial institutions from public-sector financial institutions should ease and that the former should expect to gain some of the latter's share of the market for loans as the latter's lending operations are restructured, it would be unrealistic for private-sector financial institutions to expect to gain all of the latter's share as at least some of the demand for public-sector loans may have been generated by the fact that such loans were offered on noncommercial terms.

One possible avenue for public-sector financial institutions might be for them to try to maintain their current level of business by offering assistance with securitization rather than competing with private-sector financial institutions in the field of direct finance. This would probably create a bigger market for securitization. Just as the Government Housing Loan Corporation's expansion into the securitization assistance business has boosted demand for securitized housing loans (Figure 6), a similar knock-on effect could be expected in other areas. Greater use of securitization would help to speed up the process of standardization and commoditization, as has happened in the US housing loan market. This could also lead to the oligopolization of the market for loan origination.[7] In other words, the reform of public-sector financial institutions has wider implications than simply a shift from the public to the private sector.

Figure 6 The Growth of the Securitization Market in Japan



Source: NICMR.

In addition, the number of new entrants to the industry has risen as a result of the growing use of information technology in general and the Internet in particular. However, a further boost can be expected as a result of a wide range of structural changes in the industry. These include (1) a change to the Banking Law (with effect from April 2006) that allows nonfinancial institutions such as convenience stores, supermarkets and car dealers to offer services such as cash withdrawals on behalf of banks, and (2) the inclusion in the Financial Instruments and Exchange Bill (the so-called Investment Services Bill, currently before the Diet) of a provision that would introduce financial products' sales agents, which would act as intermediaries for various investment-related services (and not just for securities brokerage services, as at present).[8] This is likely to lead to the segregation of origination and distribution, and to the oligopolization of origination as well as greater choice of and greater competition among distributors. In addition, reforms such as the passing of the Law on Electronic Receivables should also help to encourage new entrants to the industry. New entrants from other industries should become common, while new business

7 See Takeshi Inoue, "Securitization and the Mortgage Business in Japan," Capital Research Journal, Spring 2005, Nomura Institute of Capital Markets Research.

8 Intermediation of the following types of financial services is covered: sales and purchases of marketable securities; placement of marketable securities; trading in traded derivatives; investment advice; and discretionary asset management.

models should challenge the position of existing financial service companies and create opportunities for new tie-ups (e.g., between mobile telephone operators and major banks).

At the same time, in those areas of business where barriers traditionally exist, they can be expected to come down sooner rather than later. The major banks, in particular, have tended to steer clear of small loans—an area of business that has been the preserve of smaller institutions. This is because such loans can be quite time-consuming. However, where such loans are fairly standard, there should be opportunities, if anything, for the larger banks to achieve economies of scale. This can be seen most clearly in those areas of business that lend themselves to securitization. US experience suggests that competition between the larger and the smaller institutions is likely to increase in areas such as housing loans, standard loans to smaller businesses, consumer loans and credit card loans. "Larger institutions" should not be taken to mean simply those large financial groups that already exist. In the age of the Internet, new online businesses have the potential to develop a nationwide market for financial services.

In short, greater competition in a market that is unlikely to grow very much will mean narrower margins, particularly for standard services.

The Uncertainties Facing Japan's Financial Regulators

As well as commoditization (a trend common to the financial services industry in both Japan and the United States), Japan faces economic and structural changes that will probably squeeze the margins on traditional and standard financial products even more than in the United States. On the economic front it faces a medium- to long-term decline in its population that will almost certainly lead to a smaller market, while, structurally, its financial services industry faces an increase in the number of new entrants.

That these changes will occur is almost certain. The question is what impact they will have. A decline in earnings from existing business could be seen by users as a benefit in that it would reduce the cost of financial intermediation. Similarly, any efforts by financial service companies to develop new areas of business could be seen by users as a benefit in that they would improve the quality of products and services. However, there is always the risk, if such a decline in earnings was dramatic and hit deposit-taking institutions, in particular, that it could destabilize the banking system and trigger another financial crisis.

