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JAPAN FINTECH WHY THE TIMING IS NOW

A Macro Perspective

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INTRODUCTION

Made in Japan

When it comes to ecosystems where trust, stability and integrity are non-negotiables, Japan takes pole position. The current socioeconomic dynamic of Japan as a developed democracy and nation state is more relatable with nation states like the UK, Germany and the US, as opposed to city states like Singapore and Hong Kong.

Remember: Japan has always had innovators and excellent business leaders. These entrepreneurs revealed their potential in the aftermath of the second world war, giving rise to companies like Honda and Sony. This pattern was similarly observed during the Meiji Revolution, when the end of the Samurai era ushered in a new generation of political and economic leaders, leading to the formation of conglomerates like Mitsubishi.

The social construct of corporate Japan has, however, struggled to evolve with the times, with innovation bearing the brunt of Japan's inertia.

In this report, we dive into the ways in which Japan's landscape is now changing and why we see an opportunity in disguise for innovators and investors looking to enter this unique market.

Internet era innovation: The startup problem

The Japanese Banking Crisis in the 1990s followed as a direct result of the asset bubble bursting in the late 1980s. The economy slowed down and a massive increase in Nonperforming Loans (NPLs) forced government intervention, resulting in bank consolidations and deregulation in the form of the Big Bang reforms in November 1996[1].

These reforms allowed non-bank companies to play a significant role in the financial sector. Japan Net Bank (JNB) became Japan's first internet-only bank in 2000, followed by Sony Bank, eBANK and IY Bank in 2001. Yet, none were runaway successes .

The Japanese were also ahead with innovations like the i-mode (by NTT DoCoMo), launched in 1999, and Osaifu Keitai (Mobile Wallet) in 2004. These were considered revolutionary for its time and triggered immense interest from the rest of the world, but this success could not be replicated overseas.

The prime reason the above innovations failed in the global arena can be summarised as a lack of openness, or in other words, a lack of interoperability. Closed or proprietary implementations were a sure shot way to stunt innovation and scalability.

These case studies point to a major weakness inherent in mature markets like Japan. In his book, The Innovator's Dilemma, Clayton Christensen writes that incumbent players have a strong disincentive from adopting newer technologies which could undermine their current market dominance.

> *"The reason [for why great companies failed] is that good management itself was the root cause. Managers played the game the way it's supposed to be played. The very decision-making and resource allocation processes that are key to the success of established companies are the very processes that reject disruptive technologies: listening to customers; tracking competitors' actions carefully; and investing resources to design and build higher-performance, higher-quality products that will yield greater profit. These are the reasons why great firms stumbled or failed when confronted with disruptive technology change."*
>
> **Clayton Christensen**

The system of cross shareholdings of large Japanese bank shares by insurers, corporations, employees, and even other banks, resulted in independent shareholders having little sway on the governance of these banks. There was no accountability and pressure to maximise profitability.

Arguably, the corporate culture of lifetime employment also emerged from here, where so-called "salaryman C-suites" who climbed the corporate leadership ladder—not necessarily on merit—unduly emphasised governance, security, and integrity, contributing to the Japanese economy's stagnation over the past 35 years.

But this is where we see opportunity.

At the other end of the spectrum, were the startups, yearning to penetrate and disrupt the market. The challenge startups and regulators faced was that they had novel methods of conducting business but no equivalent regulations in place. The existing legal framework was not cut out for state-of-the-art technologies and usually led to dismissal of such innovations due to lack of understanding and a predisposed risk aversion of the unknown.

The concept of a regulatory sandbox, which allows live experiments, in a controlled environment under the regulator's supervision was just what Japan needed. Here both the innovator and the regulator could learn, and failure was acceptable. The first such regulatory sandbox was setup by the U.K. FCA in 2016[3].

Recognising this dual challenge of the innovator's dilemma and the regulators' fear of the unknown, the Japanese government set up the nation's own **regulatory sandbox in June 2018**[4].

