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Consolidation, Financial Innovation and Chances for Internationalization in Japanese Banking

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Consolidation, Financial Innovation and Chances for Internationalization in Japanese Banking

Summary

Japan's financial markets have become even more concentrated and dominated by a few mega-banks. This, and the low level of investment during the financial market crisis, hampered the development of significant financial innovation. But after banking consolidation, the focus of the financial industry is shifting towards developing Japan's "under-banked" and under-serviced retail banking market. On the basis of the current deregulation of non-bank financial services, the boom of e-money and e-commerce technologies might result in integrated, innovative banking platforms that could provide a basis for successful international expansion in East Asia.

Contents

1. Japan's Banking Market in International Comparison

The revival of Japan's financial markets after the 90s' "lost decade" is the result of consolidation in the banking sector and restructuring in corporations. Financial innovation, on the other hand, which has been the driving force behind the financial boom in the U.S. from the mid-80s, has remained subdued and often limited to some new online-banks and financial service providers. On the contrary, Japan's banks have even delayed operationally necessary IT investments until today.

As a result, even normal settlement transactions had become vulnerable in the early 2000s. In 2002, for example, the merger of the Mizuho Financial Group[1] resulted in an "integration" of the different computer systems of Dai Ichi Kangyo Bank (DKB) and Fuji Bank through a simple relay system instead of integrating their IT-systems properly. This led to a breakdown of the computer system and resulted in failed payments of millions of transactions (such as gas bill settlements). Clearly, the urge of the banks to create a bank that was "too big to fail" on a low-cost basis, instead of strategically planning profitable synergies and economies of scale, was the reason behind this failure in integration.[2]

Similar problems have currently been building up during the merger of the Mitsubishi UFJ Financial Group (in early 2006). At the insistence of the Financial Services Agency (FSA), Japan's financial watchdog that had become doubtful of the bank's ability to implement a stable system in time, the bank had to extend the timeframe of its system integration until the end of 2008. Most recently, the Tokyo Stock Exchange (TSE), after economizing on system upgrades for their electronic trading system since 1999, found itself at the brink of collapse after a scandal at a new-economy company (Livedoor) resulted in massive sell orders.

In Japan's otherwise highly innovative and investment driven economy, such massive technical problems should come as a surprise.[3] To their defense, the banks and the government are basically blaming the lasting bad-loan crisis, in which the banks supposedly have been more victims than culprits, for the banks' operational underperformance. Most pundits stress, however, that poor governance at private and public banks and insurance companies, and competition distorting public support for non-performing loans have been important reasons for the prolonged financial crisis and the underperformance of the entire economy (Hoshi / Kashyap 2004).

The result of the underperformance of Japan's financial sector is certainly severe: even at 0% interest rates, households placed more than 50% of their financial assets in cash or safe deposits in government-guaranteed current accounts at major banks – with the public postal bank at the top of

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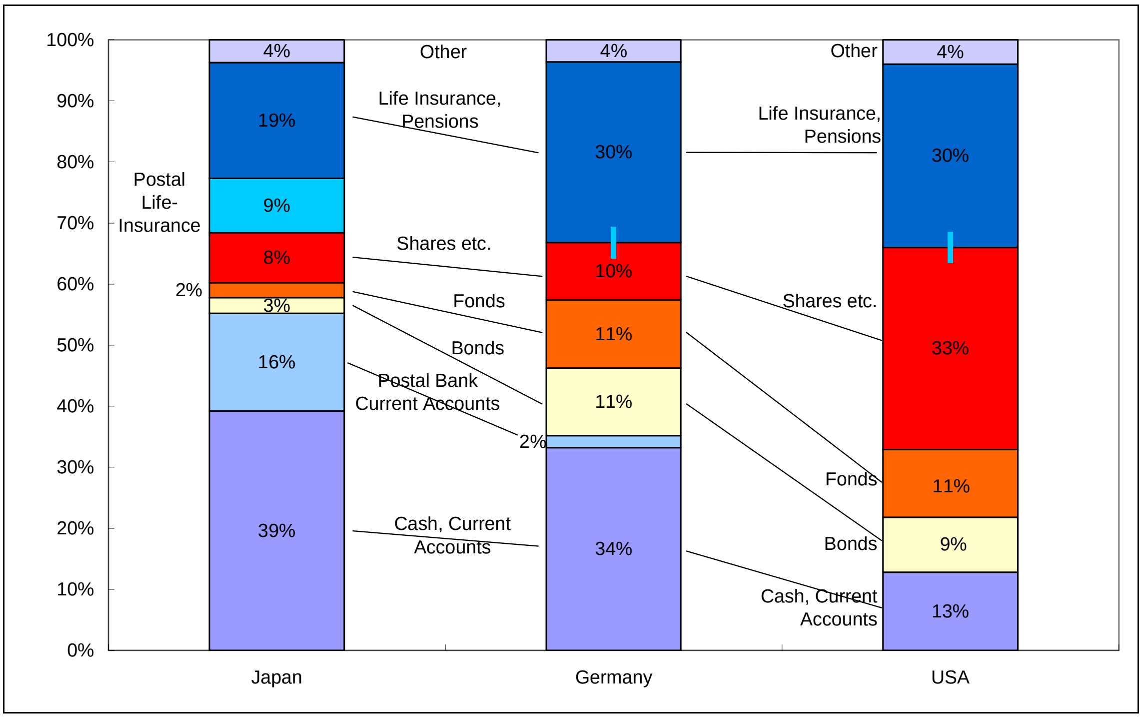
1 A merger between Dai-Ichi Kangyo Bank (DKB), Fuji Bank and the Industrial Bank of Japan.

2 It took three more years before the computer systems of the former Fuji Bank and DKB were finally integrated.

3 Other problem prone sectors are the atomic power industry and the space program.

the safe-haven list (Figure 1).

Figure 1: Financial Assets of Private Households in International Comparison (2004)



Source: © FRI 2006. Data from online-banking statistics of BOJ, Deutsche Bundesbank, Federal Reserve Bank (2005).

In combination with a high share of corporate credit (see Figure 5) below, this extreme weight of current deposits and the low share of bonds and stocks in the portfolios of Japanese households led to the widespread perception of Japan as being "over-banked". But despite the huge volume of banking deposits and the image of Japan's overgrown and inflexible "city banks", a closer analysis of the banks' balance sheet structures and profits reveals that the banks managed to stay rather trim and cost effective.

Figure 2 summarizes the most significant banking indicators in international comparison between 1993 and 2003. When comparing the number of commercial banks and the size of branch networks, Japan has one of the leanest banking systems among the major countries.[4]

[4] This excludes the cooperative and specialized SME banks (*shinkin*), and the large postal branch network of roughly 24,000 post offices.

Figure 2: Size and Profitability of Commercial Banks in International Comparison (Percent of Banking Assets in 2003 und Growth Rates 1993-2003)