Whether the impact was positive or negative would probably depend partly on the extent to which the government's campaign to "save less and invest more" was successful. If individual investors continue to keep most of their financial assets in the form of bank deposits, competition among deposit-taking institutions to lend will only increase. If it wants to be seen as a "family bank," the postal savings operation will also, sooner or later, have to step up its mortgage business and join the fray. It will become increasingly difficult for lenders to charge interest rates that reflect the risk they are incurring, and, eventually, there will be another bad debt problem when the economy goes into recession.

However, if individual investors diversify their financial assets away from bank deposits and into other products, deposit-taking institutions will not have to bear all the risk. Financial service providers will then commit resources to originating and distributing these products. Since individual investors' tastes in investment products and sales methods vary considerably, there should be scope for different types of financial service providers. This would make for a higher-quality, as well as a more stable, financial system.

Japan's financial regulators therefore need to pursue policies that will be more effective in encouraging the public to "save less and invest more" in order to ensure that the changes that will inevitably occur have a positive rather than a negative impact. This is one of the challenges they face.

At the same time, they need to adopt more direct risk controls (rather than simply hope that individual investors will change their asset allocation preferences) while conditions are still relatively normal in order to prevent another bad debt problem. Until now the regulators have refrained from taking such action, even though it is really needed, because conditions have been such that it could easily have had the opposite effect of triggering a financial crisis.

A good example of this is the need to limit the use of tax-deferred assets as capital. Such action was due to be taken in 2002 as the centerpiece of the Program for Financial Revival. However, the matter was referred to a working group of the Financial System Council in February 2003 as a result of stiff opposition from the financial services industry, and considerable time was spent discussing whether to go ahead. On the one hand, it was felt that the sudden adoption of a strict system was undesirable because it would lead to a sharp drop in the capital adequacy ratios of many banks and trigger the use of prompt corrective action. On the other hand, a state of affairs where banks relied heavily on tax-deferred assets to meet their capital adequacy requirements was hardly desirable at a time when there was so much concern about their earnings outlook.

In the end, it was decided to introduce such a system in phases, starting in March 2006, by which time conditions had returned to normal, in order to ensure that banks were better capitalized in future. Although the system will apply to the larger banks, it could, given its function, be applied to smaller financial institutions at some point in the future.

The Financial Services Agency had also proposed the introduction of a Financial Inspection Rating SysTem (FIRST) some time earlier to enable it to focus its examination resources on the banks with the lowest ratings. The aim was to give the Agency more flexibility and to give financial institutions a greater incentive to put their houses in order. As with restrictions on the use of tax-deferred assets, the value of a system such as FIRST was only appreciated when Japan's financial system was already facing a crisis and it was too late to reap the full benefits. In fact, it was decided to postpone the system's introduction because of the risk that rating information might leak out and make a bad situation only worse.

In January 2005, by which time the situation had begun to return to normal, the Agency decided to set up a study group to consider the matter in more detail, and it has since been decided to introduce such a system this summer.

A similar system in the United States has close links with the country's deposit insurance system. In 1993, the United States adopted a system of variable rate deposit insurance where premium rates are set using a matrix based on a bank's capital adequacy and rating. Such a system is rational in that, the greater the risk posed by a bank and the more likely it is to need such insurance, the higher the premium it has to pay. As a result, such systems have also been adopted in Germany (in 1998) and France (in 1999). In Japan, however, concern that requiring banks that had already been weakened by the financial crisis to pay large premiums might make them even weaker meant that such a system could not be seriously considered so long as the crisis continued.

Nevertheless, an advisory panel was set up by the Deposit Insurance Corporation of Japan in October 2003 to study deposit insurance premiums and it produced its first report in June 2004. Although no decision has been made on whether such a system should be introduced, it is probably fair to say that the panel has more or less completed its work.

Similarly, the blanket guarantee on transaction accounts that was introduced as a permanent measure even though it was really a response to an exceptional situation is in urgent need of review. Instead, systemic risk should be dealt with by improving the systems for settlement, deposit insurance and prompt corrective action in order to eliminate moral hazard as far as possible. In addition, with Basel II nearly up and running, more will need to be done internationally to improve bank finances.