FOSTERING COLLABORATION

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> *Japan's Regulatory Sandbox team acts as the single point of contact, where entrepreneurs are provided with prior consultation to design and develop their prototypes. This is then submitted to the relevant ministries as directed by the team. These ministries review and provide approvals based on consultation with a specialist committee for Innovative Business activities which comprises of experts from various fields like Legal, AI, Blockchain, economists, statisticians, management etc. If there are no regulatory hurdles the entrepreneurs can proceed to commercialization. Where changes are needed in regulation, the ministry will initiate the process accordingly.*
>
> *The Japanese Regulatory Sandbox is not just for the financial sector but also industries, including Health Care, Mobility, Transportation where, cutting edge technologies are making inroads.*
>
> ***Financial Services Agency, Japan***

The FSA champions innovation

Even after the deregulation of the banking sector in 1996, it was evident that technologies with proprietary mindsets wouldn't stand the test of time. Open but secure architecture built on data which enables collaboration and fosters innovation was needed.

The FSA realised that the nation needed a policy that enforces democratisation of access to relevant financial data and processes. The Amendment to Japan's Banking Act in 2018 imposed obligations on banks to make efforts to open up their APIs to third-party providers by 2020. Until then, primitive screen scraping technologies were the norm[5].

As a result:

- Japanese banks including the mega banks have partnered with technology companies to establish open networks in the digital payments space.
- All three mega banks have demonstrated their commitment by setting up digital champions in the role of Chief Digital Transformation Officers (CDTOs).
- Japanese banks partnered with several FinTech startups to leverage AI, IoT, DLT, and more to provide all-inclusive, efficient, and user-friendly financial services

Now, there's more ...

The FSA had, for the first time, introduced the Financial Service Intermediary Business, which allows distribution of financial products and services of banking, securities, money lending, and insurance with a single license, effective November 2021.

Imagine that you could see and manage a personalised dashboard across all your finances, savings, spending patterns, insurance coverage, credit status and more, all in a single app. Beyond this, you are only limited by your own imagination.

The VC Ecosystem

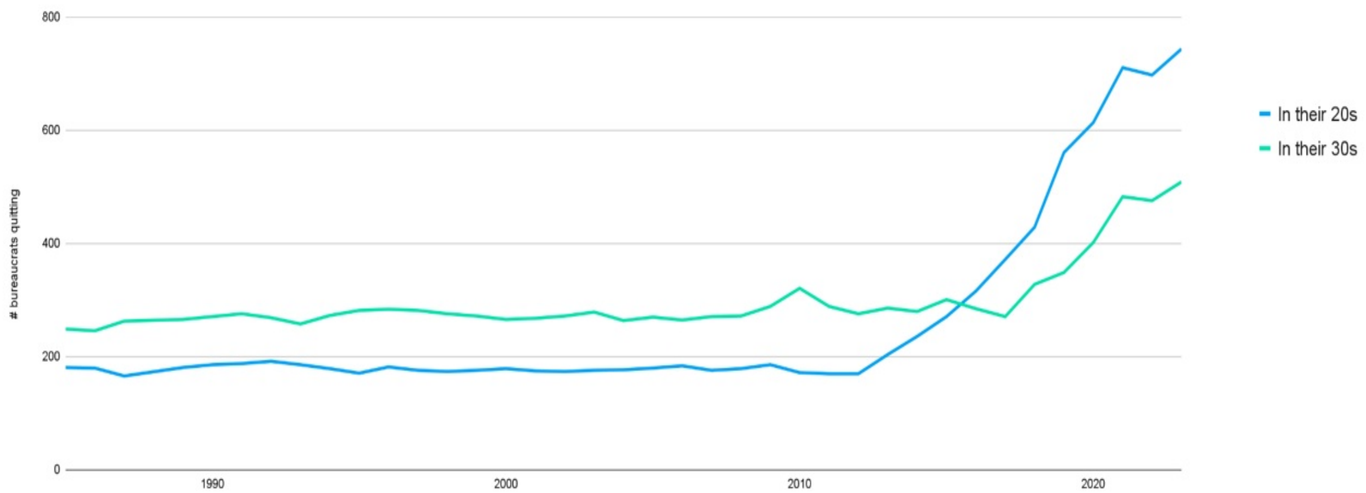
One of the biggest drawbacks of the aforementioned system of lifetime employment, is that financial institutions face difficulties restructuring their teams. While the government keeps pushing for adoption of cutting-edge technologies, financial institutions lack the organizational bandwidth to maneuver such change. There is a significant gap here, *and hence huge entry opportunities for foreign companies*.