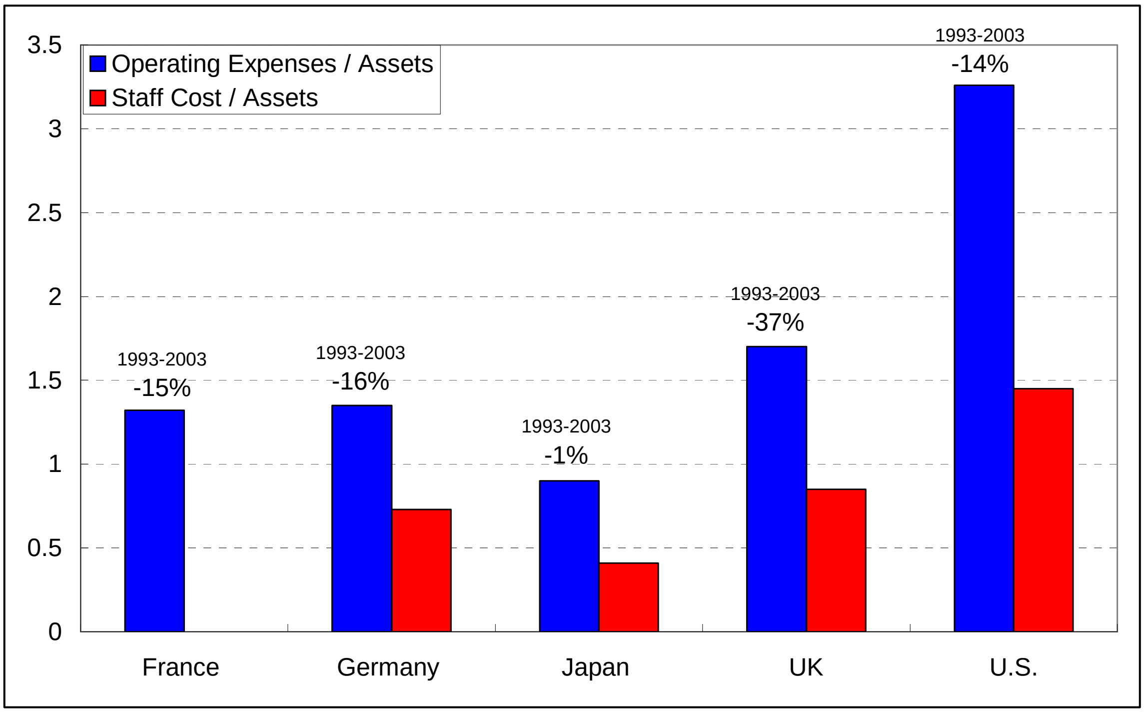
Percent of Assets (change since 1993)	France	Germany	Japan	UK	U.S.
Bank Numbers	895 (-45%)	2076 (-45%)	131 (-13%)	32 (-14%)	7,825 (-29%)
Branches	26,136 (-0.6%)	33,623 (-25%)	12,510 (-18%)	10,600 (-7%)	ca. 78,000
Employees / Bank	458 (+84%)	327 (+72%)	2,305 (-25%)	14,219 (+42%)	223 (+64%)
Operating Expenses / Assets	1.32 (-0.23)	1.35 (-0.26)	0.90 (-0.01)	1.70 (-1.00)	3.26 (-0.54)
Staff Costs / Assets	-	0.73 (-0.26)	0.41 (-0.06)	0.85 (-0.63)	1.45 (-0.13)
Assets / Employees (Million U.S. Dollar)	11.29 (+50%)	9.73 (+109%)	21.19 (+34%)	8.04 (+149%)	4.27 (+72%)
Assets / GDP	247 (+17)	259 (+90)	150 (-26)	191 (+83)	68 (+12)
Net Income after tax / Assets	0.45 (+0.43)	0.10 (-0.34)	0.11 (+0.02)	0.71 (+0.25)	1.35 (+0.18)
Net Interest Income / Assets	0.89 (-0.51)	1.36 (-0.61)	1.21 (+0.12)	1.60 (-0.77)	3.15 (-0.61)
Net Non-Interest Income / Assets	1.17 (+0.17)	0.50 (-0.11)	0.16 (-0.02)	1.39 (-0.51)	2.54 (+0.35)
Yearly Growth Rate of Fees and Commissions	9%	11%	2%	12%	-

Source: © FRI 2006. Data from OECD (2005); IMF (2005).

Note: Percentages on Basis of Assets – if not noted otherwise. Numbers in brackets are changes between 1993-2003 in percentage points. Exchange rates to USD have been calculated on the basis of the year 2003.

In comparison, banking concentration proceeded much more forcefully outside Japan and the equally concentrated U.K., Germany and France, for example, had 45% less banks in 2003 than they had ten years before. So far, the last years of banking mergers have had a major impact only at the group of largest city banks. This limited consolidation did not stop Japanese banks from further trimming their operational costs, however. When comparing productivity on the basis of operating expenses and personnel costs to assets, Japanese commercial banks even seem to be the most efficient internationally. Their costs are less than 1% of assets, and for each employee they handle assets of over 21 mill. Dollar. Figure 3 shows the low operating costs of Japanese banks in direct comparison.

Figure 3: Operating and Personnel Costs to Assets



Source: © FRI 2006. Data from OECD (2005): Bank Profitability - Financial Statements of Banks; IMF (2005): IFS

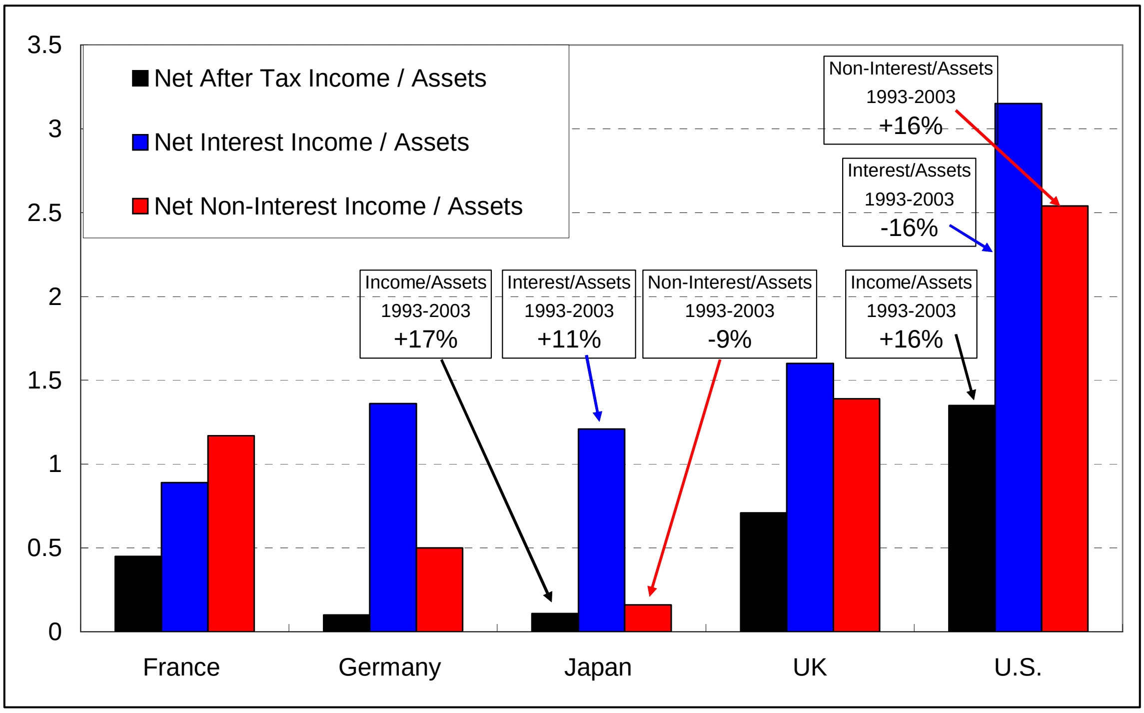
Note: Costs as Percent of Assets. 1993-2003 Percent Change of Costs per Assets

Figure 3 also shows, however, that the "IT-revolution" in banking did not produce any significant additional cost savings in Japan. Between 1993 and 2003, the banks were only able to shave off 1% of their costs on the basis of their assets. The other major countries in the comparison, on the other hand, reduced their costs by about 15%, while the U.K. banks even managed to reduce their costs by 37%.

A key difference between banking strategies in Japan and especially the U.S. becomes also obvious in Figure 3: U.S. banks accepted high labor and operational costs to invest in talented personnel and new IT systems to shift their business model from low-margin corporate credit to high-margin asset management. Japanese banks, at the same time, focused on cost-cutting and operational restructuring to keep their costs in line with falling asset levels.

Figure 4 shows that Japanese banks were even quite successful in draining income from their credit operations over the last decade. Coming from extreme levels after the bubble burst in 1991, they managed to increase their net after-tax income to assets by 17% and increased their interest-based income (despite deflationary headwinds) by 11%. But in contrast to this (limited) success in their traditional banking business, Japanese banks showed an extremely poor performance in developing innovative service-based income. Non-interest income to assets actually fell by 9%, while it increased by 16% in the U.S.

Figure 4: Interest Income vs. Fees and Commissions (2003)



Source: © FRI 2006. Data from OECD (2005): Bank Profitability - Financial Statements of Banks; IMF (2005): IFS

Note: Incomes as Percent of Assets. 1993-2003 Percent Change of Incomes per Assets.

Japanese banks' Achilles heel is not their often criticized cost structure or their inability to produce income from loans during the bad-loan crisis. They actually performed surprisingly well on both counts. Their most important weakness is a lack of innovation that limited their ability to produce income from non-interest business through fees and commissions (see Hoshi & Kashyap 2001, 2004; Fukao 2003). U.S. banks, in contrast, heavily invested to shift their low-margin, loan-based assets, such as mortgages and corporate loans, through securitization from their balance sheets.[5] By

5 Even in retail banking, the securitization of mortgages and automobile credits, as well as the increasing competition with non-banks such as automobile companies resulted in a decrease of corporate and private credit in the U.S. from 30.9% in 1974 to 24.1% in 2003. In Japan, the share

so doing, the banks started to increase their capital market based fees and underwriting incomes and extended their business models with sales of investment trusts. Their higher operational costs have therefore rather been a necessity to finance innovation while keeping incomes from traditional interest income on a comparatively high level. One important reason for the lead of the U.S. in financial innovation is the early start of financial liberalization in the U.S. The deregulation springing from the interstate banking act between 1980 and 1994 resulted in a fast consolidation of banks within their (still limited) sectoral boundaries. The gradual weakening of the Glass-Steagall Act from the late 70s allowed the stronger banks to extend their businesses into investment banking at the same time. Since it was also possible for the banks to shift operations and to consolidate under the roof of financial holding companies (from 1976) through stock swaps, the banks soon grew well beyond their "classic" credit banking businesses.

