Foreign Penetration of Japan's Investment-Banking Market: Will Japan Experience the "Wimbledon Effect"?

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Abstract

Foreign banks have long faced difficulties in attempting to enter certain Japanese financial markets. This is due partly to regulatory practices and partly to specific Japanese socioeconomic conditions, for instance the system of relationship banking. While retail banking is still a sector in which almost no foreigners have been able to succeed, some foreign financial institutions have been able to gain market share in investment and wholesale banking.

Today, Japanese financial markets offer a bizarre playing ground for foreign competitors. On the one hand, overdue reforms, deteriorating stock markets, and shockingly bad ratings should scare many foreigners away from making commitments to Japan's markets. On the other hand, it is just these problems and the dissatisfaction with the Japanese banking sector as well as an increasing division of the Japanese economy into large global players and small domestic companies that might help a few strong foreign banks with superior global capabilities overcome their liability of foreignness. Indeed, we assume that improved market opportunities for foreign banks in Japan are related to a fundamental lack of global capabilities on the part of Japanese financial institutions, despite their pronounced advantages as local players.

In contemplating the future of foreign financial institutions in Japan we propose three scenarios. Japan is often compared with Great Britain, where the term "Wimbledon effect" was coined after deregulation of Britain's financial markets—the "Big Bang"—resulted in the acquisition of many British banks by foreign companies. (The analogy refers to the fact that although Britain provides the world's foremost arena for tennis at Wimbledon, the winners of the Wimbledon tournament tend to be foreign players.) The Wimbledon effect would predict that market deregulation will strengthen the financial center but lead to a situation in which markets are dominated by foreign banks. Focusing on investment banking, our paper examines whether Japan faces the same developments as did Great Britain, whether the Wimbledon effect is a plausible scenario for Japan, and whether the analogy between the two financial centers is suitable. The two other scenarios are strong positions of foreign-Japanese joint ventures ("mixed double") and the continuing dominance of Japanese financial-service providers ("home run").

While domination by foreign financial institutions has come to pass in Britain, its Big Bang has at the same time boosted London's position as a financial center. However, in this paper we will explain why Japan's case is different from the situation in the British financial markets. Not only is market domination by foreigners in Japan an effect that cannot be expected in the medium run, but Tokyo's domestic orientation distinguishes it from so-called global centers such as London and New York and makes it highly vulnerable in the current situation. Japan's long-lasting economic problems, Tokyo's historical lack of a greater region it has served as a financial center, and an increasing need for globally competitive financial services by large international Japanese corporations cast doubt on the future status of Tokyo as a leading financial center.

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1 Background

The 1990s were a difficult period for the Japanese economy and for its financial sector in particular. Financial institutions continue to cope with post-bubble problems, especially with bad loans, whose volume is still hard to evaluate.[2] Moreover, the Japanese economy is troubled by a deep economic slump whose end is yet to be foreseen. Together with declining stock markets, this has spelled trouble for Japan's financial institutions (Japan Today 2002b, Financial Times 2002e). In addition, Japanese companies are today under unprecedented exposure to globalization, which is reflected in the fact that not only do they face competition in foreign markets but foreign companies increasingly have entered Japanese domestic markets. In the financial sector, competition has also been fostered by the "Big Bang" reforms begun by Prime Minister Hashimoto in 1996.

While Japanese political decision-makers are struggling to come to terms with the load of problems that burden Japan's economy and its financial sector in particular, the sincerity behind reform announcements is the subject of debate. Even though many steps toward reform have not been undertaken with the speed and strictness which many foreigners have wished, some major changes have been realized. In reaction, Japanese companies have been undergoing an intensive process of restructuring, in the course of which domestic and international mergers and acquisitions have played a major role. The Japanese financial-services sector has been characterized by the evolution of the banking giants, which have a long way to go until their integration and consolidation is finished. At the same time foreign banks have been able to improve their market positions in some sectors of Japanese financial markets, among them investment banking.

Today, we find that Japanese financial markets are in a transitory phase that is characterized by—besides the economic troubles—the fact that part of the distinctive Japanese governance system is changing. Japan's financial markets have long been dominated by domestic banks. Today, however, they are characterized by new requirements for innovative products and services that are in line with global standards. This is partly due to the fact that the restructuring of the system urgently requires new financial solutions, but it is also due to the very gradual and difficult opening up of markets that allows foreign firms to supply these products. The Japanese financial system seems to be searching for a balance between its own, Japanese, traditions and global standards.

Great Britain is the nation after whose deregulatory package the Japanese Big Bang was named. The Big Bang in the UK has been used as a predictor of the future roles of Japanese and foreign financial institutions. The *Wimbledon effect*—as observed in the UK—would speak for a domination of Japanese financial-services markets by foreign banks, notwithstanding a significant international role for Tokyo as a financial center. The successful players are—especially in the field of investment banking—part of the bulge bracket group[3] of firms that have been able to collect a lot of expertise and have an excellent global reputation. Taking this analogy as a starting point, this paper aims to shed light on the changing role of foreign financial institutions and on Tokyo's position as a financial center.

Compared with most Western central locations, Japan's financial system has functioned according to distinctive rules. These differences go far beyond simply having a system that is protected by rules and shielded by bureaucracy and the government. It has relied on specific rules of interaction, on specific relationships, and on a division of labor that is different from the West's. In this paper we will elaborate on this distinctiveness as a major feature of Tokyo as a financial center. We will suggest that a Japanese Wimbledon will have characteristics that are fundamentally different from the case of London, both as regards the outcome of competition between foreign and Japanese banks and the consequences for Tokyo's status as a financial center.

In Great Britain, the Wimbledon effect was due to the acquisitions that foreign financial institutions made in its financial sector. But the Japanese are not prepared to let huge parts of their financial-services sector be acquired by foreigners, even though this has happened in some cases. Another avenue toward a Wimbledon effect would be increased competitiveness on the part of foreign firms in Japan.

This paper focuses on investment banking, although other sectors will be mentioned. Investment banking is an inherently global business. It is dominated by a few global players that are nowadays competing with major securities houses and banks in Japan. It requires great and rapidly changing skills and technologies as well as global expertise. We chose the investment-banking sector because it plays an important role in the restructuring of the Japanese economy by means of advisory services, bad-loan disposal, and new ways of raising capital.[4] While it is obvious that a partial analysis cannot justify a general statement of whether Japan's financial sector will experience a Wimbledon effect, we believe that transaction-specific analyses are necessary to understand market dynamics.

We discuss two alternative scenarios to the Wimbledon scenario. One, the "mixed double" scenario, is characterized by a strong market position of foreign-Japanese joint ventures; the other, the "home run," would predict continuing market dominance by Japanese banks and securities houses. In this paper, we will argue that a mixed scenario between a Wimbledon effect and the mixed double is a possible future outcome for Japanese financial markets. Foreign banks have advantages that might be described as global capabilities, while often they lack what we call local knowledge. Part of this local knowledge is related to local access to clients.

The following questions will be discussed in the paper:

• What do the dynamics in a "bulge bracket" industry like investment banking look like, if competition by foreign firms (which bring in global capabilities, but have to build up local access) increases in a system with the distinctive characteristics of the Japanese financial markets?

• What variables are relevant to predicting whether a Wimbledon or any of our other scenarios is a probable outcome?

• Are foreign-Japanese joint ventures adequate short- or long-run strategies to help the Japanese partner gain expertise and to provide foreign financial institutions with market access?

• What predictions can be made about Tokyo's future role as a (global) financial center?

We will argue that the Wimbledon question is twofold, concerning the future market position of Japanese banks on the one hand and the role of Tokyo as a financial center on the other (Figure 1). In Great Britain, the contrasting effects of the disappearance of many British banks from the market scene and the improvement of London's position as a global and European financial center are evident. Whether a similar fate is in store for Japanese banks and Tokyo has to be carefully discussed.

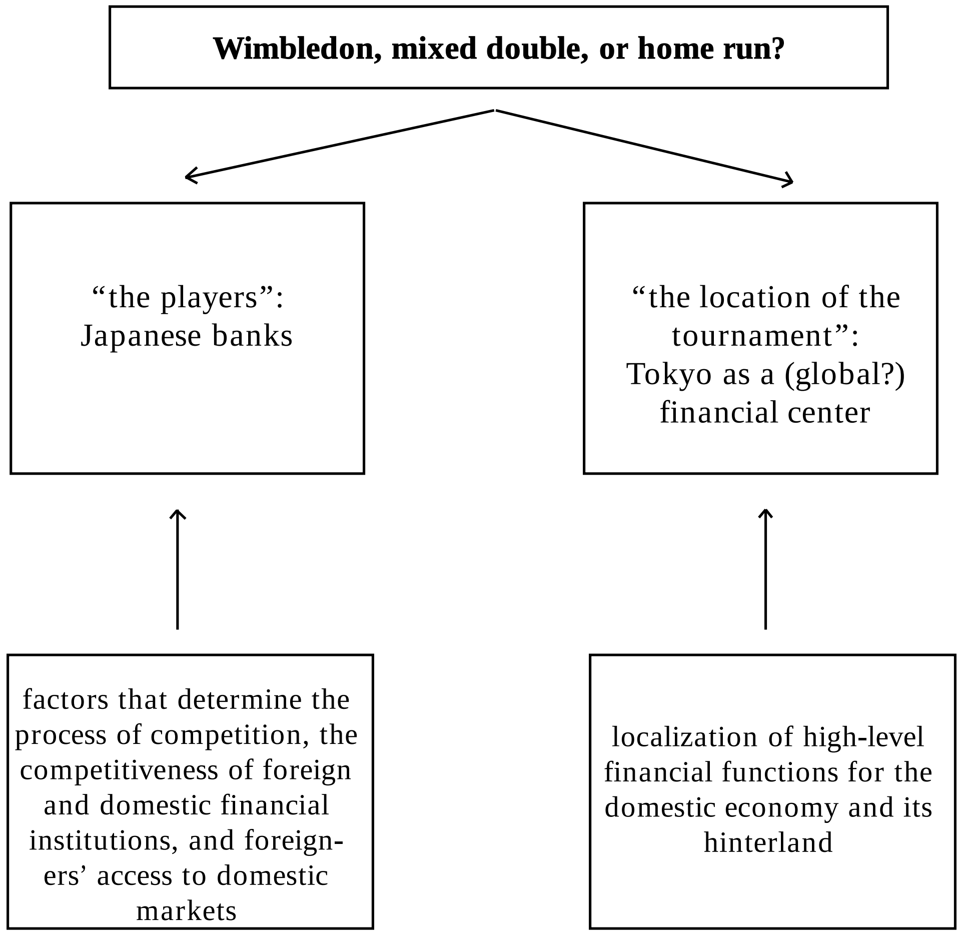

Figure 1. The Effects on Japanese Banks and Japan’s Financial Center

In Section 2 we will describe specific features of the Japanese financial system, the importance of relationship banking, and the role of bureaucracy. Section 3 will deal with the strategies of market entry and competition foreign firms have chosen. Section 4 proposes a set of scenarios about the relative domination of Japanese investment banking by foreign or Japanese firms. Section 5 discusses the competitive strengths of foreign and Japanese financial institutions and foreign-Japanese joint ventures, respectively. Section 6 describes the opportunities that have opened up for foreign firms in Japanese financial markets and of the threat they pose for Japanese banks. Section 7 will address the factors affecting Tokyo as an international financial center. Finally, Section 8 will draw conclusions and point out some of the key variables relevant to a projection of the future role of foreign banks in Japan and the status of Tokyo.

2 The Environment for Foreign Financial Institutions in Japan

2.1 Relationship Banking As a Barrier to Entry for Foreign Banks

Foreign banks have had to struggle to gain a significant position in the Japanese market, which has long been dominated by strong established ties between Japanese banks and industrial corporations. In addition to this, market entry is difficult for outsiders, as Japanese society in general is known as relatively closed and communication is embedded in contextual knowledge.[5]

After the deregulation of Japanese financial markets the traditional main-bank system may still act as a barrier to foreign firms. Most Japanese companies that are listed on stock exchanges have a main bank. For many of them loans from this main bank have long comprised the largest source of external funds. Moreover, the main bank holds a significant equity interest in the company, is represented on its management councils, and assumes special responsibilities for managing the corporation's affairs in times of financial distress (Flath 2000). Their core corporate clients have long been a major source of income for Japanese banks. Companies that belong to the same financial keiretsu group often share the same bank. The main bank handles a disproportionately large share of the client firm's daily transactions. In times of financial distress, it is likely that the main bank intervenes in the management of the firm. Sometimes the main bank dispatches its own employees to take on top management positions in the distressed firm. It also leads the recovery plan, providing external funds and supervising a possible liquidation. This role makes the main bank the best-informed party regarding the firm's management decisions and gives it an advantage over any other bank. Banks that practice relationship banking have been said to invest in customer-specific inputs and gain information that is often proprietary in nature. Relationship banks have multiple interactions with the same customer to use the information they acquire. These strong relationships are difficult to penetrate, especially for foreign banks, which may not even be willing to do their business according to Japanese traditions. Existing relationships create a certain lock-in effect that makes it difficult for newcomers to enter the market.[6] Opinions about the efficiency of the main bank system are mixed, but many scholars acknowledge that Japanese banks have long provided important services and produced public goods for the Japanese financial system (e.g., in terms of corporate governance functions), even though resources have also been misallocated.

Aoki and Dinc (1997) describe the incentives for relational contracting in the main bank system: information advantages of the financier, the possibility of inter-temporal smoothing, the need to keep an acquired reputation, and relationship-specific assets. Information rents might be one reason the system may not be completely abolished, even though there is likely to be a reduction in banks' role in corporate governance.

Relationship banking might be a barrier for foreign banks, which may not be able to establish similar relationships and which may be unwilling to occupy the role played by Japanese banks. However, there are indicators that corporate capital-raising strategies in Japan are undergoing fundamental changes, with bond and equity issuance, as well as new capital-raising options such as securitization, becoming more important (Financial Times 2000e). In the past, Japanese banks used to lend to their clients on the basis of the above-described relationships, while often neglecting their customers' ability to generate returns on the capital. Companies were accustomed to cheap funding and banks were less preoccupied with return on capital than with market share. Today, it is obvious that there were massive misallocations of capital. Since the second half of the 1990s, there have been cases such as that of Yamaichi, where a company with a main bank collapsed without the main bank being able to rescue it. This may be one sign that the Japanese main bank system is unraveling.[7] Hoshi and Kashyap (2001) go so far as to say that Japan's banks are going to shrink significantly, that funding sources are going to be more diversified, and that securities markets are going to have much greater importance than in previous decades. These and other changes might give foreign firms a competitive edge. Some observers also argue that Japan's long years of recession have created more acceptance of foreign investment (Financial Times 2002d). Others predict that Japan's financial system is moving closer to the Anglo-Saxon model, in which capital markets play a strong role (Financial Times 2002k).