Whether or not regulators are able to implement policies such as these is one of the uncertain challenges facing Japan's financial services industry.

How to Avoid Becoming a Commodity Business

However, even if the government's campaign to encourage the public to "save less and invest more" is successful and Japan's financial services industry is able to survive on narrower margins, this process will produce losers as well as winners. In order to be winners, financial service companies will have to face uncertain challenges in order to cope with the changes that are certain to occur.

In order to survive the process of commoditization, financial service companies will, generally speaking, have to develop niche businesses where they can establish a competitive edge. The following types of niche business (i.e., new products, techniques, markets and customers) can be expected to emerge.

First of all, financial services are increasingly likely to be offered in areas where they have generally not been available (e.g., intellectual property, farming, medicine and nursing care). This should include areas with a relatively high growth potential, such as business succession and the market for retirees. As Japan (whether for better or for worse) is likely to become a less equal society as its population ages, the market for high net worth individuals will become more important. Similarly, although it is difficult to predict how successful the government's campaign to encourage the public to "save less and invest more" is likely to be, some degree of success can be expected. As a result, personal financial assets can be expected to contain an increasing proportion of risky assets. Furthermore, the trend towards market-type finance is likely to continue as the demand for securitization increases.

Investment, whether in real or financial assets, can also be expected to become a more widespread activity. As the growth of the SOHO market shows, new businesses are likely to be smaller than was traditionally the case, and small-scale investment in real assets is likely to become more common. In turn, this is likely to stimulate the demand for small-scale financing. The emergence of new legislation to cover entities such as limited liability partnerships can also be expected to encourage this trend. Investment in financial assets has already become more popular as access to information technology has spread and brokerage commission has declined.

In addition, developments such as the passing of the Law on Electronic Receivables (see above) may encourage the emergence of new financial services, while the market for derivatives may also see the emergence of new areas. Just as happened with REITs, there is probably still considerable scope for the emergence of new financial services from the fusion of real and financial asset markets. As well as offering the prospect of high growth rates, markets overseas (e.g., in other Asian countries) are still uncharted territory for many Japanese financial service companies.

Just as innovation is ongoing in the world of real assets, not all financial products and services will inevitably be commoditized. What matters is whether a financial service company trying to make inroads in a new market can gain a competitive edge over its rivals. In the past, regulations offered financial service companies some degree of protection from new entrants. However, such days are long gone. Now companies need to construct their own barriers to entry by differentiating themselves in some area by means of marketing, technology, cost competitiveness, skills or know-how.

One option, given the growing number of financial services in which economies of scale and network economies can be achieved, is for financial service companies to try to form an oligopoly. This is exactly what has happened to many financial services in the United States. In fact, this process may have been slow to develop in Japan's financial services industry. It is not uncommon for many industries, in the global as well as the domestic market, to be dominated by no more than 20-30 players. That Japan's financial services industry still has several hundred players is probably, at least in part, an anomaly created by past regulations. If this is, indeed, the case, one survival strategy as the industry becomes an oligopoly would be to make the most of any opportunities for merger and acquisition. Another strategy that might pay in the medium to long term would be for financial service companies with deep pockets to try to oust rivals by offering more services at below cost in the short to medium term.

Although "oligopoly" suggests that a market is dominated by a few big players, we need to remember that this is not the trend for all financial services. Just as some areas have come to be dominated by a few giant conglomerates, others have seen a growing number of boutiques and specialist players, such as hedge funds, investment banks specializing in a few sectors, and asset managers targeting high net worth individuals.

Giant conglomerates stand to gain from economies of scale and scope in areas requiring organizational administration and large-scale investment in technology. On the other hand, boutiques and specialist players stand to gain in areas requiring personal skills and close contact with customers. The financial services industry is therefore unlikely to be dominated entirely by one trend.

Giant conglomerates can suffer from diseconomies of scale and overcomplexity. This does not mean that a company that invests heavily in technology or has a large number of administrative staff is guaranteed success simply because it is a giant conglomerate. In the United States, there has been a sharp increase in the number of conglomerates selling off key businesses. On the other hand, boutiques and specialist players may face a rush of new entrants and a struggle for survival, as has happened in the hedge fund industry. What matters is how companies decide and implement a strategy for allocating their capital.