The EU, in comparison, only introduced a rather liberal universal banking concept with the Second Banking Directive in 1989. Even after this liberalization, however, smaller national banks (and especially savings banks) remained subject to rather restrictive national regulations (and generous quasi-monopolistic provisions). Financial innovation in the EU finally started to increase from 1994, when the harmonized licensing of insurance companies led to more competition and an EU-wide consolidation in this sector. But only from 2002, when EU-wide financial holding companies were finally accepted, did financial consolidation and intergration start in earnest. Most financial services from banking to broking and insurance are now becoming gradually integrated under the roof of international financial holdings. The extend of their business models still varies within the EU, however, because – below the roof of general EU regulations – many national regulations remain intact and require special shapes of regional operations wherever EU bank's want to expand or innovate.

In Japan, banking and broking firms could only start a gradual cross-sector integration from 1993 when the corporations were allowed to found subsidiaries in the other's business. Common branches of financial holding companies, however, were only allowed to do this from 2002. Similarly, the "financial Big Bang" after 1997 gradually lowered the barriers to insurance businesses (banks can sell some insurance products since 2001; lump-sum life insurances can be sold from 2005). But only between 1999 and 2001 was the group-wide consolidation of holding companies through stock swaps liberalized. A major wave of 342 M&As with banking participation therefore only took off between

decreased from 39.5% in 1992 to 33.2% in 2003 (The Banker 2005).

1998 and 2004 and is now resulting in financial consolidation and innovation within these groups (BOJ 2005: 27).

Certainly, the Japanese banks' slow response to market chances in the non-interest business is partially due to this lasting restrictive financial regulation and slow deregulation. Until the bursting of the asset "bubble" in 1991, the Japanese government saw little reason to help the banking industry to shed its traditional focus on corporate credit by introducing competitive deregulation. Even after the severe fall in asset prices, and despite the warnings of pundits who pointed to the important role the banks had played in inflating the bubble, the government rather chose to concentrate on disaster prevention (or suppression) than on true reform of the industry. Financial regulators started to prop up single banks, extended credit guarantees and increased direct and indirect credit provision to the corporate sector (not least through public construction projects). Japan's financial "Big Bang" therefore only started between 1998 and 2001, and not in the late 80s or early 90s as in the U.S. or the U.K.

2. Banking Consolidation and Strategies

It remained beyond the reach of Japanese commercial banks to extend their business into broking for private customers or underwriting corporate bonds and stocks until 1998. But even after most regulations had been dismantled after 2001,[6] Japanese banks did not immediately start to venture into financial innovation.

An important reason for the banks' slow response to the economic crisis of the 90s had been sectoral balance sheet shifts that went well beyond the corporate sector and deep into the household sector. After the bursting of the bubble, corporations had to reduce their real estate backed debts through investment restraints and cost cutting – even successful companies started to finance their investments from cash-flows. Banks, encouraged by the government, tried to keep as many corporate customers afloat as possible by providing low interest credit to increasingly insolvent corporations (evergreening).[7] To balance their risk structures, Japanese major banks bought safe but sometimes even negative-yield carrying public bonds or fell back on "forced" injections of public capital. Japan's households, at the same time, reacted to worsening corporate risk structures and deflation by further holding back on investment and shifting their assets into cash and deposits with public guarantees.

For Japanese banks, these balance sheet shifts added to the general financial market trend towards disintermediation through securitization and increasingly available direct finance options for corporations. After not being able to recover their profitability for almost a decade (Fukao 2003), the banks were therefore forced to liquidate their stock portfolios, which led to additional cuts in their traditional investment banking activities. Finally, after their stock-selling coincided with the end of the IT-boom in 2001 and the Japanese stock market turned into a vicious cycle, the banks' were beyond their means for internal restructuring. They retreated to further public fund injections and started mergers between city banks to create mega-banks that would be "too big to fail". As a result, the banks could avoid a financial melt-down, but their valuation had fallen from a weight of more than 25% in the Topix index in 1986 to only 2.7% in April 2003.

During the late 90s, to what extent the banks have been victims of the financial and economic crisis or to what extent they had been their cause was the subject of heated

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6 Foreign banks are still facing some limitations in private banking, distribution of hedge funds and mergers through stock swaps.

7 Peek/Rosengreen (2005) show, for example, that Japanese banks provided credits to SMEs below risk-adjusted costs during the asset market crisis (especially after 1997). By so doing, they clearly focused on avoiding the writing off of non-performing loans to retain their capital asset ratios (see also Hoshi/Kashyap 2004, Arikawa 2005). Caballero et.al. (2005) estimate that about 30% of banking loans or 14% of asset-weight loans have been provided to significantly subsidized conditions.

public and academic debate. Without reviewing this debate again (Hoshi/Kashyap 1999), it seems to be safe to say that the banks were not able to deal with their balance sheet crisis by shifting their business models from traditional corporate banking to potentially more profitable retail banking and international investment banking. By not doing so, they did not contribute to a faster solution of the financial crisis in general. Furthermore, although the mega-mergers of city banks[8] (after 2002) helped to reduce the sum of non-performing loans to only 2.4% of their balance sheets by the end of 2005, this strategy has not yet provided an innovative change in their business models.

On the contrary, the mega-mergers of the Mizuho Financial Group, Mitsubishi UFJ Financial Group, and Sumitomo Mitsui Banking Group have rather preoccupied the banks with the restructuring and consolidation efforts of their old business models than with catching up in innovation. Instead of investing in innovation and new business fields, Japan's banks still need to continue to cut costs to make their mergers acceptable to investors.[9]

Figure 5 shows, for example, that the Mizuho Financial Group (after its merger) still earns most of its income from low-margin corporate wholesale banking. Even in comparison with Deutsche Bank, which has a similar problem because of its lack of retail banking prospects in its domestic market,[10] The Mizuho group is still in the most vulnerable position. In contrast to Mizuho, Citigroup and HSBC have long shifted their business models towards retail banking, while Deutsche Bank was at least able to develop profitable asset management operations.[11]

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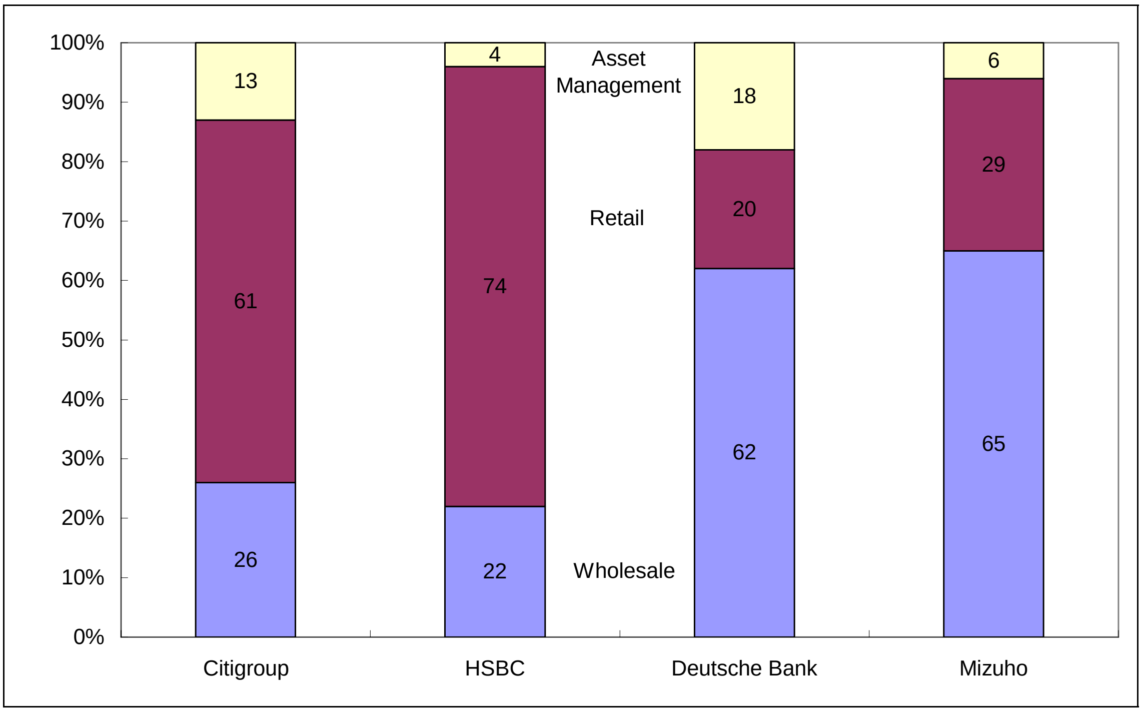
8 Additional support came from the recovery of the Japanese economy that started at the same time. It took another three years (until end of 2005) until corporate credit demand showed positive growth rates, however.

9 The Japanese government, as well as the more than 30% foreign shareholders, has been pressing the groups to increase their profitability fast.

