Restructuring Japanese Business for Growth

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7. FOREIGN FIRMS IN JAPAN’S SECURITIES INDUSTRY IN THE 1980S AND POST-BUBBLE ECONOMY

STRATEGIES FOR COMPETITIVE SUCCESS IN JAPAN’S FINANCIAL SERVICE SECTOR

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ABSTRACT

Foreign Investment Strategies in Japan’s Securities Industry in the 1980s: Criteria for Success.

This paper examines strategies foreign firms used to enter Japan’s volatile and changing securities and investment banking markets during the 1980s and their subsequent success in the post-bubble economy. Its purpose is to identify criteria needed for long-term competitiveness in Japan’s financial service sector. Some dramatic differences in competitive performance even among well-financed and well-known global companies are explained. The author postulates that due to their administrative heritage, Japanese firms are quick and effective imitators. This tradition means they price and offer services aggressively to protect and maintain client relationships and market share rather than profits. They will use existing business to cross-subsidize new or peripheral activities, often pricing below cost. Therefore, foreign financial firms investing in Japan generally only succeed by offering products Japanese competitors cannot easily emulate.

The paradigm is that merely entering and competing in an established Japanese market, even if it is growing or changing rapidly, is difficult and rarely produces good results except with a proprietary product, technology, or service. Further, to create a sustainable advantage, one must continually introduce innovations from outside Japan to control, define and influence the market’s competitive evolution. This extends the Vernon-Krugman model of continual product innovation to Japan.

and its financial service sector. Failure to achieve this usually leads to declining profitability with many firms forced to exit. This often happens when emulation is relatively easy or innovation less important. Standardization makes this even more likely. The analysis—especially for derivative products—supports the paradigm’s hypotheses as regards foreign investors in Japan’s financial markets as they experienced rapid development and intense competition due to regulatory and technical change. This has implications for foreign securities firms still competing in the post-bubble economy as well as for insurance companies formulating strategies to take advantage of recently negotiated liberalization or pension and investment management companies anticipating the next wave of regulatory change.

INTRODUCTION

In the early 1980s, many foreign securities firms pressured the Japanese government through diplomatic channels to open Japan’s large securities markets to them. After hard negotiations, the markets were liberalized and many entered in a rush. However, even before the collapse of the bubble only a few were profitable, and even fewer have been successful in the post-bubble environment. Again in 1994, the U.S. has pressured Japan to open its insurance sector. In addition, they are requesting changes permitting foreign pension and money managers better access to Japan’s large and rapidly growing asset management business. However, before executives pushing for such liberalization rush in, they should carefully examine their entry and long-term growth strategies in light of the experience of foreign securities firms in the 1980s and commercial banks in the 1970s since few of those firms who responded to similar clarion calls have been successful. Indeed, the majority lost money and several exited a few years later. This paper in turn seeks to assist these managers by identifying some apparent strategic criteria for success through an examination of various strategies used by foreign firms entering Japan’s securities industry in the 1980s and their success after the bubble.

THE PATTERN OF COMPETITION IN JAPAN

However, it is helpful to first understand a common pattern of Japanese corporate development and competition. This is familiar to many in manufacturing, but similar elements are found in financial services. In this model, most large successful firms developed first by importing products and technology from abroad, producing for local sales, improving the product and production process, then exporting, first to LDCs and finally to more advanced countries. This development was supported by rapid investment and aggressive pricing to build volume and global market share since it was difficult to establish product differentiation in markets served by several producers using similar technologies. This pattern has been repeated in a series of more technically sophisticated and higher value added industries and services starting with cotton textiles, extending to steel and ships, then to cars and earth moving equipment, and next to computers, semiconductors, and financial services. (See Abegglen and Rapp, 1970 and 1972; Abegglen and Stalk, 1985; Baba, 1989; Rapp,
1992 and Rapp, 1993.) Japanese firms are thus quick and effective imitators (Baba, 1989 and Rapp, 1992), and use price as a competitive weapon. Yet, dumping accusations in industries such as TVs, automobiles, steel, semiconductors, textiles, and banking indicate the domestic Japanese market has been used to subsidize foreign market penetration. Further, excessive protection in part of a service/product/process chain can subsidize a whole series of related products, services and technologies, including their sale abroad, e.g. ammonia based fertilizers’ support of the ammonia based chemical chain (Rapp, 1986) or fixed stock commissions’ support of Euro-market initiatives. These situations are well appreciated by foreign executives in manufacturing due to competitive export pressures. What is less known is companies in banking, securities, insurance, pension management, etc. have similar administrative heritages and compete on a similar basis. This has implications for foreign firms competing with them globally but even more if it is in Japan though a subsidiary, branch, or representative office.

Another element of this competitive pattern is firms generally offer a full range of products or services, even though it is usually more costly compared to a limited line (Abegglen and Stalk, 1985). Yet, major appliance, auto, and steel companies as well as banks, securities firms, and insurance companies directly or through affiliates present a full offering. More importantly, when a domestic or foreign competitor introduces a new product, it is quickly copied. SONY’s Walkman was soon followed by Sharp, Matsushita, Toshiba, Hitachi, and Sanyo. Similarly, Honda’s entry into luxury cars was followed by Toyota and Nissan and then Mitsubishi and Mazda while P&G’s introduction of Pampers brought competitive products from Unicharm and Kao. In financial services, the introduction of savings policies by Tokyo Marine was quickly emulated by both other casualty companies and life companies while Merrill Lynch’s introduction of a movie financing was soon offered by Nomura (Glossary). Among manufacturers the cost of such expanded lines are controlled by acting mostly as assemblers using common subcontractors (Smitka, 1990 and Fruin, 1992). Financial service firms establish either specialized subsidiaries using retired personnel or add it to items sold by the sales force with some increase in support facilities.

THE PARADIGM

Still, additional cost and effort is required. What is puzzling from a U.S. viewpoint is why they would maintain a diversified line in such a competitive price sensitive market? The answer lies in “competitive compulsion” or intense “follow the leader” behavior described by Ohmae (1991). In addition, Rapp (1993) notes a strong motivating factor in Japanese foreign direct investment (FDI) has been reluctance to risk a Japanese competitor gaining cost or market advantage or as importantly, obtaining access to a major customer overseas which could be developed into a domestic or global relationship. This feeling is especially strong within a group or keiretsu whether it is a horizontal one such as Mitsubishi and Sumitomo or a vertical one such as Toyota and Hitachi and explains the frequent complaints by foreign businessmen who have tried to market these firms whether it is auto parts or pension
management (US-Japan Business Council, 1993; Quick Research, 1993; Rapp, June 1993). With this background the paradigm can be stated: Firms often offer products or services to protect market share or a client/group relationship rather than to make a profit. They consciously use existing business to cross-subsidize this, frequently pricing at or below cost (Ostrom, 1993). A Sumitomo banker discussing their entry into Asian project finance with the *Far Eastern Economic Review* states it clearly: "For U.S. banks it is a core business. For us, advisory services are to keep the relationship. If we do not have the ability, we lose the confidence of our clients," (*FEER*, 10/6/94).

This pattern of competition is a few businesses and important relationships for those activities where firms generate profits. Many ancillary products and services, though, are offered to encircle the customer from potential competitors. In these areas, the firm breaks even or loses money. The overall rate of return may be no different than Western counterparts trying to equalize returns across businesses. The competitive behavior and resource allocation, though, are different. Resources are allocated disproportionately to core businesses and clients where firms are quite competitive, whereas peripheral businesses are run as "service" or loss leaders. Market share in core businesses or relations is substantial whereas for peripheral businesses it is minimal. These may even be sourced from neutral suppliers or industry-wide subcontractors. Sales to key customers and market share in core products will be defended fiercely because of the company's total commitment to them combined with its drive for firm survival (Porter, 1992 and Rapp, 1992). Holding market position in core businesses depends primarily on maintaining client relationships through rapid emulation and cost position rather than innovation and product development. Such tactics pressure competitors' cash flow, while one can exit peripheral businesses if they prove temporary. A foreign investor must deal with this environment. But it demands an articulated entry strategy defining an advantage based on technology, cost, and market position. This is particularly true in financial services where there are multiple competitors with similar resources, product and transaction knowledge travels quickly and advantages cannot be maintained through patents or trade marks.

**FOREIGN FIRMS AND THE PARADIGM**

Foreign firms are by definition outsiders; so they do not usually represent a threat. Yet, competition in peripheral areas is severe except for very efficient producers, because with everyone offering them, they are likely to be "commoditized". Thus, foreign investors can only succeed with a new product or service not easily emulated by Japanese firms. If it is new, it will not hurt anyone's existing core business. If it is not easily emulated, then other Japanese firms will not offer it, and it will not represent an entry threat to another Japanese firm's customer base. Foreign firms that can establish and sustain a competitive position, can be thus very profitable. This is because market returns to Japanese firms are based on the total competitive environment. However, foreign firms are not expected to offer the full range of services, giving it

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Still, to create a sustainable advantage requires a foreign firm not only establish a market but continue to define and influence its competitive evolution. Other wise imitation and price based competitive compulsion is a risk in what Japanese see as a peripheral product. Often this goal is met by continually introducing innovations from abroad, provided they remain competitively important. This is especially true once growth slows and price pressures develop. Examples of such success are IBM, Coca Cola, McDonald’s, Kentucky Fried Chicken, Motorola, Marlboro, Goldman Sachs, Salomon, AIU, Visa, American Express Card and Amftrac. In cases where emulation or substitution is relatively easy, though, or outside innovations are competitively less important, foreigners lose their advantage. Prices and market share can then drop rapidly. The foreign investor becomes much less profitable and may have to exit since it cannot compete with large Japanese companies prepared to give the product or service away at or below cost. Standardization accelerates this since Japanese competitors are excellent at imitation, mass roll-outs, and constant improvement. This model is thus a logical extension to financial services and the Japanese market of the Vernon–Krugman hypothesis (1966 and 1979) concerning international product cycles. Under their hypothesis constant innovation is seen as the driving and dynamic motivation for shifts in comparative advantage, with Krugman arguing that the innovator can only maintain its advantage by constant rather than one-shot innovation.

Once emulation and standardization is complete, market positions stabilize, but without foreign competitors. Thus, entering Japan and competing in an established or high growth market without a proprietary product, technology, or service that can be constantly improved is difficult and rarely works. The result is foreign firms are usually either quite profitable or lose money. Further, since Japanese firms will compete on price, one must keep costs under control relative to potential competition, even if one can sustain an advantage for other reasons.

FINANCIAL SERVICES AND THE JAPANESE SECURITIES INDUSTRY

This analysis of how large Japanese firms compete is consistent with other aspects of Japan’s financial services sector, such as the main bank system. Under this paradigm, one would anticipate the results of Caves (1976); Uekusa (1987); Horiuchi, Packer, and Fukuda (1988); and Weinstein and Yafeh (1994) that main banks have higher returns on relations with core or bank group related customers than with other clients. Similarly, given fixed commissions for stocks and the fact over 70% of shares are held by corporations and financial institutions, securities firms are always under pressure to reduce prices by returning excess earnings as give backs or special services (Zielinski and Holloway, 1991). The hara-kiri swap noted below in the Investment Banking Product List where Japanese banks swapped yen for dollars at a loss to obtain Euro-bond management positions with major customers is another manifestation of this.
Similarly, when the author solicited Mergers and Acquisition (M&A) business from Japanese banks and securities firms in the 1980s, he discovered all banks and securities firms had M&A departments no matter how small. However, only a few, including IBJ, LTCB, and Mitsui, actively searched for transactions and charged fees. Others were passive, waiting for a client to ask for assistance. They would then find an investment bank, usually foreign, to help, but would wave fees as “service.” The idea for the latter group was that they could then advise clients they had M&A capability, i.e. they could offer this as a service to core clients. Therefore, their competitors would be prevented from soliciting business from these core clients based on the bank or securities firm not being able to offer the M&A support the client needed. This tactic thus denied the competitor a possible entry point to a key client based on the argument that the customer should use the competitor’s M&A service since their traditional bank or securities house did not offer this.

But passive banks do not devote the same time, money, and human resources to M&A. That is, they do not emulate foreign competitors, as those deciding to compete do. One problem resulting from this situation is that foreign firms have had to separate active banks from passive ones since the latter’s willingness to give away fees has made it difficult for foreign bankers to collect for the time needed to develop a transaction. For this reason, only foreign firms with large deal flows that could show transactions to a Japanese customer as one of several clients approached could do well. Further, unless the customer had targeted a candidate, it was best to represent sellers since active Japanese banks only talk with intermediaries having “sell” mandates while passive players want to keep fees to their clients low. Thus actually only firms with a good flow of sell transactions in which they represent sellers rather than buyers and a global reach have sustained this business in the current economic and financial downturn since the collapse of the bubble.

Of the well established firms who entered Japan to broker the 1252 foreign acquisitions made by Japanese companies between 1985 and 1989 (Zielinski and Holloway), only Goldman Sachs, Morgan Stanley, and Merrill Lynch appear in this category and their business seems profitable despite the environment. Conversely, others like J P Morgan, whose global strategy has relied on giving unbiased advice and research to buyers, have not been able to make Japan M&A profitable. There are specialized “boutiques” like Blackstone, Wasserstein-Perella, and Lazard Freres, with representative offices to reduce costs that may have been profitable. But they are not considered the market leaders, and W-P’s head departed Tokyo in the early 90s terming their venture with Nomura unsuccessful.

THE BANKS

Foreign banks’ experience illustrates a similar evolution. During the Occupation, four U.S. banks set up in Japan. Then, when the Occupation was over, the window closed and other foreign banks were only permitted representative offices. Given Japan’s high growth and capital shortage, a banking license was a chance to make enormous profits. However, these profits combined with Japanese growth
attracted other banks who pressured Japan through their governments to liberalize entry in a scenario analogous to the pressure to open the securities market and more recently the insurance, pension and money management markets. Each bank projected the existing banks’ returns to its smaller balance sheet. Finally, beginning with Morgan Guaranty in 1969, foreign banks were allowed to open branches and until the oil shock made money because of continued high growth and capital demands. About 78% of listed companies’ demand for external funds were bank borrowings. Further, only foreign banks could make foreign currency loans, while each bank had a swap limit through which they converted Euro-dollars to yen. Indeed, the “Nixon Shock” created a windfall for them since exchange markets anticipated further appreciation. So banks could sell forward yen for more dollars than they had borrowed to convert to yen spot, yielding a negative funding cost and incredible profits.