In November 2022, Prime Minister Fumio Kishida spoke of a “new form of capitalism” with renewed focus on open innovation and disruptive business ideas via a two-pronged policy of growth and sustainability. The Prime Minister stated that investing in startups is the third pillar in this “new form”.

The aim is for a tenfold increase in annual investments for startups, to around JPY 10 trillion by fiscal year 2027. He noted that even at the University of Tokyo, Japan’s oldest university best known for producing leaders for government and major corporations, he sees change. It seems more than 300 venture companies are being created by the University.

More bureaucrats are quitting ministries and government offices to join startups

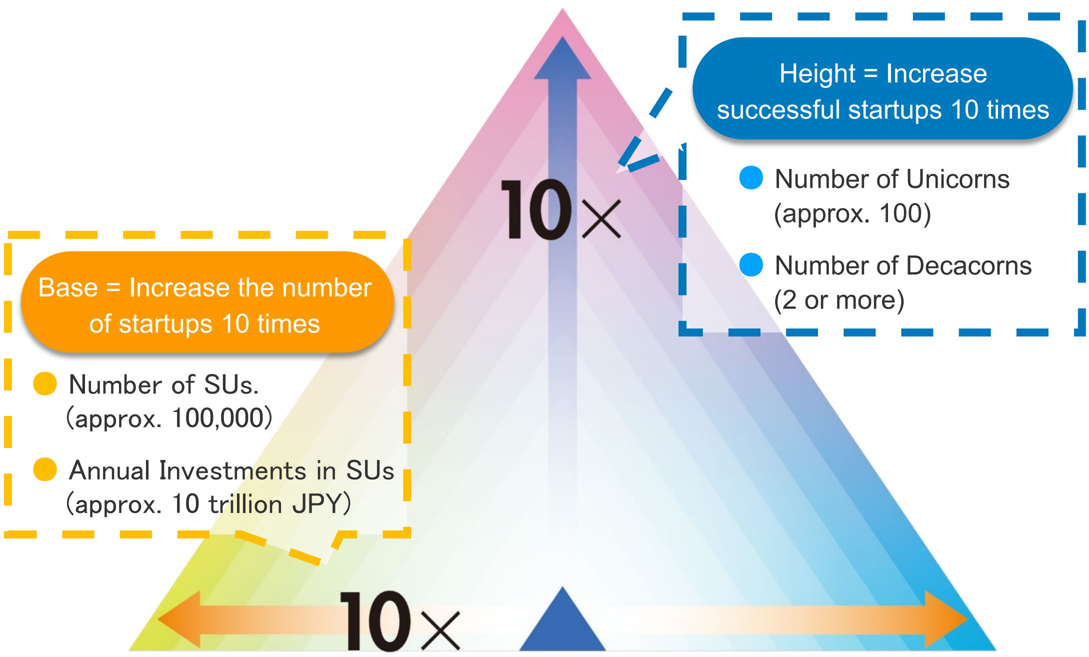
# of national bureaucrats quitting by age group



Source: Japan Optimist / Jesper Koll (Original Source: Prof. Ulrike Schaede based on Cabinet Office & National Personnel Agency with added years compiled by Jesper Koll)

The Japan Business Federation a.k.a. the Keidanren proposed their Startup Breakthrough Vision aiming for 10X10X[6]. The proposal aims to increase both the base number of startups and the number of successful startups by 10 fold. In summary, they want large corporates to aggressively explore opportunities with startups and help in the formation of 100,000 new businesses.

2027: Towards a world of 10X10X



Source: Keidanren, Policy and Action, Jan 2024 (Translated from Japanese)

In alignment with this goal, Japanese mega banks are aggressively growing their pipeline of investments for startup funds.

Mitsubishi UFJ Financial Group has partnered with another lender to set up a venture debt fund which allocates up to JPY 20 billion focused on Japan and USD 250 million on Europe[7].

Mizuho Financial Group has already established a series of growth support funds since 2013, with the latest one being a JPY 15 billion venture capital fund called "Mizuho Growth Support Fund No.5", which is designed to support the startup ecosystem[8].

