Year 2016 Marks a Turnaround for Japan's Financial Policy — Highlights of Japanese retail investors' markets

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■Abstract

The Bank of Japan (BOJ) made an unprecedented move towards negative interest rates in January 2016 in an attempt to invigorate the economy. This caused Japan's household financial assets to dip 0.4% in March from a year earlier, their first decline since September 2009. They fell a further 1.7% in June, accelerating the pace of decline.

The introduction of negative interest rates also eroded Japanese banks' profitability from lending and investing in securities. In the first half of fiscal 2016, 47 out of 64 regional banks reported declines in net income, and 38 of them recorded double-digit falls in profits. Experts had long warned that Japanese regional banks would face serious structural problems in coming years due to depressed demand for loans caused by a shrinking population. But even before a tide of demographic changes could swamp the financial sector, it has been hit hard already by a squeeze on lending margins from the BOJ's radical monetary policy.

Meanwhile, the Financial Services Agency (FSA) has been pushing regional banks to undertake a more sustainable business model by underwriting loans on business prospects of local companies, instead of relying on collateral and guarantees. The FSA itself has declared to reform its regulatory approach, moving away from the conventional supervisory approaches that focus on checking conditions of assets and prioritize compliance with rules.

Taking the above factors into account, it can be observed that the year 2016 marks a turnaround for financial policies in Japan.

■Introduction

In April 2013, the Bank of Japan (BOJ) expanded its monetary easing program into a whole new dimension, known as quantitative and qualitative easing (QQE), in a bid to end deflation. By boosting inflation expectations through lower real interest rates, it hoped Japanese households and businesses would finally start portfolio rebalancing by increasing their appetite for risk inclined assets. But since then global uncertainty grew triggered by falling oil prices and an economic slowdown in China, sending the stock market plunging in August 2015.

In January 2016, the BOJ's policy committee approved a decision to adopt a new policy of "QQE with negative interest rates" to avoid downside risks for the domestic economy and prices, while aiming to achieve the price stability target of 2 percent. This was designed to apply negative interest rates to a portion of current accounts that financial institutions keep at the central bank, with a combination of its massive Japanese Government Bond

(JGB) purchases, in order to push further downward pressure on entire interest rates.

Japanese Prime Minister Shinzo Abe announced his decision in June 2016 to further delay an increase in consumption tax, this time until October 2019, stressing that, "I decided to postpone the tax hike, which could dampen private consumption." The tax increase from 8 percent to 10 percent had previously been put off in April 2017. A series of events mentioned above have impacted on the developments of household financial assets and liabilities.

Meanwhile, the Financial Services Agency (FSA), Japan's financial regulator, has been taking steps to overhaul its supervisory policy, breaking away from conventional approaches that focus on conditions of assets and prioritize strict compliance with regulations. It has put greater emphasis on contribution to invigorate regional economies and on providing high-quality financial products and services that truly meet customers' needs.

This report will examine how a series of events in 2016 have impacted on Japan's household assets and liabilities as well as banks' profits. It will then assess the FSA's change in the supervisory policy and conclude with the author's comments.

1. Developments of household assets and liabilities

1.1 Impacts of negative interest rate policy

(a) Household assets fall from a year earlier

The amount outstanding of total household assets dropped 0.4% at March 31, 2016, from a year earlier, its first decline since September 2009, or after 26 consecutive quarters of increase. It fell a further 1.7% at the end of June 2016, totaling 1,746 trillion yen (Table 1).

Here, this report splits the annual growth in household financial assets into two parts: changes in market value (or "reconciliation" in the BOJ data); and transaction (purchases subtracting sales, or "flow" in the BOJ data).[1] The results show that an annual change in market value turned negative at March 31, 2016, and widened further at June 30. Transaction also shrunk at the end of both March and June, respectively, and an annual decline in household financial assets deepened (Figure 1).

As Table 1 suggests, the amount of outstanding shares, other equities and investment trusts had shown upward trends, but it slowed down from August 2015 when the stock market fell.

Even after the BOJ announced a negative interest rate policy in January 2016, this didn't stop the yen's rise and a weakening stock market. Britain's decision to exit the EU in a June 2016 referendum weighed on stock prices further, as investors were searching for safe assets amid global uncertainty. That led to steeper falls in shares and investment trusts at the end of both March and June 2016, causing a decrease in entire Japanese household assets. In sum, the BOJ's adoption of negative interest rates was supposed to put an end to a decline in household assets, but the effects had not materialized by the end of June 2016.

1 An annual change in the amount outstanding of household financial assets is the sum of annual change in market value and transaction (purchases subtracting sales). This report may refer to March or June, even though it means a change in market value and transaction during a quarter.

Table 1 Financial assets in the household sector

(Trillion yen, %)

	Amounts outstanding	Annual changes in amounts outstanding	Annual percentage changes							
	June 30, 2016	June 2016	Sept. 2014	Dec.	Mar. 2015	June	Sept.	Dec.	Mar. 2016	June
Total assets	1,746.1	△ 30.7	3.4	3.4	4.7	4.1	1.3	1.4	△ 0.4	△ 1.7
Currency	78.1	4.1	3.9	3.6	3.0	4.0	5.2	5.6	6.5	5.6
Deposits (a+b)	836.6	6.9	1.6	1.8	2.1	2.1	1.8	1.2	0.9	0.8
Transferable deposits (a)	376.2	13.5	4.0	3.9	4.7	5.0	4.4	3.8	3.4	3.7
Time and savings deposits (b)	460.4	△ 6.6	△ 0.0	0.4	0.2	0.1	△ 0.2	△ 0.7	△ 1.0	△ 1.4
Foreign currency deposits	5.0	△ 0.1	△ 5.3	△ 6.7	△ 9.6	△ 11.3	△ 9.1	△ 6.1	△ 4.5	△ 2.4
JGBs & FILP bonds	14.0	△ 1.4	△ 12.1	△ 13.9	△ 19.7	△ 24.4	△ 25.1	△ 26.3	△ 18.5	△ 9.3
Corporate bonds	7.0	1.3	18.7	33.9	43.3	34.3	29.0	22.3	19.0	23.4
Shares and other equities	144.1	△ 28.7	9.7	2.3	13.1	11.6	△ 4.6	2.5	△ 8.2	△ 16.6
Investment trust beneficiary certificates	86.8	△ 11.5	14.9	17.1	21.6	19.5	5.8	4.1	△ 3.7	△ 11.7
Life insurance entitlements	211.0	4.2	4.5	4.4	4.7	4.6	3.0	2.9	3.2	2.0
Pension insurance entitlements	99.7	△ 4.7	△ 1.6	△ 1.7	△ 0.7	△ 0.8	△ 2.2	△ 2.6	△ 3.7	△ 4.5
Pension entitlements	152.8	△ 3.4	3.9	5.8	8.1	5.7	3.1	0.9	△ 2.1	△ 2.2

SOURCE: BOJ, *Flow of Funds Accounts.*
NOTE 1: Total assets do not coincide with the above total data because the table excludes some items.
NOTE 2: The data in June 2016 are preliminary figures.