However, the oil shock slowed economic growth and loan demand dropped while a weaker yen meant swap funding costs rose while yen appreciation raised the dollar cost of an office. The attractiveness of a branch started to unravel, especially for latecomers who were just another foreign lender. Further, large firms favored their traditional Japanese lenders, who also priced more aggressively. So, instead of foreign loan assets’ share expanding with more foreign banks as many had anticipated, it remained the same or shrunk (3% of loans and 1% of deposits—Shinkai, 1987) with the business divided among more players. Therefore, despite Japanese growth, there was less to go around. Responding to this situation, Americans particularly felt the key to their problems was MOF liberalization of the highly segmented and controlled market (Brown, 1986). Interest rate deregulation would give them access to deposits as an alternative to swaps. By the late 1970s, they found an ear at the Treasury, which wanted liberalization to create more demand for yen, strengthening the currency and helping U.S. exporters. However, few thought through what their new service entry strategy would be or what innovation or proprietary product they could offer.

Nevertheless, the lobbying succeeded, and the Foreign Exchange and Banking Laws were changed in 1980 and 1981 respectively. The new laws shifted regulation from a negative system to a positive one, what was not prohibited was permitted. The result was Japanese banks could make foreign currency loans and raise funds overseas. Liberalization thus actually took away foreign banks’ advantage in swap funding and currency loans. Soon excessive competition forced them from that market. Then without a cheap source of yen funding and no regulatory advantage in lending, many had to close, Wells Fargo and Crocker among the first casualties. Even large profitable operations like B of A had to close offices, going from five to one and a half between 1975 and 1988, while Continental closed its office in Osaka altogether, though it had been there since the 1950s.

**THE IMPACT OF LIBERALIZATION ON PORTFOLIO STRUCTURE**

Another response to liberalization was large corporations found they could raise funds more easily and cheaply abroad, especially in Europe. This was true even if
buyers of the paper were Japanese institutions. Given high dollar rates compared to yen assets, Japanese lenders were anxious to build dollar portfolios. They were not permitted to do this easily prior to the new law. Yet these were huge institutions with billions to invest, and because they started with few foreign investments, the market impact was dramatic. The reallocation of portfolio assets frees much more money than is available from cash flow such as interest or insurance premiums. The result was in 1983 only 29% of new funds to listed Japanese corporations came from bank loans compared to over 50% in the 1970s while 32% came from bonds and 39% from stock and convertibles (Browns, 1986). Further, slower economic growth meant internally generated funds had risen from 32% to 49%, while Japanese insurance companies held $223 billion in foreign securities by 1986 (Shinkai, 1987).

These developments increased profit pressures on foreign banks but made entry into Japan’s securities business seem very attractive. Also, the rapid rise in Euro-dollar investments and borrowing seemed to give foreigners an advantage. Therefore, many foreign firms including the subsidiaries of several banks moved to enter the market. This created a big change since no foreign securities firms were licensed in 1970, then two in 1975, rising to only four in 1980. However by 1985 they numbered 14 and 52 by 1990, while including representative offices would expand this number further since more than 100 other foreign securities firms had some representative office. Given Japanese firms had steadily decreased from 1127 in 1949 to 220 in 1990, this increase in the number of licensed firms is dramatic with foreigners accounting for 20% in 1990. Nevertheless, the experience of foreign banks should have been instructive with respect to the potential risks. Japanese banks and securities companies set up in London very quickly and by 1989, Nomura was the number one Euro-underwriter in the world, again demonstrating Japanese firms’ ability to quickly emulate such non-proprietary advantages.

In addition, many of those responsible for establishing these new Japanese offices assumed regulations would continue to protect markets and that markets would grow with more foreign entrants, even though foreign banks’ experience had shown the opposite. They also projected no major future market changes that might force new strategic responses. Thus, few entrants thought about how to prepare for such eventualities. Generally, they stated in their annual reports and elsewhere that they were global firms and had to be in the third leg of the emerging global financial market. They also believed traditional foreign clients would direct Japan related business through their new offices. The latter was a tenuous assumption given Japanese securities companies and banks’ securities operations’ expanding reach in foreign financial centers. For example, the big four (Nomura, Daiwa, Nikko, and Yamaichi) since 1985 have maintained a concentration ratio above 90% in brokering foreign securities listed on Japanese exchanges, despite the entry of foreign securities firms (Kimura and Pugel, 1992).

However, tremendous growth in Japan’s financial markets in the 1980s mesmerized almost everyone. Initially, and prior to the Plaza Accord, this was because it was easy to buy U.S. Treasury bills or European government bonds in volume. Respond-
ing to high dollar interest rates, insurance companies bought aggressively and soon pushed their ceilings set by the MOF until one clever investment banker discovered the restriction on foreign assets only referred to the borrower. Therefore, Eurodollar issues by Japanese corporations were not restricted. This innovation began the surge of innovative financings, regulatory arbitrage, and exploitation of market imperfections characterizing the markets to the present.

ENTER THE BROKERS

This put even more profit pressure on the foreign banks and made entry into the securities business even more attractive. So U.S. and European political pressure combined with gradual market and regulatory liberalization to support the rush of often ill-considered foreign investments into the securities industry described above. The objective was to capture a share of the enormous profits coming from the opening of a highly protected industry still maintaining fixed commissions. But most arrived with the general global strategy explained above not with one tailored to Japan, the competitive environment, or the Japanese securities business. Therefore, like previous foreign investors in industries such as banking, many entering in the initial boom did not survive and fewer prospered during the ensuing changes and final collapse of the bubble. That is, between 1990 and 1992, foreign registered securities firms decreased from 52 to 45 (Kimura and Pugel, 1992) with 15 firms accounting for most of the industry’s profits (Appendix). In turn, County NatWest announced in 1993 it would sell its seat on the Tokyo Stock Exchange (TSE) and depart. Then in 1994, Kidder Peabody had to close its offices as it was unable to find a buyer for its Japan operations which Paine Weber had refused to accept as part of their purchase of the firm as a whole.

From these and similar situations, one can appreciate that to compete effectively in Japan’s securities markets or financial services, entering a liberalized market with “me-to” products will not succeed. Rather, an investor has to establish and maintain a business advantage the Japanese cannot emulate. Once emulation is possible, “excessive competition” emerges, and it becomes unprofitable (Abegglen and Rapp, 1970). This paradigm stresses the importance of defining, controlling and defending profitable segments by sharply differentiating profit expectations and resource allocation in leadership products from those offered as “service”. However, to better understand the reasons for foreign firms’ successes in the boom and bust of the 1980s and early 1990s in terms of this model, the paper explores the activities and profitability of the successful companies compared to the results after entry of all licensed firms as a whole. Because of their spectacular success and strategic impact on the industry’s structure, there is special focus on firms dominating derivatives, options, and futures.

THE BUBBLE

Foreign securities companies were very active in Japan’s bubble economy. In some cases, their enormous profits attracted more investors. The subsequent collapse has
in turn put pressure on many, forcing them to leave or scale back, just as foreign banks did in the 1970s. Further, because they entered during and partly due to the bubble, some analysis of it and its effects is critical to understanding foreign firms’ role in the financial markets as well as their strategic successes and long term competitiveness. This is because the origins and aftermath of the bubble have fundamentally altered both market structure and the role of foreign firms. Certain firms have now established important competitive positions that are probably sustainable for an extended period while the derivatives markets have grown from nothing to several billion dollars a day. In addition, after more than five years the Japanese economy remains relatively depressed while the stock market at the beginning of 1997 was still less than one half its all time high reached in January 1990. In addition, by creating and stimulating a large new market segment and then dominating and controlling its development, the successful foreign securities firms have joined a select group of foreign investors such as Exxon, IBM, Coca Cola, McDonald’s, Kentucky Fried Chicken and Weyerhaeuser who have succeeded in Japan despite the competitive challenge of Japanese companies.

Part of the bubble’s origin is found in excess liquidity after 1985 due to a combination of the trade surplus and sharp yen appreciation after the Plaza Accord. The ballooning surplus greatly increased the money supply as companies converted dollars to yen and the Bank of Japan permitted the increase to counter the deflationary effects of a strengthening yen (Ito, 1992). Further, as already noted, portfolio investors had stormed into foreign assets in the early 1980s in response to higher rates, also keeping the yen weak (Shinkai, 1987). Now they took billions in portfolio losses, and sought the safety of yen assets and hedges for their dollar investments. This created additional upward yen pressure. So excess liquidity found outlets in government bonds, real estate and stocks with investors primarily large corporations, financial institutions, and wealthy individuals. No longer having attractive overseas investments, excess savings chased domestic assets, driving up prices (Ito, 1992). For instance, government bond trading which had amounted to about 200 to 500 trillion yen between 1980 and 1984 jumped to roughly 2,200 trillion in 1985 and peaked at 5,800 trillion in 1987 (Japan Securities Research Institute, 1994).

However, the supply of Japanese bonds, real estate and stocks were restricted. Historically, financial institutions had bought government bonds by direct placement and held them until maturity (Shinkai, 1987) which was why trading activity was rather limited. Similarly, people and companies did not sell real estate because taxes were high (Ito, 1992) and prices always went up (Frankel, 1991 and Yamamura and Hanley, 1992). Finally, firms did not sell stock because the market had over time trended up and because of stable shareholder relationships (Zielinski and Holloway, 1991). Further, over time the proportion owned by institutions had risen since they were generally buyers, not sellers. Thus, by the late 1980s, unlike the U.S. 70% of stock was held by companies and individuals for business purposes (Zielinski and Holloway, 1991).
Given the phenomenal appreciation in stock and real estate since the war, one might assume owners would resist this commitment to low yielding high value assets. But including appreciation, yields have been good and liquidity is not a problem since banks have been prepared to lend against the collateral. Investors could borrow 80 to 85% of market value if the asset was used as collateral rather than sold. Since corporate tax rates run 60 to 75% on land, one could realize more cash this way than selling. Conversely, the cost of carrying appreciated stock is nil and land taxes on use are low (Yamamura and Hanley, 1992). For these reasons, annual real estate and stock turnover was low. Also, for many years, government bond trading was restricted to the “benchmark” bond which changed periodically to maintain a roughly ten year maturity. To provide liquidity, this bond was usually the largest recent monthly issue. Other government bonds were priced off the benchmark. In sum, the supply of bonds, stock and real estate was restricted at a time of increased liquidity and monetary easing. Declining interest rates in turn created capital gains for yen asset holders, stimulating demand.

This environment would have forced prices up more than normally in any case. But as stock and real estate prices rose, they created a compounding effect and the engine for the sharp upward price spiral and the bubble. The increase in bond, real estate and stock prices caused investors to value companies based on this hidden real estate and financial assets, bidding up their shares (Frankel, 1991 and Ito, 1992). They then used stock gains to buy real estate, either selling shares or borrowing against appreciation. Profits and loans on appreciated real estate were used to buy stocks and bonds, ratcheting both up on a continuous interactive basis as the bubble became full blown. Since rising prices for bonds, stock, or real estate affect all holders, this extended well beyond the immediate buyers and sellers to all owners, lifting the economy’s borrowing capacity and paper wealth enormously. These interactive supply and demand phenomena for assets appear to be the cause of the bubble (Stone and Ziemba, 1993). They also stimulated corporations to issue new equity and to acquire companies abroad to secure lower cost production or new technologies. As noted above 1252 foreign acquisitions were brokered between 1985 and 1989. Listed companies issued stock or equity linked bonds in 1987 of about 12 trillion yen, 14 trillion in 1988, and 24 trillion in 1989 (Sheard, 1992; Zielinski and Holloway, 1991) while the number of convertible bond issues in Japan rose from 12 in 1980 to 333 in 1988 and 295 in 1989. These and related phenomena created demand for foreign investment banking services.

CHANGING ENVIRONMENT AND EMERGING WEAKNESS

The first indication of possible weakness in this boom scenario given a change in supply/demand dynamics came with the fall in the Government Bond Market in June 1987. Here, unique features of the market combined with the loose money policy to promote ramping by a syndicate of banks and securities houses. As money expanded and interest rates fell, money poured in during the first half of 1987, and the “benchmark’s” price rose sharply. By June, the yield approached 2%. It was then
rumored the reason for this rapid rise was a syndicate had cornered the limited supply of benchmark bonds. Other dealers caught short complained, and MOF moved quickly, unilaterally expanding the issue and eliminating the corner. The ensuing collapse, though, showed what could happen when the pressure of too much money chasing a restricted asset supply was eased. So while stocks recovered after the October 1987 crash, the bond market did not because the institutional dynamics restricting supply had been permanently altered. There was no limit to MOF’s supplying the benchmark. Thus, bond trading reached its peak in 1987 at 5,800 trillion yen, falling to 3,732 trillion in 1989 (Japan Securities Research Institute, 1992).

The situation also illustrates the anomalies and risks that had emerged in the financial markets in moving from a regulated market to one where market forces operated more freely, a major shift to which foreigners should have been attuned. The MOF could change the rules while foreign traders had become players. These themes are repeated in the stock and real estate market booms and collapses as well as in the apparent criteria for strategic investment success.