10 The German retail banking market is still dominated by semi-public savings banks.

11 Deutsche Bank was able to develop its international asset management on the back of EU financial integration and the booming bond underwriting market.

Figure 5: Banking Activities of International Banking Groups in Comparison



Source: © FRI 2006. Data from Mizuho (2004); BOJ (2005).

Note: Calculated on basis of income. HSBC, Citigroup, Deutsche: Business Year 2003; Mizuho: 2005 Forecast.

Japan's banks are still plagued by their history in corporate banking. Hoshi/Kashyap (1999, 2004) estimate, for example, that Japanese banking assets would need to fall by an additional 15-40% if Japanese corporations shift their finance to the capital markets as U.S. corporations did before. Furthermore, it seems likely that Japanese will need to cut even more ties to insolvent corporations when current rock bottom interest rates start to increase. The final disposal of evergreening credit lines to "zombie" companies (Sekine/Kobayashi/Saita 2003) seems to be far from over.

Finally, much will depend on a smooth transition from deflation and depressed interest rate levels to normal economic conditions. If interest rates rise too fast, the banks will be hit with losses on their enormous public bond holdings that have been built up as a risk hedge for bad loans and because of force-feeding with liquidity from the BOJ. Senoguchi (2004), for example, estimates that an increase in interest rates of 1% would result in losses of 4 trillion yen. Net profits for fiscal 2005 would have been more than eradicated by this.[12]

[12] It is also necessary to mention that some of the internationally most successful foreign banks have not been able to become successful with fee-based business models in Japan's deflationary business environment of the last decade. Merrill Lynch after its major large-scale takeover of Yamanouchi did not produce satisfactory results, and Citigroup Private Banking ventured into

Fortunately, on the back of Japan's current strong recovery, the banks now seem to have a much better chance to continue with their restructuring plans, to expand into neglected business fields, and to catch up in terms of product and process innovation. Already the increase in last year's profits (2005: +800%) led to overdue drafts of strategy change. As a first step, their IT investments are increasing. Until the end of fiscal 2005 they planned to increase their IT investments by 44%. The next step is an improved balance of the three pillars of their universal banking models:

- Corporate Banking expansion is planned to follow the Japanese manufacturing industry into East Asia.
- Retail Banking is supposed to be expanded with more attractive branch networks and "value-added" services, such as integrated cash- and credit cards on the basis of current accounts with integrated money market and foreign currency funds shares.
- Asset Management and Investment Banking are to be extended to realize higher returns and to serve the growing interest of Japanese households in internationally diversified investment funds.[13]

While shifting their strategic focus especially towards retail banking operations for private clients and SME businesses, Japan's new mega-banks basically follow the same business models. The similarity is, however, less a result of a lack of imagination and originality than a consequence of their sheer size and the necessity to develop a universal banking model with considerable diversification. More internationalization and specialization are planned in the long run, but so far clear-cut strategies are lacking

In retail banking, the banks already have had a successful start because they are now (from December 2004) able to sell investment funds over the counter. In the booming stock market they were easily able to gain a market share of 60% at the expense of traditional brokerages like Nomura and Daiwa. From 2008, they will also be able to sell the entire range of insurances products so that they can try to compete with the dominating postal bank in this business as well. In mortgages, private banks gain from the gradual retreat of public agencies from this market (especially the

partially illegal business practices to lift the bottom line. Both companies retreated from their expansion plans in Japan.

[13] Today, Japanese banks still mainly sell international fund products from international partners like Goldman Sachs.

Housing Loan Corp.).[14]

Finally, international investment banking and asset management offer major chances for Japanese banks in East Asia. The booming Asian economies are gradually opening up their financial markets and retiring Japanese are diversifying their enormous cash holdings towards international investments. Additionally, the successful Japanese automobile and electronics industry is opening many doors in Asia while extending their international production networks. So far, however, after their huge losses during the Asian financial crisis in 1997, Japanese banks still prefer to sell their credits cross-border at low margins to Asian governments or major Japanese corporations than to seriously venture into the more profitable and risky business of opening branches for local customers in these countries. The banks also face major competition from their internationally much more successful American and European peers.

To become internationally competitive, Japanese banks first need to develop innovative and significant services at home that would differentiate them from international competition abroad as well. The Japanese retail market has certainly potential. It is huge in size, underdeveloped and technologies are available. Households are, in general, fond of good services and are, after years of 0% interest rates, looking for higher returns on their retirement assets.

But the banks are also facing major challenges. Retail banking and private banking can only be developed by significantly upgrading their branch networks, which is a challenge when cost cutting needs to continue. The banks will also have to compete with the privatized postal bank, which does not seem to be inclined to give up market share without a fight, and with more service-oriented regional banks.[15]

The following section therefore focuses on financial innovation in Japan's retail banking market, which offers the banks a chance to demonstrate their innovation potential and might give them a lead over their international competitors in Asian markets.

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14 So far, the gains are rather due to cutthroat competition between private banks because the banks are still attracted to low-risk credit business.

15 Japan Post plans to double the number of post offices that offer investment trusts within the fiscal year to 1,153 branches. It introduced investment trusts from Nomura Asset Management Co. and two others last October, with the balance handled reaching around 119.6 billion yen as of March 31, exceeding the initial target (Nikkei Online 2006.04.28). Within the network of roughly 24,000 post offices, the privatized firm is considering initially establishing 230 directly operated postal savings bank branches and around 80 postal life insurance outlets when the process begins in October 2007 (Nikkei Online 2006.03.08).

3. Financial Innovation

As in most other industries, new technologies are a driving force of financial innovation as well. In contrast to manufacturing, however, the traditional differentiation between product innovation, such as new Certificates, Exchange Traded Funds (ETF) and Hedge Funds, and process innovation, such as various forms of electronic trading, in the financial industries is much more difficult. Unfortunately for the industry, similar difficulties exist for the protection of intellectual properties or the patenting of financial innovations. Increasing integration and globalization of electronic services with the traded products (e.g., electronic transfers and orders with integrated current accounts including credit cards and investment funds) has resulted in a diversifying innovation process that cannot be protected and often not even efficiently regulated anymore.

In the (earlier) heavily protected and regulated financial industry with its strong monopolies in banking, the IT revolution therefore resulted in a polarization of innovation processes. On the one hand, often smaller, non-bank financial corporations like online-brokers and financial services providers, and large internationally active investment banks, credit card companies and diversified universal banks are developing and driving financial innovation and internationalization. On the other hand, still regulated (and often public) commercial and savings banks often resist internationalization and additional competition – and consider innovation as an additional cost factor only.

Lerner (2004), for example, analyzed articles in the *Wall Street Journal* between 1990-2002 on financial innovations. According to the records, 33.5% of innovations in the U.S. appeared in Security Underwriting and Trading, while equally 26.2% of innovations appeared in Asset Management as well as in Pension Funds sectors. Retail- and Mortgage Banking, on the other hand, saw only 11.6% of financial innovations, credit card and insurance business only 5.2%, and commercial banking only an insignificant 0.6%.

But commercial banks participated to a high degree in the development of these technologies. The analysis of Lerner showed that commercial banks were almost as active in innovative development as brokers. Securities Brokers & Dealers were mentioned as innovators in 23.5% of the articles, Commercial Banks in 22.3%, and Non-Depository Credit Institutions in 8.2%. IT-Companies appeared in only 6.7% of the articles.[16]

In the U.S., driven by a gradual liberalization towards universal banking and the opening of the regional markets, commercial banks had strong incentives to promote financial innovation and diversification. Most financial innovations of the 90s therefore focused on capital market based security trading, underwriting, and asset management, but they were introduced by commercial banks to develop these markets. Especially from the end of the 90s, this innovative development and extension of products and processes resulted in increasing profitability. Even in an environment of slowing corporate credit business and stagnating stock markets, as after 2001, the banks were able to keep their high margins while international competitors were falling back.

In Japan, as discussed in the last section, the lack in fee-based profitability shows that comparable financial innovations have not happened yet. This situation is currently changing, however. Especially in international wholesale banking Japan is catching up fast. Hedge Funds with an Asian focus have been growing by 35% per year since 2000. About 30% of their assets of 70 billion USD come from Japanese capital markets. Especially Japanese insurances and pension funds are currently trying to improve their low interest income and to reduce their (in the long-term risky) exposure to Japanese government bonds. From 2004, more than half of Japan's corporate pension funds have started to invest in hedge funds, and even the "Japan Government Pension Investment Fund" is now considering such a diversification (Business Week 2005).

On the retail side, demand is building up especially for foreign currency products as Figure 6 shows. The share of foreign currency based publicly offered investment trusts has exploded during the last three years. While their share was still rather stable with only 6-7% of all offered investment trusts between 1990 and 2000, they jumped to 26% in 2005, and already reached 41% in early 2006. Most of this demand is still directed towards "safe" currencies and assets like U.S. treasuries (the share of Asian funds is only about 5%). But recently interest in Asian funds (especially with a focus on India) is growing strongly in the general public as well. Although the overall level of investment trusts starts to grow from only a very low level in household portfolios (see Figure 1), the recent increase to 55 trillion invested in investment trusts is quite significant because it marks an increase of 12% over the stock market peak of 1990.