Foreign banks have been in Japan for a long time, but there are relatively few success stories. Rapp (1999) explains that this is partly due to the ability of Japanese companies to emulate comparative business advantages. Also, for many foreigners the strategy of participating in the huge Japanese market by duplicating their advantages and capabilities elsewhere and being a player in European markets did not prove successful. A few foreign firms have been able to build up successful business operations in Japan, however. When the bubble collapsed foreign financial institutions were often said to be part of the problem because they were important traders and market makers in futures markets. Afterward some foreign firms were able to build on their ability to arbitrage market imperfections for institutional and corporate clients who tried to protect profits. To some extent foreigners may have also been one of the forces introducing change into Japan's financial markets, when their home countries exerted pressure on Japan to open markets (gaiatsu). One example where such pressure was conceivable was the abolition of Article 65 of the Securities and Exchange Law, which separated commercial banking from the operations of securities houses.

2.2 The Role of Bureaucracy

The role of bureaucracy in Japan is considered to be much stronger than in many other countries. At the same time there have been doubts about whether the traditional regulatory system in Japan is capable of allowing change and fostering reform, even though the system was fairly successful in promoting Japan's boom earlier in the twentieth century. It is obvious that it has been difficult for the Japanese government to solve the problems in the financial sector after the burst of the bubble and to restore the competitiveness of its banks. The reasons for Japan's resistance to change have been analyzed by a number of scholars.

While the bureaucracy might come into play in an analysis of the determinants of the competitiveness of domestic financial institutions, it also may play a role in erecting barriers to market entry by foreign companies. However, at least in the last decade the problems of foreigners were not mostly due to legal restrictions on their operations. Nabor (2000) also finds that many difficulties of foreign banks before the Big Bang were not due to direct discrimination by laws or other rules, but to the distortions in competition introduced by the Ministry of Finance (MOF). Advantages due to new products were wiped out because of delays in licensing processes and the fact that MOF forwarded information to competitors. While prices and products were not the most relevant variables in competition, relationships were important. We find many examples where foreign banks were punished for certain behaviors or where the government tried to intervene in their business practices. Whenever this occurred and was directed particularly against foreigners, it triggered intensive debates between Japanese and foreigners over whether this was due to foreigners having broken the rules or whether it reflected xenophobic behavior on the part of the government.[8]

The other dimension in which the government plays a role concerns not its behavior toward foreigners but its determination and ability to deal with the difficulties that trouble the domestic banking sector, the most prominent of which is the question of bad loans. The ability to find long-term solutions influences the probability of a Wimbledon effect significantly, as a stronger domestic sector would reduce the demand for foreign banking services and at the same time the difficulties accompanying the entry of foreign banks. While a discussion about the treatment of foreign banks in Tokyo easily results in normative debates, the question that is raised again and again is: Why is Japan so resistant to reform at a time when the economy is in such devastating shape? Or: How bad does the economy have to get before pressure forces the government to commit to drastic reform measures? Different reasons have been forwarded to explain Japan's resistance, which is often difficult to understand from a Western perspective:

- cultural reasons relating to different approaches to dealing with change, distributing the pain related to change, and ascribing failure.
- arguments that barriers to progressive political decision-making, not economic problems, are Japan's worst problem; politicians are not willing to risk their necks by taking drastic measures, but instead they wait for the next person in charge to act (which seems to be a political-economy problem on a global scale).
- arguments referring to the distribution of power and to the interaction between the relevant decision-makers.

In particular the last two explanations are strongly related to the fact that the benefits of reform would be macroeconomic and long-term in nature, but the costs would mainly be microeconomic or concern individual political reforms and have a short-term nature.

Amyx (2000) has followed developments in the distribution of power of MOF in particular for the period 1998–99. She offers the following explanation for the government's inability to prevent bank problems from escalating and for the system's resistance to change: Japan's Ministry of Finance has traditionally used informal means to achieve policy goals (*gyosei shido* or administrative guidance), which was possible because it "sat at the intersection of a dense and pervasive web of ties extending to financial institutions, the Diet, and other government agencies." Or, as Brown (1999) also states, "(c)onsensus, secrecy, informal relations, and an incremental approach to reform were all controlling principles."[9] It is interesting to note that far from being overregulated, Japan's financial markets have been interpreted to be less legalistic than for instance those of the United States.[10] Dore (2000) names "institutional interlock" and "motivational consonance" as factors that inhibit change in Japan. Also writing of a "social contract" that prevents failure and change, Carlile and Tilton (1998: 200) come to a similar conclusion:

> Pervasive informal regulation and weak antitrust law have combined to create a context in which public and private interests supportive of existing regulatory arrangements have become fused and strongly entrenched. It is this connection, perhaps more than anything else, that accounts for the longevity, tenacity, and adaptability of the Japanese regulatory regime and makes regulatory reform so difficult politically.

Obviously, foreign banks were very uncomfortable with MOF's habit of micromanaging markets.[11] Removing these informal relationships, however, would have meant depriving

MOF officials of important sources of intelligence about financial markets, which—without adequate substitutes—might have resulted in a deterioration of the situation.

Reality has shown that this system based on informal exchange of information was hardly suitable to tackling the problem of bad loans in Japan's financial sector. It was also not very conducive to injecting a spirit of competition into the financial-services industry (Brown 1999). Akiyoshi and Katsutoshi (2001) add that the effectiveness of financial supervision in Japan was undermined by the system of *amakudari* ("descent from heaven"), in which retired officials from the Ministry of Finance were employed by banks. They assume that this created principal-agent problems and collusion between regulators and regulated banks. However, Brown (1999) points out that far from all financial institutions accepted *amakudari*; in particular the former *zaibatsu* banks did not, and as they merge with others this practice is spread. Brown also assumes that the creation of superbanks as well as the penetration of the market by foreigners will lead to a reduction of ex-ante informal communication between financial institutions and MOF.

Past experience in Japan has shown that its increased integration into the global economy has not necessarily meant significant decreases in state intervention. Often, deregulation and change seemed to have occurred in a piecemeal fashion, which may have led to results that actually enhanced existing problems.

In 1998 criticism of MOF's practices finally led to the transfer of inspection and supervisory authority over the private financial sector to the newly created Financial Supervisory Agency (FSA and later Financial Services Agency). While this was a move toward a formal and expectedly more rule-led institutionalization of governance, the FSA also had some problems which inhibited it from triggering significant change: it lacked the infrastructure and resources for monitoring and dealing with bank failures, falling bank shares, and low market confidence, and it needed to consult with MOF. According to Amyx (1999), the Financial Revitalization Law moved things significantly toward a rule-based supervisory system.[12] But it also led to a greater fragmentation of financial authority and thus to less efficient policy coordination and more time-consuming communication and coordination. MOF officials were already known to study new questions for a very long time in order to avoid "career-ending blunder(s)" (Brown 1994: 197). The creation of the FSA was announced as the beginnings of an independent agency and a system that is fair, transparent, and based on market discipline with clear rules. Several times, however, the FSA has come under attack because of its rigorous market interventions, with the latest example being its interventions concerning the short-selling of stocks. While there are some analyses of the interaction between MOF and the private sector, equivalent literature that analyzes the importance of the FSA in the period following 1998 is rare.

With the outcome of these recent steps yet uncertain, one important point emerges clearly from the above discussion of the Japanese political economy of change and deregulation. Foreign banks obviously fall through the dense network of informal contacts that characterized the past and their presence would thus change the way information can be exchanged and monitoring can be done. Without a doubt, this has a significant impact on the way Tokyo functions as a financial center. It might also be one of the reasons that regulators have problems accommodating foreign banks in the domestic banking system and why it is difficult to open markets. Reform in Japan will have to be built on a broader foundation than adjustments in rules and the legal framework alone. It requires a fundamental change in mentality. The way information is exchanged among private-sector decision-makers and between the government and the private sector crucially affects the degree to which outsiders can penetrate markets. Major changes in the way economies work can be expected when societies with "closed" systems of information circulation are to a significant degree penetrated by foreigners.

3 Market-Entry Strategies

In this section we discuss the strategies foreign financial institutions have employed to enter Japanese markets. We deal with acquisitions of Japanese companies by foreigners, which is a relatively new phenomenon with only few examples, as well as with foreign-Japanese joint ventures.

Looking at the published financial statements of foreign-bank branches in Japan (KPMG 2001), we find that nearly half have zero or negative ordinary earnings (Table 1). While it is easy to lament the protectionist attitude of the Japanese government and the difficulties of entering Japanese financial markets, some observers have pointed out that the blame may have to be shared between foreigners and Japanese (Brown 1994). Brown explains that foreign banks conducted lucrative business in Japan in the 1970s and emphasizes that there are cases of banks that were able to overcome restrictions set by the Japanese government and also that foreign governments were able to influence the reform process. Moreover, he supports the opinion that foreign banks were not always treated differently from Japanese banks and that the stance of the Japanese government was not anti-foreign but designed mostly to maintain its overall authority. But most important, he stresses that some of the blame is to be placed on foreign banks and foreign governments. Far from all banks were willing to commit to Japanese markets. Most entered in good times and withdrew when times turned bad. Similarly, foreign governments "did not devote the time and energy necessary to understand the domestic dynamics of reform and the places where pressure could be applied most effectively" (Brown 1994: 194).

Company (winners)	*Ordinary earnings in million ¥*	*Company (loss-makers)*	*Losses in million ¥*
1. Citibank	**14,082**	75. Hong Kong and Shanghai Banking Corporation	**2,990**
2. Chase Manhattan Bank	**9,989**	76. Korea Development Bank	**3,178**
3. Credit Lyonnais	**5,005**	77. ING Bank N.V.	**3,237**
4. UBS AG	**4,434**	78. Korea Exchange Bank	**3,251**
5. Banco do Brasil S.A.	**2,027**	79. Shinhan Bank	**4,626**
6. Westdeutsche Landesbank	**1,646**	80. Housing & Commercial Bank, Korea	**5,616**
7. Australia and New Zealand Banking Group Limited	**1,571**	81. Morgan Guaranty Trust Company of New York	**10,580**
8. Banque Paribas	**1,514**	82. Cho Hung Bank	**10,590**
9. Banque Nationale de Paris	**1,400**	83. Deutsche Bank	**16,113**
10. HSBC Bank USA	**1,393**	84. Hanvit Bank	**25,843**

Table 1. Ordinary Earnings of Foreign Financial Institutions in Japan, Top 10 and Biggest Losses, 2000

Source: KPMG (2001)

Recent surveys show that foreign bankers think that the liberalization and internationalization of Japan's financial markets is not yet adequate when compared with New York and London (JCIF 2001). Many bankers say that the pace of liberalization is too slow. Major reasons for their dissatisfaction are delays in improving disclosure and the tax system. Moreover, the rules and methods of administration and examination by the FSA are criticized and the need to shift accounting systems to global standards is underlined.

3.1 Company Buyouts

The Wimbledon effect in Great Britain was related to the acquisition of British banks by foreigners.[13] To a limited extent, this is also part of the situation Japanese banks face. Foreign buyouts add to the fear of a Wimbledon effect in Tokyo. By May 2001 foreign investors had sealed three significant deals in Japan's banking sector. Kofuku Bank was an example of a regional bank that collapsed under the weight of bad loans. Afterward the Financial Reconstruction Commission (FRC) announced in 2000 that it would sell the bank to a U.S. private equity group established by Wilbur Ross, known on Wall Street as a buyout expert. Such a move was remarkable for Japan, where a U.S. buyout would have deeply dismayed the Japanese government only a few years before. Other cases have occurred: Ripplewood bought Long-Term Credit Bank (LTCB, now Shinsei) in 1999, and in 2001 Lone Star Fund outbid Ross and won the right to take over Tokyo Sowa Bank.

The Shinsei case is an especially interesting one. When LTCB was sold to Ripplewood in 1998 this move was expected to inject new competition into Japan's financial world (Financial Times 2001c). Until then, foreigners had never owned a bank in Japan and never attempted to impose Western lending criteria—based on investment return, not relationships. And, indeed, Ripplewood seems to have engendered change in Shinsei. Since the acquisition, however, the government has wavered about whether it is willing to let Shinsei cut loans to troubled borrowers. In October 2001 the FSA ordered Shinsei to increase lending to small and medium-sized businesses to comply with the rules governing banks that have received an injection of public money.[14] Shinsei has recently announced that it is planning its initial public offering.

After the sale of Long-Term Credit Bank to a foreign buyer, the head of the FRC suggested that the next buyer of a failed bank should be Japanese. The FRC subsequently announced this for Kokumin Bank. The FRC also decided that failed Nippon Credit Bank should remain in domestic hands. It was finally sold to a group of Japanese bidders, led by Internet financier Softbank, despite a potentially stronger bid by Cerberus Capital Management of New York.

Recently the case of Aozora Bank (former Nippon Credit Bank) has again shown the concern of the Japanese over foreign ownership of banks. It has been reported that a group of former Japanese government officials was trying to buy a stake in Aozora held by Softbank in order to prevent the bank from being taken over by a U.S. investor and becoming a second Shinsei (Bloomberg 2002, NikkeiNet 2002b).[15] The FSA has to approve the acquisition by a foreign investor if the transfer of a stake is greater than 20 percent.

There are government estimates that buyout funds in Japan are worth several billion dollars, even though much of this money has not yet been spent.[16]

Even though there have been cases of buyouts in Japan, there are still many barriers that block more foreign capital from flowing into its banking sector. Shinsei may also to some extent have been an easier case than any future deals, since the government had removed about half of its bad debts before Ripplewood took over and had agreed to compensate Ripplewood for a portion of Shinsei loans that go bad in the future.

Buyouts are a heavily discussed topic in Japan. However, they have up to now been too few in number in its financial markets to talk of a Wimbledon effect.

3.2 Joint Ventures

Foreign investment banks have mostly chosen go-alone strategies in entering the Japanese market. (For a ranking of foreign banks by assets and ordinary earnings see appendix.) However, there are several remarkable exceptions of foreign-Japanese joint ventures, and at least one has attained considerable success in the field of investment banking: Nikko Salomon Smith Barney (NSSB), established in 1999. Nikko Cordial holds a 51 percent position against 49 percent by Salomon Smith Barney.