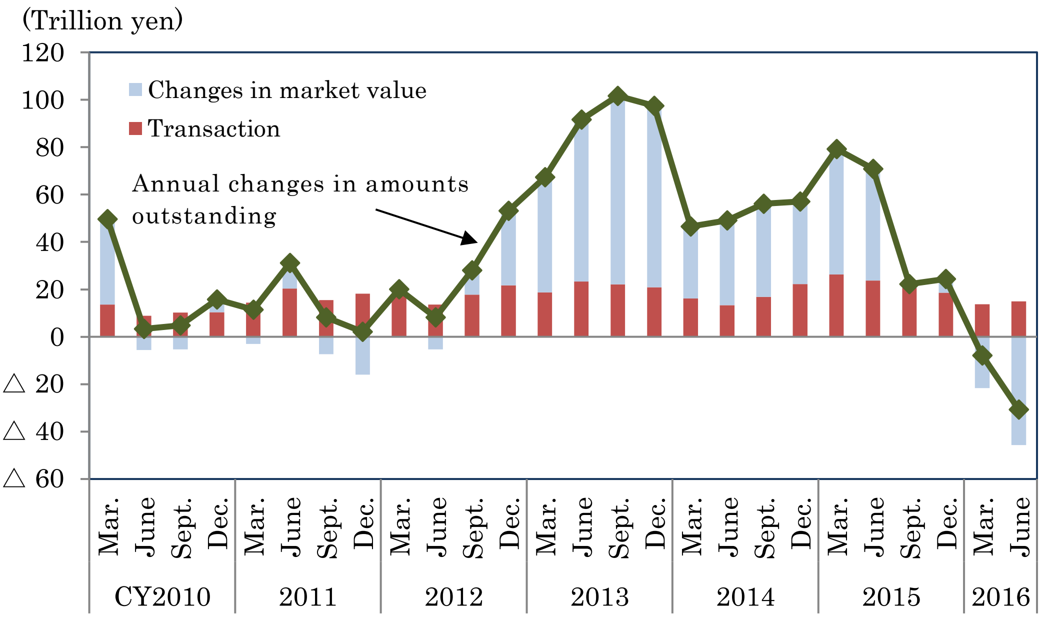
(b) Appetite for risky assets stalls

As discussed above, the market value of shares and investment trusts in household assets declined due to a slumping stock market. With regard to the transaction, investment trusts increased for 12 consecutive quarters from March 2013 to December 2015. But by March 2016, they also lost 166.1 billion yen (Figure 2).

One contributing factor: With government bonds yielding below zero following the BOJ's decision on negative interest rates, an increasing number of asset management companies wrapped up early redemption of money market funds (MMFs) and medium-term government bond funds due to being unable to secure investment returns. The amount outstanding of MMFs and medium-term government bond funds fell by 726.1 billion yen at June 30, 2016, from the same month a year earlier. Medium-term government bond funds went down to zero in July 2016, and MMFs down to nearly zero in October 2016.

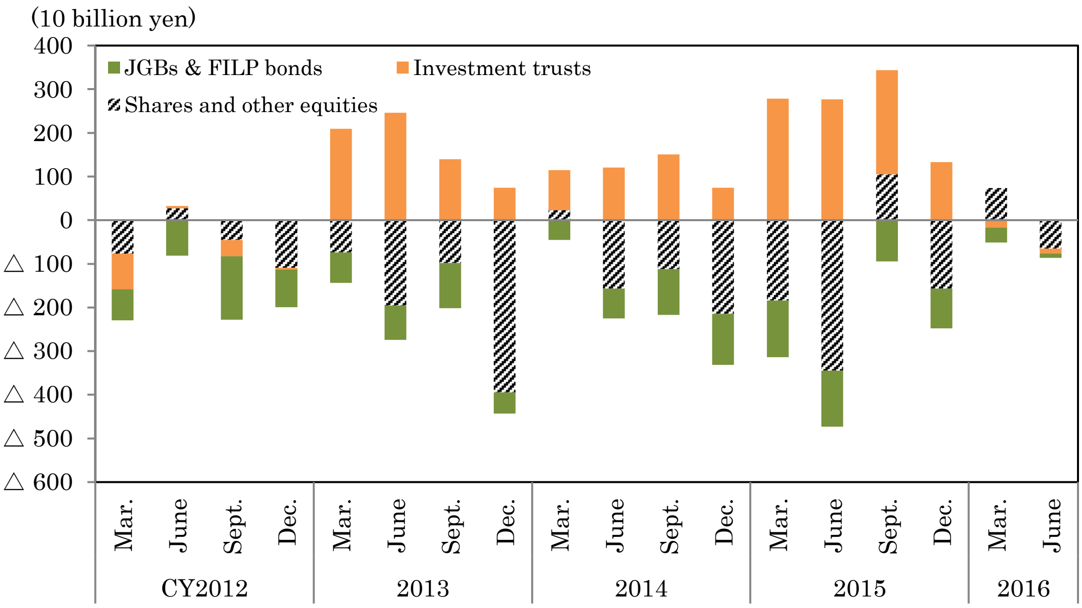
It has been said that some Japanese households have been shifting their holdings to fund wrap accounts and Japan's real estate investment trusts (J-REITs) for higher-yielding securities, but the move hasn't been strong enough to push up transaction in investment trusts.

Figure 1 Breakdown of annual changes in household financial assets



SOURCE: Same as table 1.
NOTE: Changes in market value refer to "reconciliation" in the BOJ data, while transaction refers to "flow." An annual change in amount outstanding is the sum of annual reconciliation and flow. Changes in market value refer to "reconciliation" in the BOJ data, while transaction refers to "flow." An annual change in amount outstanding is the sum of annual reconciliation and flow.

Figure 2 Transactions in shares and other equities, investment trusts, JGBs & FILP bonds



SOURCE: Same as table 1.
NOTE: Transaction value refers to "flow" in the BOJ data.

The Central Council for Financial Services Information annually surveys the financial behavior of households (with at least two persons).[2] According to the survey, some 5.8% of respondents in 2015 said that they would increase their holdings in stock investment trusts, up from 1.7% in 2011 responding to the same questionnaire. But the figure dropped to 4.1% in 2016, suggesting that Japanese households have appeared more prudent for holding investment trusts.

In the meantime, individual investors have been drawn to JGBs as a safe asset because they guarantee a 0.05% minimum annual rate, relatively higher yields than bank deposit rates. The amount outstanding of households' JGBs and Fiscal Investment and Loan Program (FILP) bonds continues declining, as they have been nearing maturity of previous purchases (See Table 1). Yet, the issuance of JGBs for individual investors soared 88.3% in March 2016 from a year earlier. It has surged more than 40% in recent months except in September and November 2016, narrowing the decline in transaction of JGBs and FLIP bonds (See Figure 2).

As mentioned earlier, the sales of MMFs and medium-term government bond funds were suspended, and JGBs seem to have supplanted them as a safe and relatively low-risk investment for individual investors. In order to cash in such trends, financial institutions have been actively promoting JGB sales targeting individual investors.

(c) Time and savings deposits fall year-on year

It is notable that the pace of annual growth in household deposits started slowing from the end of September 2015. The amount outstanding of household deposits rose barely 0.8% at June 30, 2016, from a year earlier. As Table 1 shows, time and savings deposits have continuously decreased, with the speed of decline deepening.