The Need for a Capital Allocation Strategy

Even if most Japanese financial service companies have no intention of becoming conglomerates, they tend to be conglomerates by virtue of having affiliates in areas other than financial services, not to mention providing a wide range of financial services.

In the 1960s and 1970s, many US companies became conglomerates. Since then, however, most have been broken up. This is because of the perverse tendency of conglomerates to underinvest in profitable areas and overinvest in unprofitable ones.

More recently, however, a number of conglomerates have appeared in the United States that have shown themselves able to increase the shareholder value of the group by skillfully managing operations in different areas of business.[9] Studies of such conglomerates have shown the key importance of capital allocation (i.e., of being ready to scale down or withdraw from unprofitable businesses but to invest more in profitable ones). The process of putting together such a business portfolio needs to be based on a sound strategy. For example, clear guidelines are necessary in order to

9 For more on capital allocation, see Yuko Numata, "Beikoku Kin'yu Konguromaritto no Shihon Saihaibun no Ugoki" [Capital Reallocation of US Financial Conglomerates], Shihon Shijo Kuwotari [Capital Market Quarterly], Spring 2005, Nomura Institute of Capital Markets Research.

decide whether to wind up existing operations or start up new ones. Similarly, a consistent strategy should enable companies to reduce the types of business they run even if these are in many different industries.

Capital allocation needs to be an integral part of the management process with its own specialist staff to review it on a daily basis. It should not be allowed to become just another event in the budget season. Accountability is also important. In the past few years, US financial service companies have begun to arrange briefings for analysts and institutional investors on capital allocation as well as business strategy.

The first thing that Japanese financial service companies, which are already (more or less) conglomerates, need to do, if they are to develop a competitive edge in new areas without falling victim to commoditization, is to review their existing business portfolio and reallocate their capital.

In particular, Japanese financial service companies need to be aware of the risk that they may be less rigorous in how they review their unprofitable operations than they have been during the past 15 years simply because the economy has recovered. They need to develop a strategy that takes account of the conditions they can expect to face in the medium term and not to be misled by benign conditions in the short term.

What Areas Are Likely to Become Increasingly Important?

Each company will have to decide for itself which areas to reallocate capital to. Nevertheless, the conditions that Japanese financial service companies can expect to face and US experience (see above) both suggest that any financial service company should consider increasing its capability in the following areas:

(1) Customer-oriented service

Although there is nothing new in suggesting that financial service companies need to provide a more customer-oriented service, the fact that, until very recently, becoming a conglomerate in order to provide a one-stop service was the aim of many financial service companies should remind us that this principle has yet to be fully accepted by the industry. What matters most to the customer is to be able to find the most suitable combination of financial products from different groups of companies in one place-not whether one group of companies can offer a full range of products.

It took the emergence of financial planners and neutral distributors for the industry to realize this. As a result, financial service companies can increasingly expect to have to look to outsiders to distribute the products they have originated. At the very least, they will need to be able to access different levels of distribution channels. Originators will have to persuade distributors to sell their products and be able to act as wholesalers.

It also goes without saying that they will have to measure customer satisfaction in order to increase it. In the spring of 2005 the Financial Services Agency asked financial institutions to carry out customer satisfaction surveys and to publish the findings, explaining how they had used them to improve their service, by August 2005. It goes without saying that financial institutions should be doing this without having to be prompted by the regulator. However, according to the summary of progress reports presented to meetings held between industry representatives and experts in May-June 2005 to discuss what the surveys should seek to achieve, 20% of the regional banks and 70% of the cooperative financial institutions had still to carry out a survey. Similarly, most of the institutions reported that they had instructed teams of specialists to analyze the survey findings rather than report them to their boards of directors. In addition, few institutions had published their findings or how they intended to use them to provide a better service.