Nikko was the third-largest securities firm in Japan before joining Salomon Smith Barney. It had one of the largest retail networks in Japan and as such could bring its relationships in the Japanese market into the joint venture. Like the other Japanese securities companies, it was hard-hit by the financial crisis. In March 1999 Japan's largest three securities companies, Nomura, Daiwa, and Nikko, reported record losses for the previous year, which was in contrast to the profits some foreign firms made. Nikko brought its entire wholesale securities structure, its bond and equity trading department, its underwriting and product development division, and Nikko Research into the joint venture.

Salomon Smith Barney is part of Citigroup.[17] The joint venture of Nikko Salomon Smith Barney is without a doubt one of the most remarkable cases of a foreign-Japanese alliance in the financial sector. There was much speculation, particularly on the part of NSSB's competitors, about the cultural problems that the joint venture might face, and indeed there seem to have been some problems in the beginning (Financial Times 2001b). Currently, however, the venture is characterized by growing success. In the financial year 1999–2000 Nikko Salomon Smith Barney had net profits of ¥17.5 billion (Financial Times 2001b). These were higher than the profits of any of its foreign rivals in the Japanese market. It had more than a 30 percent market share in Japanese equities markets. In underwriting it was also able to capture many larger deals. It had 3.5 times more clients in underwriting than all other foreign firms put together. Nikko Salomon Smith Barney has been using its joint-venture status particularly well, bringing European and U.S. clients to Japan while helping Japanese customers raise money or sell assets overseas (Wall Street Journal 2002).[18] In 2001 Thomson Financial ranked NSSB at the top of underwriters in several categories, with a 45 percent market share of Japanese equity and equity-related issues worldwide. Integration is not yet perfect, however. Its mergers and acquisitions business is divided into two groups. One group does small local mergers and acquisitions and is managed by Nikko managers. The other group, led by SSB managers, is responsible for big domestic and cross-border deals. In mergers and acquisitions, NSSB is still weaker than in other segments. It is known that the NSSB deal triggered political battles inside the company which dragged on for months and eventually forced it to take the unusual step of appointing co-heads from each partner for every single department.

The Wall Street Journal (2002a) also reports that Citigroup's increase of its stake in Nikko has been a source of friction. In 2000 Citigroup sold back convertible bonds that gave it the option to increase its stake from 9.5 percent to 20 percent. The sale was contingent on Nikko's share price reaching 1,500 yen.

Even though an exceptional example, Nikko Salomon Smith Barney is by no means the only example of a Japanese-foreign alliance in the banking sector. In November 2001 Nomura Holdings announced an alliance with Thomas Weisel (headquartered in San Francisco) to coordinate cross-border merger and acquisition activities between Japan and the United States (Nomura press releases 2001, Japan Today 2001a). Under this deal Nomura will make a US$ 200 million strategic investment in Thomas Weisel Partners and its affiliates. Moreover, the alliance will include exchange of personnel. Nomura will take a seat on Thomas Weisel Partners' advisory board and intends to place a number of professionals in the firm, while Thomas Weisel Partners will send professionals to work in Nomura's main office in Japan. This announcement is interesting as it is an example of an integrative alliance in which the Japanese partner ties up with a company that has no presence in Japan's financial markets but possesses capabilities that are transferable to Japanese markets if combined with local market knowledge and access. As the alliance is still in the planning stages, we cannot evaluate whether its potential benefits will materialize.

In a recent interview, Nomura's president, Junichi Ujiie, responded to the question of whether he would do a big deal with an American or European rival with the statement that conversations "are always going on. … The world is changing very quickly and I do not completely exclude any possibility."

Another interesting development is the announcement that Asahi and Goldman Sachs plan to form an alliance, in which Asahi will sell its problem loans at market value to a wholly owned subsidiary to be set up by Goldman at the end of 2001. They also plan to set up a joint service company to help restructure Asahi Bank's troubled corporate clients and to help collect debts from its borrowers (Japan Today 2001b). Shortly after this announcement UFJ stated that it would set up a subsidiary with the help of Merrill Lynch to help its group of banks accelerate the disposal of problem loans (Japan Today 2001c). This joint-venture plan was realized in 2002. Merrill Lynch holds a 40 percent stake in UFJ Solution Consulting and UFJ bank the rest (Japan Today 2002d). Recently Merrill Lynch and UFJ have been in discussions about a banking partnership that is expected to be a fee-sharing arrangement (Financial Times 2002b).

Daiwa SBCM has an extensive network of alliances (Financial Times 2000b). It has a strategic alliance to provide financial advisory services and transaction execution and to pursue related opportunities on a global basis with Lazard, a European investment bank. This alliance is a fee-sharing agreement. It is intended to serve Japanese and non-Japanese customers in connection with any Japan-related transactions. Before entering this alliance, Lazard lacked a significant presence in Tokyo. In the transactions of Daiwa SBCM this alliance is invisible, so that we cannot evaluate how much its potential benefits have materialized. However, at the end of November 2001 another announcement raised expectations for major changes in Japan's financial competitive landscape. Fulford (2001) cites sources saying that Daiwa was about to shift all of its profitable business into a joint venture that will be 51 percent owned by Daiwa and 49 percent owned by Deutsche Bank. Deutsche Bank would in this deal also buy an undisclosed amount of shares of the rest of Daiwa, since its struggling retail business is not expected to be merged in the joint venture. This deal would closely resemble the Nikko Salomon Smith Barney alliance. It is reported that Sumitomo Mitsui Bank, which owns 40 percent of Daiwa, is pushing the deal because it sees no future for its investment without an infusion of foreign capital and know-how. However, this would fundamentally alter the relationship between Sumitomo and Goldman Sachs.[19] Daiwa has denied that it is discussing such a relationship with Deutsche Bank.

The list of other foreign-Japanese alliances in Appendix A shows that there are instances in most of the major fields of the financial-services sector and that European as well as U.S. firms are entering the market through different kinds of tie-ups. However, the Nikko Salomon Smith Barney case is up to now the only joint venture in investment banking that is based on strong institutionalized ties where firms operate under a common name. Looking at the broader field of financial services we find that many of the joint ventures are "product manufacturer–product distributor" joint ventures.

4 Scenarios between Wimbledon and Conservation of the Old System

In this section we outline some scenarios that deal with the question of how and to what degree the Japanese investment-banking market might in the future be influenced by foreign financial institutions. We will discuss three different scenarios, although more may be relevant. It should be noted that mixed scenarios are plausible, for instance one in which a few foreign or Japanese banks are successful and there are some instances of strong foreign-

Japanese joint ventures. We will also explain why this question has implications that go beyond pure competition for market share.

A Japanese Wimbledon. A stronger position of foreign banks together with a decline in the competitiveness of Japanese banks is one possible scenario. Some have suggested that Japan might be a case similar to Great Britain, whose financial markets became more and more dominated by foreigners after its Big Bang in the 1980s, notwithstanding the importance of London as a financial center. In Great Britain this phenomenon has become known as the Wimbledon phenomenon, derived from the fact that although Britain provides the world's foremost arena for tennis at Wimbledon, the winners of the Wimbledon tournament tend to be foreign players.[20] Augar (2000) notes that only two of the top ten merchant banks in London in 1983 (all of which were home-owned at that time) were still independent in 2000 (Rothschild and Lazard). Besides this there are only few British investment banks with a significant global market position or reputation, among them Cazenove and HSBC. Applied to Japan, such a development would indicate that foreignness or lack of local knowledge is not a long-term barrier for foreign banks. Without a doubt, if this scenario were to be realized it would require major changes in the thinking of Japanese political decision-makers, regulatory agencies, and clients.

Fukushima (in Austin 2000) assumes that the Wimbledon effect is "the envisaged domination of Japan's financial markets by foreign institutions, if they are allowed to operate freely." But domination is an effect that is much too strong to be expected in Japan in the short run. In investment banking, any tendency toward a Wimbledon effect has been due less to acquisitions of Japanese banks by foreigners, but—if at all—to improved market positions of foreign banks. Fukushima also describes the different attitudes toward a Wimbledon effect (Fukushima 1998):

> 'Wimbledon effect' is a very interesting term that all of you know well. I have heard about four different theories about the origins of this term. … It is very interesting to me that nobody in the United States has ever heard of the 'Wimbledon effect,' except for those people who know about Japan. The term indicates that in Japan the nationality of capital is still very important. In England, where the London financial Big Bang resulted in foreign, that is, American and European, financial institutions, this was considered a good thing. In Japan many believe that the 'Wimbledon effect' must be avoided at all costs.

In the case of London, the Wimbledon effect may not only have changed ownership conditions in the financial sector, but also the support of the government for surviving domestic companies.[21]

> Fifty years ago the City still consisted of a series of merchant banks which had been in existence for a hundred years or more. These institutions were run by families personally known to the Governor. The Bank kept closely in touch with these banks and they kept the Bank of England informed about everything that was going on. But during the last fifty years the City changed. As a result the close personal relationship disappeared and was replaced by something purely professional. During this period practically every one of the big houses in London was taken over by foreign banks. Today only Rothschilds and Lazards are left out of the dozen or so banks, which once upon a time formed a hard core of the City's institutions. … The City was no longer a club in which (in) the last resort members would come together to bail out one of their own. (The Weekly 2000)

Home Run. Japanese banks might begin a gradual process of learning how to deal with new requirements. In this scenario Japanese banks would have a strong market position and be able to support the restructuring process of the whole economy. An important condition for this is their ability to attract and keep highly skilled human capital (besides solving their bad-loan problems) and to adopt capabilities that are relevant in global markets.

A home run would not necessarily have to be related to the overall strengths of Japanese banks. If they were to some extent able to solve their bad-loan problems and integrate new corporative structures, this would relieve some of the pressure for further financial reforms without necessarily attacking the root of the problem. The degree to which Japanese financial institutions can continue to be sheltered following the reforms that have been introduced is an open question.

Mixed Double. In the medium run a third scenario is possible. Foreign-Japanese alliances in the banking sector match the global capabilities of the foreign partner with the market access provided by the Japanese partner. This could be a short-run rather than a long-run scenario. Even though alliances are one possible path, the long-term outcome of such a scenario is by no means evident: dissolution of the alliance after one of the partners feels it no longer needs it or the long-term evolution of completely new structures. Very often alliances and joint ventures are not seen as permanent frameworks for the joint benefit of the partners, but as temporary arrangements for mutual learning of existing capabilities. Intercultural alliances might therefore lead to either of the first two scenarios. An alternative solution would be a set of alliances that are stable and create new foreign-Japanese companies with their own identities.

Considering these scenarios is important not only because a Wimbledon effect might be resented by the Japanese because of their belief that the financial sector is crucial and should be supported by local players. Competition between foreign and Japanese financial institutions is above all about the efficiency with which capital is allocated in Japan. This might induce us to suggest that the most competitive players should win the greatest market share independent of their nationality. Edward George, the governor of the Bank of England, has argued in favor of the British Wimbledon effect on various occasions, stating that “it is activity rather than nationality of ownership which creates a competitive marketplace, and in turn provides employment and income and tax revenue …” (George 2001). He also asserted that London is “staffed by locals, dominated by foreigners, but still generating bags of prestige and money for the UK” (in Augar 2000: 3). Other voices are critical of the direction London’s financial center took, such as Augar (2000), who worries in particular about the City’s “lack of control over its own destiny.”

A domination of Japanese financial markets by foreigners would certainly go along with major changes in the Japanese financial system. As described above, relationships have long played an important role in this system and based on these relationships banks have had very special functions. While such relationships also mattered in London’s time of “gentlemanly capitalism” (Augar 2000), the unique characteristics and insider-outsider structures in the Japanese system are even stronger. Such relationships have been relevant between clients and financial institutions, but also in the form of informal information exchange between MOF and the private banking sector. Assuming that foreign banks would not be willing or capable of playing a similar role, monitoring and other functions that are important in any financial system would have to be taken over by new institutions and rules. This is why our question of Wimbledonization, mixed double, or home run is about more than an ideology positing that domestic financial markets should be dominated by domestic players. It is about the general structure of the future Japanese financial system, which renders this question of high importance. While Great Britain may have benefited from the Wimbledon effect from a macro perspective, we can at the same time assume that the adjustments that had to be realized in its financial system may have been smaller than in Japan's case. A well-functioning financial sector is a prerequisite for growth in any country, and Japan might be a good example to show that in order to function optimally financial systems have to be designed according to the unique characteristics of the country.

Besides the competitive position of Japanese versus foreign financial institutions, the Wimbledon effect is also related to the future role of Tokyo as a financial center. In Great Britain the Wimbledon effect seems to have helped sustain London's role as the major European financial center (Figure 2). However, as we will show below, Tokyo has traditionally never had such a role as a regional center. It is strongly focused on the domestic economy.

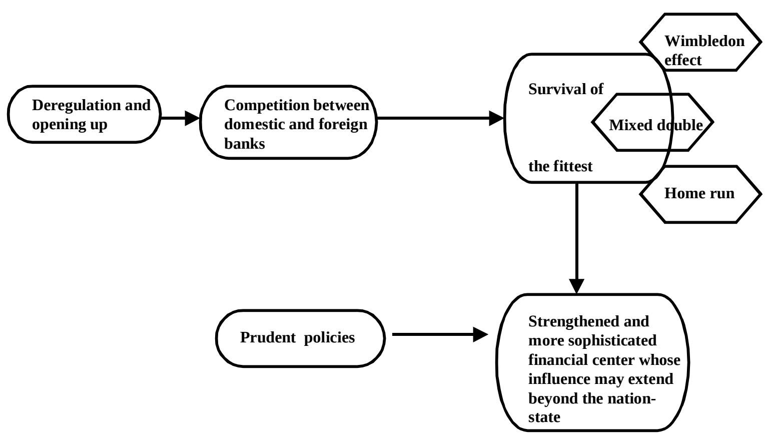

Figure 2. Opening Up, Competition, and Financial-Center Sophistication

5 Competitive Advantages of Foreign and Japanese Investment Banks and Foreign-Japanese Joint Ventures

In the following sections we will first discuss the market position and competitive advantages of foreign financial institutions and then offer some thoughts on Tokyo as a location for the tournament.

5.1 Global Capabilities and Local Knowledge: The Competitive Advantages of Foreign and Japanese Financial Institutions[22]

This section will discuss the proposition that foreign and Japanese banks might offer different competitive advantages. The exploitation of these distinctive capabilities is the aim behind the strategies that companies choose. Even though foreign financial institutions have long been unable to seriously threaten the role of Japanese banks, this may be changing. There is some agreement that Japan's financial-service providers are lagging behind foreign rivals.[23] As Rowley (2000) assumes, foreign banks

> are also acknowledged to have much more sophistication than their Japanese counterparts in investment banking, asset management, trading in derivatives and other instruments, electronic banking, and operating automated teller networks.