In Japan, fund inflows to time and savings deposits normally exceed outflows during an April-June bonus season. But the flow was reversed during the same period in 2016, with outflows surpassing inflows by 1.6 trillion yen. Though there is no data focusing on individuals, the BOJ data shows that new acceptance of time deposit at domestic banks has continued to fall sharply since March 2016 from the previous year (Figure 3).

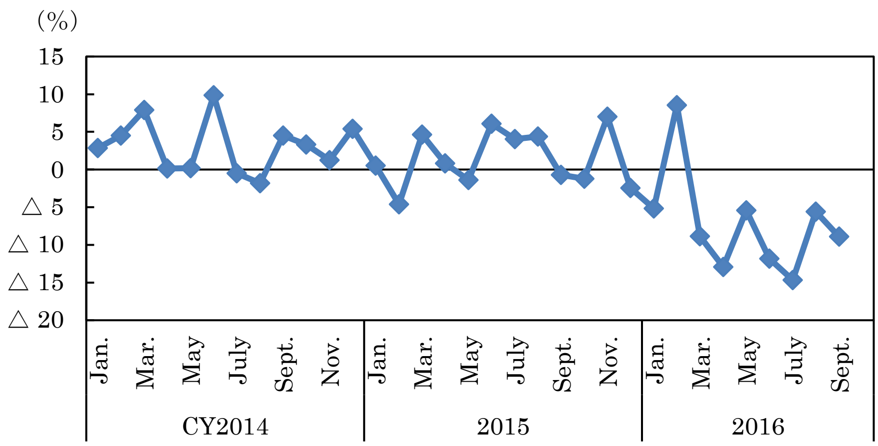
There are several factors behind this. For one, household incomes have remained stagnant. Another is declining fund inflows to household deposits from August 2015 due to the falling stock prices.

Furthermore, this is also attributable to the BOJ's decision to adopt negative interest rates, which prompted banks to cut deposit rates that were to be paid to customers. Between February and March 2016, major banks slashed rates on all time deposits from an annual 0.025% to 0.01%. Japan Post Bank also joined them in March by lowering rates on all types of fixed-amount (known as *teigaku*) savings deposits and time deposits to 0.01%.

Banks have been increasingly reluctant to take new time and savings deposits, as they found few alternatives to manage funds. This appears to stall funds inflows into cash and transferable deposits and accelerate a decline in time and savings deposits.

[2] The 2016 survey was conducted nationwide in June and July among 7808 Japanese households of at least two persons aged 20 and older. It excluded the Kumamoto and Oita prefectures in western Japan, which were rocked by a series of earthquakes. The response rate was 44.8%.

Figure 3 New time deposits at domestic banks
(annual percentage changes)



SOURCE: BOJ, *Time Deposits*.
NOTE: The data includes individuals and others.

1.2 Effects of Japan Post Bank's deposit cap raise

Japan Post Bank, the country's biggest bank in terms of deposits, raised the deposit limit from 10 million yen per account to 13 million yen in April 2016, following a government panel approval. That was an increase in the deposit cap for the first time in 25 years. The Japanese Bankers Association (JBA) in 2015 surveyed better banking services, and found that 76.4% of individual respondents hold accounts at Japan Post Bank. It had been speculated that raising the deposit cap might prompt depositors to put their money elsewhere.

But before the post bank moved to raise the deposit cap in April 2016, the BOJ had already imposed negative interest rates on banks in January, and that hit Japan Post Bank significantly harder. With the yields of JGBs, which is the major source of its income, sliding into negative territory, Japan Post Bank slashed its *teigaku* deposit rates to levels compatible with those at major banks. The post bank didn't launch a promotional campaign to retain depositors for the planned deposit cap raise in April 2016. When the bank held its financial results meeting in May, it said: "There is no impact of the deposit cap raise."

However, the total sum of liquid and fixed-term deposits at Japan Post Bank rose 0.8% year-on-year at the end of June and September 2016, respectively, compared with a 0.1% increase at the end of March 2016 (Table 2).

Among all types of deposits at the post bank, a growth in transferring (known as *furikae*) deposits has slowed down, whereas that in regular (known as *tsu-jyo*) deposits has risen. Under the deposit insurance system, Japan Post Bank's *furikae* deposits, which give no interest, apply to payment and settlement deposits, thus they are protected in full. In addition, there is no limit in *furikae* deposits, so if other types of deposits exceed their limits, they are transferable to *furikae* deposits.

According to documents the post bank submitted to the government's postal privatization committee, three quarters of the total *furikae* deposits, or an estimated 10.1 trillion yen, are held by individuals. The balance of *furikae* deposits held by individuals rose by 400 billion yen in fiscal 2014 and in April-June 2015, respectively. But it dropped by 700 billion yen in fiscal 2016.

Table 2 Japan Post Bank's deposit balance

(Trillion yen, %)

	Balance	Annual changes in balance	Annual percentage changes				
	Sept. 30, 2016	Sept. 2016	Sept. 2015	Dec.	Mar. 2016	June	Sept.
Total liquid and fixed-term deposits	178.3	1.4	△ 0.5	△ 0.4	0.1	0.8	0.8
Liquid deposits	65.1	3.6	△ 0.3	2.4	4.6	4.4	5.8
Transferring (*furikae*) deposits	12.9	0.7	△ 3.8	8.2	18.1	8.9	5.5
Regular (*tsu-jyo*) deposits, etc.	51.9	2.9	0.6	1.1	1.3	3.4	5.9
Savings deposits	0.4	△ 0.0	△ 0.8	△ 0.6	△ 1.3	△ 1.2	△ 0.7
Fixed-term deposits	113.2	△ 2.2	△ 0.5	△ 1.9	△ 2.2	△ 1.2	△ 1.9
Time deposits	10.7	△ 1.7	△ 8.8	△ 17.1	△ 15.7	△ 10.8	△ 13.9
Fixed-amount (*teigaku*) deposits, etc.	102.5	△ 0.5	0.6	0.2	△ 0.5	△ 0.1	△ 0.4

SOURCE: Japan Post Bank, Financial results supplementary documents.

On the other hand, *tsu-jyo* deposits grew by 2 trillion yen during the fiscal year 2016, which was nearly double that of the preceding two years. As Table 2 shows, an annual growth in *tsu-jyo* deposits rose 1.3% year-on-year at March 31, 2016, and jumped 5.9% year-on-year at September 30, 2016. This suggests that the post bank's deposit cap raise appeared to result in transferring some funds from *furikae* to *tsu-jyo* deposits within the post bank. It also appeared to result in retaining funds, which had been normally withdrawn from the postal savings system in the maturation of accounts, and being redeposited in *tsu-jyo* deposits. As fund outflows of the postal system have decreased, a growth in *tsu-jyo* deposits appears likely to continue rising even after 2016. Thus, it seems that there are some effects of the post bank's deposit cap raise.

Japan Post Bank has repeated a large number of *teigaku* deposits, which is a guaranteed high-yield postal savings account, reaching maturity and redepositing every 10 years since 1980. Apart from this, a cluster of *teigaku* savings accounts, which were initially deposited at a time of relatively high deposit rates after the BOJ lifted its zero-interest rate policy in 2006, will reach maturity in fiscal 2016 and after.