Since bonds did not recover but stocks did with the Nikkei Index rising from about 18,000 in 1987 to 38,000 at the end of 1989 (Japan Securities Research Institute, 1994), the interactive upward price ratcheting in stock and real estate resumed with the speculative money in bonds adding to the pool. Also, insurance companies and banks who had lost on bonds as they had on their dollar portfolios put more funds into stock and real estate, generating more upward pressure on prices and on their desire to invest. This added to market momentum. Because of excess liquidity and the hot stock market (Ito, 1992), traditional loans to industry lapsed, and banks increased their direct real estate loans, indirect real estate loans using securities as collateral, and securities lending. They also became aggressive in overseas markets, including merchant banking and capital markets, often underwriting some of their customers equity linked debt issues. This aggressive expansion and seemingly unlimited financial power caused concern among U.S. and European banks, weakened by LDC debt burdens, the aftershocks of the 1987 crash, and the fall in U.S. real estate. This created the political climate in 1988 for the Bank for International Settlements (BIS) representing the major central banks to issue after two years of negotiation capital limit guidelines for large international banks. Japan, however, insisted their banks be allowed to count a portion of their hidden stock appreciation as tier two capital. This was set at 45% to allow for tax effects. As a result, banks now had a strong incentive to hedge their stock portfolios in a market downturn.

At the same time, there were overseas pressures on MOF to permit a futures market, allowing U.S. and European firms to expand into this business based on their experience. MOF had some interest in this as a way to improve liquidity in government bonds as a debt management tool and to avoid the previous supply problems leading to the June bust (JSRI, 1994). Financial institutions had already received permission to trade the Nikkei index offshore in May 1987 and had traded actively on the Simeex (JSRI, 1994). Thus MOF agreed to futures trading partly to improve the government bond market and partly in response to foreign pressures.
The Osaka 225 index began trading in September 1988 (JSRI, 1994) and soon replaced Singapore as the volume leader with about 10 times the contracts and about 20 times the volume. In this, MOF unknowingly uncoupled a link in the support chain for high stock prices and opened a major opportunity for foreign securities firms the MOF is now unsuccessfully trying to limit.

This occurred because index futures can increase the supply of a securities portfolio. Anyone can create a futures contract or option, just as the MOF can create more benchmark bonds. An investor wanting to hold a group of stocks can purchase index futures or options as an alternative to buying the stocks (Lim, April 1992). Further, one can sell the portfolio without placing an order through the TSE. Therefore, the development of index futures expanded the equity supply far beyond the additional stock, warrants, and convertible bonds issued by companies, though the holders of these new securities were potential users. Using Nikkei and Topix index futures, any amount of stock could be created and then sold or bought without the demand-supply constraints that had characterized the market for so long and had contributed to the vertical increase in prices. Sidney Fried in his book on warrants, options, and convertibles predicted this would lead to a market crash (Fried, 1989).

A futures seller could now be a “stable” shareholder who because of the presence and expertise of foreign dealers did not have to go through Japanese brokers. They were thus no longer subject to the informal discipline of business relationships, the MOF, or the market. Further, banks now had the capital preservation incentive to hedge. The insurance companies also had a similar motive to hedge after successfully pressuring the MOF to be allowed to include up to 25% of their capital gains as policy income. These “stable” shares were now salable via the index, undermining an important market support, e.g. in 1991 banks and investment trusts accounted for 18.7 and 7.4% respectively of Nikkei futures trading (JSRI, 1994). This new instability was first signaled in December 1988 when a downturn was exacerbated by futures market selling.

THE BUBBLE COLLAPSES

The real estate prop was removed about the same time. Spiraling real estate prices had forced the government to act by restraining bank real estate lending and activating the 1975 real estate pricing law. These actions began to rein in real estate. Thus “undervalued” real estate stocks would not appreciate. Therefore, when interest rates started rising in January 1990, and stocks fell in response to less liquidity and lower hidden values, the futures market supply from “stable” shareholders increased too as they sold index contracts, bought index puts or sold index calls. The market dropped precipitously. Those who sold puts to or bought calls from the hedgers then covered in the cash market, putting more downward pressure on prices. Further, rising interest rates increased the premium in futures contracts over the cash equivalent, increasing downward pressure on the cash market. Hedging shareholders included financial institutions and corporations who had invested in Tokkens (stock investment trusts) or had borrowed against their “stable” shares as collateral.
Because of their extensive portfolios, the index provided a good proxy for their holdings, stimulating use. In turn the daily cash trading value on the futures index market rose from 1990 to 1991 from 1.6 trillion yen to 2.2 trillion yen as the cash market was falling from 846 billion to 504 billion. The primary traders and market makers, however, were foreign securities firms expert in futures. The MOF and the big four securities firms (Nomura, Nikko, Daiwa, and Yamaichi) thus rightly viewed the futures market as influencing the collapse and foreign securities firms as providing support for this activity. But foreign brokers were not the large hedgers even though they took positions for their own account. Rather, the hedgers were “stable” shareholders. In the end, however, many banks and insurance companies were hurt as their hidden reserves largely disappeared. In addition, several have had to use these reserves to cover lending losses. Thus lenders were heavily affected by the collapse in which as much as two trillion dollars in market value was lost plus additional amounts in yen government bonds as the BOJ drove interest and bond rates to 7% to puncture speculative demand. Further, since they had loans secured by stock and real estate, loan losses mounted too.

PROFITS AND PERMANENT MARKET CHANGE

However, foreign firms who had strong strategic positions in futures and derivatives continued to do well even though Japan’s financial community was reeling. This was a function of their ability to arbitrage market imperfections and the strong demand for these products noted above by institutional and corporate clients trying to protect profits. Conversely, foreign firms who had come with the idea of participating in the third major world financial center by being a player in the Euromarkets, providing superior stock analysis, getting their share of market turnover, brokering Japanese stocks for foreign clients, or providing a mix of their usual services to Japanese customers encountered real difficulties and several have closed down. This latter group includes banks such as Chase, Chemical, NatWest, Continental, and Security Pacific who had planned to salvage their position in Japan by a timely switch from branch banking to securities. Yet, they had not planned for a shakeout any better than they had in branch banking, even though business cycle history demonstrates there are periodic economic downturns that put pressures on financial institutions and their basic business strategies.

The relative performance of both groups is reflected in their reported earnings. But just examining these earnings will not identify winning and losing strategies. These numbers can be misleading because it is not clear where profits are booked. If one represents a U.S. M&A seller to a Japanese buyer, the U.S. company pays the fee to the broker’s parent. If the swap book is in London, profits are booked there. If foreign exchange is involved, it is booked offshore because securities firms cannot trade foreign exchange. In addition, many firms entered Japan using representative offices where by definition transactions are done elsewhere. To identify and understand successful strategies, therefore, published results on Japan based performance are reviewed along with other recent information about their activities and performance. These have in turn been discussed with industry participants to verify the
conclusions reached (footnote 1). To see how these strategic criteria might apply in other situations, the paper examines the strategies and performance of other participants too: Continental Bank, Bank of America, Chemical Bank, Security Pacific, Citibank, Chase and Smith Newcourt Securities.

However, reported numbers do accurately reflect business done in Japan with Japan based customers. If a foreign firm’s competitive advantage is offshore business, there is no need for an expensive, heavily taxed and highly regulated locally registered securities firm, much less the seat on the Tokyo Stock Exchange held by 25 foreign firms. A representative office is not only sufficient but is more attractive. Even securities can be traded in Hong Kong or Singapore via such an office. It is therefore local business that is at stake in making an investment in a Japan based securities firm. So reported earnings are in fact a good indicator of these firms’ ability to compete with Japanese firms for Japanese business with their major clients, the paper’s central focus. If they cannot compete, the local investment strategy was not successful. Examining such relative firm performance shows only a few have competed well. This data is reported on 50 firms or most foreign firms registered during 1990–92 (Euromoney, February 1993). It accounts for over 100% of reported earnings for licensed foreign securities firms in Japan during this period and only licensed firms are permitted to do securities business in Japan. It thus covers the foreign firms successfully competing for local Japanese customer business against Japanese firms and almost all their foreign competitors.

The data for the six months ending September is examined first to highlight the effects of the initial collapse after January 1990 and the final collapse and partial recovery in August 1992. This analysis is supplemented by annual data (Appendix). The idea is to capture stress periods that potentially identify superior strategies, separating successful strategies as several foreigners withdrew. 1990–92 was of course very tough for Japanese markets and most participants. Listed Japanese securities companies reported losses for the period ending March 1992 except Nomura and Kokusai, a Nomura affiliate. They reported profits of 30 billion yen and 500 million respectively, down from 219 billion and 28 billion in FY 1990 (end 3/31/91). Thus, if a foreign firm could sustain or improve its position in this period, it indicates competitive strength and a sustainable advantage even under adverse conditions.

Of the 50 listed foreign firms, only six were profitable in all three years: Societe Generale, Salomon, Goldman Sachs, Barings, Bankers Trust, and Merrill Lynch. On the basis of average profitability over the three years, the number jumps to 24. But this means about half the firms were on average unprofitable during this period. To further assess the level of profitability, these 24 profitable firms were examined to determine which on average could sustain above average profitability. The median level of average profits over the period was yen 203 million per annum and the mean was 318 million yen. By definition 12 firms were above the median, but only eight exceed the mean. Ranked by average profitability, they are: Salomon (Y933MM), Goldman Sachs (Y857MM), Swiss Bank Corporation International (Y853MM), Societe Generale (Y813MM), Barings (Y637MM), Bankers Trust
(Y633MM), JP Morgan (Y603MM), and Morgan Stanley (Y337MM). Thus, of our consistent profit earners only Merrill drops out and SBCI, JP Morgan, and Morgan Stanley are added. This group of eight are the exceptional performers accounting for 79% of the profits of the 15 leading foreign firms and over 100% of the profits of all licensed foreign firms (Appendix) while representing less than 20% of their total number. Indeed, most licensed foreign firms reported annual losses during the period, and in fact, in the aggregate foreign firms lost money, more than giving back their FY 1989 returns (Appendix). Therefore, the reported results support the hypothesis that only a few foreign securities firms who invested in Japan in the 1980s developed successful strategies to compete consistently for Japanese clients' Japan business that was sustainable, especially under the adverse conditions of the post-bubble economy.

Looking at the 12 most profitable firms, four lost money for one six month period with Chase quitting after a loss for FY 1991. Ranked by average profits for the September periods, though, there is a sharp drop between the top seven firms and the rest: Salomon (913 million yen), Goldman Sachs (857), Swiss Bank Corporation International (853), Societe Generale (813), Bankers Trust (753), Barings (637), JP Morgan (603), followed by Morgan Stanley (337). Although profitable every year, Merrill ranked 12th. Still, the top eight firms' superior results are very clear looking at the period ending September 1992 when their profits equaled those of all foreign securities firms combined.

APPLYING THE PARADIGM

To better analyze the strategies separating the performance of the leaders from the others in terms of the paradigm, major products and services offered by foreign and Japanese firms during this period are split into five categories that are listed below with their associated products. (The glossary presents detailed product-firm explanations by category so objective differences between the various products and their competitive profiles can be understood.)

- **I. Products with Technology or Market Position Advantage for Foreign Firms** are those that can be defined, defend and sustain as a source of profits and ongoing business. In the cases examined, most successful strategies seem to rely on providing products in this category and include: Corporate Finance (M&A), Interest Options and Futures, Long-Dated Forwards, One-Sided Dollar Interest Rate Swaps, Other Derivatives, Private Placements (Structured Finance or Mixed Credits), Real Estate Securitization and Portfolio Packaging, Real Estate Trust Advice, Stock Index Options and Futures (Weighted and Unweighted, Topix and Nikkei), Strategic Alliances, Swiss Franc Bonds (Straights, Convertibles, and Bonds with Warrants), Synthetic Securities, and Yankee Bonds.

- **II. Products with Regulatory or Variable Market Advantage** are those where a foreign firm's advantage depends on regulations, which could therefore change, or a specific market situation, which could alter with time just as banks' advantages in providing impact loans or funding via swaps changed due to the
new foreign exchange law. Examples of such regulations are the prohibition on Japanese bank involvement in leasing or administrative guidance against Japanese participation in the OTC derivatives market. Products include: Samurai Leases (Advanced Sale of Receivable), Shogun Leases (Defeasance Leases: Aircraft, Power Equipment, Movies), or Index Warrants. Profits from these activities can be substantial, but the influence to sustain an advantage does not lie with the firm. Further, the more successful the product, the more pressure from Japanese financial institutions on the MOF or other agency to change the regulation. In the case of market based advantages, changes in market conditions can eliminate the product’s appeal. Thus, profits from these products should be used to build position and expertise in category one.

- **III. Products Widely Available or Easily Emulated** are those offered by both Japanese and foreign firms where neither has a particular advantage. They include: Sushi Bonds (Eurobonds issued by Japanese borrowers), Currency Swaps (Harakiri Swaps), Interest Rate Swaps, High/Low Bonds, Preplaced “Public” Issue, Corporate Finance (Euro-bond Underwriting, Equity Related Underwriting), Equity Linked Securities (Convertible Bonds and Bonds with warrants), Trading U.S. Government Securities and Agencies (Primary Dealers), and Trading Eurobonds. Given these conditions, Japanese competitors are likely to offer these services at or below cost, especially in the securities business because of excess earnings they receive on core products (Kimura and Pugel, 1992). Therefore, unless a foreign firm can achieve low costs coupled with other advantages, it is unlikely to sustain a competitive position in these products.

- **IV. Japanese Proprietary Products due to Regulations** are those where MOF or other regulations prevent foreign firms from competing. These include: Samurai Bonds (yen bonds issued in Japan), Investment Advisory Management, and Investment Trust Management (Quick Research, 1993 and US-Japan Business Council, 1993). If a foreign firm has a technical or other sustainable advantage here, they should clearly press for deregulation. This is probably true in the mutual fund or investment advisory business. However, if no advantage exists, it is a waste of time, effort and money unless one’s strategy is to compete with the goal of putting pressure on a competitor’s cash flow.