Part of this backwardness may result from the regulatory practices applied in Japan in the past, for instance the convoy system which did not allow financial institutions to fail, slowed industry segments to the pace of the slowest member, and allowed no one to get too far out in front. Moreover, Japanese financial institutions were forced to keep their businesses segregated until very recently, so that none of the banks has ever been allowed to develop full-fledged securities operations and none of the brokers has had a treasury operation. Japanese banks have been bound by law, but also by traditions.[24]

Tsugawa (2000) also argues that the American investment banks are more creative and proactive than Japanese financial institutions.[25] Gyothen (2000) states that Japanese banks

> face a number of problems, particularly the difficulty of using English for daily business in Japan. Another problem is human resource management, including the need to reform traditional personnel systems and to completely deregulate the labor market. Also, the salary system must change. … It seems very difficult for Japanese banks to regain international competitiveness as there is a widening gap between Japanese and foreign banks in terms of capital, human resources, and brand names. Particularly, it is almost impossible for Japanese banks to compete with their foreign counterparts in the investment banking sector.

Similarly, Kyoji (2001) ascribes to foreign companies advantages in "management resources," including their stock of technological knowledge accumulated through research, development, and investment, outstanding management systems, and marketing know-how. He understands foreign direct investment in Japan as an international movement of management resources. Foreign banks might also be able to offer more flexible service packages to Japanese customers because of their less rigid management structures. Moreover, it may sometimes have been more acceptable for Japanese companies to use a foreign bank to perform "un-Japanese" tasks like selling distressed companies or unwinding shares held in a close customer, which would once render foreignness an advantage.

We define global capabilities as *all those skills that are based on the experiences of a company in global markets* (Table 1). As most banks have started business as players in their home market, it is obvious that every global player will have local capabilities. Global advantages are present when multinational banks are able to establish themselves in a number of foreign markets and optimally if they are able to manage global interdependencies by fine-tuning information flows and expertise in their network. In this sense, it seems justified to describe the relative advantages of foreigners and Japanese companies in Japan not as an advantage of the Japanese but as the liability of foreignness.[26] Global capabilities refer to a competitive edge that is created in the global network of multinational banks and can be used in various geographic markets without an additional cost related to developing or transferring the assets.[27] Very often global capabilities seem to be related to expertise in tasks that obey global standards rather than country- (Japan-) specific ones. Meanwhile, local knowledge is different in that it is deeply embedded in a local/ national context and does not necessarily have to be valuable in other markets. Moreover, local knowledge may require the completion of a local learning phase and a long-term presence in a market. As a part of this local knowledge, access to clients is an essential input for global players.

Japanese banks benefit from their local knowledge and access, which foreign banks are often lacking. *Local knowledge* and resources in the financial sector may consist of trusted relationships with clients, detailed information about their market position and needs, and knowledge about the legal and administrative environment and about specific requirements and behaviors of clients in the retail and corporate sector as well as a reputation as a local player.[28] Physically, access may be evident in an extensive domestic distribution network and customer base for financial products and services. In underwriting, relationships to institutional investors and status as a trader in bonds and equities are important as they are the source of placement power. This type of knowledge is location-specific. Very often it concerns assets that develop out of relationships or a history of success in the market.

Global capabilities may concern the ability to tailor sophisticated and flexible services (which may then have to be adapted to the local market) and to offer a full range of services to clients. Moreover, they are the capability to monitor, foresee, foster, or adopt market changes. It has been argued that American companies benefit from the experiences they have gained in more advanced markets and that they are used to operating in a deregulated market environment according to global standards (Financial Times 1998). Big bang deregulation makes it possible to bring new financial products into Japan while prompting Japanese corporate clients to demand more sophisticated capital market and corporate advisory services. This might give foreign banks a competitive edge.[29] They have more experience with rapidly changing environments and well-trained and professional staff in various areas of expertise. For some fields of the banking sector, it was also important that foreign financial institutions had deeper pockets than Japanese banks in the second half of the 1990s. Moreover, a global presence and global relationships to the investor community are considered an advantage. To some extent, the perception of global capabilities is also influenced by the global reputation a bank has been able to build. Without a doubt, market power and a good capital base are also important aspects of such a role. Global capabilities are specific to companies, but not to locations.[30]

In Japan, local access could be more difficult to achieve than in other countries and regions. At the same time the current situation shows that locally available capabilities may not be sufficient to support the restructuring process of the Japanese economy. The complementarities between global capabilities and local knowledge are well reflected in foreign-Japanese joint ventures. Besides foreign-Japanese joint ventures, there have been joint ventures among Japanese banks as well (for instance, Sumitomo and Daiwa, IBJ and Nomura; see Benton and Terramoto 2000). And certainly these joint ventures can also offer certain advantages, starting with size and market power. But it has been argued that none of the Japanese partners could bring in the global expertise a foreign company brings to the joint venture. This is why Daiwa Securities and Sumitomo have been quick to announce that they would welcome joint ventures with foreign affiliated companies in order to offer uncommon (in Japan) products and services.

Similarly, after the alliance between Nomura and IBJ[31] was created, their foreign competitors stated that this would not help them to compete in global markets or bring leading-edge technologies of foreign financial institutions into the joint venture.

Global capabilities	**Local knowledge, access, etc.**
experience operating in deregulated, competitive markets flexibility to adapt to a changing environment a global network of branches and subsidiaries global research capabilities concerning macroeconomic developments, regions, countries, products, industries ability to interpret and synthesize global and local data in a fast-changing environment knowledge of international standards global reputation, trustworthiness ability to attract skilled personnel ability to tailor products and packages to the customer; ability to create innovative new products	reputation as an established local/domestic player a large domestic network of clients and institutional investors understanding of locally idiosyncratic features and requirements personal ties and trusted relationships local market intelligence enjoy the benevolence of regulatory agencies

Table 2. Global Capabilities, Local Knowledge

An important question is why global capabilities provided by foreigners might have become more important today after the system has worked so well for decades. At least two hypotheses can be made in this context:

1. Financial services and financial products have developed dynamically globally, but Japanese financial institutions are lagging behind in expertise and technology in some services (see also Maudos and Pastor 2001 or Oyama and Shiratori 2001) for which there is demand by Japanese clients, which have become more global in their activities and need support in a restructuring economy.

2. The current economic crisis requires financial expertise that cannot be provided by Japanese financial institutions alone. Supporting this hypothesis is the fact that some Japanese banks have created joint ventures with foreigners in order to get rid of their bad loans.

The complementarity of global capabilities and local knowledge and the transitional phase of the Japanese system may also be reflected in the fact that some U.S. banks have built up relationship management in Japan. Meanwhile, some Japanese banks state that they want to strengthen their position using Western methods because they feel that financial institutions are increasingly chosen on the basis of merit rather than relationships (Financial Times 2000d).

5.2 Joint Ventures: Synergies through Learning

This section will present the theoretical underpinnings of joint ventures as strategies to combine global capabilities and local access.

There is a vast literature on the creation of synergies and the different motives of the partners in international joint ventures.[32] Due to the limited scope of this paper we cannot elaborate on this but will only comment on some approaches that might be of special relevance.

For the foreign partner, international joint ventures are often viewed as ways to provide fast, low-cost access to new markets by "borrowing" a partner's "already-in-place local infrastructure" (Doz et al. 1990).[33,34]

> This infrastructure includes sales forces, local plants, market intelligence, and the marketing presence necessary to understand and serve local markets. Local knowledge also relates to cultural traditions, norms, values, and institutional differences.
>
> (Inkpen and Beamish 1997)

Foreign-Japanese joint ventures in Japan's banking sector have not received much academic interest up to now. However, Japanese joint ventures abroad have been studied more extensively. Some approaches have interpreted joint ventures above all as platforms for learning the intangible assets of the partner. It is interesting to note that different authors have argued that the Japanese are particularly good at learning from their partners. When the learning is complete, they often acquire or liquidate the ventures. For example Reich and Mankin (1986) have written that many of the Japanese joint ventures in the United States benefited from the marketing expertise of the American partner. The Japanese provided the manufacturing technology, while the U.S. partner did the selling. They argue that such joint-venture agreements can act like a Trojan horse instead of learning platforms: the U.S. company provides access to its customers only to see the Japanese decide to go it alone and set up a distribution network on the basis of a reputation gained with the help of the U.S. partner.[35] As the situation in Japanese financial markets is today partly reversed, we might also guess that this might be true for the learning processes in foreign-Japanese joint ventures (Trojan horses for foreign banks). The question is whether the Japanese can use joint ventures in their own market in a way that is also beneficial for them (we might describe this as the "guest advisor" strategy of inviting foreigners in order to benefit from their skills) or whether foreign-Japanese joint ventures in the financial sector will become Trojan horses for foreign companies.

The danger of a Trojan horse effect may make the Japanese partner feel uncomfortable in an alliance with a relatively well-established foreigner in Japan. Moreover, the potential for friction is strongest in an alliance between two strong players. This would speak against symmetric alliances as regards market power. Moreover, alliances can not only involve foreign companies that are well established in Japan, but outsiders that are—as in the case of Nomura and Thomas Weisel and Partners—young or smaller firms. From the perspective of the Japanese partner, the benefits of joint ventures will also depend on the possibility of transferring expertise and on the degree to which expertise is incorporated in people and organizations.

Hamel (1991) has touched upon the dynamic aspects of joint ventures and described alliances as a race to learn. According to his scenario, there are winners and losers in joint ventures. Accepting the race-to-learn hypothesis we might argue that winners are those partners who learn fastest or are quick in adopting the resources of their partner. While learning may be an individual capability, we may also argue that some skills and resources are easier to acquire than others. Whether foreign companies can "outlearn" their Japanese partner in this respect depends crucially on the level of acceptance they receive from Japanese companies.[36] The skills that are relevant in the banking sector are deeply embedded in practices and individuals. To what extent the Japanese partner can learn from such alliances depends on the setup of the joint venture: how are employees from both sides embedded into the joint venture, to what degree is teamwork realized that allows the local partner to learn by doing, and to what degree does the foreign partner disclose certain parts of his expertise and how intensive is the information exchange?

Wong and Leung (2001) approach this topic in a model dealing with moral hazard, cooperation costs, and technology spillovers. They state that the learning hypothesis requires multi-period models to deal with joint-venture decisions. Learning "leads to a change in the technology they [banks] use in the second period, thus affecting their choice between a joint venture and separate production." Integrating companies' expectations about the effects of a joint venture into their model, they distinguish between two situations: strategic cooperation, in which companies get less profit from a joint venture in the first period than they would get from a subsidiary, but where the long-run effect of the joint venture is favorable; and strategic non-cooperation, when a company does not agree to form a joint venture, even though its profits in the short run would be fairly high. This would happen when the long-run learning effect of the partner and the possible dissolution of the joint venture creates a drop in profits for the company.

Altogether these studies present pessimistic scenarios for Japanese-American joint ventures as stable agreements in the long run.[37] They are considered to be unstable constellations in which one partner loses. Long-term observation will determine whether this is also true for foreign-Japanese joint ventures in Japan's financial sector.

6 Foreign Financial Institutions in Japan: A New Era?

6.1 Overview

Above we discussed how foreign financial institutions enter Japanese markets and on the basis of which competitive advantages they can succeed. In this section we empirically illustrate their market activities and positions, focusing on the investment-banking sector.

Today, U.S.—and less often European—investment banks in Japan appear in the first ranks of top mergers and acquisitions advisors (Table 3), arrangers of syndicated loans (Table 4), and underwriters of both bonds and equities.[38] In this section we highlight the operations of foreign banks in investment banking.

Table 3 shows recent data on advisory transactions by foreign and Japanese banks. In this table foreign banks occupy seven of the top ten positions.[39] What is interesting is that foreign banks have recently been involved not only in international mergers and acquisitions deals, but also in deals between domestic groups. One of the most striking moves was the decision of the Financial Reconstruction Committee to choose Morgan Stanley and Goldman Sachs as advisors for the sensitive sales of the nationalized banks Long-Term Credit Bank and Nippon Credit Bank (Financial Times 2000a).[40] It is evident that foreign banks had a smaller number of deals than Japanese banks, but managed to get deals with higher volumes. In this field, Nomura had to surrender its first rank to a foreign company. Obviously, these numbers have to be interpreted very carefully, as one transaction can make a big difference and the total sum of M&A and equity issuance in different time periods can vary significantly.[41]

Foreign financial institutions have also played an important role in introducing new strategies for corporate capital raising, for instance securitization and different strategies of structured finance. Some have also been prominent in the purchase of non-performing assets from Japanese financial institutions (in line with some vulture funds).

A few foreign banks have thrived in Japan in other fields in recent years. For instance, the big U.S. investment houses were often trading more in Japanese securities markets than the leading Japanese firms (Japan Today 2002a). In 2000, foreign investors were also the second-largest shareholder block in listed Japanese companies (18.8 percent).[42] Trading dominance and underwriting often are related because a strong trading position enables companies to support securities in the first periods after they have been issued. Foreign players have also shown that they are good at managing mutual funds, also for Japanese stock and bond portfolios. Rapp (1999) names interest options and futures, innovative derivatives, and stock index options and futures as fields where foreign banks have market advantages, above all because these transactions require "sophisticated computer software, mathematical talent, and portfolio modeling capabilities combined with good communications and the ability to execute trades quickly."

Advising company	*value in mil $*	*no. of deals*
1. Goldman Sachs	94,010.2 (4,344)	22 (5)
2. Nomura	57,713.1 (1,988)	61 (16)
3. JP Morgan	56,618.6 (1,769)	21 (2)
4. Daiwa SMBC	48,482.3 (NA)	34 (NA)
5. Merrill Lynch	32,464.6 (3,9338)	11 (3)
6. Salomon Smith Barney	28,739.8 (2,866)	29 (1)
7. Morgan Stanley Dean Witter	25,675.2 (8,162)	15 (6)
8. Mizuho Fin'l Group	21,742.0 (NA)	82 (NA)
9. Credit Suisse	17,485.2 (NA)	9 (NA)
10. Lehman Bros.	17,130.8 (2,400)	7 (2)

Source: Thomson Financial League Tables

Table 3. Completed Advisor Deal Ranking Japan, 2001

(numbers in brackets are for 2002/I)[43]

Company	*market share*	*no. of deals*
1. Mitsubishi Tokyo	35.7	18
2. Mizuho Financial	19.8	69
3. Sumitomo	8.0	49
4. Citibank/SSB	7.1	8
5. JP Morgan	4.7	6
6. United Financial	2.8	24
7. CSFB	2.1	1
8. Deutsche Bank	2.1	2
9. Barclays	1.9	2
10. CAI	1.8	2

Table 4. Top Arrangers of Japan Syndicated Loans, First Half 2001

In retail banking, Citibank is the only foreign bank that has gained a top position in Japanese retail banking.[44] Citigroup has often been cited as an exemplar of a successful foreign bank in Japan (Wall Street Journal 2002a). It earns 8 percent of its global after-tax income in Japan and has a broad range of businesses there, consumer finance being the most profitable. Other business lines include consumer banking (since 1902), corporate banking (since 1902), private banking (since 1986), investment banking (together with Nikko Cordial since 1999), trust banking (together with Nikko since 2001), asset management (since 1998), insurance (from 2002 on together with Mitsui Sumitomo Insurance in a joint venture). Interestingly enough, despite its image as a truly global business, Citigroup seems to have won over Japanese consumers by establishing a reputation of being more local than its foreign competitors. Several of its business lines have been strengthened by mergers with or acquisitions of non-Japanese companies which were however very active in the Japanese market (merger with Travelers in 1998, acquisition of First Capital consumer finance in 2000, acquisition of Unimat Life in 2000, acquisition of Taihei Co in 2002).