Japanese financial institutions need to learn from the example of companies like Bank of America, which commissions regular customer satisfaction surveys from a market research company, uses the findings to improve the way it runs its business (incorporating them, for example, in personnel appraisal), and publishes them for the benefit of its stakeholders.[10]

(2) A market-oriented finance capability

The move to market-oriented finance is no longer something that is simply talked about. Demographic data alone suggest that the proportion of personal financial assets held in the form of risky assets is likely to continue to increase for the foreseeable future. For banks as well as securities companies, the ability to place investment funds with customers has become an increasingly important performance indicator.

In addition, the increasing use of securitization for housing loans and loans to small businesses (see above) can be expected to accelerate the move to market-oriented finance. Similarly, the growing use of loan syndication will narrow the gap between traditional lending and market-oriented finance, just as the growth of a secondary loan market can be expected to make loans more liquid.

(3) Technological adaptability

Although the spread of the Internet has had a major impact on retail finance, it is not the last technological change that the financial services industry will have to adapt to. A good recent example of such change is tie-ups between banks and mobile telephone companies to provide mobile credit services. In what marks the

[10] See Yasuyuki Fuchita, "Customer Satisfaction Surveys as a Means of Improving Disclosure," Nomura Capital Market Review, Autumn 2005, Nomura Institute of Capital Markets Research, and Yuta Seki, "Banku obu Amerika no Seicho Senryaku" [Bank of America's Growth Strategy], Shihon Shijo Kuwotari [Capital Market Quarterly], Summer 2005, Nomura Institute of Capital Markets Research.

development of a new service distribution channel, subscribers are able to use their mobile phone as a cash machine or credit card as well as to carry out other financial transactions or access other financial information.

Such developments mean that well capitalized financial service companies or those with strong networking capabilities will have increasing opportunities to gain a competitive edge over rivals, while smaller financial service companies will increasingly have to either outsource or share their computer systems.

In the case of the securities industry, many companies have tried to develop an online trading system only to abandon the attempt. Moreover, only a handful of those which succeeded in developing such systems have captured a significant share of the market for online trading. What this demonstrates is that it is not enough simply to try to catch up with technological change by, for example, adopting the latest technology after it has been developed.

(4) A global business capability

The decline in Japan's population means that, in simple terms, economic activity will also decline in the medium to long term. Therefore, one option for companies hoping to maintain the same level of business in absolute terms might be to try to increase their share of the market. However, that is unlikely to be enough. Another option might be to try to develop a global business capability.

Although the concept of a global financial business might seem alien to anyone not involved with a big financial services group, the demand for global financial services, even from individuals and small companies located outside Tokyo, is growing. Therefore, even small regional financial institutions will probably have to develop some sort of global business capability.

Even in the United States, not many financial service companies have succeeded in fully developing such a capability. However, unlike their US counterparts, which can count on a growing population and a large domestic market in the medium to long term, Japanese financial service companies may need to develop a global business capability in order to survive.

(5) Risk-taking capacity

Japan's five largest general trading houses have managed to more or less double their profits in the past four years and are expected to have generated an aggregate profit of nearly ¥1 trillion in the year to March 2006. At one time their business was in danger of becoming commoditized, but they managed to recover by drastically overhauling it. With commissions falling, they found it increasingly difficult to turn a profit simply from acting as intermediaries in the commodities trade. Their answer was to become involved in the development of natural resources and to invest their own capital in overhauling distribution structures while withdrawing sooner rather than later from areas that failed to generate a minimum return.

This shows not only the importance of withdrawing from unprofitable areas of business but also of being prepared to risk one's own capital rather than act simply as an intermediary. Financial service companies will also have to be prepared to do this if they are to escape the downward drag of commoditization and increase their returns.

In the case of deposit-taking institutions there will, of course, be natural limits to how far they can do this. However, even if they cannot take such risks themselves, they could still generate new income by learning how to set up units that can take them.