- **V. Japanese Firms’ Core Products or Services** are where Japanese firms and related players derive most of their profits from major clients. The share numbers presented for the Big Four, though, do not consider the added market position of their affiliates. These products include: Commission Trades, Underwriting of Equity and Bond Issues over 80% of which are through the “Big Four (Kimura and Pugel, 1992), and Brokerage of Foreign Securities. Because Japanese firms will defend them in depth, even if one is prepared to devote considerable resources to entering, it is generally not a good strategy. Still, to the extent regulations maintain fixed pricing and commissions, it makes sense to push for change. This is not to compete for a big piece of business but rather to pressure competitors’ cash flow, reducing resources they have to compete for category three and more importantly category one business. Japanese securities firms will compete on price when
necessary to hold position in these products as indicated by the lower spreads in yen government bonds after the entry of Japanese banks and foreigners while the Big Four's share remained the same (Kimura and Pugel, 1992).

Examining relative foreign firm performance, it has been established that only a few firms have actually competed successfully in the Japanese securities and investment banking market. Discussions with these firms or their competitors combined with published trading data (Appendix) indicates that their strategies have relied heavily on supplying products in category one. Strategies putting too much reliance on category two were profitable for them and other firms for a time but often evaporated quickly when regulations or market conditions changed (Glossary). Competing in category three only works for a low cost supplier. But generally a low cost supplier approach was difficult for foreign firms entering the market in the 1980s to achieve since they had to bid people away from Japanese or other foreign firms at a significant premium, and space costs soared along with real estate prices. However, as outlined below, BoA and Smith Newcourt offer interesting examples of that approach. Further, in the post-bubble economy with the collapse of real estate prices and the decline in trading volumes on the stock market, many leading foreign firms have been able to substantially reduce their costs relative to Japanese competitors. This should reinforce their other competitive advantages as argued more generally at the beginning of the paper.

Trying to make progress in category four only makes sense if one has the opportunity to actually change it to category one. This is because it takes a great deal of time and effort to achieve regulatory change in the face of entrenched Japanese interest groups who have a lot to lose from such changes (Blaker, 1977). This is an important point for insurance companies planning market entry post-deregulation or for asset managers in the future if deregulation continues. Category five is only for the brave with substantial resources. Most Western firms won’t sustain the cost of this strategy. Salomon had to put $500 million of capital into their Japanese subsidiary to become a player in Japanese government bonds and even then needed to couple it with futures expertise, a category one product, to make it successful.

Given this brief overview, Merrill’s closing of its Yokohama, Nagoya, Kobe, and Kyoto retail branches to reduce costs made sense since retail is either category three or five and is unlikely to be profitable long-term. Conversely, elements of their corporate business concentrated in Tokyo and Osaka should be sustainable, where they are reported as expanding. Certainly their earnings as reported by office bear out this conclusion (NikkeiNewsletter, 1989–93). Responding to the post-bubble environment, others logically moved certain operations offshore. Barings for example cut staff in Japan by 15% to 220 (Euromoney, February 1993), but also moved people to Singapore to trade the Nikkei index on the SIMEX in response to moves by MOF and major Japanese securities firms to restrict index trading in Osaka. Morgan Stanley shifted part of its trading to Singapore as well and also to foreign exchange and bonds, some of which, due to regulations, occurs outside Japan. Therefore, part of the drop in Barings’ and Morgan’s reported profits in 1992 reflects this shift.
This ability to shift between markets is an important strength of the most profitable foreign firms since the common thread among the industry leaders is expertise in arbitrage, derivatives, and international innovation. Based on interviews with various firms, those considered preeminent in these products are Goldman Sachs, Morgan Stanley, JP Morgan, Salomon, Societe Generale, Barings, and First Boston. All of these, excepting CS First Boston, who was still building, are in the star performer group. Together in 1992 they accounted for 45% of the OSE Index Arbitrage activity compared to 33.4% for all Japanese firms combined (Source: Salomon Brothers). They also represent four of the six consistent top performers and five of the top seven in profitability. This group of seven therefore are the exceptional performers, though representing less than 20% of the total licensed foreign securities firms in Japan. In addition, as noted above, they are in the group exceeding the median or the top 25% of our sample. Only SBCI and Bankers are outside the group. But, Banker's expertise in synthetic securities, portfolio repackaging, and structured finance is closely related and falls in group one. SBCI has similarly focused on category one, acquiring O'Connor, a derivatives specialist in Chicago, while big Swiss banks have traditionally controlled the floating of Swiss franc bonds for Japanese companies. In turn some futures activity is related to hedge strategies for the holders of their SF convertible and warrant bonds and is an extension of that base business. During 1992 SBCI accounted for about 2 to 3% of the OSE Index Arbitrage volume (Source: Salomon Brothers).

Thus futures and derivatives are an important element in the leaders' successful strategies. So it is essential to examine the index market in greater detail subsequent to the start of trading in Osaka (OSE) in 1988. Monthly volume was rather steady at about one trillion yen until the beginning of 1990, coinciding with the first burst of the bubble. It then doubled and increased again by 50 percent in 1991. Conversely, TSE trading volume dropped precipitously along with prices. The futures market in terms of value traded reached a peak in 1991 at a daily average of 2.3 trillion yen substantially exceeding the TSE's yen volume even at the height of the 1989 boom (JSRI, 1994). Therefore, while some activity was no doubt due to arbitrage between the cash and the index markets, a large part also reflected portfolio hedging. Otherwise greater volumes would have been traded in the cash market. The open interest has run about three days trading volume. In addition, there is a large over-the-counter market for Nikkei options not reflected in the OSE or Simex data (Goldman Sachs, August 1992). However, the numbers fell back to 1990 levels after the end of 1992 corresponding with the rally in stocks.

WHO WILL DOMINATE

Therefore two important strategic questions are whether the index market's spectacular development is only a temporary phenomena that will fade with a stock market recovery, especially given MOF pressures to curtail its influence (Goldman Sachs, July 1992) and second, regardless of stocks, will foreign firms sustain their influence? It appears it is not temporary, the MOF will not control it, and foreign firms will continue to dominate. The reasons are:
Index futures and options permit large corporate and institutional holders of Japanese stocks significantly greater flexibility in distributing their assets in response to economic and political events. This is true even if they have no desire to hedge in a rising stock market as they did in a declining one. This is not just a product related to the bubble’s collapse. This is because one can hold any assets, i.e., Japanese stocks, U.S. government bonds, or Deutsche Mark CDs and convert them in and out of Japanese stocks or several other assets on a worldwide basis by using index futures. For example, if one had invested heavily in U.S. Treasury bonds and was reluctant to report a loss after yen appreciation but wanted to increase exposure to Japanese stocks, previously one could only do this out of cash flow or by selling another asset. By using foreign exchange and index futures, though, to buy the yen and Nikkei forward, one can now do this without having to sell the bonds. Or if one wished to increase one’s exposure to the U.S. stock market, one could buy S&P futures in conjunction with buying dollars forward. Alternatively, if one felt German interest rates were about to fall and their stock market would respond bullishly but the Deutsche mark was also likely to depreciate, wiping out the gain, one could buy the DAX index but keep assets in yen. Given that Japanese corporations and financial institutions now have global portfolios and investment exposures, this ability to shift asset exposure without triggering long-term capital gains or losses has immense appeal. It is in turn heavily promoted by foreign firms specializing in this business (Goldman Sachs, April and August 1992).

In addition to flexibility, there is price and confidentiality. To trade the same yen volume using the index costs about one-third as much on the OSE as to trade the same stocks on the TSE, it is even cheaper on the Simex. (See Nikkei growth on SIMEX noted above.) The margin requirements are also less for the index than for the equivalent TSE stocks. Investors have responded to these differences as the trading growth on the Simex more than doubled after the commission and margins increased on the OSE due to MOF guidance and is strong evidence for the argument that index trading will persist in large volumes. In addition to price is the fact Japanese investors using foreign brokers and the index can keep their

<table>
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<tr>
<th>F1 Months</th>
<th>F2 Singapore</th>
<th>F3 Osaka</th>
<th>F4 Simex</th>
<th>F5 OSE</th>
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<tbody>
<tr>
<td>9/88–2/90</td>
<td>70,584</td>
<td>479,056</td>
<td>4,544</td>
<td>27,556</td>
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<tr>
<td>3/90–1/91</td>
<td>73,562</td>
<td>1,239,512</td>
<td>4,670</td>
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<td>1,846,337</td>
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<td>357,863</td>
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<td>69,646</td>
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<td>430,183</td>
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<tr>
<td>1/94–12/94</td>
<td>483,425</td>
<td>520,665</td>
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Source: Simex (Singapore International Monetary Exchange Limited) and Goldman Sachs.
trading more confidential since they do not have to report any particular stock sale, possibly upsetting a stable shareholder relationship. Nor do they have to go through the TSE, thus tipping off the major brokers or the MOF about their trades. Finally, the investor can take a long-dated position in the index so it remains suitable even for the typical institutional or corporate investor with an extended time horizon. That this occurred in the rising market between August 1992 and June 1994 demonstrates index futures have demand in a rising as well as a falling one. Therefore, this business should have a very long life span.

- Given the realization of this, though, by the MOF and the large Japanese securities firms, can the foreign houses maintain their dominance? History argues the answer is unclear but one should not be optimistic. However, there are institutional and structural considerations that may override the Japanese houses ability to emulate, catch up, and compete on price. First, everyone agrees the easy arbitrage between the cash market and the index has disappeared ([Euromoney, February 1993]). Therefore, to make money in these products one needs to extend beyond Japan. A primary appeal is the portfolio switching described above. This requires one to have sophisticated technical and market capabilities including advisory services in all major markets worldwide which plays to the strength of the foreign firms and puts Japanese firms at a distinct disadvantage. Further, foreign houses can achieve economies of scale in these other markets given their larger global customer and multiple market/product base making them low cost suppliers. Indeed, they already have such a presence and are supplying global advice to Japanese clients (Goldman Sachs, April and August 1992 through November 1994). In addition, they can reduce Japanese costs by selling expertise to non-Japanese as well as Japanese clients giving them a potentially bigger base than the Japanese houses. They also have an active presence in Singapore in the Nikkei which gained market share from 1% in March 1991 to 21% in 1993. Second, to the extent confidentiality and price remain areas of investor concern, the Japanese houses will always have a problem. This is because institutional and corporate investors will always perceive Japanese companies as open windows on their domestic and international activities. Close historical relations in this case are a competitive liability. This situation has been exacerbated by the recent securities scandals. With respect to price, the fact an index trade is an alternative to a TSE trade means that every index trade reduces the higher income flowing from the fixed commissions on normal brokerage. Further, Japanese firms have significant bricks and mortar as well as large numbers of personnel committed to the brokerage business that have been hired and trained under the long-term employment system. Foreign firms do not face this problem since they have never captured a large share of the brokerage business, a category five activity, and so do not have extensive branch networks. Rather, they are in the enviable strategic position of being able to put pressure on the cash flow coming to Japanese competitors from this core business through derivative substitution.

- Finally, derivatives require significant technical sophistication, including past and continuing software development worldwide. Interviews with the technical
support groups in three of the Big 4 firms and in the leading foreign derivatives houses indicate that the foreign firms have incorporated network server/workstation computer systems which allow them much faster turnaround and greater flexibility in developing new product support systems than the mainframes used by the Japanese. Also, software development in the foreign firms is generally done within the derivatives unit whereas the Japanese firm subcontracts the work to a software subsidiary where programmers have no particular expertise in derivatives. So whereas foreign firms can generate computer support systems in a few weeks, the Japanese firms often take several months. By this time the market may have changed sufficiently to make the original product obsolete. Thus the foreign firms can introduce innovative products with appropriate technical support faster than the Japanese can emulate them allowing them to widen the product/technology gap. Thus, unless the Japanese change the way they manage their computer support function, it will be difficult for Japanese houses to emulate the foreign firms' product development cycle (footnote 3).

- In sum, from a management, compensation, product, strategic and technical viewpoint, even if the Japanese houses become committed globally to this business and hire several experts in different locations, it will be difficult for them to match the customer, cost and technical advantages of the leading foreign firms. Also only the very largest firms could possibly compete on this basis, thus putting MOF in a difficult position as smaller firms were forced out of business. At the same time, not all foreign firms can meet these survival criteria either since they require a global commitment to technology and product development sufficient to constantly define and influence Japanese stock futures. This is why only a few of the 52 firms investing in the Japanese securities industry in the 1980s were able to become leaders and to survive in the post-Bubble environment. Yet, this global capability has become more critical since the Nikkei adopted a market weighted index in 1994. Indeed, through October 1994, the open interest on the Nikkei 300 had grown to 171,670 (Goldman Sachs, November 1994). This is because this index is more useful to those wishing to invest in an instrument more closely representing the market as opposed to those arbitraging the index and cash markets. The MOF hopes this change will restrict futures trading, but this is misguided. In the U.S., futures and stock markets are highly efficient; yet the most popular index future is the S&P which is market weighted not the Dow Jones which is price weighted. Nor has the popularity or the higher volume in the S&P in anyway diminished over time. It increases the liquidity of the cash market related stocks as well as transforming assets in response to various events. As Goldman Sachs notes “fairer pricing of the futures should be good news for investors; It enables them to trade the market both ways without paying excessive premiums on the buy side or giving up substantial discounts on the sell side.” Therefore, the prospects for foreign firms continuing to define and compete effectively in this important market segment appear quite good. Therefore, it is possible for foreign firms with focused product strategies based on proprietary products and constant innovation, cost control and adaptation to succeed in Japan’s financial markets.
SPECIFIC COMPANY STRATEGIES

Conversely, firms like DB Capital who were just thinking about getting into the derivatives in 1993 (*Euromoney*, 1993) are probably too late in terms of their perception of the opportunity and what will be required to compete in Japan and globally. If they have not been in derivatives in Japan, then they have not offered their clients the full spectrum of portfolio switching technologies. If they have not had clients with those interests, then they probably do not have the technology to compete against those who do. This would appear a classic case of someone under profit pressure looking for a business making money without fully considering what will be required to compete currently and in the future. They are under pressure along with the other German Bank related securities companies: Dresdner, Commerz, BV Capital, and Westdeutsche Landesbank (Appendix), because they did not perceive in time that their initial strategy of raising funds for Japanese companies in German financial markets or selling Japanese securities to German clients was subject to the risk of moving from category one to category two or three. Unification with East Germany created inflationary pressures that drove interest rates and the value of the Deutsche Mark up so that Japanese corporations had little interest in issuing DM bonds, while the Tokyo market collapse meant German investors had little interest in Japanese stocks or warrants. In addition, most major Japanese securities companies had opened offices in West Germany and were thus able to offer the latter services as effectively as German bank related security firms.