Sumitomo Mitsui Financial Group has set a goal of deploying 135 billion JPY in investments in startups over the next 3 years[9].

The VC industry in Japan originally stemmed from SME-focused non-bank finance.

Standard templates for investment contracts in Japan tend to still include stock buy-back rights and management guarantees despite being equity investments. These conditions are highly incompatible with startup investments.

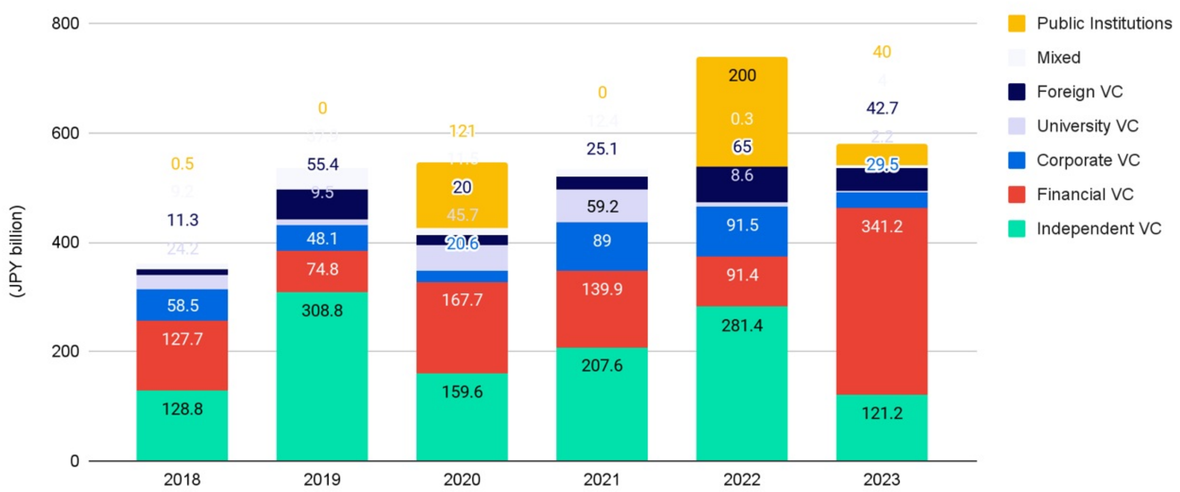
The VC industry, including these old practices, requires disruption in the future. Given this, there are significant opportunities for foreign General Partners (GPs) to enter Japan, not to forget the continued low cost of capital in Japan.

Why else is the timing excellent for VCs ?

Governments across the world, including Japan, implemented massive stimulus packages during the pandemic. Lockdowns and other restrictions on consumer spending on travel, dining out and leisure activities led to a record glut in cash and interest rates came down to historic lows.

Valuations of startups shoot up in low interest rate environments. Once the pandemic was past us, governments started tapering and eventual rate hikes led to a drop in these valuations. Right now, rates have peaked out in the US, making startup valuations attractive once again.

New Funds by Investor Type



Source: INITIAL - Japan Startup Finance 2023

The macro landscape

Households

Japan is among the most well-banked countries in the world—with 98.5% of the population being banked as of 2022[10] . Having said that, the Japanese are also risk averse when it comes to personal investments. The experience of the asset bubble burst left a deep scar on Japanese society. Businesses and individuals became more risk averse, hesitant to invest or borrow money for fear of repeating past mistakes.