According to the post bank's disclosure statement, the amount outstanding of *teigaku* deposits maturing in fiscal 2016 is expected to reach 7.8 trillion yen, or 4.6 times that of the previous year. The amount outstanding of *teigaku* deposits maturing due in the next three years is estimated at about 38 trillion yen and, given its scale, it remains to be seen how much maturing *teigaku* money will be retained at the bank.

1.3 Trends of household debt

This section will look at trends of Japan's household debt. The total outstanding amount of household debt surged 2.5% from a year earlier to 317.5 trillion yen at the end of June 2016 (Table 3). Housing loans from private-sector financial institutions rose 2.1%, while those from public lending institutions fell 1.2%, totaling a 1.7% increase from a year earlier. Year-on-year growth of the total housing loans has gradually risen, as the continuous decline in housing loans by the public lending institutions has been narrowing. Moreover, lending to small businesses, such as a housing rental business by individuals, and consumer credit have been steadily growing.

Table 3 Trends of household borrowing

(Trillion yen, %)

	Amounts outstanding	Annual changes in amounts outstanding	Annual percentage changes							
	June 30, 2016	June 2016	Sept. 2014	Dec.	Mar. 2015	June	Sept.	Dec.	Mar. 2016	June
Total loans	317.5	7.8	1.1	1.2	1.4	1.9	2.3	2.3	2.3	2.5
Of which: private-sector financial institutions	272.5	8.0	1.9	2.0	2.1	2.7	3.0	3.0	2.8	3.0
Housing loans (a)	178.7	3.7	1.7	1.6	1.7	1.9	2.0	2.0	1.7	2.1
Consumer credit	24.3	1.0	1.2	2.0	2.3	3.6	4.0	3.9	4.1	4.2
Business loans to individuals, etc.	69.5	3.3	2.8	3.1	3.4	4.5	5.1	5.3	5.2	5.0
Of which: public-sector financial institutions	39.5	△ 0.2	△ 2.9	△ 2.9	△ 2.5	△ 1.9	△ 1.4	△ 0.9	△ 0.9	△ 0.4
Of which: housing loans (b)	23.1	△ 0.3	△ 5.0	△ 5.1	△ 4.7	△ 4.2	△ 3.4	△ 2.4	△ 1.8	△ 1.2
Housing loans (a+b)	201.8	3.4	0.8	0.8	0.9	1.1	1.4	1.5	1.3	1.7

SOURCE: Same as table 1.

NOTE: BOJ's Flow of Funds Accounts use the term "lending" to households. This report refers to "loans" to households instead. The BOJ includes independent consultants in the household sector, so this report refers the BOJ's "lending to corporates and governments" as business loans to individuals, etc.

An increase in consumption tax is an important factor for trends of household debt. There was a surge in last-minute demand for houses and durable goods, ahead of the consumption tax rate hike in April 2014. Housing starts jumped 10.6% from a year earlier to 987,000 units in the fiscal year that ended March 31, 2014. Consumers also made last-minute purchases for farm machines, cars and electronic consumer goods. From October 2013 consumer spending soared by some 2.5 to 3 trillion yen more than normal circumstances, according to the Cabinet Office's annual report on the Japanese Economy and Public Finance 2014.[3] With boosted consumer spending, housing loans and consumer credit grew rapidly.

Future consumption expectations might have been taken a hit at that time, but it was widely expected there would be another surge in last-minute demand before a second increase in consumption tax rate for 2017. Housing starts in fiscal 2016 were expected to jump as high as the level of 2013, and there would be another strong rise in last-minute purchases for consumer goods. Around the spring of 2016, however, speculations about delaying the planned tax increase began circulating, and the attention was largely focused on whether there would be one more time to nudge consumers into a last-minute demand for borrowing.

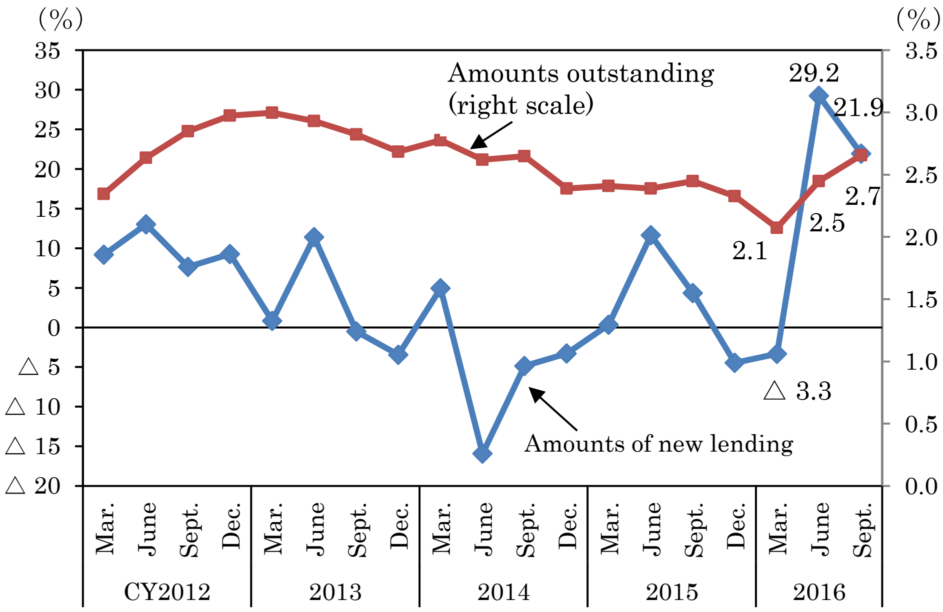
The Japanese government postponed the second increase in the consumption tax; notwithstanding, Table 3 shows that consumer borrowing has been growing. This is because the growth in consumer credit has been driven by cuts in lending rates following the introduction of negative interest rates, and that has made it easier for households to

[3] Cabinet Office (2014). *Japanese Economy and Public Finance Annual Report 2014*, 15.

borrow more. For example, Sumitomo Mitsui Banking Corp. on its website releases a monthly mortgage rate, which is fixed between for the first 10 and 15 years after issuance and become variable afterward. The rate was 1.91 percent in December 2015, kept falling from January 2016, and dropped to 1.23 percent in July 2016. Since then, it has recovered slightly and stood at 1.44 percent as of Dec. 1, 2016.

Given the record-low interest rate environment, the amount of new housing loans to individuals, offered by domestic banks and *shinkin* banks, increased more than 20% both in April-June and in July-September 2016, from the same period a year earlier, respectively (Figure 4). Although it is not as strong as the amount of newly extended housing loans, the growth rate of outstanding housing loans also has continued upward trends, reflecting a rise in refinancing deals. As negative interest rates lowered rates on housing loans, many homeowners have appeared to shop around for cheaper rates. As for financial institutions, more refinancing means fiercer competition for businesses, which are increasingly squeezing their lending margins.