In this respect, the German banks fell into the same difficulties experienced by others who thought they could survive by just participating in Japan’s securities business as an extension of their regular securities business elsewhere or believed they had products or market position that could not be emulated by Japanese competitors. Other examples of such perceptual or strategic errors are Chemical Capital Market Corp., Hoare Govett when owned by Security Pacific, Citibank Scrimgeour Vickers International, Continental Bank’s foreign exchange and options trading business, and Chase’s investment banking operations (footnote 2). In all cases, strategic misperceptions were accentuated by lack of cost control.

While Chemical set up their securities company in 1987 as the subsidiary of a Swiss Merchant Bank, Chemical's senior management hoped to use approval of the branching of a bank owned foreign securities company as a wedge to encourage US authorities to do the same. Neither of these objectives provided the strong product/market focus or innovative strategy to succeed long-term on a sustainable basis. In addition, to meet MOF requirements they were saddled from the beginning with an expensive operations and reporting staff and thus more space and people than they needed to trade and do market underwriting. The result was within

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2 These case studies are based on interviews with former or current bankers at the institutions involved or on actual transactions in which the author was involved. Because much of the information supplied was proprietary or internal to the firms cited, it provides an excellent insider's view of the strategies employed and the apparent reasons for their success and failure. The results also appear to be consistent with the firms' reported actions, e.g. closing offices, or performance in terms of trading, revenues and profits as presented in the Appendix or as reported by Nikkei Newsletter and others. At the same time, certain issues by their nature cannot be fully confirmed by reference to empirical data which the author regrets and for which as noted in footnote 1 he takes full responsibility.
a year it was closed down. Confirming they had no special capability, they subsequently closed their London Euro-bond and swap operation as well.

While Security Pacific’s rationale for purchasing Hoare Govett was more thoughtful and an extension of their global thrust into financial services, it failed to match the reality of their client base. Having determined international commercial banking was unattractive, they made a determined effort in the 1980s to expand domestically as a super regional while diversifying abroad into securities. This latter strategy was seen not only as generating good profits but as establishing the expertise to go into the U.S. securities business once barriers to bank entry came down. In addition, it would keep them involved in the high growth financial markets abroad where they had been weak as a bank. Like BoFA, they also bought a U.S. discount brokerage firm. In addition to Hoare Govett, they purchased an interest in Wood Gundy, the large Canadian securities firm. However, for this strategy to work, they needed to push volume and customers through the system. Because they never had customers abroad, they could not direct business to their affiliates while expansion of their domestic banking base as a super regional meant most new U.S. clients were domestically oriented. This was particularly true in Japan where BoFA had dominated the Japan-California relationship. Finally, they did not have any particular technical or product expertise to transfer to its affiliates. Nor did it understand the securities business enough to create synergies between them. The result was they sold their interest in Hoare Govett back to the original partners for a fraction of what they had paid even before the rest of their strategy started to unravel, ending in their acquisition by Bank of America.

Citibank’s Vickers operation faced neither Chemical’s nor Security Pacific’s difficulties. Indeed, they had real first mover advantages as well as Citibank’s large Japanese customer base. Nevertheless, they managed to undermine this through a combination of management conflicts, reductions in corporate lending, and lack of strategic focus. While not having to withdraw from the market, their operation has been break-even. Historically, Scrimgeour Vickers De Costa was a successful UK securities house that had built a reputation for doing high quality research on Far Eastern stocks, particularly Japanese. When their Far Eastern operations were bought by Citibank in 1983 and subsequently the parent after the Big Bang, it sent shudders through Japan’s financial community since Vickers had a licensed Japan operation. However, instead of finding experienced securities executives to manage it and the interface with Citicorp, they placed commercial bankers in control. The imposition of tight controls on the freewheeling brokers and analysts immediately led to conflict as a credit culture used to dealing in defined cash flows opposed a research “story paper” culture used to projecting what might occur. Vickers also had a retail orientation in contrast to the wholesale bank mentality of the managers. The best analysts, brokers, and operations staff thus left. Indeed, they were heavily courted by headhunters trying to feed the demand for experienced securities personnel generated by the Bubble and the rapid entry of other foreign firms. It became a poachers paradise.

Since the firm was not well regarded, it was difficult for them to attract capable new staff and the adverse situation quickly compounded with slots filled by more
bankers who did not understand the business. They thus lost their research capability and focus, their original competitive edge. In fact, it was quickly and effectively copied by others such as Barings, BZW, Merrill, Morgan Stanley, Smith Newcourt, and Jardine Fleming. Nor was it replaced with any proprietary or leadership products. Finally, because of LDC debt losses and capital constraints at the parent, the Bank decided to rationalize and significantly reduce its Japanese loans. This was also driven by large write-offs on Sanko Steamship. In the process, however, they undermined their long-standing and large corporate relationships so it became difficult to direct business to Vickers. In this way, Citi gave away their initial advantages by not defining and maintaining their market influence. This contrasts sharply to their success as the only foreign bank to establish a retail banking presence by targeting wealthy internationally oriented Japanese.

Despite many years in Japan, Continental also made the error of thinking it could reduce loans and still do business in other areas that could be supplied by multiple vendors. Since US banks cannot own shares as Japanese banks can, loans substitute for stock to maintain client contact and market access relative to competitors in an over banked market. Therefore, when the Chicago head office decided to down size by shedding Japanese assets, they undermined their relations with established clients. Yet, they thought they could still build a foreign exchange trading operation and introduce the index options capability of their recently acquired subsidiary, First Options. They thus put $12 million into a trading room with desks, systems, etc. only to close it down six months later due to no customers or trading volume. They paid a high price for investing heavily in a category three business with no close clients. Now they are limited to a small regional banking office and a representative office for their merchant bank under the BoA umbrella.

Chase Investment Bank, a subsidiary of a British brokerage firm Chase bought after the Big Bang in London, was an early developer and leader in leasing products, particularly samurai and shogun leases described elsewhere (Rapp, 1994). However, they were initially so successful that these products eventually contributed about 80% of earnings and revenues, and the investment bank became over reliant on them. The Shogun lease was the first to be emulated, indicating it was a category three rather than a category two product. Nornura-Babcock and others soon took the lead while fees dropped, i.e. price competition increased. In addition, as the National Tax Agency became more concerned about revenue loss, the regulations were tightened as had been true in other countries experiencing growth in tax oriented leasing. Therefore, by late 1989 the product was dead, and the investment bank's revenues dropped precipitously, demonstrating the risks of becoming too dependent on category two products which are heavily influenced by government regulation.

The samurai lease had a longer run because regulatory barriers prevented Japanese banks doing anything related to leasing. However, here there was a change in the market as government related corporations in the NICs, the primary borrowers, found they could access the lower cost Euromarkets. The Euro-underwriting business is a category three activity offered by everyone, and it suffered along with the general market collapse after 1989. Finally, their M&A activity never matured
due to a lack of sell side mandates. In this manner an extremely profitable and well
known investment banking operation floundered because it failed to perceive the
vulnerability of its position in category two and three market segments and to
instead build expertise in related areas that could be defended long term such as
private placements and synthetic securities supported by sophisticated swaps and
foreign exchange capabilities as JP Morgan and Bankers Trust had done. They were
therefore forced to close after a loss in 1991.

Still, as described above, it is possible to achieve sustainable and profitable com-
petitive advantage in the Japanese financial services sector by correct and select
positioning that defines and influences a product or market, especially when cost
considerations and price based competition are kept in mind. Yet a firm does not
have to employ several hundred people such as the top eight performers like
Salomon, Goldman Sachs, and the others to accomplish this goal. This situation is
illustrated by Bank of America and Smith Newcourt Securities.

The former while applying for a securities license in 1985–86 with other com-
mercial banks used a combination of circumstance and insight to withdraw its ap-
lication in early 1987. The reasons were MOF staffing requirements would have
required a tripling of head count without adding any trading capacity over using a
representative office of its Hong Kong merchant bank. The required extra person-
nel were only operation and reporting staff. They were also expensive since they
had to be experienced people whose cost was rising rapidly as other foreign firms
bid for them. Also, because trades would now be booked in Japan rather than Hong
Kong, London, or San Francisco, taxes would increase. Further, because the Bank's
trading advantage was in U.S. Government bonds and Agencies plus California state
and municipal bonds, having access to Japan's securities markets had little value. They
could already trade yen government bonds through the branch from changes in the
1981 Banking Law. With no equity experience or research, trading stocks made little
sense. Therefore, they withdrew their request, using financial difficulties and restric-
tions placed by the Federal Reserve as legitimate if convenient excuses for a sound
business decision that avoided the problems that hurt Chemical.

However, they continued to serve Japanese clients through the BA Asia represen-
tative office, providing information on a limited range of activities in core com-
petencies: on trading U.S. Government and Agency securities where they were a
major global player, on one-sided swaps, and on real estate trust advisory services.
The latter two products were unique BofA services. (See Rapp, 1994.) These core
businesses provided a long-term revenue stream to cover office expenses plus
some profit to BA Asia. Additionally, strategic alliances, M&A, defeasance leases,
regular interest rates swaps, private placements, long-term currency hedges, Euro-
bond sales, and some Euro-underwriting were pursued on a situation by situation
basis that in any year could supply additional returns to the basic businesses. While
the specialty areas used dedicated personnel, each specialist was expected to be able
to explain and act as a representative for more general products areas with special-
ists from overseas BofA product groups used to complete transactions. As part of
this activity, the group monitored various markets and products so clients could be
directed to the appropriate vendor if the group felt it did not have the expertise to
handle a transaction. In this manner costs were controlled, product/market focus maintained, and outside innovations in core category one products introduced; yet the Bank responded to clients' requests. More importantly, the group was kept small but profitable so its activities could be sustained long-term.

Smith Securities owned 30% by Rothschild has used a somewhat unique time based management approach in combination with stringent cost controls and effective use of their global network to successfully enter the Japanese equity securities market. In this way they were able to convert a category three type situation into a category one environment where they should be able to sustain advantage over a long period provided that the Japanese securities industry does not seriously move away from a fixed commission system. Having decided to expand internationally after the Big Bang, they acquired an experienced group with a strong capability in Southeast Asia who soon recognized the importance of being in Japan as well. However, they initially had no strategy other than being international and in the major markets, Europe, Asia, and the U.S. Further, they thought that the cost of a Tokyo operation could be carried by business flowing from UK investors interested in buying Japanese equities and Japanese clients buying UK equities, not envisioning the intense competition for that business coming from both Japanese securities firms set up in London and larger British firms such as Barings and County NatWest establishing offices in Japan.

However, management discovered that most stock research in Japan is done only periodically and then updated in response to customer requests. In this sense it is reactive rather than proactive. Smith therefore developed a proactive time based cost effective production system for its research. To keep costs down their office was located out of the main stream, and all analysts had to be bilingual so that translators were not required. This also meant that access to information and companies was current and timely. They invested in an efficient but less than top of the line computerized production system and were on line to Hong Kong where they had their printing done inexpensively. They were also on line to certain customers, and made their research available to the entire organization's client base located in Japan, Southeast Asia, London, Continental Europe and the U.S. In the end they were able to offer continual updated research on industries and companies of interest to their clients on a 24 to 48 hour turnaround. This research of course had the advantage to its customers of both a Japanese and a Western valuation perspective, and could present itself as being unbiased by close business relationships with major Japanese corporations. But this was true for the other foreign securities firms too. What now differentiated them from their Western competitors as well was the low cost and timeliness of their research. The net result of this sales oriented approach was that for 1992 they were both profitable and the number one firm in Japan in terms of volume and value among the 106 licensed securities houses that did not have a seat on an exchange. Since then they have maintained this momentum and built their Japanese customer base, being the number one house again in 1994. The major market change that might hurt them would be a move towards flexible commissions. However, given the current state of the industry and the pressure on the MOF coming from small and medium size brokerage firms this does not appear likely in
the near future. Further, the exit of several large foreign brokers has now given them the opportunity to acquire a seat on the Tokyo Exchange at a substantial discount to pre-1990 prices, again helping them to control costs.

CONCLUSIONS AND THE POST-BUBBLE ECONOMY

The paradigm used in this analysis stressed the importance for competing in Japan's financial service sector of defining, controlling, and defending profitable market segments by sharply differentiating a firm's profit expectations and resource allocation in its leadership products from those it offers as "service". For foreign securities firms, this seems to depend on establishing and controlling a market-product segment through a combination of technology and expertise continually imported from abroad, successful local adaptation, and cost control. These segments have usually been category one businesses and in some cases like foreign exchange and derivatives have become global (Porter, 1980; Euromoney, March 1993 and Loomis, 1994). Attempts to compete with Japanese firms in areas they control or can easily emulate have been ill advised. Yet, most foreign securities firms investing in Japan in the 1980s lured by the Bubble have not followed these principles, have not done well, and several have left. However, the licensed securities and representative offices of a handful of firms that appear to control key market segments have done well, have continued their success in the post-bubble world and seem well positioned for the future (Appendix). These criteria may appear common sense, but the fact most firms have failed implies they are not easily perceived or are difficult to implement in practice.

Finally, it is important to recognize stock index futures and options seem to be an area a small group of U.S. and European securities firms will continue to dominate in Japan and globally. Since volumes traded will likely continue to dwarf and influence stocks despite MOF and Japanese firms' efforts to control them, the structure of Japan's stock bond and other financial markets appear to be permanently altered. Yet, the recent derivatives problems of Tokyo Securities and Barings indicate that maintaining leadership in derivatives also requires strong internal controls and constant vigilance, especially as the economy and stock market continue to be depressed. Tokyo Securities lost $400 million in 1994 because a manager was able to speculate in US bond futures without appropriate supervision.