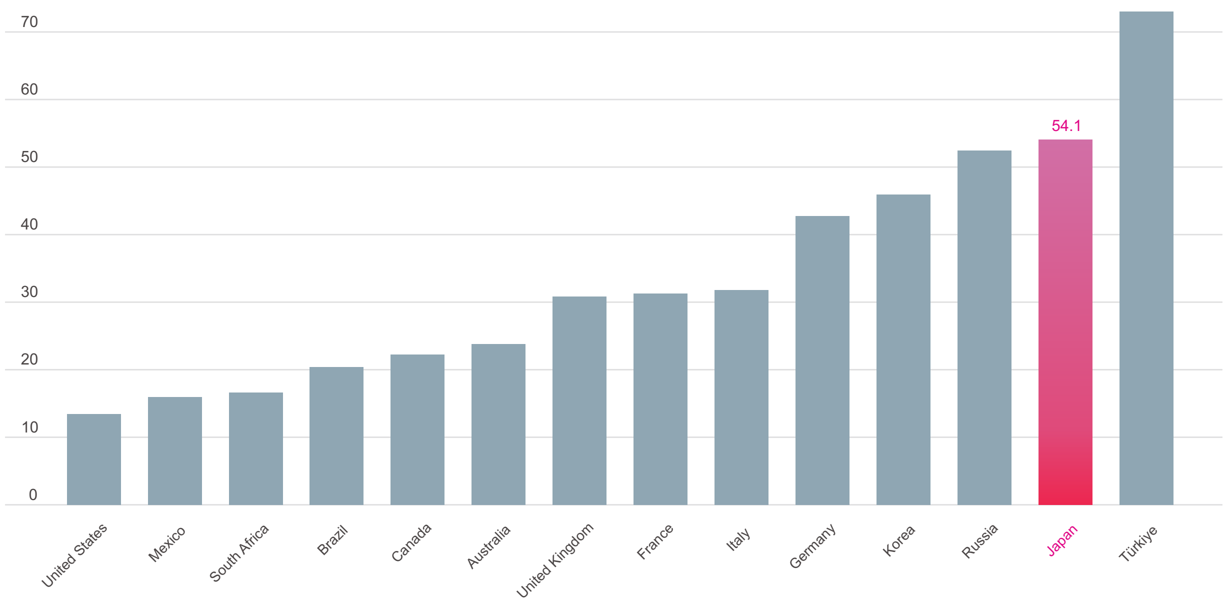
Despite this, credit card usage is high, but their spending patterns do not trigger revolving credit. The flip side to this being that the Japanese are meticulous about their spending patterns and would welcome modalities which provide a holistic view of their finances across the various types of financial services they use i.e. banks, insurance, credit, retail shopping and so on.

Japanese try not to live beyond their means and do not take on excessive debt. This does not work out well for credit businesses, unlike other countries where credit thrives. This has also led to huge coffers of untapped liquid household assets.

OECD (Organisation for Economic Co-operation and Development) data as of 2022 shows that cash and deposits formed about 54.1% of household assets in Japan, the highest (except for Turkey) among the G20 nations which are part of the OECD. In comparison, that ratio is about 13.4% for the US, 30.8% for the UK and 34.1% for the EU.

There is plenty of untapped potential for innovative startups in the PFM (Personal Financial Management) space once they understand the Japanese mindset and approach to risk management.

Household financial assets



Source: OECD

Corporates and activist investing

Shigeki Morinobu, Senior Research Fellow at the Policy Research Institute of Japan's Ministry of Finance wrote about the financial trends among Japan's large corporations, observed by the Government Council for the New Form of Capitalism. The Council noted that over 2 decades,

from 2000 to 2020, ordinary profits of Japan's large corporations rose 91.1% (up ¥17.7 trillion) and dividends rose 483.4% (up ¥16.8 trillion). Staff costs decreased by 0.4% (down ¥200 billion), and capital investment fell 5.3% (down ¥1.2 trillion). Accumulated retained earnings rose by a full 175.2%, an increase of ¥154.1 trillion[11].

It seemed like corporates were keener on rewarding shareholders than giving back to employees, which is a sign of short-term shareholder appeasement through dividends rather than reinvestment into medium to long-term and fundamental business portfolios.