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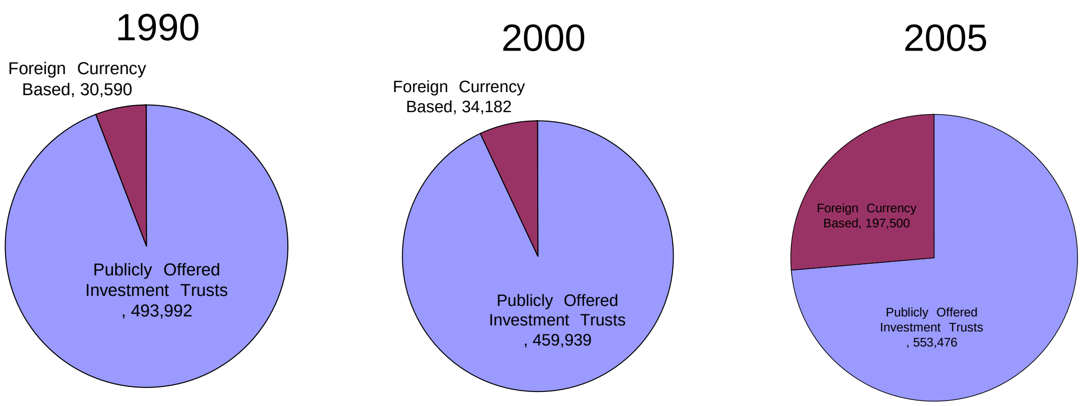
16 The remaining articles quoted companies from various other sectors.

Figure 6: Private Domestic and Foreign Currency based Investment Trusts



Source: © FRI 2006. Data from Investment Trust Association (2006).

Note: Publicly Offered Investment Trusts in 100 million Yen.

With increasing demand for riskier financial products, the lack of financial innovation and attractive product offerings becomes more obvious in Japan. So far, there had been only limited room for small and specialized financial service providers to develop new products and services. The following Figure 7 shows, for example, that IT investment of Japanese banks remained well below the investment levels of U.S. banks throughout the 90s. An interesting market for financial innovation therefore did not develop on the back of demand from the public or the major banking groups.

Figure 7: Investments of U.S. and Japanese Banks in IT (Bill. USD)

	U.S. Banks	Japanese Banks
1990-1994	19,2	11,3
1995-1999	25,1	10,0
2000-2001	30,8	12,4

Source: BOJ (2005).

Note: Period averages for Yen-USD rates have been used for conversions.

While U.S. IT investment tripled during the 90s, investment levels in Japan remained stagnant and focused on system maintenance and integration. Only 30% of Japanese banks' IT investments went into new systems (BOJ 2005). In the U.S., on the other hand, system maintenance required a mere 2% of investment in 2003, while 38% were invested in the development of new systems (Center for Financial Industry Information Systems 2003). Japan's FSA (Financial Service Agency), in its currently promoted "Program for Further Financial Reform", therefore concludes:

"....compared to other countries, Japanese financial institutions have fallen behind IT investments and IT costs remain high" (FSA 2004, p. 5).

As mentioned above, a main obstacle for financial IT innovation, the lack of profit at Japanese banks, should become less significant in the future. The banks will therefore likely join the rest of Japan's industries with catch-up investment. For fiscal 2005 alone, the three mega banking groups alone are planning IT investment of 2.7 billion USD (again, however, with the major part going into system integration, not system innovation).

If innovation investment finally catches up in Japan, the potential for improvement is huge and progress likely fast. All important technologies are not only available internationally, they are often already developed by Japanese corporations. Figure 8 shows that a major part of financial innovation in the U.S. is based on patents of Japanese corporations

Figure 8: Financial Patent Owners most often mentioned in the WSJ (1990-2002)

Corporation	Patents	Corporation	Patents
Hitachi	76	Toshiba	23
IBM	55	Merrill Lynch	18
NCR	55	First Data	14
Citigroup	47	Citicorp	13
Fujitsu	47	Microsoft	12
AT&T	33	Xerox	12
Diebold	30		

Source: Lerner (2004).

Especially the high penetration of broadband and internet connected cell phones offers an enormous potential for advanced financial retail technologies today. Small, innovative financial service providers are therefore preparing for their chances to follow the success of online brokers and net-based banks in recent years.[17] Online banks, like

[17] Successful online brokers like Monex Beans Holding (with Sony as strategic investor in the background) already offer of a full service lineup of investment and private banking services.

Sony Bank, Japan Net Bank or eBank (which even offers hedge-fund-based investment trusts online now), or specialized online-banks with ATM networks in convenience stores, like Seven Bank (before IY Bank), are already gaining market share from the slowly changing major banks. It is quite likely that the prospects of these holdings are taking off when new market platforms have taken hold in Japan because most market barriers have fallen in the meantime. Miwa and Ramsmeyer (2004), for example, stress that small financial service provider are not (and have not been for years) more regulated than their peers in the U.S.

Even more importantly, major non-bank groups are now developing wireless market platforms for e-commerce and e-money systems that look promising. One of the most important platforms is NTT DoCoMo's (Japan's dominant cell phone company) "i-mode" internet service with 45 million users. This service is currently being enhanced by "mobile wallets" for electronic transfers and payments. With this step, mobile phones are about to break the barrier from simple terminals that can be used for money transfers to real electronic wallets that can be used for cash payments at ticket gates of Tokyo's main train lines, discount stores and vending machines. By summer 2006 an estimated 10 million of such phones will be in use.[18]

Such product and process innovations should be a good basis for solving many of the banks' problems in retail banking. Japan still has only less than 13,000 commercial bank branches, which is only one sixth of available branches in the U.S. and about the same number as in the much smaller U.K. Furthermore, most branch offices still have inconvenient office hours, offer customers only limited space (in relation to the visible administrative areas behind the counters), and keep customers waiting after fetching numbers under a numbered ticket system for each specific service at different counters. A similar situation prevails at ATMs, which often stop their services when branch offices close.

The major banks are therefore now following the lead of online banks and innovative conventional forerunners towards retail customer services and platform integration. Foreign-owned Shinsei Bank (the former Long-term Credit Bank), for example, has already shifted many basic services, such as money transfers, to its online platform. It has concentrated cash services in its branches at ATM lines, and focuses on financial advice at its branch counters.

All these changes in business practices are, of course, not financial innovations. At their branches, the banks are simply introducing retail customer oriented practices that have

[18] As of January 2006: 3 million users.

been standard in other countries for many years. In online and mobile services, as well as e-payments systems, other countries have a long lead as well. In Hong Kong, for example, an integrated e-payments system ("Octopus") started as a contact-less commuter payment system based on Sony's "Felica" RFID cards back in 1997. It now covers e-money functions from commuting to banking and convenience store sales. In the U.K., debit card use rose by 9% in 2005, and now accounts for 37% of all retail transactions. Already at the end of 2004, payments with credit and debit cards had overtaken the use of cash for the first time.

The market for financial services in Japan might outgrow this catching-up phase very fast, however. Most likely, the current liberalization of banking services for non-banks[19] from April 2006 will provide a major push for further innovation and service development. Especially online banks and financial service provider are jumping at the chance to offer additional face-to-face services and approach customers at a variety of existing service company outlets. After the liberalization, they are now able to extend their reach into the brick-and-mortar retail world by forming alliances with select retailers. While online banks start to move deeper into retail services, online shopping malls like Rakuten and internet portals like Yahoo are increasing the competition by expanding their financial services with credit cards, e-payment systems, and banking alliances to become comprehensive retail service providers.

In the conventional brick-and-mortar world of retailers, the enthusiasm for offering banking services is almost as big as the interest of online banks in finding such partnerships:

- convenience stores, which already run successful ATM networks, hope to add additional banking counters,
- travel agencies want to handle foreign exchange and offer foreign currency accounts,
- department stores and shopping malls want to extend their credit services and internal settlement transactions,
- real estate agents hope to offer mortgages more directly and to better tailor their financing packages.

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[19] Before the revision, the banking law allowed only banks' wholly owned subsidiaries to serve as bank agents. Now, after obtaining approval from the Financial Services Agency, non-banks can serve as bank agents and provide deposit and lending services as well as foreign exchange transactions.