In 1998, Merrill Lynch bought failed Yamaichi and became the first U.S. retail broker in Japan. Its success fell short of expectations, however.[45, 46] The retail stock brokerage market in Japan is certainly a sector in which foreign companies have had a lot of problems recently, which is only partly due to the difficult situation in global stock markets. Many are today reducing their activities, which they built up in times of great expectations of the potential of this sector for foreign companies.[47]

Projecting these developments into the future, we should keep in mind that events other than those occurring in Japan might be relevant, the most important of which could be the global consolidation of the investment-banking sector. During this process, companies may rethink their operations in terms of geographical involvement, which might affect the resources they are willing to invest in the Japanese market. There are expectations that staff reductions will also concern Japan, with some commentators pointing out that equity-related staff might be reduced more than M&A-related staff (Financial Times 2002j).

In the next section, we will present a more detailed look at underwriting of stocks and the role of foreign banks before discussing alternative scenarios.

6.2 Underwriting Activities by Foreign Banks: Underwriting of Common Stocks

Underwriting of equity and bond issues is by no means a field in which foreign firms would excel in Japan naturally. It has long been a core service offered by Japanese securities houses, which had a dominant market position in this field. Kimura and Pugel (1992) report that only 5 percent of 1,000 firms between 1975 and 1984 changed their underwriter and if they did so they changed within the group of the big four. It is obvious that the market advantages of foreigners in Japan and their choice of market strategies are very transaction-specific. While their advantages seem to be strongest in fields that are characterized by a need for complex technologies, high levels of expertise, and global market reach, their need to partner with a local institution and their problems in entering the market depend on the local features of financial transactions, the importance of being well-connected to a local client and investor base, and the liability that goes along with foreignness.

In this section we examine whether foreign firms have been able to make inroads into a field in which Japanese securities houses can be expected to defend their position heavily. Compared with other transactions in investment banking, underwriting of bonds and equities is not characterized by high complexity. Success seems to rely on both a global and a local market reach and reputation. Without a doubt, intensive interaction with local clients is important. For a long time the inertia in the choice of underwriter seemed to indicate that underwriter positions were bound into the overall network of relationships between financial institutions (securities houses) and corporate clients (Kimura and Pugel 1993). Moreover, the four big securities firms in Japan had a market share of 80 percent in newly underwritten issues in 1989 (40 percent in trading in equities).

The most relevant foreign players in underwriting currently are Goldman Sachs, Merrill Lynch, Morgan Stanley, and UBS.[48] They are part of the globally leading group of managing underwriters. Morgan Stanley and Merrill Lynch have been present in Japan for more than thirty years. All of these foreign players have extensive global networks (Merrill Lynch is present in forty-four countries, Morgan Stanley in twenty-eight, and Goldman Sachs in twenty-three). Regarding their global and Japanese placement power, they manage large asset volumes (Merrill Lynch manages $557 billion worldwide, but less than 8 percent of this sum in Japan). Merrill Lynch also claims that it has twenty-eight of Japan's top corporations in the institutional investor sector as clients. Meanwhile, Nomura's assets under management are much smaller, and more concentrated in Japan. It is also interesting to note that Sumitomo Mitsui Bank is a major shareholder of Goldman Sachs and may have passed Japanese institutional business to it, which might change if the joint venture between Daiwa Securities and Deutsche Bank is realized.

In investment banking[49] the main competitors on the Japanese side are Nomura and Daiwa plus some second-tier securities houses. Nomura is among the world's leading financial institutions. It is said to have more capital on hand than its rivals, which gives it the ability to finance big deals. Among its Japanese competitors it has long been an outstanding case because of its emphasis on an independent strategy. Between 1998 and 2000, Nomura was among the top fifteen international managing underwriters. Daiwa does not have a comparable position on an international scale. Both Daiwa and Nomura have branch networks in Europe and also are present in New York.[50]

Daiwa has tied up with Sumitomo and developed a wholesale investment banking joint venture and a separate securities retail company. Due to the new possibilities opened up by deregulation it has chosen a holding-company structure. The joint venture, which is called Daiwa Securities SB Capital Markets, is owned 60 percent by Daiwa and 40 percent by Sumitomo. Sumitomo has invested US$3.4 billion into the joint venture and transferred its entire wholesale securities and capital markets staff.

Equity issuance in Japan in the 1990s was dominated in terms of deal size by a few huge privatizations (NTT, NTT DoCoMo, Japan Railway, Japan Tobacco). This meant that the Ministry of Finance played an important role in the search for global coordinators. The deals by NTT alone were big enough to justify the presence of foreign banks in Tokyo, and they have been able to get their share of the pie.[51] By the end of the 1990s more private borrowers were turning to capital markets in Japan, among them foreign subsidiaries that were listed on Japan's stock exchanges.[52]

Financial innovation—referring to strategies that are new to Japan, although not globally, and that are based on global capabilities—might provide foreign banks with market access which they would otherwise not get. Morgan Stanley has (in a deal involving General Electric) issued the first Samurai bond to adopt Japanese Government Bond spread pricing and the fiscal agent method in Japan. Besides being the global coordinator and sole bookrunner of NTT's international tranche, it got the first mandate for a bookrunner role in NTT's domestic bond offering. This deal might also have hinged on the fact that Morgan Stanley proposed new issue-price transparency and secondary liquidity. Since 1991 it has been involved in nine of thirteen such transactions by NTT.

As privatization deals were already under way in the beginning of the 1990s, we might assume that the decisions made by the Ministry of Finance served a signaling function for the entry of foreign banks into Japanese markets.[53] This is interesting, as the Japanese Ministry of Finance—even though it has announced that it promotes reform—has not always articulated opinions in favor of foreign banks.

Figures 3a and b give an impression of the numbers and volumes of issues of common stock in Japan during the last decade. What cannot be seen here is that the number of firms among which these deals were shared as bookrunners has been increasing. While a large percentage of equity deals was managed by a group of six or eight bookrunners in 1991 and 1992, this number rose to eleven or twelve firms between 1993 and 1998. This was due at that time to deals done by smaller Japanese securities houses such as Shinko, Kokusai, and Tsubasa. In 1999, 2000, and 2001 the group expanded to sixteen bookrunners, which is due above all to the deals done by foreign investment banks. Figures 3a and b show that the number of deals in which all firms were involved increased until 1996 (with the exception of 1992) and fell in the two subsequent years. In terms of volume, developments were less smooth.

What role did foreign banks play in this set of transactions?[54] Figure 4a is a first glance at the role selected foreign and domestic investment banks have been playing as underwriters since 1991.[55] It measures the number of deals regardless of size or the role the bank played (lead managing underwriter, co-lead manager, member of managing syndicate, etc.). Up until 1997 the market was dominated by the four (Daiwa is not included in our figure) big Japanese securities houses. Today, one of them has failed (Yamaichi) and one has been partly integrated into a joint venture (Nikko's wholesale). Merrill Lynch started to get some deals in 1996, although on a significantly lower level (in terms of the number of deals) than the Japanese securities houses. Goldman Sachs followed with a moderate number of deals in 1998 (see Figure 4b).

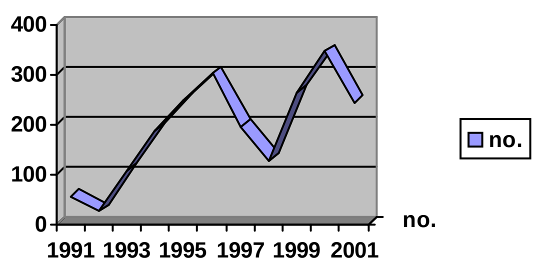

Figure 3a. Numbers of Tranches Issued, Japanese Common Stock Underwriting

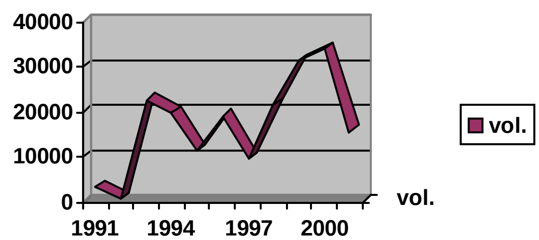

Figure 3b. Volume of Deals, Japanese Common Stock Underwriting, in US-$ Mil

Source: Data taken from Thomson Financial's league tables

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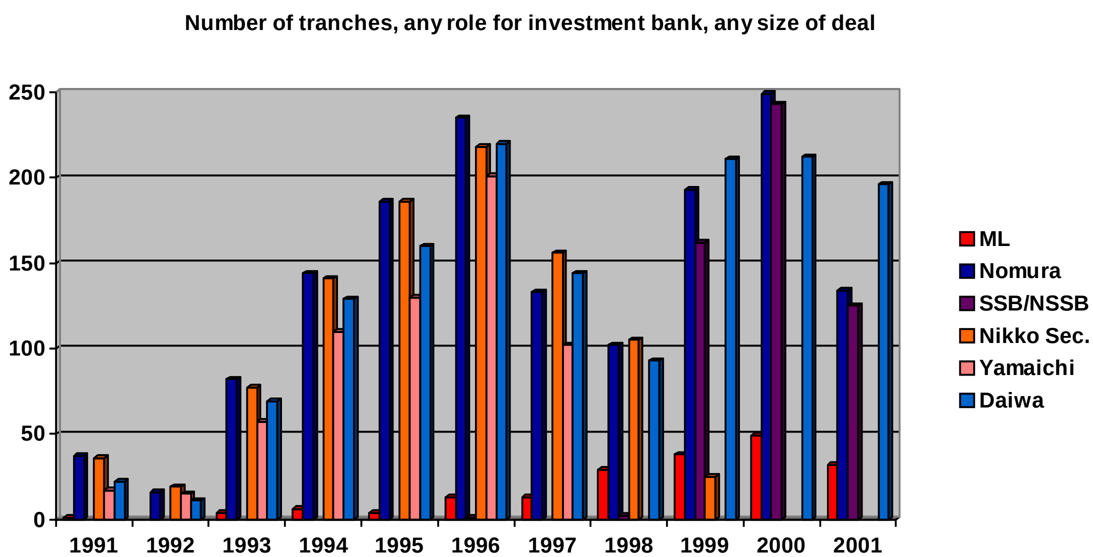

Source: Thomson Financial Services, SDC Platinum
Note: Nikko and Salomon Smith Barney created their joint venture in 1999. This is why the data for Nikko end in that year and we see the rise related to Nikko Salomon Smith Barney as a joint venture.

Figure 4b.

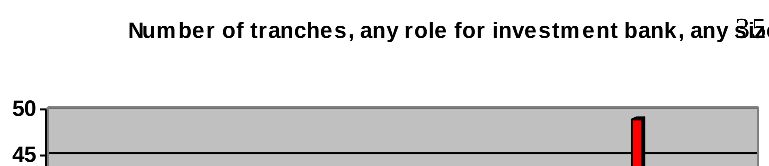

Figure 4b presents the number of deals in which foreign banks have been involved. The companies are foreign investment banks (U.S. and European) that have chosen subsidiary strategies in Japan. Nikko Salomon Smith Barney is not included in this figure. What is remarkable is the leadership that Merrill Lynch has achieved among foreign service providers. While 1996 had already been an important year, Merrill Lynch also made a great leap in 1998, the year in which it bought failed Yamaichi. Nineteen ninety-eight was not characterized by many deals for Japanese securities houses relative to previous years and years thereafter. In 1999 Merrill Lynch was the first foreign company to be sole bookrunner of the international and domestic tranches of a Japanese issue. In the same year, it managed the first entirely domestic deal in which a non-Japanese company led. Goldman Sachs displays a similar trend on a lower level. Moreover, UBS's activities have also grown disproportionately since 1994.

In general the number of deals by foreign banks has grown disproportionately, while Nomura and Nikko Salomon Smith Barney, for instance, have very much followed the trend. It is difficult, however, to recognize any smooth path of expansion in the number of deals. At times Merrill Lynch and Goldman's deals have run counter to the overall market trend. Morgan Stanley has enjoyed remarkably few deals in contrast to its overall role as a global bulge-bracket bank.

Even though Merrill Lynch can to some extent be compared with Salomon Smith Barney in that it tried to benefit from the existing network of a Japanese service provider (in the retail sector, however), after the acquisition it never reached a level comparable to that of Nikko Salomon Smith Barney. Although we have only one joint venture as an example and we must acknowledge the high risks involved in such ventures, this might still say something about the potential synergies that can be created by joint ventures in this kind of constellation.

Table 5 replicates the league tables provided by Thomson Financial Services for the years 1991 to 2001. It ranks service providers by market share based on the volumes they handled as bookrunners.[56] The first figure indicates the market share of the most important companies, the second (one star) is the volume handled, and the third (two stars) indicates the number of tranches they handled to get this market share. It is obvious that Goldman Sachs became the first foreign underwriter in the top-eight league table. Even though it was not among the top four, it managed to get in with a single deal. This deal was the privatization of shares of Japan Tobacco, in which Goldman Sachs shared the bookrunner position with Nomura. Two years later, Goldman managed to make it into second place, again by handling only two deals. The issuers in these two deals were NTT Mobile Communications Network Inc. (NTT DoCoMo) and Nippon Telegraph and Telephone. Goldman shared its role in the first case with Nikko and Daiwa and in the second case with Daiwa and UBS.[57] In 1999, Merrill Lynch, Goldman Sachs, and UBS again entered the league tables because of single deals: again Nippon Telegraph and Telephone for Goldman and UBS. Merrill Lynch had several deals of smaller size in which it was the bookrunner. NTT played another important role for Goldman Sachs in 1999, when it managed the underwriting process of Toys"R"Us Japan and NextCom KK. Its 2001 presence in the league table is due to its underwriting shares of NTT DoCoMo. It is remarkable that UBS Warburg got four positions as managing underwriter in 2001: with Fuji Television Network, Prestige International, Matsui Securities, and Lawson Inc.