In turn, Barings' Singapore trader in 1995 was able to take positions on the Nikkei that ultimately brought down the two hundred year old firm, though it must also be recognized that prior to that his arbitrage between the Osaka and Singapore markets had accounted for 30% of Barings' total firm profits. Also, Bankers Trust reported in its 1994 annual report that globally derivatives accounted for 80% of their earnings. Similarly, in one interview, the manager of a leading U.S. investment bank confided that derivatives and related products now accounted for 80% of his earnings in Japan. Thus, the major story of the securities and financial markets in Japan as of the mid 1990s and the post-bubble economy remains derivatives and trading. Foreign firms that have organized to innovate in these markets will continue to succeed. Indeed, the experience of Tokyo Securities and Barings has made Japanese financial institutions very cautious. Thus, Japanese banks are laying off their derivative exposure to their clients.

APPENDIX

<table>
<thead>
<tr>
<th>Foreign Securities</th>
<th>3/90</th>
<th>3.83</th>
<th>0.39</th>
<th>1.68</th>
<th>1.01</th>
<th>1.03</th>
<th>1.34</th>
<th>0.26</th>
<th>0.78</th>
<th>0.39</th>
<th>1.08</th>
<th>0.18</th>
<th>0.23</th>
<th>0.03</th>
<th>0.46</th>
<th>-1.25</th>
<th>11.44</th>
<th>-3.14</th>
<th>8.30</th>
</tr>
</thead>
</table>

(Source: Nik)
on the major foreign banks, making the strong foreign firms stronger. This will force other foreign firms to either retrench or exit as Kidder and Prudential Bache have done adding to the list established by County NatWest, Chemical, Chase, Continental, Security Pacific and others before them, unless they can achieve an alternative and focused approach like that developed by BoA and Smith Newcourt.

These developments have large ongoing ramifications for foreign securities firms and for Japan’s financial institutions, financial markets, shareholder relations, corporate finance and US and European government negotiations into the next century. They also provide strategic guidelines and warnings to firms entering newly liberalized financial sectors such as insurance and funds management. These represent the next wave of financial competition for which major Japanese firms are already preparing since weakened financial markets have pressured them to maintain all existing business. This is the only way they can continue to provide employment and sustain their existence. Therefore, there will no doubt be future foreign casualties in these sectors too, since only innovation and focus based on corporate competencies adapted to Japan will provide a sustainable competitive advantage in a deflated post-bubble economy.

Examining the data above, it is clear the top of the bubble in the second half of FY1989 was a watershed for foreign firms separating “enter the growth market” strategies from ones based on proprietary products and technology. Of the 33 firms that did not lose money in FY 1989, only 15 sustained this into FY 1990 and only 8 into FY 1991 too. The UK brokerage houses particularly seem to have profited at the top, having lost money starting up in 1988–89, but quickly gave these profits back with the collapse. Only Barings could sustain profitability, though

**APPENDIX**

*Foreign Security Firms’ Profits by Three-Year Total*

<table>
<thead>
<tr>
<th>3/90</th>
<th>3/91</th>
<th>3/92</th>
<th>9/92</th>
<th>Total</th>
<th>FY ends to 3/31/92 and 6 months 9/3/92</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.83</td>
<td>2.28</td>
<td>1.42</td>
<td>1.47</td>
<td>9.00</td>
<td>Salomon</td>
</tr>
<tr>
<td>0.39</td>
<td>0.56</td>
<td>1.87</td>
<td>1.31</td>
<td>4.13</td>
<td>Goldman Sachs</td>
</tr>
<tr>
<td>1.68</td>
<td>0.76</td>
<td>0.66</td>
<td>0.29</td>
<td>3.39</td>
<td>Barings</td>
</tr>
<tr>
<td>1.01</td>
<td>0.47</td>
<td>0.88</td>
<td>0.55</td>
<td>2.91</td>
<td>Bankers Trust</td>
</tr>
<tr>
<td>1.03</td>
<td>1.26</td>
<td>0.02</td>
<td>-0.62</td>
<td>1.68</td>
<td>DB Capital</td>
</tr>
<tr>
<td>1.34</td>
<td>0.32</td>
<td>-0.88</td>
<td>0.48</td>
<td>1.26</td>
<td>Lehman</td>
</tr>
<tr>
<td>0.26</td>
<td>0.23</td>
<td>0.70</td>
<td>-0.16</td>
<td>1.03</td>
<td>Morgan Stanley</td>
</tr>
<tr>
<td>0.78</td>
<td>-2.39</td>
<td>0.85</td>
<td>1.70</td>
<td>0.94</td>
<td>Societe Generale</td>
</tr>
<tr>
<td>0.39</td>
<td>0.21</td>
<td>0.13</td>
<td>0.17</td>
<td>0.90</td>
<td>Merrill</td>
</tr>
<tr>
<td>1.08</td>
<td>-0.12</td>
<td>-0.22</td>
<td>-0.07</td>
<td>0.67</td>
<td>James Capel</td>
</tr>
<tr>
<td>0.18</td>
<td>0.12</td>
<td>0.01</td>
<td>0.26</td>
<td>0.57</td>
<td>BNP</td>
</tr>
<tr>
<td>0.23</td>
<td>-1.52</td>
<td>0.06</td>
<td>1.30</td>
<td>0.57</td>
<td>SBCI</td>
</tr>
<tr>
<td>0.03</td>
<td>0.24</td>
<td>-0.11</td>
<td>0.37</td>
<td>0.53</td>
<td>CRT</td>
</tr>
<tr>
<td>0.46</td>
<td>0.37</td>
<td>-0.21</td>
<td>-0.14</td>
<td>0.44</td>
<td>Kidder Peabody</td>
</tr>
<tr>
<td>-1.25</td>
<td>1.56</td>
<td>0.38</td>
<td>-0.27</td>
<td>0.42</td>
<td>JP Morgan</td>
</tr>
<tr>
<td>11.44</td>
<td>4.22</td>
<td>5.56</td>
<td>7.14</td>
<td>28.36</td>
<td>Subtotal</td>
</tr>
<tr>
<td>-3.14</td>
<td>-16.64</td>
<td>-12.46</td>
<td>-2.00</td>
<td>-34.24</td>
<td>Subtotal Other 37 Firms</td>
</tr>
<tr>
<td>8.30</td>
<td>-12.42</td>
<td>-6.90</td>
<td>5.14</td>
<td>-5.88</td>
<td>TOTAL 52 FIRMS</td>
</tr>
</tbody>
</table>

(Source: Nikkei Newsletters).
their success in derivatives was ultimately to bring the firm down in 1995. This indicates the UK strategies were only viable in a buoyant market and could not sustain the pressures of a downturn. Similarly, the German banks turned unprofitable as rising interest rates made the DM less attractive for bond issues. As noted in the text, Deutsche Bank saw a big drop in profitability in FY 1991 and then losses as their existing strategy failed to manage the market shift. On the other hand, 5 firms converted a loss in FY 1989 into an overall profit position for the three year period. One of these, JP Morgan, is a leader in derivatives and in performance during the 6 month periods ending September examined in the text.

Trading is an important aspect of the leading firms’ business strategies as is indicated by data from the Nikkei Newsletter reflecting income from commissions versus trading for the 15 most profitable firms over the 3.5 years: 15 Most Profitable Foreign Firms by 3-Year Total: Commission Income and Trading Profits for FY 1988—September 1992 (6 months) [yen billions]

This data confirms trading technologies as a critical element in the strategies of foreign firms. During the Bubble, the leading firms had less than 60% of commission business going to foreigners as entrants crowded the market. Their share of trading profits was somewhat less. But, after the collapse, firms with superior trading technologies demonstrated their advantage, especially those expert in derivatives that could arbitrage the cash and futures markets. Their share of trading profits rose from less than 60% to more than 80%. They could increase their share of

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<td>---------</td>
<td>---------</td>
<td>---------</td>
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<td>------</td>
</tr>
<tr>
<td>Salomon Bros.</td>
<td>13.8</td>
<td>9.9</td>
<td>30.7</td>
<td>11.4</td>
<td>30.1</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>14.7</td>
<td>1.0</td>
<td>18.9</td>
<td>-1.2</td>
<td>21.4</td>
</tr>
<tr>
<td>Baring</td>
<td>7.6</td>
<td>0.2</td>
<td>15.3</td>
<td>1.2</td>
<td>13.1</td>
</tr>
<tr>
<td>BT Asia</td>
<td>2.1</td>
<td>0.2</td>
<td>5.4</td>
<td>0.2</td>
<td>6.6</td>
</tr>
<tr>
<td>DB Capital</td>
<td>1.5</td>
<td>0.1</td>
<td>4.0</td>
<td>0.2</td>
<td>4.5</td>
</tr>
<tr>
<td>Lehman</td>
<td>4.5</td>
<td>2.4</td>
<td>10.8</td>
<td>1.5</td>
<td>9.7</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>20.8</td>
<td>1.9</td>
<td>27.2</td>
<td>7.2</td>
<td>24.6</td>
</tr>
<tr>
<td>Societe General</td>
<td>0.8</td>
<td>1.0</td>
<td>1.4</td>
<td>3.4</td>
<td>2.3</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>17.4</td>
<td>-1.2</td>
<td>18.6</td>
<td>-1.3</td>
<td>15.6</td>
</tr>
<tr>
<td>James Capel</td>
<td>3.1</td>
<td>0.2</td>
<td>5.7</td>
<td>0.6</td>
<td>4.3</td>
</tr>
<tr>
<td>BNP</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.3</td>
<td>0.1</td>
</tr>
<tr>
<td>Swiss Bank</td>
<td>3.6</td>
<td>0.9</td>
<td>4.1</td>
<td>0.6</td>
<td>3.3</td>
</tr>
<tr>
<td>CRT</td>
<td>—</td>
<td>—</td>
<td>0.4</td>
<td>0.0</td>
<td>1.8</td>
</tr>
<tr>
<td>Kidder Peabody</td>
<td>3.1</td>
<td>0.2</td>
<td>4.6</td>
<td>0.8</td>
<td>4.4</td>
</tr>
<tr>
<td>JP Morgan</td>
<td>1.6</td>
<td>0.1</td>
<td>3.6</td>
<td>0.5</td>
<td>5.2</td>
</tr>
<tr>
<td>Total 15 Firms</td>
<td>94.7</td>
<td>17.0</td>
<td>150.8</td>
<td>25.1</td>
<td>147.0</td>
</tr>
<tr>
<td>All Foreign Firms</td>
<td>161.2</td>
<td>30.1</td>
<td>246.7</td>
<td>42.1</td>
<td>227.4</td>
</tr>
<tr>
<td>15 Firms’ % Share</td>
<td>58.7</td>
<td>56.5</td>
<td>63.1</td>
<td>59.6</td>
<td>64.6</td>
</tr>
<tr>
<td>Number Non-Traders</td>
<td>4</td>
<td>4</td>
<td>6</td>
<td>9</td>
<td>13</td>
</tr>
</tbody>
</table>
commissions too. This is because trading and commission business are interactive. Trading forces one to take a view, and successful trading means the view is generally correct. Further, it requires research support and technical sophistication, including advanced software. These factors improve the advice and service to clients, generating more commission income. At the same time, more client business increases one’s knowledge about large investors’ attitudes towards the market, helping to position trading strategies. The more successful the trading, the more a firm can afford for research and systems. Further, derivatives expertise, trading, and support systems lead to an increase in commissions based on executing clients’ purchases of derivatives, especially complex structures. So expertise, experience, and profits compound.

At the same time, an effective trading strategy by itself is not sufficient for success. As in other businesses, an important element is cost control, including inventory management. Thus, Morgan Stanley, despite outstanding trading performance, suffered large valuation losses from large securities and derivatives positions they held as part of their trading activity. Given this higher break-even and larger potential for valuation losses, their performance is more erratic than Salomon or Goldman. Another cost element that must be watched is the cycle time to develop and establish new products, including support systems. This is because software systems for new products must be put in place quickly to fully and rapidly take advantage of opportunities or client requests due to market developments. Therefore the software development system must be technically sophisticated and highly flexible. These systems form part of the innovation stream that is the basis for foreign firms’ competitive position. Indeed, the most successful foreign firms see software systems and their development as major entry barriers making emulation by Japanese competitors difficult, and they are moving to improve this lead (footnote 3).

GLOSSARY OF SELECTED SECURITIES AND INVESTMENT BANKING PRODUCTS

The competitive environment of the Bubble and post-Bubble period is illustrated in the explanation below of some of the many innovative investment banking products that appeared in Japan’s financial markets and their sustainable advantage to the firms that offered them. It is an alphabetical listing within each type of advantage to domestic and foreign firms with definitions and assessments of the market for each. It is not meant to be a complete catalogue. Rather, its purpose to help define and clarify the relationship between specific products, firms and strategies as listed in the five strategic product segments presented in the text and the type of objective criteria that are used in determining or changing a product’s classification.

\footnote{The author directed a two year research study comparing the US and Japanese software industries under a US-Japan Friendship Commission grant. This involved distributing questionnaires and interviewing users in the financial services sector.}
Category 1: Foreign Firm Advantage—products where the foreign firm's advantage is due to technology and/or market positioning

- Corporate Finance covers many activities including M&A, limited partnerships, restructurings, junk bonds, and new product development such as securitization. Foreign firms have often had an advantage in these niches, at least initially. The biggest area of interest in the 1980s was of course M&A, discussed in the text. Several firms, lead by Goldman, were also successful in repackaging real estate as securities and selling them in large amounts to Japanese investors. The most notable transaction was Goldman's creation of a real estate investment trust incorporating Rockefeller Center. With the collapse of the Japanese stock and real estate markets, the ubiquitous interest in M&A and prime overseas real estate faded. Therefore, while leaders Goldman Sachs and Morgan Stanley remain active, their product focus has shifted. Other firms with less depth and expertise have not been able to maintain momentum and have reduced staff.