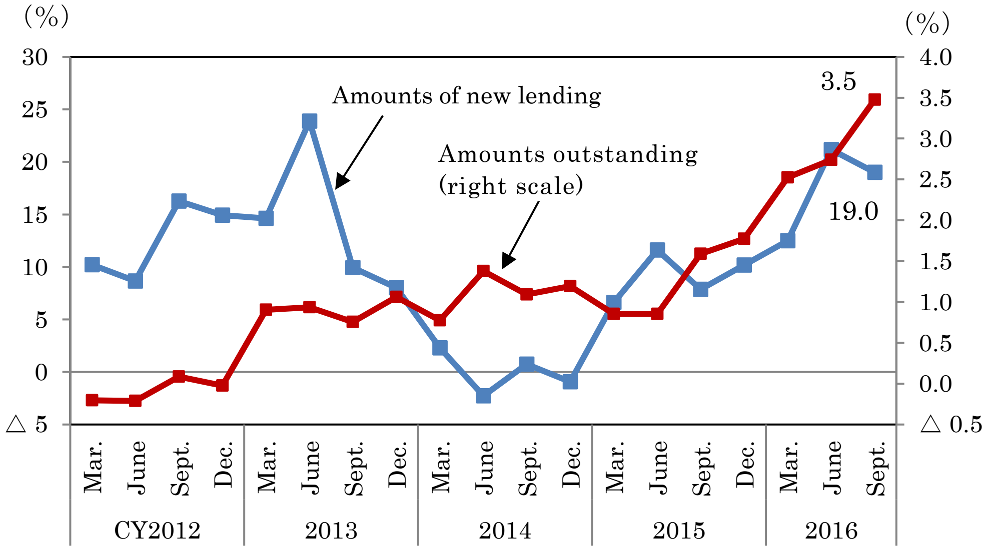
Figure 4 New housing loans to individuals and annual percentage changes



SOURCE: BOJ, *Loans to individuals (housing funds)*.
NOTE: Total sum of accounts of domestic banks and *shinkin* banks.

With respect to the Japanese housing market, new housing starts reached 253,000 units in July-September 2016, up from 236,000 in the same period a year earlier. In September alone, they were at 85,622 units, with apartments and rental properties accounting for the largest share of the total, or about 45 percent (38,400 units), followed by own houses with 30 percent (25,573 units) and condominiums with 25 percent (21,339 units). Demand for construction of apartments and other rental housing has been rising due to several factors: more people have continued to migrate from provincial to metropolitan areas; and there is a growing need for tax saving by land owners or wealthy individuals to lower their appraisal values for inheritance tax following inheritance tax reform in January 2015. Since the beginning of 2015, the amount outstanding of new lending for the housing rental business by individuals has been significantly increasing and its growth rate has continued to rise (Figure 5).

Figure 5 New loans to housing rental business by individuals and annual percentage changes



SOURCE: BOJ, *Loans and Bills Discounted by Sector*.
NOTE: Total sum of accounts of domestic banks and *shinkin* banks.

Not only for loans to the housing rental business by individuals, but loans to the real estate sector in general has been growing rapidly. There was a news report[4] citing the amount outstanding of new property loans provided by domestic banks and *shinkin* banks reaching a record high in the first half of fiscal 2016. That was a second straight year increase and exceeded the previous peak in real estate lending in the first half during the bubble economy of the 1980s in Japan.

The rapid rise of real estate lending growth in Japan has triggered alarms from the BOJ and the FSA. In March 2016, the BOJ published a Financial System Report Annex Series, *Tasks and Challenges regarding Regional Financial Institutions' Loans for the Housing Rental Business and Credit Management*. The report pointed out that the rise in construction of apartments and other rental properties has been partly motivated by the supply side, and the central bank wants financial institutions to do the following:[5]

1. They develop data analysis based on information from region-specific and characteristics peculiar to each property;
2. In the initial screening, they assess whether revenue and expenditure plans are well prepared by a business owner or a house builder (the appropriateness of the outlook on occupancy ratio and stress-testing exercises, etc.); and
3. They increase interim management reviews of credit risks and develop analytical work on portfolios.

The FSA also highlighted regional banks' property lending practices in the report,

[4] Jiji Press, news article released on 16:19, 16 November 2016.

[5] BOJ (2016a). An annex of Financial System Report, *Tasks and Challenges regarding Regional Financial Institutions' Loans for the Household Rental Business and Credit Management*, 1.

Progress and Assessment of the Strategic Directions and Priorities 2015-2016, published in September 2016. The financial regulator said that the recent rapid growth in lending to the real estate sector, particularly among regional banks and second-tier regional banks, could pose a potential risk for financial stability in Japan.

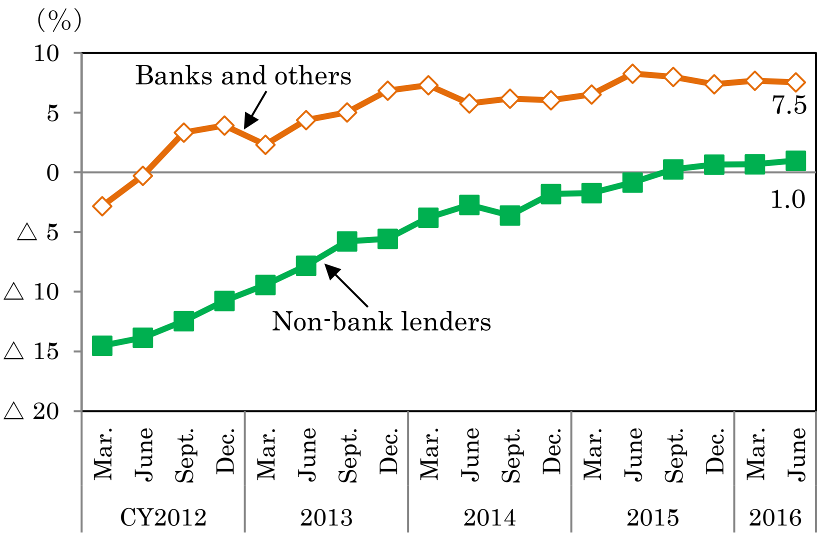
In addition, while consumer spending has not yet fully recovered after the tax increase in 2014, the use of consumer credit has been recently growing in the household sector.

In 2006, Japan revised the consumer lending law, which now includes a borrowing ceiling and a refund of overpaid interest in an attempt to tighten the lending standards to high risk borrowers. As a result, the amount outstanding of consumer credit continued to drop significantly.

But since mid-2015, consumer credit by non-bank lenders has increased, though slightly (Figure 6). Consumer credit by banks and others also rebounded in 2012, and has expanded at a 7 to 8 percent annual rate over the past year. In fact, banks are not subject to the lending law revisions, and they have likely succeeded in boosting consumer loans to individuals who have relatively high credit scores, by advertising to promote the terms for borrowers as more attractive.

Many financial institutions have put more efforts into promoting card loans because their interest rates are relatively higher than rates on mortgage loans, which have faced stiff competition. But in the meantime household debt has been growing amid sluggish recovery in consumer spending, fueling concerns some households have turned to loans to cover their living costs.

Figure 6 Consumer credit's annual percentage changes



SOURCE: BOJ, *Flow of Funds Accounts*.
NOTE: Banks and others refer to the total amount of domestic banks and financial institutions for SMEs (including the Japan Post Bank).