In the first half of 2002 equity and equity-related new issues decreased 21.45 percent by volume compared with the same period in 2001. In the first quarter of 2002, this led to a situation where one significant transaction, the initial public offering of Daido Life, brought Nomura from the fourth to the first position in the league tables.

It is obvious that Nikko Salomon Smith Barney was—as a joint venture—able to get more bookrunner positions and more deals than any other foreign and gradually also domestic company in the market. Looking at its market position in 2001, its future looks promising (in terms of number of deals). What is also observable is that Nomura seems to have been involved in large numbers of smaller deals compared with the larger deals by foreign investment banks.

What kinds of hypotheses do these data support?

- Joint ventures may provide good opportunities for foreign firms that lack a significant presence in the Japanese market, as they can benefit from the network of the Japanese partner.[58]

- Whether a foreign company buys a failed Japanese company or joins one makes a difference, as shown in the case of Nikko Salomon Smith Barney versus Yamaichi/Merrill Lynch. For Merrill Lynch, however, an important factor may have been the length of time before it was ready to take over the operations of Yamaichi. By the time it was ready, many retail customers had already left. Moreover, the Merrill Lynch/Yamaichi case was an indirect case of acquiring capabilities, as it was primarily related to the retail brokerage sector. Without this complication a comparison of the cases of Merrill and Nikko might have indicated whether local access is bound to an actively participating partner, to the knowledge and relationships that are instantiated in Japanese employees (Merrill kept a lot of Yamaichi's employees and retrained them), or to the physical presence of branches.

Subsidiaries of foreign companies have up to now not been able to attract many bookrunner positions. They have got into the league tables because of single very big deals (Merrill Lynch still has higher numbers than UBS or Goldman). Their position looks better if measured by the number of deals in which they were involved in different underwriter roles. Here we find disproportionate growth, although with exceptions as discussed.

Table 5. Bookrunners, Market Share, Volume, and Number of Deals

6.3 Underwriting of Non-convertible Bonds

Looking at the league tables for non-convertible bonds, we find that foreign banks have improved their positions as underwriters in this field also since 1998–99. Table 6 displays the league rankings by Thomson Financial. It is obvious that there has been a significant increase in deals underwritten by foreign banks. For Merrill Lynch and Goldman Sachs the initial increase in the overall number of deals again slowed a bit in 2000–2001. The opposite is true for Morgan Stanley. Finally, we can observe the interesting effects that followed the creation of Nikko Salomon Smith Barney. Obviously underwriting of bonds has for some time continued to be done in separate teams, as Nikko and SSB appear separately in the rankings until 2001. What can be observed is that Citibank/SSB achieved a similar rank to that Nikko had had alone (rank four or five). Basically however the rankings are still dominated by Nomura, Daiwa, and the Mizuho Group.

In Japan the choice of an underwriter for bonds is different from the choice of an underwriter for equities. This is partly due to the rules that govern this part of the financial sector. In 1948, Article 65 of the Securities Exchange Law led to the separation of banking and securities business in Japan for the next forty-five years. Only in 1993 were banks allowed to set up securities firms to engage in selected securities businesses, most notably underwriting of public and corporate bonds. This still excluded them from underwriting and equity trading. The latter restriction was lifted only in 1999. The existence of bank-owned securities subsidiaries is the reason the main-bank relationship in bond underwriting can extend to bank-owned security subsidiaries. Hamao and Hoshi (2000) find, however, that bank-owned securities subsidiaries have begun to underwrite bonds of corporations that do not have their parent banks as their main banks or do not have a main bank. They have tried to overcome investors' suspicions of interest conflicts in such "universal" banks by promising higher issue prices than security houses do.

Yasuda (2001) hypothesizes that choosing another commercial bank over the main bank as a bond underwriter would be perceived as a betrayal by Japanese borrowers. This is not so much a problem if they choose an investment bank, whose market is characterized by arm's-length transactions, instead of their main bank. This would predict that foreign banks might attract a particular clientele of borrowers, who—possibly because their firms are young—do not have strong established relationships. Moreover, under this hypothesis those companies that switch from their main bank would more readily switch to foreign investment banks than to other Japanese securities companies.

Source: Thomson Financial Data. MS = Morgan Stanley, JP = JP Morgan, BNP = BNP Paribas, Sumit. = Sumitomo Mitsui Banking Group, Mits. T. = Mitsubishi Tokyo Fin'l Group. The first number indicates market share, the second (*) volume, and the third (**) the number of deals.

Table 6. Underwriting of Non-convertible Bonds, Bookrunner, and Co-Lead Underwriter Roles

6.4 Will the Americans Win the Wimbledon Tournament?

Investment banking traditionally has been the domain of U.S. financial institutions. If foreign financial institutions are able to penetrate Japanese financial markets, can we expect that American investment banks will be the winners? Would a trend toward Wimbledonization in fact be a trend toward Americanization of some Japanese financial markets? What room is there for the involvement of European financial institutions in Japan?

Globally, market shares in investment banking are distributed among a few big players: the American investment banks such Goldman Sachs, Morgan Stanley, Merrill Lynch, Citigroup, JP Morgan, and Lehman Brothers. A few European banks have joined them: Credit Suisse First Boston, Dresdner Kleinwort Wasserstein, UBS Warburg, Lazard, Deutsche Bank. While we might suspect that each of the players has local advantages at home, competition in investment banking transactions such as underwriting or M&A advisory services seems to rely on transactional rather than regional expertise (at least in countries other than Japan). This is reflected also in the league tables for M&A advisory services in Europe: half of the top ten players are American investment banks. Only few European banks are able to pose a similar threat to U.S. investment banks in the U.S. market (potentially Credit Suisse First Boston, UBS Warburg, and Deutsche Bank).

Looking at the involvement of these European players in Japan, we find that some are significant players in particular fields. A survey by Pricewaterhouse Coopers (PWC 2001) sheds some light on the position of foreign banks in different market segments. PWC sent questionnaires to a set of foreign banks in Japan and—among other things—asked them to review the performance of their non-Japanese competitors in these fields. Table 7 gives some of the results of this survey. The numbers indicate a bank's rank among foreign competitors in particular fields according to the evaluation of its non-Japanese competitors.

	Government bonds	Credit derivatives/ securitization	Interest rate/ forex	equities	equity derivatives	investment banking	lending	asset management
DB	1	4	3	7	7	7	9	4
UBS	5	6	4	6	11	6		12
BNP	10	9	6		6		3	
CSFB	8	13	5	8				9
ABN		11	11				4	
Societe			10		5	11		
CB					9		5	
Barcl.	9							6
GS	2	1	8	2	2	1		1
ML	4	5		1	4	3	8	3
MS	7	7	9	3	1	2	10	8
JP	6	3	2	5	8	5	2	5
NSSB	3	2	1	4	3	4	1	7

Source: Pricewaterhouse Coopers 2001. DB=Deutsche Bank, UBS=UBS Warburg, BNP=BNP Paribas, CSFB=Credit Suisse First Boston, ABN=Abn Amro, Societe=Societe Generale, CB=Commerzbank, Barcl.= Barclays, GS= Goldman Sachs, ML=Merrill Lynch, MS=Morgan Stanley, JP=JP Morgan, NSSB= Nikko Salomon Smith Barney.

Table 7. Positions of Foreign Banks and Securities Houses in Different Segments of Japan's Financial Markets

This survey suggests that Deutsche Bank is relatively strong in government-bond trading and interest rate/foreign exchange transactions and not too badly positioned in asset management and credit derivatives trading/securitization. BNP Paribas has a good position in lending; it is joined by ABN Amro in this category. Few European banks currently seem to be in a position to join the top group of well-established foreign companies in Japan's investment banking markets through a go-alone strategy. Up to now there have also been few alliances between Japanese and European banks.

The understanding that investment banking is to some extent an "American specialty" works to the disadvantage of European financial institutions. This might support the potential first-mover advantages which some of the American investment banks already have. If Japanese clients seek global capabilities and long-term experience, they might be more inclined to choose one of the big American investment banks. However, for some of the European banks the term European may be misleading, as they derive large parts of their revenues from operations in the United States. Some European banks have also tried to improve their expertise in investment banking by acquiring U.S. companies, for instance the case of Deutsche Bank and Banker's Trust.

In the preceding sections we have understood the increasingly strong position of foreign banks in Japan as a source of substantial change in the Japanese financial system as well as much friction during the adjustment process. Countries such as Germany have traditionally had financial systems (characterized by the "Hausbank") in which banks played a role that was much more similar to that of banks in Japan than banks in the United States. This might lead to the assumption that banks from such systems could have advantages to offer to

Japanese clients because adjustment costs are reduced. Moreover, the historically different structures in each of the countries—the integration of investment and commercial banking in Germany, its separation in the United States, and the newly evolving structures in Japan—might also lead to specific forms of U.S.-Japanese and European-Japanese alliances.

Altogether the global dominance of investment banking by mostly American companies plus the fact that European-Japanese alliances are still rare might indicate that this is not a field in which Europeans can have a significant impact in Japanese financial markets. The dominance of American investment banks also factors into the discussion of whether Japan's financial system will conform to Anglo-Saxon standards.

7 Tokyo As a Financial Center: Big, but Inward-Oriented

The previous sections have illustrated the role of foreign banks in Japan's investment banking sector. They indicate that while strong foreign banks seem to be doing fairly well in Japan, a Wimbledon effect in the sense of an overall domination by foreigners is not (yet) in sight. In our conclusion we will argue that the evolution of the market position of foreign financial institutions is not comparable to that which occurred in London.

In the introduction we pointed out that the other part of our question about the Wimbledon effect is related to Tokyo's role as a financial center. We will comment on this aspect in the following paragraphs.

Japan today is in a bizarre situation. On the one hand its financial markets have for a long time been very attractive, above all if measured by their mere size. On the other hand, however, Japan's economy is in a bleak situation, its banking sector is suffering, and its stock markets have reached historic lows. There is little reason to expect these problems to be solved in the near future. One of the world's most attractive markets, in which some foreigners have made significant investments to get a foot in the door, has become notorious for shaping daily newspaper headlines with negative news.[59]

In trying to assess the effects of the downturn we have to keep in mind that Tokyo is different from London. Its attractiveness is crucially related to its domestic market, while London has a European hinterland. Another feature that distinguishes Tokyo from global centers such as London and New York is that—besides its long-run dominance by domestic banks—intensive interaction between the government and the private sector has been more important than in other financial centers because of the reliance of the government on market intervention and the way information is exchanged.

By the middle of the 1990s it had been observed that financial institutions took steps to transfer business from Tokyo to other Asian financial centers, in particular Singapore. At that time this was understood as part of the overall phenomenon of "hollowing out." In its 1998 survey of foreign banks in Japan, the Japan Center for International Finance found that only a few saw Tokyo as a "linchpin of their Asian strategy." Most said that Tokyo is important mainly to their strategy for Japan as distinct from the rest of Asia. While many had rated Tokyo's potential as a financial center in Asia as fairly high at the time they started their business, many also revised this opinion later and stressed Tokyo's importance as the site of "access to abundant 'Japan money.'" In the 2001 survey, bank managers again stated that Tokyo only covers business in Japan.

Despite the fact that Tokyo has often been mentioned as an international financial center on the same level as New York and London, we argue that this perception is wrong. While we will also argue that the term "international" or even "global financial center" is not useful and that "financial centers of excellence" might be a better term, we define these financial centers as *centers that are not based on the unequal distribution of productive capital users or abundant capital sources, but locations whose success is based on their ability to perform transformative functions for mobile financial resources based on expertise and market excellence that are not easily available elsewhere. This expertise can be created locally or attracted.*

Different indicators for this type of center can be constructed.[60] While we believe that this definition fits centers such as London and New York and potentially others also, we do not think it is a good description for Tokyo. Tokyo's success is based on the distribution of capital resources, which are abundant in Japan, and not on its attractiveness as a center for sophisticated financial decision-makers or on its importance as a center that serves a wider hinterland.[61] Obviously, this is also closely related to the fact that the political environment and government policies have long been sources of frustration for foreign financial institutions in Tokyo. Compared with London and New York, Tokyo has less diverse financial markets, more trading regulations, and—as foreigners see it—the lack of a trustworthy administrative structure and supervisory system. Foreign banks complain about the lack of professionals in international finance, insufficient disclosure rules, a low degree of business communication in English, and high operating costs (JCIF 2001). Nonetheless, many bank managers state that their most important business units in Asia are in Tokyo.

While London managed to develop from a domestically centered location to a center with a European hinterland that attracts mobile resources such as skills and capital, Japan's political dynamics and the unique requirements of its financial markets make this an unlikely path for Tokyo.

Financial centers with a domestic orientation are much more dependent on domestic economic developments. It has been observed, for instance, that a two-track economy is developing for Japanese companies (Financial Times 2002i, TANKAN 2002). The TANKAN survey for the first quarter of 2002 shows that business sentiments of big manufacturing companies did not further deteriorate, while small companies in particular had become more pessimistic. Some observers have interpreted this by saying that the business development of some large companies has become detached from the development of the Japanese economy in general. While large companies depend on global business, smaller companies seem to be increasingly left behind, which was untypical for Japan in the past. One reason for this is the focus of big companies on streamlining their supply chain, a process that finally decouples small suppliers from the business successes of large global players. While this trend still seems to be too weak to be used as an indicator, it suggests that internationally competing Japanese companies are more likely to choose foreign financial-service providers and to have a more urgent need for innovative financial services that comply with global standards. The 2001 survey by the Japan Center for International Finance (2001) indeed found that most foreign banks saw leading companies and financial institutions in Japan as their target customers after companies from their home country that are operating in Japan.

The timing and rate of recovery of Japan's economy will affect Tokyo's status as a financial center as well. With the domestic corporate sector suffering from long-term economic trouble, the future role of Tokyo as a financial center is questionable. In that sense the consequences of the Japanese malaise may go beyond a situation where a few globally successful firms enter the market. There seems to be little doubt that Japan's resistance to significant change will in the long run hurt the economy badly, if it has not already done so. While some observers argue that the situation has to become bad enough for politicians to initiate severe and painful changes, with Japan struggling for more than a decade now one may wonder how bad it has to get. If the decoupling of the success of a few globally competing companies from Japan's overall economic fate is indeed a trend shaping Japan's future economic development, there might be good reason to ask why these potentially lucrative clients should have to rely on Tokyo only to meet their needs for financial services. With stock markets reflecting the Japanese malaise and consumer market share difficult to grab for foreign banks, there seems to be less and less reason to talk of Tokyo's position as a global financial center, if indeed there ever has been any. While this is a provocative hypothesis, Tokyo has always been different from other world financial centers. Or, stated differently: The prizes to be won in the British and Japanese financial tournaments are as different as the rules of the game.