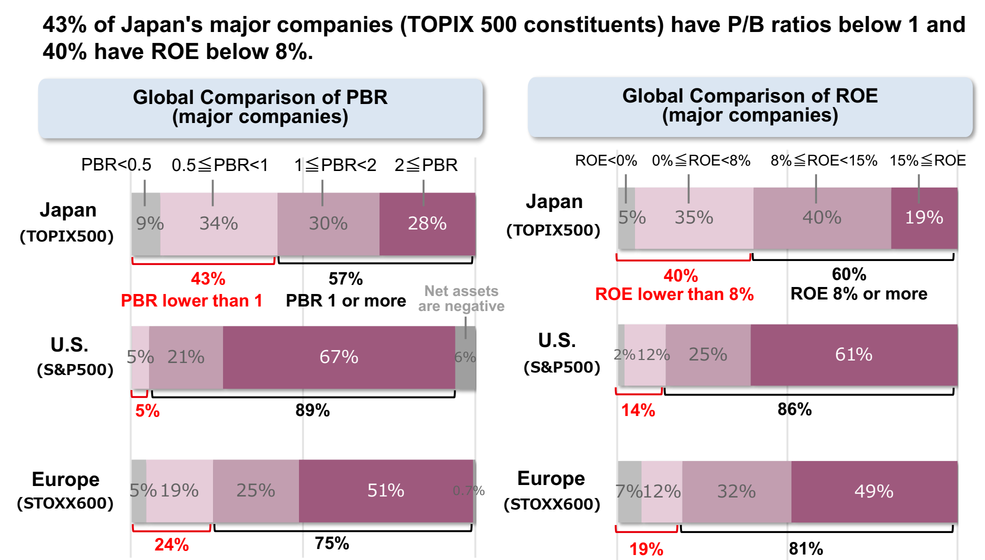
Cutting costs and increasing dividends don't require strong leadership vision and transformative power.

PM Kishida's recent push to up wages to kickstart the virtuous cycle of growth and set the uninvested cash reserves in motion are essentially an urgent call for a change in corporate behavior. In fact, these calls have started materialising. Just last month (March 2024), Japan's largest corporates agreed to wage hikes of 5.28% as per the Japanese Trade Union Confederation, the highest in 33 years[12].

In March 2023, the Tokyo Stock Exchange (TSE) requested that all listed companies on the Prime and Standard markets take action to implement management that is conscious of the cost of capital and the stock price.

Starting January 2024, the TSE publishes monthly the list of companies that have disclosed information in accordance with this request to inform investors of who is taking proactive action. Companies with a PBR (Price to Book Ratio) consistently below 1x (i.e., not achieving capital efficiency in excess of their cost of capital OR achieving capital efficiency in excess of their cost of capital but future growth potential is not adequately expected by investors) are required to disclose their policies and specific initiatives for improvement.

International comparison of PBR and ROE



Note: Compiled by TSE based on Bloomberg data as of July 1, 2022.

Furthermore, many overseas investors cited a complete lack of information as a major deterrent to invest in Japan following which the TSE also asked for an expansion of English Disclosure Practices and to eliminate the time lag between publication of Japanese and English documents.

A confluence of factors

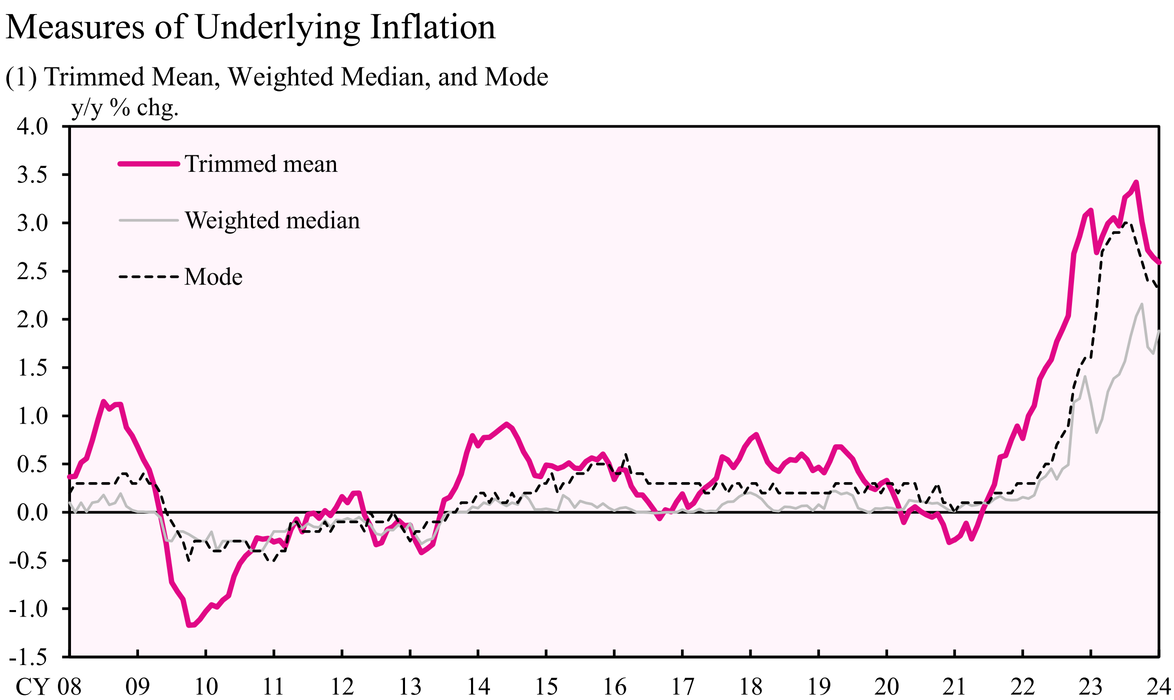
The sections above highlight how Japan's public sector in partnership with the private sector has set things in motion.