1.4 Conclusions

This chapter examined mainly the impact of negative interest rates on household assets and liabilities. "Abenomics" — Prime Minister Shinzo Abe's economic revival program — sent the Japanese stock market soaring, and this helped Japanese households shift some savings into risky financial assets, such as stocks and investment trusts, until mid-2015. The move was stalled when the stock market plunged. Negative interest rates were supposed to encourage households to diversify their assets, but their appetite for risk assets has lost momentum, despite lower deposit rates at banks.

On the other hand, while avoiding a surge in last-minute demand due to the postponement of the consumption tax hike, household debt was rising on the back of various lower rates following negative interest rates as well as financial institutions' strong push in expanding loans.

The FSA's report, cited earlier in this report, and the recent trends of household financial assets suggest that it has remained largely unchanged for Japanese individual investors to hold fast to the primacy of their cash and deposits. Compared with other developed countries, the FSA report said that the share of cash and deposits in the total household assets in Japan is higher and that of stocks and investment trusts is lower.

Moreover, with a rapidly aging population, the proportion of those aged over 60 holding financial assets has been rising in the entire spectrum of Japanese household assets, it said. The report emphasized the importance of promoting stable asset building among the working-age generation; fostering financial and investment literacy; and improving and disseminating the Nippon Individual Savings Account (NISA), a small tax-break investment scheme, as a vehicle for individuals to build up their assets through investment.

However, 59.5% of the NISA accounts concentrated among investors aged over 60 as of June 30, 2016, and it is unknown whether engaging in expansion of the NISA investment would broaden the base for the working-age generation to invest in risk assets. So far, Japanese households have increased their holdings of risk assets when stock markets were buoyant, and that appears far from making sound financial decisions.

There are some possible factors why the working-age generation seldom invest in risk assets. They may face more economic uncertainty ahead. They may take on excessive debt to pay for their homes and their children's education, and they may have little financial resources to make room for risky investment.

According to the *Family Income and Expenditure Annual Survey (Savings and Liabilities)*, issued by the Ministry of Internal Affairs and Communications, the household debt to income ratio among working-age families with at least two persons was 106.5% in 2015, up from 85.7% in 2005. The fact that it recorded higher rates in particular among those in their 30s (169.3%) and 40s (145.7%) suggests that working-age households have borrowed more in the absence of real wage growth, being unable to shift some assets into investment.

2. Banks' profits and the FSA's regulatory approach

The chapter 1 examined the impact of the negative interest rates on household assets and liabilities. The chapter 2 will assess how negative interest rates have affected banks' profits as well as the supervision policy of the FSA, which oversees banks and other financial institutions.

2.1 Trends of banks' profits

In September 2016, the BOJ published an analytical report, *Comprehensive Assessment: Developments in Economic Activity and Prices as well as Policy Effects since the Introduction of Quantitative and Qualitative Monetary Easing (QQE) — the Background.*

In the report, the BOJ explained the impact of negative interest rates on Japanese banks' profits. It said the major transmission channels through which the decline in interest rates, due to the adoption of the negative rate that affects the profits of financial institutions, are:

- The compression of the spread between deposit and lending rates; and
- The deterioration in the profitability of bond investments.

The reason for the compression of the spread between deposit and lending rates is that Japanese banks have a structural surplus of deposits over loans, and while there is little room for deposit rates to decline, lending rates are falling. The reason for the deterioration in the profitability of financial institutions' bond investments is that once a bond they hold matures and it is redeemed, the reinvestment return on those funds will fall under the current interest rate environment.[6]

The report cited the financial results of major banks,[7] regional banks and second-tier regional banks on a non-consolidated basis in April-June 2016. The combined net income was 780.2 billion yen, a 28% drop from the same period the previous year that was recorded at 1,076.3 billion yen. A breakdown of the decline in net income shows that net interest income decreased by 301.5 billion yen, realized gains on stock holding decreased by 136.5 billion yen, and net fees and commissions for the sale of investment trusts fell by 30.7 billion yen.

The BOJ attributed the decline in net interest income to the compression of the spread between deposit and lending rates as well as the deterioration in the profitability of bond investments, following the introduction of negative interest rates. It also cited other factors: a decline in profits due to the cancelation of investment trusts on the back of the decline in the stock prices; a decline in profits from revenues denominated in foreign currencies due to the appreciation of the yen; and an increase in foreign currency funding costs.

The BOJ noted in the report that the impact of negative interest rates on financial institutions' profits was only starting to be reflected in the financial results for the April-June quarter of 2016. Indeed, the regional banks encountered an adverse situation in the first half of fiscal 2016. According to documents, compiled financial results for 64 regional banks in the first six months of fiscal 2016, 47 banks showed a decline in net income, compared with 14 banks reporting a drop in net income in the same period from a year earlier. Of 47 banks, 38 reported double-digit drops in net income.

Moreover, 55 out of 64 regional banks reported a fall in net interest income in the first half of fiscal 2016, compared to the same period a year earlier. 51 banks also reported a decline in fees and commissions due to falling sales of investment trusts, as mentioned earlier. According to the Regional Banks Association of Japan, the combined net income of

[6] BOJ (2016b). *Comprehensive Assessment: Developments in Economic Activity and Prices as well as Policy Effects since the Introduction of Quantitative and Qualitative Monetary Easing (QQE) — the Background*, 15-16.

[7] Major banks are the 10 banks of Mizuho Bank, The Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui Banking Corp., Risona Bank, Saitama Risona Bank, Mitsubishi UFJ Trust and Banking Corp., Mizuho Trust and Banking Co., Sumitomo Mitsui Trust Bank, Shinsei Bank and Arizona Bank.

64 banks fell 13.8% to 469.3 billion yen in the first half of fiscal 2016,[8] down from 544.3 billion yen in the same period a year earlier (Table 4). The combined net interest income also dropped 4.6%, or by 71.4 billion yen, to 1.471 trillion yen in the same period, and the combined fees and commissions sank 10.4%, or by 24 billion yen, to 207 billion yen.

Table 4 Summary of regional banks' 1st-half financial results

(100 million yen)

	Figures			Percentage changes in the same period from the previous year	
	FY 2014 H1	FY 2015 H1	FY 2016 H1	FY 2015 H1	FY 2016 H1
Net business income	6,424	6,773	6,172	5.4	△ 8.9
Of which: core business profits	17,732	18,170	17,175	2.5	△ 5.5
Net interest income	15,255	15,424	14,710	1.1	△ 4.6
Net fees and commissions	2,201	2,310	2,070	5.0	△ 10.4
Other business profits	276	435	394	57.6	△ 9.2
Of which: expenses	△ 11,908	△ 11,550	△ 11,612	3.0	△ 0.5
Extraordinary profits and losses	448	1,208	472	169.6	△ 60.9
Ordinary profit	6,871	7,980	6,644	16.1	△ 16.7
Net income in 1st-half	4,531	5,443	4,693	20.1	△ 13.8

SOURCE: Regional Banks Association of Japan, *Regional Banks: Summary of 1st-half financial results in fiscal 2015*, *Regional Banks: Summary of 1st-half financial results in fiscal 2016*.