8 Conclusion

8.1 Are the *Gaijin* Coming? Key Variables Determining the Future Market Position of Foreign Financial Institutions in Japan and Tokyo's Role As a Financial Center

How can foreign companies improve their chances of market access in Japan? Why is it so difficult to restore the competitiveness of Japanese financial institutions? We have pointed out that political-economy views must be added to market-oriented perspectives to understand current developments and that the specific system of interaction between financial institutions and clients and between the private sector and the government has to be taken into account. The striking thing about Japan's current situation is that economic and political realities seem to be inconsistent at least from a Western point of view. Looking at the economy, most observers would point out that changes were needed years ago. Meanwhile, the political reality in Japan reflects the resilience for which the country has become famous.

Starting from a rational Western market-economic perspective one easily comes to the conclusion that the economic problems of Japanese financial institutions should have long ago created a demand for globally competitive financial services. That this has occurred only to a limited degree shows that Western rationality was not the basis for the creation and longtime persistence of Japanese bank-corporate ties. At the same time it also indicates that the interplay between economic and political decision-makers in Japan obeys specific rules that have to be taken into account in order to answer our questions.

The key determinants of the future role of foreign banks in Japan—besides individual firm strategies—will be at least threefold (Figure 5):

- The economic situation of the Japanese economy: while the current crisis may create opportunities for some strong foreign players, it also weakens the confidence of foreign investors. Moreover, the need for further restructuring influences the demand for different types of financial services.

• The institutional characteristics of Japanese financial markets: the degree to which the main bank system is broken up, changes in the type of financial services that are demanded (e.g., loan financing versus capital market financing, the importance of innovative financial products), and the influence of foreign shareholders in Japanese companies, which determines their need to accept international standards and foreign interests.

• The political situation: the reoccurrence of incidents which foreigners perceive as xenophobic (but which may be less so from a Japanese point of view), the reliance on interventionist measures in financial markets, and the determination with which reforms are realized.

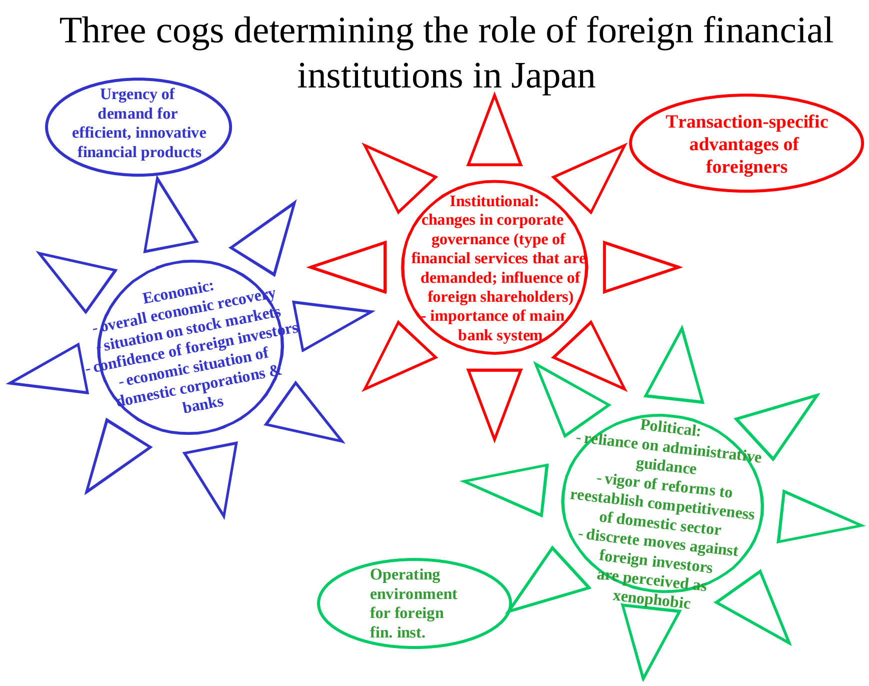

Figure 5.

As an external factor we might add the current processes of consolidation in the investment-banking industry, which will affect the way multinational financial institutions distribute their resources in various geographical markets.

Global experiences in investment banking have shown that investment banking is a bulge-bracket business: investment banks with a long history of deals are likely to attract more deals. This is why it is relatively easy to identify a group of investment banks that are global market leaders. Obviously Japan is a market with special characteristics, which accounts for the fact that the importance of regional expertise and transactional expertise might be more balanced there than in other markets. Observations for instance in Europe would render it probable that the big American investment banks (those with a lot of transactional expertise, but also a strong commitment to the Japanese market) have the best opportunities to lead a process of Wimbledonization (meaning a strongly improved market position for foreigners, but hardly their domination of the market), once they have overcome barriers to access. Moreover, if access to clients is really the most important hurdle, we might assume that this is particularly so in the beginning. But once foreigners have had a chance to build up a reputation in Japan as financial-service providers, these two aspects should lead to a self-reinforcing improvement of their market position with every successful deal they get. Nonetheless it is doubtful that a strong Wimbledon effect in the sense of the domination of Japanese financial markets will occur.

Second-tier foreign players may have many more difficulties in this business and they are less likely to use the crisis of the Japanese banking system as an opportunity. The literature on joint ventures and Nikko Salomon Smith Barney's successful example might indicate that joint ventures can help to realize synergies that lead to success. However, it is also obvious that these ventures face several hurdles and many risks:

• The Japanese partner might fear a Trojan-horse effect and prefer to ally with a company that has as yet no market presence in Japan. We have little evidence of how well such alliances work.

• The number of attractive joint-venture partners is limited. The constellations that result differ in the symmetry between joint-venture partners; there is also the question of whether a Japanese securities house with a relatively narrow business field or a Japanese banking giant with departments and subsidiaries in many fields is better suited to partnering with a foreigner. While asymmetric joint ventures—in whatever form (weak Japanese partner or weak foreigner)—hardly seem to be promising strategies, symmetric joint ventures can be more risky.

• The intangible nature of expertise may make it questionable for the Japanese partner that a joint venture is the right mechanism to acquire this asset.[62]

• Joint ventures are more relevant for some fields and financial transactions than others; they may provide advantages for the foreign partner where foreignness weighs heavily as a liability, and where local distribution networks and relationships are important. For the local partner joint ventures are attractive in those fields where expertise can be transferred by learning.

While the example of Nikko Salomon Smith Barney has pointed toward the potential success of joint ventures, we believe that it will be very difficult—although not impossible—for other companies to replicate this success. The risks involved in joint ventures are one of the reasons there have up to now been no endeavors similar to the NSSB joint venture. The choice of an adequate partner is a difficult step, in particular in cases in which each partner has already acquired significant market share on its own. Meanwhile it is doubtful that joint ventures between weaker partners are promising in a business so dominated by a few strong players and undergoing consolidation. Asked in 2001 about their plans for business tie-ups and acquisitions in Japan, half of the bank managers surveyed stated that they had nothing planned, while more than a third answered that while they would not make acquisitions, partial (rather than comprehensive) tie-ups were planned (JCIF 2001).

Economic rationalism renders a scenario of "weak Wimbledon plus mixed double" probable, even when taking into account market access barriers faced by foreigners. This scenario would be characterized by gradual improvements in the market position of a few globally competitive (mostly American) investment banks and the creation of a few successful foreign-Japanese joint ventures. This is a process which has already begun. While one might argue that this is not enough to speak of a Wimbledon effect at all, the fact that foreign banks have successfully entered the Japanese market is still striking in a country where market access is so difficult. We have pointed out that the gap that exists between foreign and Japanese financial institutions in technological know-how, expertise in complex transactions, and global capabilities might be one of the relevant reasons. Currently some foreign financial institutions also derive business from the expectation that foreigners might help Japanese banks clean up their business, get rid of bad loans, and recover. This is without a doubt also not an indicator that a Wimbledon effect similar to the UK's is happening, but a more or less temporary crisis-related phenomenon.

Altogether a Japanese Wimbledon effect comparable to what has happened in the United Kingdom is not to be expected, either regarding the position of foreigners in the market and their increasing dominance or the impact of foreign-domestic competition on the financial center. Japan's continuing economic problems, the potentially divergent paths of its globally and domestically oriented companies, and Tokyo's role as a purely domestic center render it very vulnerable. These in addition to the ongoing consolidation in the investment-banking sector are important factors to be taken into account when thinking about Tokyo's future role as a financial center.

8.2 Open Questions

One must consider a complex system of variables when trying to make projections about the role of foreign banks in Japanese financial markets. Currently there is no theoretical model with which to address the question. Few approaches deal with the effect of increased competition (between commercial banks and also on capital markets) on relationship banking (Boot and Thakor 2000, Peterson and Rajan 1995). These studies mostly ask which corporations would be served by bank loans and which would access capital markets under certain competitive conditions and given the heterogeneity of borrower profiles. These models clearly point out that the importance of investment banking in financial markets goes along with major changes in the structure of the type of financial services that are demanded. None of these models has distinguished between competition by foreign and Japanese financial-service providers up to now, nor have they taken into account joint ventures. More knowledge is needed of how corporate clients choose their service providers, which would be more likely to interact with a foreign financial institution, and what kinds of competitive strengths are important for them.[63]

Moreover, we believe that studies dealing with the transfer of financial expertise in different types of joint ventures and alliances would be useful to improve our understanding of foreign entry into Japan's financial markets.

Another direction for research is to revisit the conceptualization of financial centers, in particular from a dynamic point of view. While some past studies have distinguished between regional, international, global, or supranational financial centers, we believe that there are striking differences in how financial centers function and evolve. Size is not a good indicator of the international character of a center. Like many other industries the financial sector and its location seems to be more and more guided by information and knowledge requirements. A distinctive characteristic of financial centers seems to be how information circulates among private and between private and government institutions. In Tokyo this flow of information seems to be skewed toward the government. Particularly in times when new information and communication technologies have created new channels for the exchange of information, the relationship between geography and centers for information- and knowledge-intensive industries has become more complex.

Appendix A. Foreign-Japanese Alliances in Japan’s Financial Markets

Daiwa has a joint venture with Robert Fleming and T. Rowe Price Associates in asset management. After merging Daiwa SB Investments, Daiwa International Capital Management, SB Investment Management, and SBIMN Trust Management, they formed a joint venture with T. Rowe in which the latter has a 10 percent stake, Daiwa and Sumitomo each hold 44 percent, and Sumitomo Trust Management holds 2 percent. The joint venture was supposed to have a board member from T. Rowe.

Daiwa Ltd. also formed a partnership to offer investment advisory services with Brown Brothers Harriman. Harriman also agreed to train some of Daiwa’s employees in investments in foreign stocks and bonds.

Finally, Daiwa SBCM has a memorandum of understanding with GE Capital to form a new equity investment fund in Japan. The new alliance is supposed to operate independently from the existing operations of the partners in Japan.

Another example of a foreign-Japanese alliance is the case of Dai-Ichi Kangyo (DKB) and JP Morgan. They have created a new company to offer investment trusts and foreign-currency co-branded investment products. These are distributed through DKB channels. It is a 50-50 joint venture with a CEO and president from JP Morgan and a COO from DKB. DKB had the aim to participate in JP Morgan’s global asset management, investment trust, and product development skills. JP on the other hand had experienced losses in Asian markets before. It wanted to use DKB’s domestic sales network and retail/wholesale customer base.

Before Wasserstein Perella was acquired by Dresdner Bank, there was a cross-holding relationship between Wasserstein Perella and Nomura. This relationship has been dissolved. Dresdner Bank also has a tie-up with Meiji Mutual Life to form Meiji Dresdner Asset Management. Meiji has a 51 percent share. Dresdner has prime responsibility for asset management.

Bank of Tokyo—Mitsubishi has alliances with Lehman Brothers for M&A advisory services? and with TD Waterhouse. In the latter case, a joint venture has been formed for online financial services including discount securities, brokerage services, and equity trading. Bank of Tokyo—Mitsubishi also has an alliance with Dreyfus Corporation to develop and distribute investment trusts.

Barclay and Nomura have launched a Barclaycard-branded Internet shopping portal.

Putnam has a 10 percent equity participation in Nissay Asset Management. Trust Company of the West has a 30 percent equity participation in Yasuda Fire & Marine’s subsidiary Yasuda Kasai Asset Management.

Charles Schwab and Tokyo Fire and Marine as well as DLJdirect and SFG have alliances to sell products via the Internet.

Cigna and Yasuda Fire and Marine, which have been working together for twenty-five years (Ina Himawari Life Insurance), have also tied up to sell pension and investment products.

Jardine Fleming set up a brokerage company specialized in selling mutual funds jointly with various Japanese firms (Marubeni, Fuji, Yasuda Fire and Marine, Yasuda Mutual Fund).

Appendix B. Ranking of Foreign Banks in Japan by Total Assets and Ordinary Earnings—Selected Examples

Ranking by assets	*Ranking by ordinary earnings*
1. Deutsche Bank (6,069,897 mil. ¥)	**1. Citibank (14,082 mil. ¥)**
2. UBS AG (3,711,630 mil. ¥)	**2. Chase Manhattan Bank (9,989 mil. ¥)**
3. Citibank (3,665,649 mil. ¥)	**3. Credit Lyonnais (5,005 mil. ¥)**
4. ABN Amro (2,611,515 mil. ¥)	**4. UBS AG (4,434 mil. ¥)**
5. DePfa Deutsche Pfandbriefbank AG (2,428,491 mil. ¥)	**5. Banco do Brasil S. A. (2,027 mil. ¥)**
…	**…**
12. Credit Lyonnais (1,097,950 mil. ¥)	**11. Morgan Stanley Bank (1,149 mil. ¥)**
15. Credit Suisse First Boston 760,990 mil. ¥)	**19. Merrill Lynch Capital Markets Bank (643)**
16. Chase Manahattan Bank (588,497 mil. ¥)	**23. De Pfa Deutsche Pfandbrief (371 mil. ¥)**
36. Banco do Brasil S.A. (140,495 mil. ¥)	**56. ABN Amro (-235 mil. ¥)**
58. Morgan Stanley Bank (45,951 mil. ¥	**74. Credit Suisse First Boston (-2,344)**
63. Merrill Lynch Capital Markets Bank (35,060 mil. ¥.)	**83. Deutsche Bank (-16,113 mil. ¥)**

Source: KPMG (2000)
Note: Only 44 out of 84 banks have positive ordinary earnings.