Japan's year-on-year Consumer Price Index (CPI) has been hovering around 0% over the past 3 decades. But in the recent 2 years, this has shifted into healthy positive territory.

In September 2023, the trimmed mean (one of the measures of core inflation by the Bank of Japan (BOJ)) touched 3.4%; in January 2024, this figure dropped to 2.6%, falling into the ballpark range typically targeted by most developed nations.

The March Bank of Japan meeting saw a historic move away from its Negative Interest Rate Policy. A rate hike in Japan has not been seen since 2007.

Inflation in Japan



Notes: 1. The CPI figures exclude the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs. The figures from April 2020 onward are estimated by the Research and Statistics Department, Bank of Japan, and exclude the effects of measures such as free higher education introduced in April 2020. The same applies to the chart below.
2. The trimmed mean is obtained by excluding the upper and lower tails (here, the 10 percent tails) of the price change distribution adjusted for item's weight in the CPI. The weighted median is the weighted average of the inflation rates of the items at around the 50th percentile point of the distribution. The mode is the inflation rate with the highest density in the distribution.

Source: Bank of Japan

ABOUT THE AUTHORS

Japan had a slow but steady growth in real GDP over the past 3 decades. Despite a declining birth rate, the labor force population is at its highest in the same time period. Most of it attributable to the rise of female participation, which is now almost at 45%[14].

We already covered the staggering amount of liquid cash and deposits sitting within household assets and within corporate retained earnings. PM Kishida has stressed the need to overcome underinvestment in R&D and a push to increase wages at a faster pace, which has seen a start.

Last month, the Nikkei crossed its all-time high. Yet, the consensus is that the valuation of Japan is cheap at P/E multiples of 15 to16. No doubt, the JPY has weakened 30% over the past 2 years, but as Jesper Koll, Economist and Investor rightly put: Japan is cheap but not poor! [15]

Japan today is home to policymakers with the right level of commitment, support from corporate-backed VCs and an immense amount of untapped capital in both individual and corporate coffers. Innovators need just bring their creativity and business acumen, because the time is right, right now.

I write about Capital Markets and Fintech

The co-author **Mukund Tatipamula** is the Chief Operating Officer and Head of Hybrids Markets for TP ICAP Japan based in Japan. He is also an Advisor at Elevandi Japan.

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The views expressed here are their own and do not necessarily reflect the views of company or its staff.

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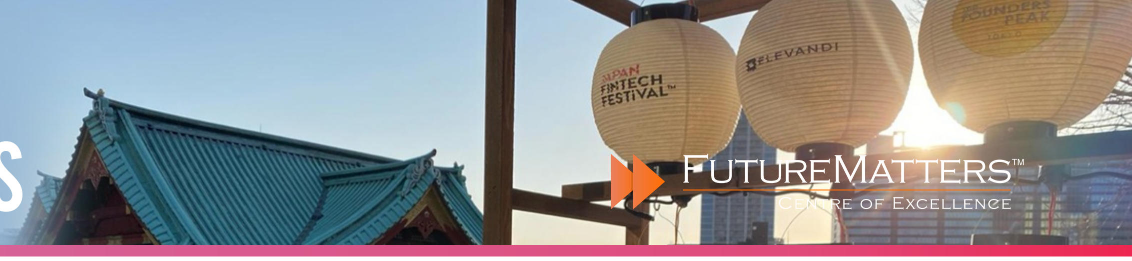

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