Following the introduction of negative interest rates, many regional banks have apparently tried to offset the loss in net interest income by boosting fees and commissions from more sales of investment trusts. But that didn't materialize as of the end of the first half of fiscal 2016.

2.2 FSA regulatory regime change

The FSA expressed the concept of its new supervisory approaches in two papers — *Progress and Assessment of the Strategic Directions and Priorities for 2015-2016*, dated September 2016, and *Strategic Directions and Priorities for 2016-2017*, dated October 2016. The idea was so drastic that one magazine described the shift as a "Copernican change".[9] This section will examine the details.

In September 2015, the FSA published its first annual *Financial Administration Policy*, replacing *Financial Monitoring Policy*, which began in 2013. In the new report, the FSA set

[8] The Regional Banks Association of Japan. *Summary of Mid-Term Earnings Results in 2015* and *Summary of Mid-Term Earnings Results in 2016*.

[9] The Japanese journal *Kindai Sales*, 15 October 2016.

out new policy goals as well as new policy directions with respect to financial administration.

In November 2015, the FSA set up a regional finance planning office within its Coordination Division of the Supervisory Bureau. It aimed to create a pervasive culture of customer-oriented financial services among regional financial institutions to improve the quality of financial intermediary functions.

The new planning office's major works include:

- Planning and coordinating hearings from corporate borrowers to grasp how financial institutions are perceived by them;
- Create a set of benchmark indexes that measure financial institutions' performance as financial intermediaries in order to determine their commitment to revitalize local economies, as well as establish a new approach to monitor financial institutions; and
- Work as a secretariat of the working group on better financial intermediation, as well as plan the FSA policies on regional finance.

Indeed, the FSA held hearings from 751 companies nationwide, mainly small and medium-sized enterprises (SMEs), to capture their views on the manner financial institutions have been taking.[10] It also sent out questionnaires to 15,000 micro-sized businesses and received 2,460 responses.

The findings revealed that financial institutions are still largely relying on collateral and guarantees and their business stance has remained unchanged. Moreover, there are information gaps between what corporate customers seek from financial institutions and what financial institutions have provided to their customers. At the same time, it was further noted that highly regarded financial institutions have quite a good understanding of each corporate customer's needs and challenges, and provide continuous support at all levels to improve its management, which in turn have helped bring stability to their own management.[11]

Following those surveys as well as the debate at the working group, comprised of outside experts, on better financial intermediation, the FSA put together its report, *Progress and Assessment of the Strategic Directions and Priorities 2015-2016*, as mentioned earlier.
The report included simulations, which illustrate that more than 60 percent of regional banks[12] would make losses in the lending operations and the commission business by the fiscal year ending March 2025, in the face of a shrinking population and the low interest rate environment.[13]The simulations were based on the assumption of ongoing correlation between the loan-deposit gaps and the loan-deposit spread, as well as strong correlation among deposits, loans and demographic changes. They were conducted according to an estimated population of each age group in each region.

The FSA conducted the simulations against the backdrop of falling demand in lending operations due to a shrinking population, and explained the issue in the report: "As the credit demand is likely to fall continuously due to a shrinking population in Japan and rural areas in particular, the profitability of the conventional lending business model that largely relies on collateral and guarantees or on creditworthy big firms may be fall apart over the long term… Generally speaking, small and medium-sized financial institutions don't have the leverage to take advantage of economies of scale. As a means of ensuring

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[10] Regional financial institutions include regional banks, second-tier regional banks, Saitama Risona Bank, *shinkin* banks and credit cooperatives.

[11] FSA (2016a). *Progress and Assessment of the Strategic Directions and Priorities 2015-2016*, 27-32.

[12] Regional banks include regional banks, second-tier regional banks and Saitama Risona Bank.

[13] FSA (2016a). *Progress and Assessment of the Strategic Directions and Priorities 2015-2016*, 21-22.

their survival, it is more important for them to review the sustainability of their business model at the earliest possible time."[14]

In order words, based on the assumption of the nation's changing demographics, regional financial institutions may struggle to make profits from the spread between deposit and lending rates, by simply lending to a limited range of creditworthy big corporate customers. Thus, they are urged to develop an unconventional business model. Furthermore, in an attempt to generate new income sources, while refraining from shrinking their lending margins, it is suggested some winning business models: having better understanding of local corporate customer bases; lending to their business potentials; and fostering better relationships with them.

Along the same lines, the FSA put forward a set of benchmark indexes that measure financial intermediary functions for financial institutions (Table 5). It aims to gauge their contribution to buttress customers' growth and revitalize local economies, by assessing whether they are lending based on evaluation of customers' business needs and challenges, and whether they are offering best-suited solutions, such as expertize and industry specific advice, to their customers.

The benchmarks have two parts — "common benchmarks" and "optional benchmarks." The common benchmarks are applicable to all financial institutions to assess the performance of financial intermediary functions, while they can choose the optional benchmarks based on their business plans and models. Each item of the benchmarks in Table 5 sets out several indexes.

For instance, the common benchmark (2), which says "Improve productivity of corporate customers through restructuring and other measures," has three indexes:

1. Reviewing the progress against management improvement plans of the corporate customers to which a financial institutions applies changes in lending terms and conditions;
2. The number of start-ups and second core business start-ups that a financial institution has facilitated with funding; and
3. The number of credit guarantees and the amount of such loans to corporate customers (on a parent basis) at each stage of business life cycles.

The FSA is expecting financial institutions to change their stance when making credit decisions by using the benchmark indexes. It has also said it will monitor multiple institutions within the sector to compare and identify best business practices, and will engage in the exchange of views with various stakeholders to help financial institutions to enhance the quality of their role as financial intermediaries.

At the same time, the FSA has been soul searching on its part to engage in discussion within and outside the organization on how to overhaul its approach to supervision. In its *Progress and Assessment of the Strategic Directions and Priorities 2015-2016*, the FSA explained its intentions in the following: "Despite the changing financial and economic environment, the government's financial administration has so far been unable to move away from its overly punitive mentality, like a "Financial Sanctions Agency," as Japan experienced a financial crisis in the 1990s after the burst of the asset inflated bubble economy. In order to transform it as a "Financial Fostering Agency," it is important for the FSA to identify priority issues and respond effectively in a rapidly changing environment."[15]

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[14] FSA (2016a). *Progress and Assessment of the Strategic Directions and Priorities 2015-2016*, 22.

[15] FSA (2016a). *Progress and Assessment of the Strategic Directions and Priorities 2015-2016*, 118.

Currently, the FSA has taken steps to become a more open organization by setting up a monitoring system for financial administration, in which independent experts seek outside inputs, instead of only the FSA staff, and establishing various advisory groups for better regulation and supervision. It's been also implementing initiatives to change the mindsets of the staff members.