  Nomura, Nikko, Yamaichi, Sumitomo Bank, Yasuda Trust, and Nippon Life all invested in prominent US investment banking firms to gain international corporate finance expertise but have not received what they expected, indicating such business has more to do with people, organizational structure, and accumulated expertise which can forecast and respond to dynamic market conditions than to any technical black box that can be learned or acquired.

  While a significant part of Goldman's and Morgan Stanley's business interacts with their overseas client base, e.g. Rockefeller transaction, some products developed by other foreign investment banks purely for Japan were quickly emulated by Japanese competitors, who then assumed product leadership. Thus, Merrill pioneered movie financing to wealthy Japanese investors using tokumei kumiai (special associations), but Daiwa, Nomura, and Yamaichi with better placement power, given their large Japanese client base and superior connections with Japanese movie companies, soon replaced them. Similarly, after the idea was pioneered by a foreign real estate company in conjunction with a Japanese real estate developer and Arthur Anderson, Nomura was able to quickly combine a U.S. limited partnership with a tokumei kumiai to place tax oriented U.S. real estate investments with their huge client list. These cases appear to have been temporary product offerings by the Japanese securities companies designed to satisfy a current investment fashion rather than an attempt to build a long term business activity. This situation clearly illustrates the difficulty in Japan of maintaining profits and leadership in areas one has pioneered if Japanese emulation is relatively easy and the Japanese use such products as "service".

- Interest Options and Futures are traded on several exchanges on a global basis. While in practice they are available to everyone, when combined and repackaged with other derivatives and financial instruments, they can become quite unique. In addition, they offer arbitrage possibilities for those trading extensively in various bond markets. These activities require sophisticated computer software, mathematical talent, and portfolio modeling capabilities combined with good communications and the ability to execute trades quickly. For this reason, these marketa
as explained in the text are dominated by a few U.S. and European firms that meet these requirements.

- Long-dated Forwards go beyond the quoted forward market for yen which extends to at most 5 years, the longest available Euro-yen deposit. However, many firms raising yen funds from insurance and leasing companies for longer terms want to hedge their exposure. There is thus a market for long-dated forward exchange contracts. It is supplied by foreign firms that are consistent large net earners of yen such as insurance companies like AIG, airlines like United and Northwest, and movie companies like Disney and Warner Brothers. Morgan Guaranty and Bankers Trust developed and lead this activity and often combine them with other instruments to structure synthetic securities and various private placements.

- One-Sided Dollar Interest Rate Swaps were developed by Bank of America with the hedge being a futures position in U.S. Treasuries on the Singapore, London or Chicago futures exchange instead of a counterparty. This is a successful product protected by sophisticated software technology and day to day experience using it. However, its growth was eventually limited by the size of its share of the open interest position in Singapore and London, which in 1986 reached 25% and 10%, respectively. Using the futures market as a hedge creates great swap design flexibility, the ability to run an unbalanced book, and the opportunity to arbitrage differences between the regular swap market and the futures market. Particular positions can be laid off at a later date if an appropriate counterparty emerges. This technology was also adapted to other countries such as Japan (yen-yen swap) as interest rate futures markets developed, thus freeing BofA from the need to have a large asset portfolio to compete with local institutions. Further, because of the Bank’s financial difficulties between 1985 and 1988, it freed BofA from being reliant on reluctant counterparties as the only way to compete in swaps.

- Innovative Derivatives—The same foreign firms that have dominated other derivative markets are now experimenting with several new types of derivatives that will cover a wide range of assets and markets including troubled loans, real estate, and price changes. (See Financial, March 1993, The Economist, April 1993, and Loomis, 1994.) In addition these firms are constantly introducing more sophisticated second and third order derivative products such as futures on interest rate swaps. With the exception of Barings, the leaders in these markets are all U.S. Banks: Bankers Trust, JP Morgan, Citibank, Goldman Sachs, Morgan Stanley, and Salomon. Joining them in the next tier are Chemical, Chase, and BofA with First Chicago and some of the big Swiss and German banks also actively taking on exposure. Major Japanese financial institutions, banks or securities companies, did not enter this market until late 1993 when Mitsubishi Bank and Bank of Tokyo, who are now one bank, became active. Their share, however, is still small.

- Private Placements (structured finance or mixed credits) are complex financial structures generally involving a private placement with a Japanese life insurance company. They represent an extension of the asset and liability customization at
which foreign investment banks excel. That is, they are structured to meet specific portfolio objectives of lenders that may arise at different times, using in various combinations loans, foreign currency deposits, yen deposits, interest rate swaps and foreign exchange swaps. Very flexible, they can be modified and adjusted continually as circumstances change. They are a permanent asset management tool similar to the synthetic securities described next. For example, during the stock market boom, most major Japanese companies raised money by issuing shares or equity linked securities rather than borrowing. This meant insurance companies found it difficult to make yen loans to major corporations. At the same time, highly rated foreign corporations were reluctant to borrow long-term in yen as they correctly expected yen appreciation. An arrangement was thus made whereby the insurance company deposits yen with a bank at a below market interest rate. Through a yen-dollar swap, the bank converts the yen deposit to dollars, which are used to make a floating-rate loan to the ultimate borrower. Using a combination of interest rate and foreign exchange swaps the placement bank can also convert the dollar loan to fixed rate or another currency.

At the same time, the insurance company signed an agreement with the lending bank that if there is any problem with the loan, they will accept the dollar loan and the yen-dollar swap in full satisfaction of the bank’s obligation under the deposit. This is therefore a pass through obligation. In this manner, the insurance company gets a yen asset that they can book in their deposit basket, and the borrower receives an attractive loan in his currency with the term and interest of choice. The attractive borrowing rate is subsidized by the below market yen deposit. JP Morgan and Bankers Trust pioneered and lead this business, building on their derivatives expertise and strong credit positions, as both the borrower and the insurance companies have exposure to them on the swaps. Because many of these loans are still outstanding, they are part of the potential derivatives exposure currently roiling the financial markets.

• Real Estate Securitization and Portfolio Packaging was pioneered by JP Morgan, who continues to dominate its development. However, Japanese investors have not used it much since the Japanese stock and real estate markets crashed. Initially, properties owned by pension funds managed by major U.S. insurance companies were packaged as portfolios and sold to syndicates of Japanese investors. The U.S. insurance company, however, retained a piece of the portfolio and continued to manage the properties. In this way Japanese investors got access to a diversified group of quality properties managed by a knowledgeable investor that retained an economic interest. The concept was then expanded to look for investors on a more global basis and for undervalued properties that could be purchased by a pool of investors. So far, the undervalued U.S. properties do not include any foreclosed by Japanese financial institutions from overly aggressive Japanese developers. International access and technical expertise will keep U.S. banks at the forefront of this business and any return of Japan-related activity.

• Real Estate Trust Advice is closely related to the securities business. This is because
the underlying real estate in commercial real estate transactions is held by a single purpose corporation, and the stock in the corporation is bought and sold not the real estate. Therefore, Japanese and foreign securities firms joined with real estate brokers in this business during the 1980s. While most would consider this an activity where everyone could and would compete, some firms were able to establish leadership products or to effectively and creatively pursue real estate transactions as part of a broader and well established corporate finance activity. One leadership product introduced by Bank of America rested on its real estate trust business, which gave the bank a fiduciary obligation to act on behalf of real estate buyers and subsequently to manage the properties for asset appreciation. It was the only U.S. bank with such a legal vehicle. In addition, it had substantial properties already under management for entities like the Kuwaiti government. Building on this established expertise as well as its knowledge of West Coast properties of interest to Japanese investors, BofA was able to establish a client base among some wealthy Japanese investors and real estate companies. By the end of 1989, they had over $500 million in Japanese owned U.S. real estate under management. This generates fee income, as well as the opportunity to acquire additional clients and success fees related to the purchase and sale of assets. Further, as Japanese real estate developers have come under pressure since the collapse the bubble and some foreign properties have been foreclosed by Japanese banks, BofA has been engaged to manage and sell U.S. properties on behalf of the banks. U.S. buyers looking for divestiture situations by Japanese owners also engage BofA to find, assess, and purchase certain types of properties such as U.S. golf courses. In this manner, the bank has established a profitable long-term business presence in Japan built on its unusual legal structure and contacts with real estate investors and properties on a global basis. Flexibly using its external international expertise has thus been a key to establishing a sustainable position in what was otherwise an intensely competitive market that then changed drastically with the crash.

- Stock Index Options and Futures (Weighted and Unweighted, Topix and Nikkei) are available to everyone but for the reasons discussed in the text they are dominated by a handful of foreign securities houses, especially those with equity as well as trading and derivatives capabilities. The ability to propose and implement their use as part of a global investment strategy, including portfolio switching, or in complex hedging structures seems to be a key competitive element in this important market segment.

- Strategic Alliances are commercially oriented business arrangements often between large Japanese companies and smaller US firms with proprietary products or technologies who are looking for capital, manufacturing expertise, and access to Japanese companies. Because the transactions are often small with fees around $100–200 thousand, they are largely ignored by major international M&A firms or the large Japanese securities companies. They are therefore an opportunity primarily for commercial banks with a large base of small and medium size clients, such as BofA and First Chicago. They also provide good access to Japanese firms with
respect to financing their FDI, such as municipal bond and lease financing for plant expansions.

- Swiss Franc Bond issues (strays, convertibles, and bonds with warrants) were very popular during the 1980s because of low interest rates and the traditional stability between the franc and the yen. There was also an active warrant market in Switzerland for Japanese securities. Despite the entry of U.S., other European, and Japanese securities houses into Switzerland in the 1980s, this market was controlled by the three large Swiss banks (Swiss Bank Corporation, Union Bank of Switzerland, and Credit Swiss).

- Synthetic Securities are customized financial instruments created in response to specific customer demand. For example, if a Japanese insurance company wants to purchase a 5-year Kingdom of Denmark bond in Swiss Francs with a certain rate and principal structure, that bond may not exist in the market. However, even if it does not, it can be emulated. One finds a Kingdom of Denmark Euro-bond of at least five years maturity and couples it with the appropriate interest rate and currency swap or interest rate swap and long-dated forward to synthesize the security. To create and market these securities on a regular basis, though, requires and unusual combination of market access, institutional credit, and financial expertise, including a good presence in the Euro-bond markets to access an purchase the bonds. Many large U.S. banks (e.g. BoFA and Chemical) do not have this capability and have actually cut or closed their London bond operations. An active presence in foreign exchange and a Japanese foreign exchange license are also necessary. Only banks have been allowed FX licenses, which limits the players to banks with related securities companies or more recently large securities companies with affiliated banks. Further, players need both an FX and an interest rate swap book and to be credit worthy enough that the bond purchaser will accept their credit relative to payment under the swaps. Finally, fairly sophisticated software, involving significant financial and market expertise is needed to quickly find, price, and create the bonds.

Only JP Morgan, Bankers Trust, and Citibank have met all these requirements and have thus pioneered and dominated this market. Citibank, however, began to lose position once its credit was affected by bad U.S. real estate loans and mounting LDC debt problems. Similarly Bankers Trust’s credit downgrading due to problems with derivatives could affect its ability to transact this business and in turn its future participation in this product market.

- Yankee Bond are dollar-denominated bonds issued in the U.S. by foreign corporations, governments, or international agencies. Japanese companies did not borrow much in this market during the 1980s but in the Euro-dollar market. Lead managers are usually U.S. firms with Morgan Stanley, Goldman Sachs, and Merrill Lynch apparently continuing to lead this business. These firms have an innate advantage in this market due to their U.S. placement experience, contacts, and market knowledge.

Category 2: Regulatory or Variable Market Advantaged products where the foreign firm’s advantage is due to Japanese regulations which can change or to a market situation which can alter with time.
- Index Warrants are based on the Nikkei Index, usually issued with a three-year duration. They achieved international popularity (Shaw, Thorp and Ziemba, 1993) trading on the American Exchange. Both call and put warrants were issued in the last half of the 1980s. Sometimes they were issued by themselves and some times in connection with a bond issue. Their value is determined by the value of the Nikkei relative to a particular level or strike price and at a predetermined or floating exchange rate (Shaw, Thorp and Ziemba, 1993). However, due to pressure from the MOF and the availability of index options, including the JPN (also traded on the Amex), they appear to have lost their appeal. Salomon, Bankers Trust, and Paine Weber were the major developers and underwriters. Administrative guidance prevented the Japanese firms from being heavily involved, particularly with the puts, which were very popular as the Bubble collapsed.

- Samurai Leases (Advanced Sale of Receivables) are “leases” that were actually privately placed offshore loans in dollars or yen by a syndicate of Japanese leasing companies. The loans could be to corporate or government entities, but the most popular borrowers seemed to be government corporations in the NICs. Limitations on the country exposure of Japanese banks facilitated demand. Since Japanese leasing companies are not permitted to make loans and Japanese banks are not permitted to be in the leasing business, this product offered the opportunity of foreign financial institutions to control the market as middlemen. Citibank and Chase led and dominated the market. The loans continued to be popular until the Bubble’s collapse put pressure on the leasing companies and the banks that financed them. Growth also slowed due to the direct access of the NICs to the Euromarkets.

A bank in a tax haven was usually involved, such as Citibank’s Channel Islands branch entering into a sale-leaseback agreement with a syndicate of Japanese leasing companies for some asset, often gold. Citibank would borrow the gold, sell it to the syndicate for the face amount of the “loan” and then lease it back on the exact terms and conditions of the ultimate loan to the borrowers. Citibank would simultaneously pay back the gold and enter into a bank loan with the borrower. Next, it swapped the bank loan with the leasing syndicate for all Cititi’s obligations under the lease agreement. It then walked away from the transaction, collecting a fee, while the syndicate would own a Citibank loan as an investment asset and the borrower would have the money. Protected from entry by Japanese competitors by MOF regulations, Citi and Chase did several billion dollars in transactions before market conditions changed. This regulatory arbitrage proved quite profitable for them and ultimately accounted for as much as 80% of Chase’s investment banking earnings in Japan. The most prominent transaction of this sort was Disney using Citibank, and involved an additional wrinkle, the “forward sale of receivables.” Disney agreed to sell a syndicate of Japanese leasing companies 20 years of receivables from its various yen royalty streams, particularly Tokyo Disneyland—the equivalent of $700 million in yen. Since most of it was on a non-recourse basis, Disney was able to book most of this cash as a deferred credit rather than debt. The royalties had not yet been earned, so there were no taxes.
Disney had effectively capitalized 20 years of income at both an attractive yen interest rate and exchange rate with beneficial tax and accounting treatment (Disney 1989 Annual Report). Other people tried to emulate this structure using other royalty streams or the forward sale of airline tickets, but by that time as just noted the leasing companies were no longer such aggressive lenders. The market for this product had turned after about ten-years.