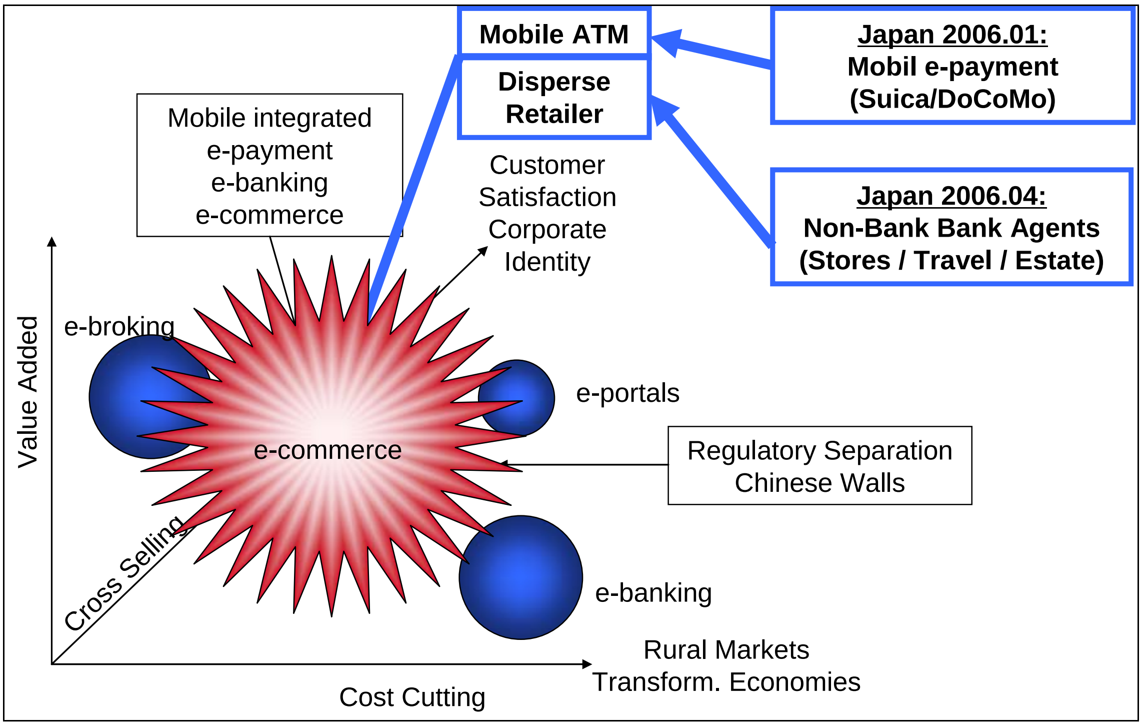
The biggest winners at first might be telecoms, however. They are eager to expand into both directions. They want to extend their mobile payment systems as wide as possible, and they can use their existing branches and customer service centers as financial service outlets. In Japan, NTT DoCoMo is therefore especially active in investing into everything from credit card companies, to banks, convenience stores and music companies.

To further evaluate the potential of such financial service integration, it is important to assess the advantages of financial e-services in general. Basically, the potential of such services reaches into three dimensions (see Batta, Pasa and Schnitker 2006):

- Cost cutting through (mobile) e-banking and e-payments without the need for developed branch networks and infrastructure in rural areas, and e-money systems in city centers.
- Value added through increasing market transparency and product availability to broad customer markets (ex: e-commerce, e-broking services).
- Cross-selling of products and binding of customers through personalized web-portals and mobile platforms (ex: Yahoo, NTT i-mode).

Figure 9 plots the three dimensions of financial e-service business models, and adds the steps that Japanese service companies are currently taking to develop integrated e-commerce platforms.

Figure 9: Dimensions of Financial e-Service Integration



Source: © FRI 2006.

So far, most ventures in any of these dimensions have not been particularly successful. The cutting of transaction costs through e-banking is a viable option in developing countries where banking services are not yet available. But in developed markets, they have long become a necessary additional service that does not add to the bottom line of banks. Value-added services, like e-broking, on the other hand, have not become particularly profitable because such services have remained too limited due to regulatory barriers in most countries. Finally, the cross-selling of products through personalized e-portals suffers from both problems (limited transaction cost gains and limited value-added possibilities). These services usually add value only indirectly by reducing churn rates for network providers or financial holding companies.

But with regulatory barriers between these services falling fast, companies from all directions are likely to break out of their market niches to win as much of the huge integrated e-commerce market as possible. By doing so, a wave of new technologies and services from partnerships between retailers, telecoms, banks, railways, IT companies (e.g., Rakuten, Ito-Yokado, NTT DoCoMo, MUFG, JR, Sony, etc.) will change the face of many of these services and greatly extend their availability and attractiveness.

With the licensing of non-bank banking agents, financial deregulation in Japan has moved beyond the limits in other developed markets. In the U.S. and in Europe, the licensing of retailers as banking operators has so far run into strong opposition.

Wal-Mart, for example, has just lost its case to win a (limited) industrial bank license for the third time. Regulators fear the obvious risks of handing over licenses "to print money" to merchandise companies, while a strong lobby of retail banks, which have just built up shiny networks of branch offices, is fiercely opposed to such far-reaching deregulation.[20] In Japan, the special situation of underdeveloped branch networks at major banks and the need for further cost cutting had lowered this resistance. For Japanese banks, the cooperation with non-bank agents offers a chance to follow the success of U.S. and E.U. banks in retail banking with lower costs.

Instead of building up a full-fledged branch network, they will be able to link their online platforms to quasi-branches in convenience stores and to cell phones that will take over many functions of current ATMs. Branches need only to be upgraded where added-value personal financial services promise high returns. For the recently merged Mitsubishi UFJ Financial Group, the world's biggest bank in terms of assets, this would result in the possibility of further reducing its, by Japanese standards, large branch network of 900 branches. Instead, MUFG could develop its partnership with the "Lawson" Convenience Stores network with almost 8,000 franchise stores to a network of nation-wide quasi-bank branches. Compared to the enormous investments of U.S. and E.U. banks into the expansion of their branch networks, such a strategy would certainly add to Japanese bank's maneuverability in other investment and expansion plans.

If this happens, Japanese financial markets would be among the first to close the missing link between integrated e-commerce, e-payments, and e-money operations. The resulting new business models in business-to-consumer platforms would not only offer a wide range of innovative financial service providers important chances in Japan's banking dominated market. It would also improve the chances of Japanese banks for an international come back by exporting new types of e-services and retail banking operations to other markets (especially in technology-focused Asia).

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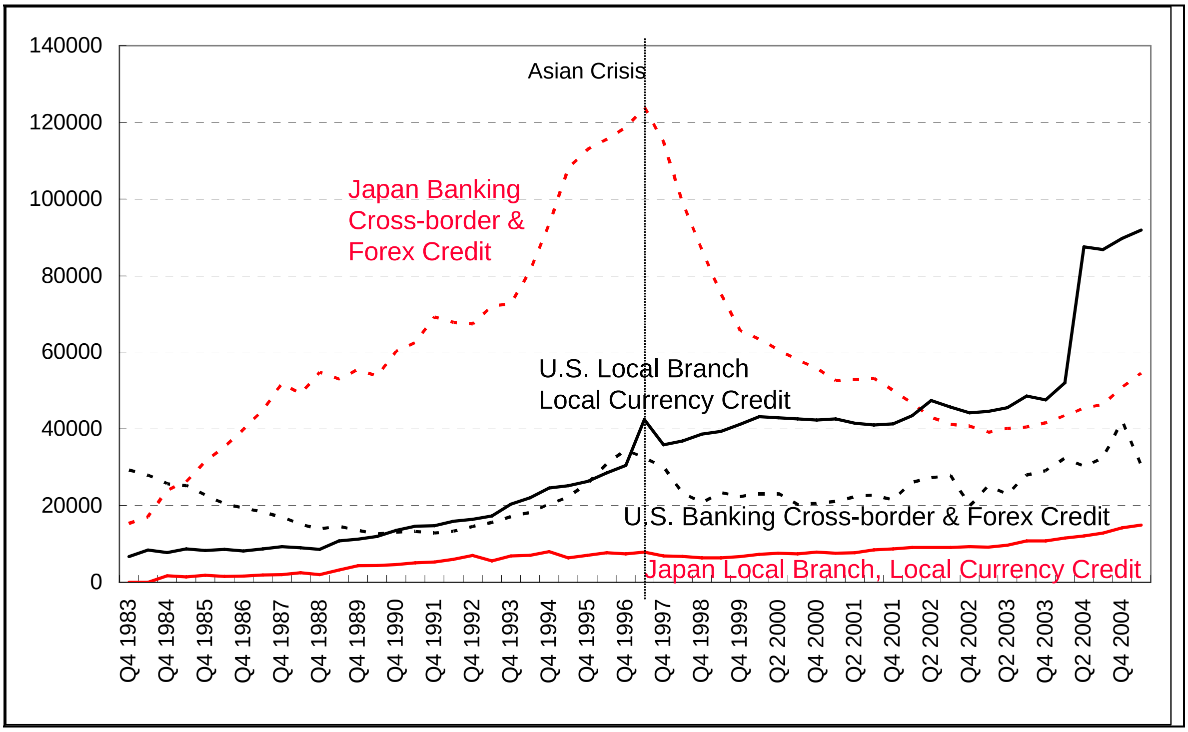
20 The liberalization in Japan does not yet include the licensing of non-banks as banks. But the licensing of non-banks as bank agents most likely lowers the barriers between the two enough to allow for far-reaching service integration.