Table 5 Benchmarks to measure financial intermediary functions

		Items	Benchmark scores
Common Benchmarks	(1)	improve corporate customers' management and help accelerate their business growth	1
	(2)	improve productivity of corporate customers through restructuring	3
	(3)	shift from an excess reliance on collateral and guarantees in making loan decisions	1
Optional Benchmarks	(1)	commitment to local communities, relationships with local companies	4
	(2)	lending based on evaluation of corporate customers' business prospects, relying less on collateral and guarantees	7
	(3)	support enhancing corporate value, propose optimum solutions according to corporate customers' life stages	16
	(4)	develop human resources	2
	(5)	provide expeditious services that meet the needs of corporate customers	4
	(6)	establish a system to enhance businesses	2
	(7)	assess business performance at outlets	1
	(8)	assess business performance of staff members	2
	(9)	empower human resources	1
	(10)	bring in outside experts	2
	(11)	cooperate with other financial institutions and make use of SME support programs	3
	(12)	profitability management	1
	(13)	status in the business strategy	2
	(14)	governance	3
Total			55

SOURCE: FSA, *The Benchmarks for the Banks' Financial Intermediary Functions*, September 2016.

2.3 Establishing operations of fiduciary duty

In October 2016, the FSA outlined a new supervisory approach in principles in its second annual *Strategic Directions and Priorities 2016-2017*. In the report, the FSA argued that if it maintains inspections that automatically prioritize strict checks for the conditions of assets and compliance with rules and regulations, it may cause adverse effects, such as curtailing corporate lending and cutting off credit lines, or fail to address emerging issues. Rather, said the FSA, it will put on a greater emphasis on examining whether financial institutions are providing high-quality financial services, whether they are establishing a sustainable business model for the future, and whether they are devoting resources to underlying root causes of problems.

The FSA's expectation is that financial institutions will create shared value with customers in three distinct ways: by providing high-quality financial services for the best interest of customers; helping to enhance the productivity of the corporate sector; and contributing to steady asset accumulation of the household sector. As a result, those would serve to grow strong customer bases and secure stable revenue sources for financial institutions.

Specifically, the FSA is demanding that the financial industry in Japan fulfil the principles of fiduciary duty. This is because the FSA seems to strongly suspect that financial institutions do not fully disclose and explain all product fees and charges as well as risks when selling risky assets, such as investment funds, and financial institutions prioritize selling products for high commission fees, with little regard for customers' interests.

To enforce this direction, the working group on financial markets of the Financial System Council, an advisory body to Japan's prime minister, began looking for ways to enhance disclosure on commission fees and charges of all products and services and to provide an easy-to-understand explanation to customers. The aim is to establish financial accumulation of household assets as well as to ensure financial institutions fulfil fiduciary duties.

2.4 Conclusions

It had long been said that the regional financial industry in Japan could face serious structural problems against a backdrop of a weaker loan demand from the nation's aging and shrinking population. But as discussed above, even before a tide of demographic changes could swamp the sector, regional banks were hit hard already by a squeeze on lending margins from the BOJ's radical monetary policy. Many of them reported declines in net income in the first half of fiscal 2016 from the same period a year earlier.

The FSA presented simulations showing that if regional financial institutions maintain the current lending practices that rely on collateral and guarantees, the majority will suffer losses in the years to come. It has urged them to embark on a more sustainable business model by underwriting loans based on proper assessment of their local SMEs' business prospects.

Encouraging reginal financial institutions to place a greater emphasis on having deep roots in their home regions and lending more to local SMEs is in line with requiring them to draw up their own plans on region-based relationship banking efforts. They are also asked to make their region-based relationship banking plans publicly available. This is how they have been directed by *the Action Program concerning enhancement of Relationship Banking Functions*, issued on March 2003, and *the New Action Program* *ensuring further promotion of region-based Relationship Banking Functions*, issued on March 2005.

In addition, the Japanese government's policy on regional revitalization, started in 2015, puts emphasis on cooperation among industry, academia, government and financial groups, and has asked regional financial institutions to actively participate in drawing up regional revitalization strategies.

Even without such requests, regional financial institutions have long been playing a pivotal role in invigorating local economies. Yet, bearing in mind the FSA's stringent inspections which prioritized checking conditions of assets and narrow compliance with minimum standards, they might have been unable to satisfy the needs of their local corporate customers. The FSA has committed to reform its regulatory approach, and it seems to be putting an end to the situation where it is unclear whether it steps on the accelerator and the brake pedal at the same time.

■Afterword

The year 2016 marks a turnaround for financial policies in Japan: the BOJ adopted a negative interest rate policy for the first time in its history; and the FSA set forth its regulatory regime change. In the light of these developments in the Japanese financial markets, this report will conclude with the author's comments.

One main concern is that, as attention has been given to lending practices to SMEs, it may spur more competition among regional financial institutions, which could hurt their business prospects. Regional financial institutions had essentially segregated themselves according to the size of corporate customers. However, if larger regional financial institutions begin aggressively poaching corporate customers from smaller rivals, while it may benefit customers for having more lenders, regional financial institutions may face greater competition, and their profitability could be dragged down.

The BOJ's *Financial System Report*, issued in April 2014, pointed out the effects of an increase in regional banks' loans outside their home regions. The majority of regional banks and second-tier regional banks have increased loans outside their home regions to expand and ensure their lending volumes. For financial institutions that need to compete with incoming banks from other regions, this means a decline in their share of companies with high credit scores, which may expose them to more credit risks.

Indeed, the report said that data such as the ratio of normal loans to total loans show that *shinkin* banks that need to compete with incoming banks have fallen behind other groups of banks in improving their loan asset quality.[16] In this case, the majority of such loans extended were to companies with relatively high credit scores, and that is different from what the FSA has been asking for. Yet it indicates nonetheless that the cost of attention given to loans to SMEs is likely to be more intensified competition among regional financial institutions.

Here, I would like to share my idea of how we could do to put community at the heart of our businesses; creating a new financial scheme, where the households can actively invest in companies that offer optimum solutions to regional problems through regional financial institutions, though they may not be able to achieve strong profits.

For instance, the Netherlands has the Green Funds Scheme (GFS), a unique way of promoting investment to support environmentally friendly projects. The Dutch scheme encourages investors and savers to invest in green funds at designated banks that finance environmental projects. The banks, mainly subsidiaries of major banks, assess the

[16] BOJ (2014). *Financial System Report*, 58.

prospects of green projects and apply a certificate for green projects from a governmental organization. Under the scheme, the interest rate that investors and savers receive is lower than conventional rates so that the banks can offer lower rate loans to certified green projects, which in turn give investors and savers a tax credit from capital gains and incomes.[17]

Following this example, I believe Japan could broaden targeting areas beyond environmental issues, and create a framework that allows individuals who are eager to help creating a better future in their home regions to make investment that truly deliver best-suited solutions to their communities. In an attempt to live up to the expectations of individual investors, financial institutions need to enhance transparency, for example, by disclosing information about projects that would be invested in. The Dutch GFS was first originated by private initiatives, which then invoked strong support from the government for sustainable economic growth.

In Japan we expect regional financial institutions to make themselves drivers to connect local companies and demonstrate their commitment to create an enabling environment for business to invigorate local economies. The national government as well as municipalities across the country could also set the ball rolling by extending a helping hand wherever needed.

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[17] For details, see Yukari Shigeto (2005). *Green Fund Scheme and Toriodos Bank — The Dutch green funds that finance environmentally friendly projects.*

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