- Shogun Leases (defeasance leases: aircraft, power equipment, movies) are tax-oriented Japanese leases where assets such as aircraft, power equipment, or movies are sold to wealthy investors who want to shelter income. Generally, public companies are not involved because in Japan firms must report for financial purposes the same as for taxes. Public firms do not want to report declines or losses in income, so they are reluctant to invest for tax reduction. Private firms have a different view, being more cash flow oriented. This business grew very dramatically in the 1980s and interacted with the change in the foreign exchange law and the rise in real estate and stock prices. This is because one could easily lease to foreign companies and the asset boom created many high-tax payers who wanted to shelter income. Further, MOF had little experience with the effect of tax-oriented leasing on tax revenues. There was also global demand for aircraft which fed the market with deals.

Nomura Babcock was the leader. However, as the number of leases grew into the billions of dollars, the National Tax Bureau became increasingly concerned about the loss in revenues and began to periodically tighten the regulations. By 1990 the window was quite small. Combined with the Bubble collapse, which made it difficult to find investors, this development meant the product no longer provided substantial profits to investment banks. In addition, as there were few artificial barriers to entry, the product gradually became a commodity, and fees and income for the structurers dropped. One area where the MOF did provide a regulatory barrier, though, was defeasance leases. These leases were a Japanese invention which allowed the lessee to take the tax benefits as a discount on the capital cost. This structure was especially attractive to government entities such as state airlines or power authorities who could borrow more cheaply in the market than through the debt in a leveraged lease. In some cases, airlines also wanted to pay for the equipment at the beginning because that allowed them to double dip on the depreciation, or in the case of national flag carriers, to "own" the aircraft. Under this structure, the airline or power company made a lump sum payment to a bank, the defeasance bank, which in turn assumed the lessee's obligation to make the lease payments. The defeasance bank then invested the funds in Japanese government or other high quality bonds. Because the payment was made to an international banking center branch like Taiwan, and the investments were made on behalf of the offshore branch, no taxes were paid by the defeasance bank. The earnings to the bank were calculated based on the discount, its up front fee, and the earnings on the investment.

Leaders in this were the big British banks, Barclays and Nat West particularly, who did billions of dollars in transactions. The structure provided an attractive
growth product for the foreign banks because of MOF's prohibition on Japanese banks' involvement in leasing even through offshore branches. However, it favored European banks more than U.S. ones since most U.S. banks could not develop a structure satisfying the accountants and the Federal Reserve that would limit the capital attributed to their lease assumption obligation. Only BoA was able to develop such a pass-through structure. But it was late to the market, and was only able to complete a few transactions before the product's demise in 1990 after the MOF prohibited legal defeasance.

**Category 3: Widely Available or Easily Emulated products offered by both Japanese and foreign firms where neither has an advantage**

- Corporate Finance services such as Euro-bond or equity related underwriting are widely available. Profitability, especially for managers, has thus become marginal. Indeed, as Japanese borrowers have become more demanding, the chances for losses has become greater. Thus, without ancillary profits from other business to cushion such losses, the interest of foreign firms has waned, especially for straight debt. Equity linked issues remained attractive somewhat longer while the stock market was hot. In sum, money could only be made on bonds if issued in combination with products where the underwriter had an advantage. Because of this, several foreign firms—especially bond houses—with neither equity underwriting expertise or other value enhancing products exited this business.

- Currency Swaps (hara-kiri swaps) were a key element in many other products such as synthetic securities, mixed credits, and Euro-bond issues. Although foreign banks and, in particular, U.S. banks dominated most swap markets, yen/yen interest rate swaps, yen/ Swiss franc and yen/dollar swaps tended to be dominated by Japanese banks. There were two main reasons. First, they were dealing in their own currency and had a large asset base to hedge their position. Second, they were willing to price aggressively to buy business or protect their position with a core customer. (For example, they might offer a very attractive swap to get a co-lead manager role on a Euroissue for an important client.) If these were done below expected cost, they were called hara-kiri swaps. The market for them declined as Japanese banks established their London operations and the number of Euro-issues by Japanese firms declined with the stock market's collapse and the recession.

- Equity Linked Securities such as convertible bonds and bonds with warrants are very competitive product markets that favor firms with international equity trading, especially if they also have stock related derivatives expertise. The collapse of the stock market from January 1990 brought what had been a high growth ride to an abrupt end as these issues became unattractive to investors and Japanese issuers reduced investment plans and demand for funds generally. Therefore, they have now become a more normal source of corporate finance. Brokers that did not have other businesses but were only living on their share of the available transaction flow quickly became unprofitable, showing once again that in a
highly competitive market innovation and proprietary products are the key to success.

- Eurobond Trading has been actively pursued by Japanese, European, and US firms since the 1980s. As a commodity business, one can only make money when it is coupled with other activities like synthetic securities. So firms like Chemical and BoA thus departed.

- High-Low Bonds were generally Euro-bonds issued by foreign companies and preplaced with the Japanese life insurers. They were designed by Japanese securities companies for their life insurance customers and issued close to the end of the fiscal year. They paid very high interest compared to market for the first one or two years and then dropped to very low rates. The overall rate was below market too, and the bonds were often sold above par, which is why borrowers were interested. When the insurance companies bought the bonds, they marked them to market or at least to par value and realized a loss on their capital account. However, the rate of return on their income account rose sharply. The reason for this activity was that although overall it hurt policyholders, MOF restrictions excluded capital gains and losses from income. Since income is the basis on which companies compete for business, they had an incentive to find ways to transfer capital gains to the income account. High-low bonds allowed this and thus arbitrated the regulations. Some foreign firms tried to emulate the product, but the window did not last long because MOF negotiated a compromise with the insurance companies allowing transfer of up to 25% of gains to the income account. This again illustrates how profitable opportunities due to institutional arrangements can disappear quickly if those arrangements change.

- Interest Rate Swaps, except for yen-yen swaps, have been mostly a dollar market dominated by large U.S. and European banks. The strongest players have been JP Morgan, Bankers Trust, and Citibank for credit reasons and because of their ability to tie the swaps to higher value-added products. They run global 24 hour swap books which pass from New York, to Tokyo, to London and have very sophisticated software and teams to manage them. Even in the 1980s, swaps by themselves were a commodity. For example, one calls for quotes and brokers search the market for the best deal meeting a customer's needs. Therefore, most banks look for ways to add value to maintain profitability.

- Preplaced "Public" Issues with insurance companies are due to regulatory limits on how much they can lend directly to foreign borrowers. The restrictions on "marketable" securities are more flexible. To arbitrage the regulations, a loan is negotiated with a foreign borrower and a group of insurance companies. To make the loan, a Euro-bond is sold in the market to the insurance companies' foreign affiliates, which sell it to their parents after a waiting period. In this way a private placement is converted to a marketable security.

- Sushi Bonds are Euro-bonds issued in London by Japanese corporate borrowers and usually denominated in U.S. dollars. Because the obligors are Japanese entities, the bonds do not count against MOF restrictions on Japanese insurance companies with respect to the amount of their investment in foreign securities. Foreign
is defined by the nationality of the borrower not the currency or the location of
the bond issue. Thus, as a Japanese company, IBM Japan was able to do a
sushi issue. Because of this anomaly in the regulations, Sushi bonds for awhile
commanded a premium in the market. Banks and trading companies used the low
cost dollars directly whereas other companies swapped them back into yen, achiev-
ing a lower cost of yen borrowing. These swaps were often hara-kiri swaps. Sushis
were quite popular up until the Plaza Accord in September 1985, but became
much less so afterwards as the yen strengthened and dollar interest rates fell,
pressing the demand for dollar assets. Lead managers were generally Japanese or
U.S. securities firms with Japanese bank-owned UK investment houses acting as
co-lead managers in return for providing the swap.

• Trading U.S. Government Securities and Agencies as a primary dealer mirrored
the growth in demand for U.S. government bonds by Japanese insurance compa-

nies in the early 1980s which stimulated entry into the U.S. Government bond
market by major Japanese banks and securities companies. Some like Nomura
applied for and received primary dealer status while others like IBJ bought an
existing U.S. primary dealer. The combination of the 1985 Plaza Accord and the
entry of major Japanese financial institutions as primary dealers has meant U.S.
government instruments are readily available at aggressive pricing. The ability to
compete is thus dependent on volume, low costs, and the use of derivatives as a
marketing tool. The big U.S. bond traders like Salomon, Morgan Guaranty, Bank
of America, Citibank, and Morgan Stanley thus have had some advantage. On
the other hand, European houses with no specific advantage have given up their
primary dealerships in the face of this intense competition. So far the Japanese
firms have stayed the course, not wanting to give a customer advantage to a com-

petitor and being more willing to subsidize unprofitable services from other client
income.

Category 4: Japanese Proprietary Products due to Regulations where MOF
or other regulations prevent foreign firms from competing.

• Investment Advisory Management involves the management of tokkin funds,
which are specified money trusts set up by large Japanese corporations and
financial institutions to trade stocks outside their stable shareholding relations.
Under this structure, capital gains can be included in reported income, while for
tax purposes profits or losses can be deferred until the trust is terminated. Foreign
firms can enter this business, but they need to obtain a special license and estab-
lish a separate company, which is time consuming and expensive. It is also very
difficult to compete with established Japanese banks, insurance companies, and
securities firms that set up subsidiaries to do this business and which can sub-
dize them with profits from other business. In the 1980s, competing against the
security company affiliates was particularly difficult due to the tobashiri and guar-
anteed returns that came to light in the various financial scandals (Zielinski and

• Investment Trust Management is managing trusts purchased by the public which
are similar to mutual funds. Their management is dominated by 15 firms who were the only ones with licenses until 1990. The Big Four control 75% of this business. While as of 1990 MOF has allowed a handful of foreign managers to enter, the door is still quite narrow. Also, because they have no branch network, foreign managers must use Japanese brokers to sell their trusts, paying them substantial commissions. The trusts are very profitable to the firms that manage them since they apparently turn over their assets around 2.5 times a year, paying commissions to their affiliated securities firms on top of what they receive for managing the trusts (Zielinski and Holloway, 1991).

- Samurai Bonds are yen-denominated bonds issued in Japan by foreign borrowers, usually governments or international financial institutions. They were popular throughout the 1980s as foreign borrowers saw Japan as a major international source of capital. Lead managers are always Japanese securities houses, and government permission is required, since there is usually a queue. However, with the strength of the yen, customer interest has declined because in retrospect borrowers have found the money very expensive.

**Category 5: Japanese Firms' Core Products or Services where they and related market players derive most of their profits. Share numbers presented for the Big Four, though, do not consider the added market position of their affiliates.**

- Brokerage of Foreign Securities is a core business due to their placement power and the need for market preparation prior to launch. The Big Four have traded more than 90% of foreign securities in Japan since 1985. This has occurred despite the entry of foreign firms that might have been expected to make a market in the stocks of their home country corporate clients. Interest in foreign securities has diminished greatly since the late 1980s because of the stock crash and the yen's appreciation, so this area is not of great competitive importance except as an indicator of the Big Four's strength in all types of stock brokerage.

- Commission Trades are Japanese securities firms' primary core business that are highly profitable because of fixed commissions. Commissions typically account for 50% of the earnings at the Big Four and about 75% at smaller firms. Extensive branch networks and customer bases form the foundation for its defense, which is supplemented with various types of "service" such as billing "mistakes". In 1989, for example at the height of the Bubble, foreign firms did only 6% of the turnover on the TSE, and much of that was index related (Kimura and Pugel 1992). Merrill Lynch, the most aggressive firm as regards retail, consolidated from six offices to two in 1993–94. Similarly, Salomon in mid 1993 redeployed 60 people from its equity commission business to bring expenses more in line with revenues. Big Four firms in turn had about 40% of the turnover in 1990. Their share of total bond trading including government bonds was 75% in 1988. Affiliated firm transactions could add more than 10 percentage points (Kimura and Pugel 1992).

Foreign firms did achieve a remarkable 20% of TSE volume in 1992. However,
closer examination indicates this was due primarily to the big drop in total trading volume and the higher percentage accounted for by index arbitrage. It is thus an indicator of their strength in index futures, not a shift in their competitive position with respect to brokerage. This is supported by the index arbitrage numbers presented in the text for 1992. Nevertheless, due to the depressed stock market and the shifts in institutional trading to the index markets, the brokerage business is not the money earner that it was, though profitability in 1994 did recover from the losses of the immediate post-bubble decline.

• Underwriting of Equity and Bond Issues is another core business for Japanese brokers. Kimura and Pugel (1992) report that between 1975 and 1984 only 5 percent of the almost 1000 firms issuing securities changed underwriters. Of the 23 switchers from among the largest 500 firms, all switched to another Big Four firm. Of the 24 from among smaller firms, only one switched to a non Big Four firm. This is very profitable business. The commission structure is fixed at 3.5 to 4.0% for equities, 1.3 to 1.6% for bonds, and 2.3–2.5% for convertibles. These fixed fees mean other firms cannot bid competitively for the business. The Big Four firms have thus consistently accounted for about 80% of equity and bond underwriting. They are able to control the former because of the need to support the share price for six weeks prior to issue. In the case of the latter, their dominance of bond trading is a key factor. New equity issues are especially profitable because in addition to the fixed underwriting fees, shares seem to be consistently underpriced as much as 40% compared to subsequent market performance, assuring substantial underwriting profits.

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