4. Expansion in Asian Markets

Important future markets for Japanese banks are in East and Southeast Asia. In these markets, however, the current revival of interest by Japanese banks almost marks a new beginning. During the 90s, the banks had gradually retreated from international markets in general. Along with their falling capital valuations, they had to cut back on their assets to remain within the limits of BIS capital adequacy ratios – and they started overseas (Peek & Rosengreen 2000). Despite the risks, the booming Asian business was at first not directly affected by this change in strategy. But the Asian crisis of 1997 led almost to a full stop in these markets and even more cut-backs than in other, safer regions. After 1997, credits to the ASEAN4 countries, for example, were cut by two thirds (Figure 10).

Figure 10: Japanese and U.S. Banking Credit to ASEAN4 Countries (Million USD)

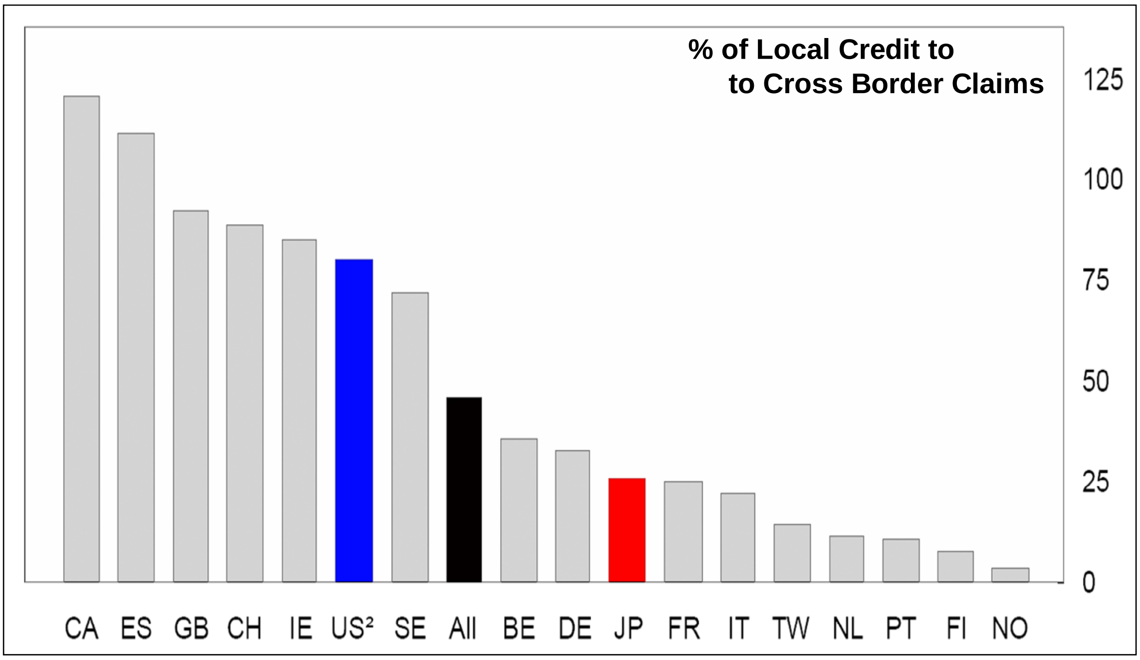


Source: © FRI 2006. Data from BIS (2005). Quarterly calendar year figures in million USD.

Note Japan & U.S. Foreign Banking Claims on ASEAN4 Countries.

Since 2004, foreign credits from Japanese banks have been growing strong again, and even credits to the developing BRIC countries (Brazil, Russia, India, China) jumped in fiscal 2004 by 40% (BusinessWeek 2005). But the banks remain focused on the traditional business of cross-border credits with these countries. This is in strong contrast to E.U. and U.S. banks, which are building up their local branch and local currency operations.[21] Japan today, remains the foremost provider of international credit but is not even in mid-field in terms of international local credit claims (Figure 11).

Figure 11: Local Credit to Cross-Border Credit by offering Country (Percent, 2003)



Source: BIS (2005).

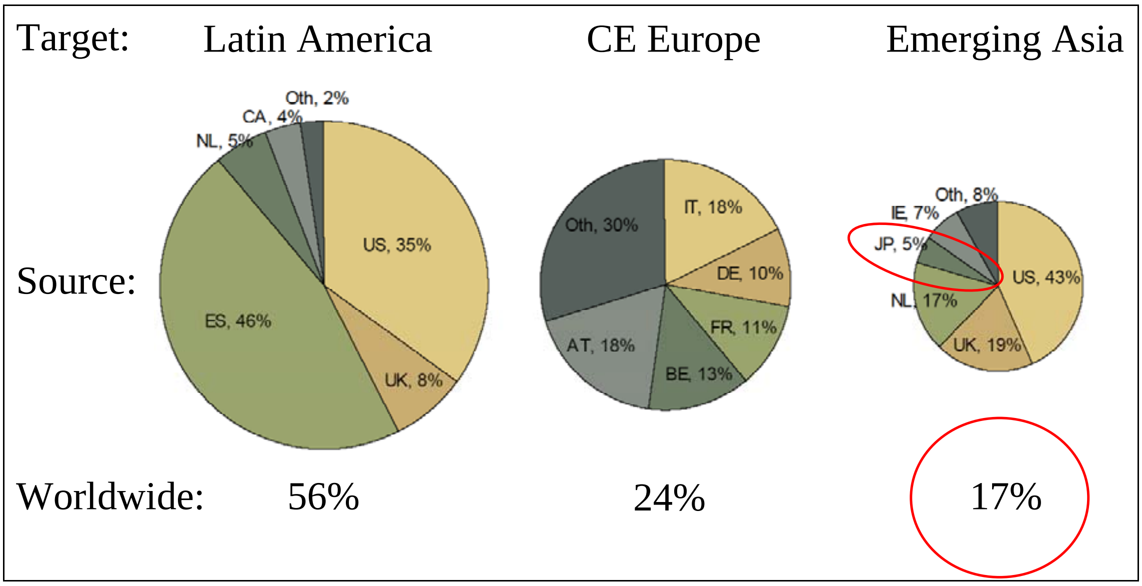
Note Figures for local claims in local currencies as a ratio of cross-border claims in all currencies plus local claims in foreign currencies. (2) For the U.S.: Local claims as a ratio of cross-border claims.

For international banks, investment in local branch networks is an important opportunity not only for developing regional retail markets. They are an important basis for participating in the explosively growing M&A markets, Initial Public Offerings (IPO) and providing securization services. Figure 12 gives an impression of the potential of this market. Until 2003, M&As in Asian financial sectors only accounted for 17% of the worldwide total. This is in strong contrast to economic growth in these markets. Japanese financial corporations, with a share of only 5% of takeovers, have been even slower in investing in opportunities in these markets than their U.S. and E.U.

21 In the graph, the one-time jump in local credit provision of U.S. banks in 2004 is due to tightened capital controls in Malaysia. Ceteris paribus, capital controls require an increase in local credit in relation to cross-border credit.

peers.

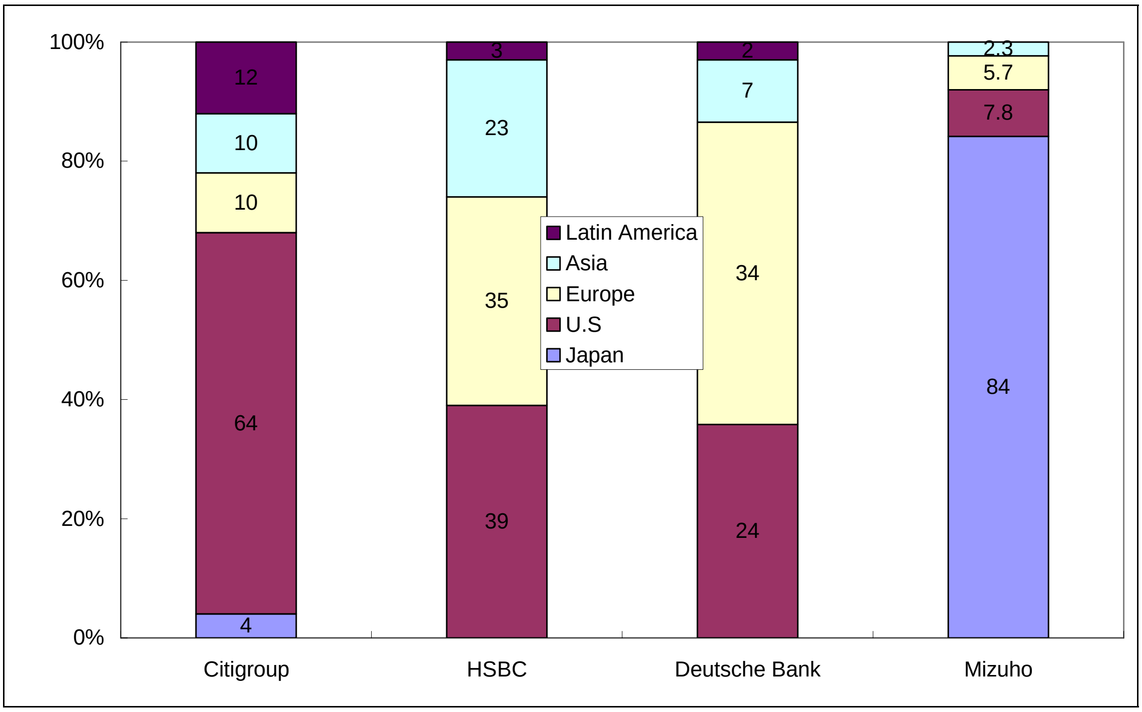
Figure 12: Financial Sector M&A by Region (1990-2003)



Quelle: BIS (2004).