(6) Risk sensitivity

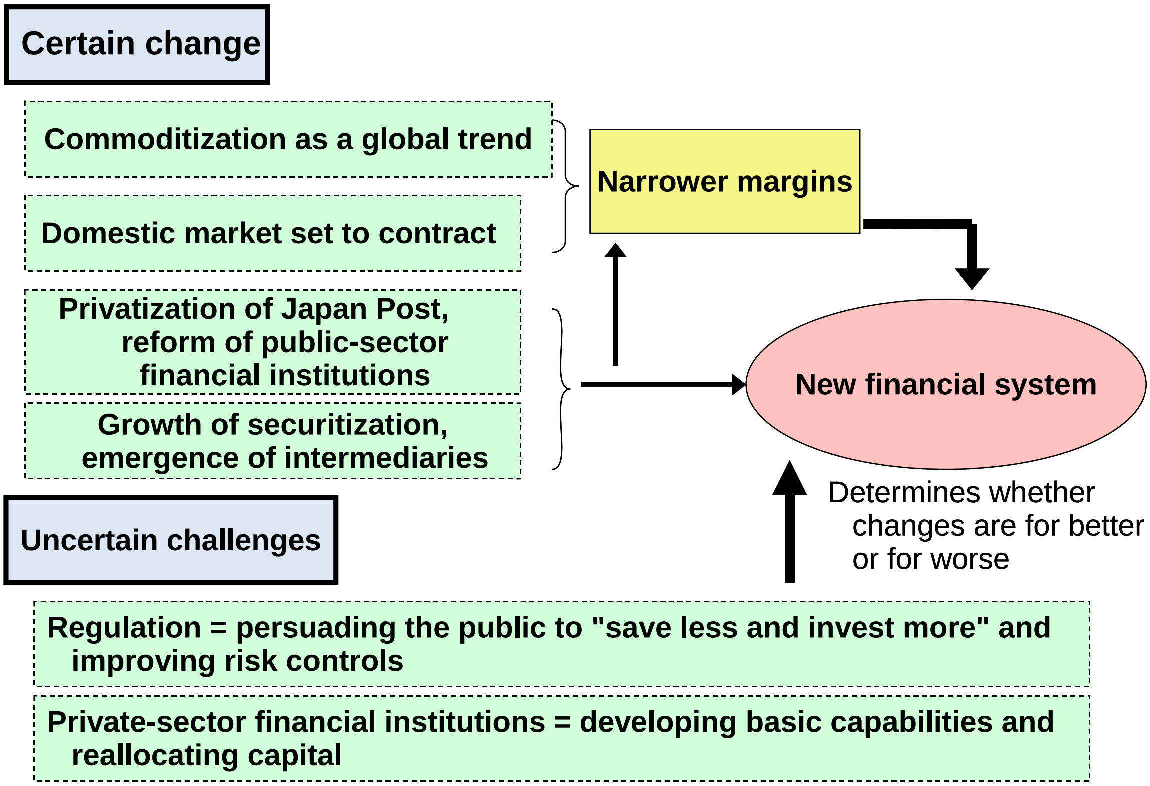
An important aspect of risk taking is being sensitive to risk. There are two particularly important reasons for this. First, companies need to have plenty of their own capital in order to increase their risk tolerance. At an average of 8% or so of total assets, Japanese regional financial institutions are particularly undercapitalized. The average figure for US banks is 12%. Moreover, many Japanese financial institutions still rely heavily on tax-deferred assets to maintain their equity ratios.

Second, it will help them to maintain public confidence in the event of some failure or lack of transparency in the management process, which could occur in spite of their efforts to monitor the risk and return of individual transactions and businesses. They may need to take action in a number of areas (e.g., by complying with the Financial Instruments and Exchange Law, by ensuring proper internal controls and corporate governance, and by improving compliance with the Antimonopoly Law). What they need to remember is that regulations represent the minimum standards they must meet and that they should aim for higher disciplinary and ethical standards of their own.

For Japan's financial services industry, developing these basic capabilities and devising a capital reallocation strategy is essential if it is to make the transition from an industry that has recovered with public-sector support to one that develops as a result of private-sector initiative and make a full contribution to the national economy.

However, if, instead of facing up to this challenge, Japanese financial service companies try to slog it out amongst each other in traditional areas of business, they and their customers will suffer when their margins are inevitably squeezed.

Figure 7 Future Trends in Japan's Financial Services Industry



Source NICMR.