Japanese banks are now planning to stop this retreat from future markets. The Mizuho Financial Group, for example, plans to open 10 new foreign branches by 2009. This is an increase to (then) 32 branches, which is certainly still not a high number by international standards. This careful advance shows how much domestic problems are still weighing upon international strategies. While international corporate banking, which basically serves Japanese manufacturing in East Asia, is expanding again, the overall group had to close 72 international branches by 2005 that had become unnecessary after the merger of the three city banks.

Figure 13: Regional Incomes of Financial Holding Companies in International Comparison

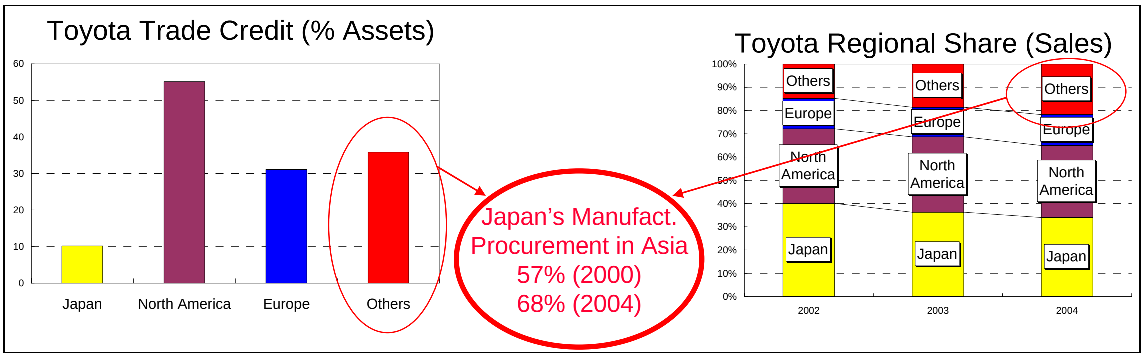


Source: © FRI 2006. Data from Mizuho (2004); BOJ (2005).

Note: Calculated on basis of returns. HSBC, Citigroup, Deutsche: business year 2003; Mizuho: 2004.

Figure 13 shows that Japanese banks are still strongly focused on their domestic business. Fortunately, however, their equally strong focus on corporate banking (Figure 5) might now help them to expand in Asia along the growing production networks of Japanese manufacturers in Asia. About 68% of the procurement of Japan's industry already happens in neighboring Asian countries and sales are increasing fast as well (Figure 14).

Figure 14: Example Toyota: Corporate Foreign Credit, Procurement and Sales

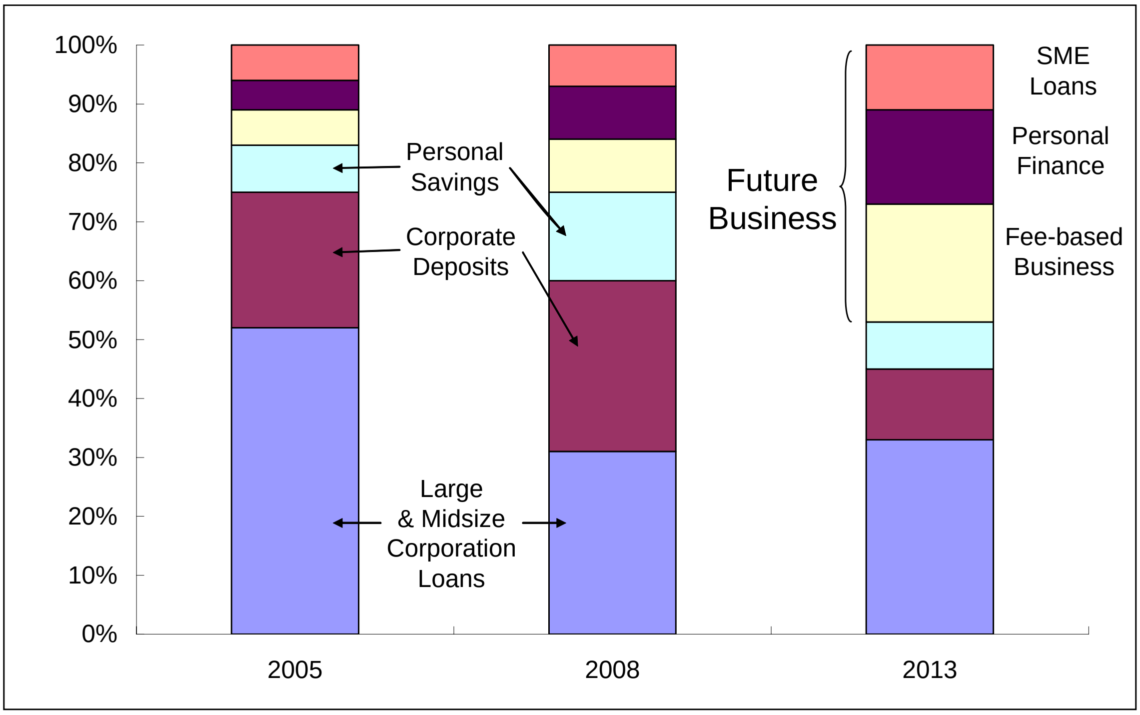


Note: In Toyota's Report, the "Others" region basically covers Asia.

Source: © FRI 2006. Data from Toyota Consolidated Financial Statements 2005.

But focusing on Japan's manufacturers in Asia only, would certainly be a too limited business strategy. Asian regional banking markets are becoming interesting investment targets in their own right – even in China. Estimates of McKinsey (2004) show that China's banking market will grow strongly by 2013 (see Figure 15). Especially fee-based businesses, personal finance and SME loans are expected to expand over the next years. For foreign companies this retail market seems to be attractive, even though it is still dominated by major public banks, because consumer satisfaction with existing services is low. In the city centers, on back of growing credit card use, demand for advanced (foreign) financial services is therefore developing fast. Japanese banks would therefore be well-advised to overcome their dependence on corporate banking fast.

Figure 15: Forecast of Earnings by Source for China's Banking Sector



Source: McKinsey (2004).

Long-term success for Japanese banks in Asia depends on the (re-)establishment of businesses and brand names in these markets, and on the development of attractive technologies domestically. Corporate banking linkages can be a first step, but deep market knowledge in private asset management needs to follow soon to invest Japanese households' assets efficiently in Asia. To establish such a presence, banks must develop their retail banking expertise as well – and this can, against the internationally established competition, only work on the basis of innovative products.

The customer and commerce-oriented e-money platforms that have been discussed in the last section could be an excellent basis for this. Although a full-fledged application would still be hampered by strict regulation in most countries, a working model case in Tokyo would become very attractive in two directions: First, Japan would finally be able to make use of its potential as an innovative service provider from IT to convenience stores. Secondly, technology that has been developed in Japan is very attractive in Asia's shiny business centers and metropolises – from Bangkok to Seoul and Shanghai. All these metropolises are currently upgrading their infrastructures, so scalable e-money and e-commerce systems that reach from subway ticket gates to investment services, online malls and convenience stores could becoming an interesting selling point – not only for Japanese banks but for a wide range of financial and IT service providers.

5. Conclusion

Dominance of a few major banks has hampered significant financial innovation in Japan so far. Current mega-mergers, and the resulting necessity of further consolidation, will continue to be an obstacle to innovation and investments in new systems. But especially in retail banking, Japan is certainly not "over-banked" - and demand for better services and higher returns is increasing. On the basis of existing infrastructures and technologies, the current deregulation of non-bank financial services might very well become the start for a major wave of financial innovation in e-money and e-commerce services. If Japan's banks follow up on this chance, they might even be able to stage an (earlier) unlikely catch-up in retail banking and asset management in Asia.

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