Appendix C. Funding Patterns of Japanese Companies, 1975–1995

	securities markets					*borrowed funds*		
	TOTAL	**equity**	**domestic bonds**	**foreign bonds**	**commercial paper**	**TOTAL**	**private lender**	**public lender**
1975	**13.6**	**4.4**	**0.3**	**9.0**	**0.0**	**86.4**	**78.4**	**8.0**
1980	**13.3**	**4.6**	**0.9**	**7.9**	**0.0**	**86.7**	**77.6**	**9.1**
1985	**17.0**	**5.1**	**2.0**	**9.9**	**0.0**	**83.0**	**74.7**	**8.3**
1990	**23.5**	**6.1**	**4.8**	**10.1**	**2.5**	**76.5**	**66.6**	**9.9**
1995	**22.2**	**8.2**	**3.1**	**9.5**	**1.4**	**77.8**	**64.6**	**13.2**

Source: Hoshi and Kashyap 2001: 245.
Note: Hoshi and Kashyap find that the shift in financing was particularly dramatic for large firms. Meanwhile, the dependence on bank financing increased even for small firms.

Appendix D. Top Financial Firms in Terms of Market Capitalization at End of Year, US $Bn

1990		*2001*
1. Industrial Bank of Japan	**now Mizuho Bank**	**1. Citigroup**
2. Fuji Bank	**now Mizuho Bank**	**2. American International Group**
3. Mitsui Taiyo Kobe Bank	**first renamed Sakura Bank, then merged into Sumitomo Mitsui Banking Corp.**	**3. HSBC Holdings**
4. Sumitomo Bank	**now Sumitomo Mitsui Banking Corp.**	**4. Berkshire Hathaway**
5. Dai-ichi Kangyo Bank	**now Mizuho Bank**	**5. Bank of America**
6. Mitsubishi Bank	**now Bank of Tokyo-Mitsubishi**	**6. Fannie Mae**
7. Sanwa Bank	**now UFJ Group**	**7. Wells Fargo**
8. Nomura Securities		**8. J.P. Morgan Chase**
9. Long-Term Credit Bank	**failed**	**9. Royal Bank of Scotland**
10. Allianz		**10. UBS**
11. Tokai Bank	**now UFJ Group**	**11. Allianz**
12. Mitsubishi Trust & Banking	**now Mitsubishi Tokyo Financial Group**	**12. Morgan Stanley Dean Witter**
13. Deutsche Bank		**13. Lloyds TSB**
14. American International Group		**14. Barclays**
15. Bank of Tokyo	**now Bank of Tokyo-Mitsubishi**	**15. Credit Suisse**

Source: The Economist (2002), A Survey of International Finance, May 18

Notes

[1] I am grateful for constructive comments by James Raphael, Kozo Yamamura, and Günter Heiduk.

[2] According to the Financial Services Agency non-performing loans totaled 38.8 trillion yen on September 2001, 3.1 trillion yen more than six months earlier (Japan Today 2000c).

[3] The term bulge bracket usually refers to the biggest full-service investment banks. Currently, the sector is characterized by consolidation , which leads to the fact that the list of small firms gets shorter and that even big companies have to worry about takeovers.

[4] In its 2001 survey the Japan Center for International Finance (2001) found that investment banking transactions that are centered on security dealings and secondary business are important business segments for foreign banks. Other fields include wholesale commercial banking, settlement, derivatives, and foreign exchange. Foreign banks expect that the importance of asset liquidation and securitization is going to rise in the future. Meanwhile, mergers and acquisitions business does not seem to have increased as much as they expected and many of them have misjudged the possibilities of foreigners entering retail banking.

[5] Baron (1995) reports in detail on the role of foreign banks in Japan in the mid-1990s. He remarks that they also had some privileges. On the one hand, so-called impact loans (originally loans in foreign currency intended to finance investments that were of macroeconomic interest) were usually supplied by foreign banks. On the other hand, foreign banks were treated favorably in the case of insolvencies of creditors.

[6] These barriers might fit into Zaheer and Mosakowski's (1997) idea of a "liability of foreignness." They stress that this liability is "a function of the social and cultural barriers foreign banks perhaps face in becoming fully integrated into the 'local' information flows."

[7] For an overview of recent developments of bank-industry ties see Fair Trade Commission (2001). See also appendix for changes in funding patterns.

[8] Recently Hakuo Yanagisawa, head of the FSA, made it very clear that he believed foreigners could not understand how may things in the Japanese financial system work (Financial Times 2002l). "These details [the rolling over of loans at the same interest rate regardless of a company's changing financial position] may be difficult for foreign economists to understand. That is probably why they are exaggerating the non-performing loan issue." But he also tried to make it clear that he welcomes foreign participation in Japan's banking sector: "I want the Japanese market to be like a welcoming *ozashiki* room." (Ozashiki are tatami rooms where Japanese executives relax.)

[9] Dore (2000) also talks about the entertainment of the regulator by the regulated, or "relational regulation."

[10] This also leads to the fact that changes can be much more difficult than mere legal changes, but involve changes in mentality.

[11] With increasing signs that there would be bank failures, this interventionist approach also led to the fact that MOF risked taking the blame for insolvencies.

[12] Cargill et al. (2000) distinguish different steps in Japan's system of financial supervision and regulation: Denial and forbearance (1991–1994); a period in which financial distress

was recognized, but with only minimal policy response (1995–1996); a period where it was considered under control, but where institutional change (e.g., the FSA) was initiated together with the Big Bang (1996–1997), a time of large-scale financial crisis and recession (1997–1998), the continuation of crisis and the recognition of the need to adopt new policies (1998–1999); and the time of capital fund injection and a shift to a new regime (1999). According to them, the new regime is reflected in a more aggressive government approach to resolve financial distress and in higher standards for banks to secure public funding in addition to institutional changes.

[13] Examples include the acquisition of Morgan Grenfell by Deutsche Bank, S.G. Warburg by Swiss Banking Corp., Barings by ING, Smith Newcourt by Merrill Lynch, and Kleinwort Benson by Dresdner Bank.

[14] This criticism was one incident showing that foreigners still have to cope with the interventionism of the Japanese government. Recently a similar debate about xenophobic tendencies of the Japanese government arose when the government censured five foreign investment banks for infringements related to short-selling of shares (Financial Times 2002f). This criticism has been strongly rejected by many Japanese voices.

[15] U.S. Cerberus Partners LP already holds 11 percent of Aozora's stakes. Softbank currently holds nearly 49 percent.

[16] Japan has seen a particular high number of failures of credit unions (54 between the end of 2000 and beginning of 2002). Moreover, its secondary regional banks are endangered, as the cases of Chubu Bank and Ishikawa Bank show. Both banks failed and did not find buyers, so that they will now be folded into a "bridge bank" (Financial Times 2002g).

[17] Citigroup also holds a 20 percent share in the retail activities of Nikko Securities. Recently it has confirmed that it is to buy 50 percent of Nikko Trust and Banking from Nikko Securities. Citigroup will then back its Japanese trustee and custody business into the joint venture. The joint venture will be renamed Nikko Citi Trust and will have assets of US$58.3 billion under administration.

[18] For instance it serviced Walt Disney in a $110 million bond issue, which it won in New York, arranged in London, and sold entirely through its branches in Japan (Wall Street Journal 2002).

[19] Sumitomo Mitsui Banking announced that it would sell 8.7 million Goldman Sachs shares. Sumitomo Bank had invested $500 million in Goldman Sachs (or 12.5 percent) as part of a business cooperation scheme in 1986. Between May 1999 and February 2001, it sold a total of 23.1 million Goldman Sachs shares at the request of the U.S. investment bank. In September 2001, it sold 6 million shares to improve its financial position. This new sale is part of the overall tendency of Japanese banks to scale back overseas assets to help reinforce eroded capital bases (Japan Today 2002).

[20] A detailed and interesting, though pessimistic, record of the British Wimbledon effect is given by Augar (2000).

[21] London's last move toward Wimbledonization was the London Investment Banking Association, LIBA, announcing that it was considering dropping "London" from its name in a bid to become a European representative for international investment banks. This is intended to reflect the fact that almost all investment banks based in the UK are foreign-

owned. The name change is to reflect London's international aspirations. Just eight years ago LIBA still had the name British Merchant Banking and Securities Houses Association, until it dropped the "British." LIBA is also considering mergers with other European trade associations (Financial Times 2002a).

[22] Even though we have chosen the term local "knowledge" in this paper, we are sure that there are better terms to describe the assets Japanese banks possess.

[23] Hoshi and Kashyap (2001) see this reflected in the fact that large Japanese banks made about the same fraction of their income from fee-based activities at the end of 1998 as they did in 1978. Over the comparable time period U.S. banks more than doubled this type of business.

[24] One should also not forget that Japanese banks have had dominating positions globally when measured by market capitalization and that this has only changed dramatically toward the end of the 1990s (see appendix).

[25] Tsugawa (2000) even goes so far as to say that Japanese banks have aimed merely at ensuring survival and have long been living by their own "non-global" rules. He states that American banks do not only import advanced skills, but they also induce a new philosophy in Japanese corporations.

[26] The ability to be a player in many geographic markets takes on many forms. The literature has pointed out that many foreign banks first follow their domestic multinational clients to serve them in foreign markets. Alternatively, a foreign bank can try to tap into foreign markets by acquiring a base of foreign individual or corporate clients.

[27] They are to some extent very near to the firm-, but not plant-, specific inputs that are often assumed when dealing with multinational companies in trade models (Helpman/Krugman 1985) and that can be transferred and used at multiple locations without extra costs. Leung's (1998) model is built on this concept.

[28] For bond underwriting Yasuda (20001) remarks that main-bank relationships in Japan are seen to be more crucial than expertise in bond sales per se. He illustrates this using the example of Sanwa, which is a top bidder for Japanese Government Bonds but lags behind other banks in underwriting because it has relatively weak main-bank ties with the best blue-chip companies.

[29] Rapp (1999) enumerates the following fields where foreign firms in Japan seem to have a technology or market position advantage: corporate finance, interest options and futures, long-dated forwards, one-sided dollar interest rate swaps, other derivatives, private placements, real estate securitization, portfolio packaging, real estate trust advice, stock index options and futures, strategic alliances, Swiss Franc Bonds, Synthetic Securities, and Yankee Bonds. He states that historical relations might even be a barrier when it comes to index trading because corporate investors perceive Japanese securities houses as "open windows" on their domestic and international activities.

[30] To some extent this argument is similar to the ownership-localization-internationalization literature, which was established by Dunning. Multinational corporations which choose to supply foreign markets by direct investment must possess ownership advantages to overcome disadvantages they have relative to local companies, e.g. unfamiliarity with the local culture and system.

[31] Their joint venture IBJ Nomura Financial Products (with branches in London and Tokyo) has by now been dissolved. It was a very interesting case. It was intended to help Nomura and IBJ to efficiently develop their expertise in the face of the invasion of foreign companies. The joint venture concerned the field of derivatives. Nomura and IBJ chose to locate its headquarters in London as they planned to enter Tokyo's markets as foreign players in order to benefit from exceptions granted to the latter.

[32] See for instance Benton and Terramoto (2000), Koza and Lewin 1998, Park and Russo 1996, Park and Ungson 2001, Parkhe 1993.

[33] Other authors who argue that joint ventures are organization forms where the foreign partner contributes his ownership advantages and the local partner contributes knowledge of the local market are Blodgett (1991), Kogut (1988b), Kogut and Singh (1988), and Leung (1998).

[34] An interesting alternative for foreigners to acquire local knowledge is to hire senior executives of Japanese banks. While it is still very unusual for Japanese CEOs to accept such offers, a recent example has shown that the option should not be totally discarded: the chairman of Industrial Bank of Japan has agreed to become the chairman of Merrill Lynch Securities Co. While such moves, when occurring in greater numbers, would put even more pressure on Japanese banks, the foreign financial institution expects to benefit from the local CEO's "experience and deep knowledge of clients and the financial markets" (Nikkei Net 2002).

[35] Wong and Leung (2001) approach this topic in a model dealing with moral hazard, cooperation costs, and technology spillovers.

[36] If the benefits of the joint venture for the foreign partner lie in getting access to Japanese clients, this is not correctly described by learning, at least not on the side of the foreign investment bank.

[37] See also Beamish 1985; Franko 1971; Kogut 1988a and 1988b; Geringer and Hebert 1991; Gomes-Casseres (1987).

[38] It should be taken into account that the large sums involved in one single deal are the reason why M&A rankings are hardly stable configurations over time.

[39] In 2001 worldwide M&A activity declined by almost 50 percent. This trend was also observable in Japan, which accounted for 3.79 percent of the total volume worldwide and experienced a drop of 43.88 percent. Another feature of the Japanese market is that foreign investment as a percentage of total Japanese M&A has significantly increased and accounts now for one-third.

[40] Harner (2001) describes Goldman Sachs and Morgan Stanley as "hi-tech zaitech."

[41] For time series data see next section.

[42] The historical lows of the Nikkei have without a doubt hurt investor confidence and the recent discussions about short-selling of shares will also have an impact.

[43] In announced mergers and acquisitions as of 2002/I Nomura has a leading position with 51 percent, ahead of NSSB and Morgan Stanley. Goldman does not even appear in this ranking, nor does JP Morgan. Some observers have commented on this by remarking that

global consolidation in investment banking is leading to a curbing of activities by American investment banks in Japan.

[44] There are indicators that the concern of Japanese depositors about the financial health of Japanese banks is growing. While most foreign banks in Japan had double-A ratings (Standard & Poor's), the Japanese banks were rated triple B. These concerns have led to a strong increase of yen-denominated deposits at foreign banks in Japan (NikkeiNet 2002a).

[45] Merrill Lynch's advertising did not match Japanese customs, its offices were not attractive for Japanese clients, it had to do a lot of retraining, and it lost many former Yamaichi customers before being ready to enter the market.

[46] Merrill Lynch is an interesting example. It was the first U.S. bank to open a retail brokerage in Japan, in 1998. In contemplating reducing retail brokerage transactions Merrill Lynch today has to take into account that this might also endanger its corporate banking. The retail broker had supported the expansion of the wholesale business in Japan, helping it win mandates. The retail network allowed Merrill Lynch to offer something that no other U.S. company could offer: a combination of significantly local Japanese retail and global distribution (Financial Times 2001e). Merrill's retail problems have been debated as bad luck, easily avoidable mistakes, or indications that "Japan as a whole is still distinctly dangerous for outside banks" (Financial Times 2001g).

[47] Most recently Merrill Lynch announced that it would reduce its twenty-eight branches to eight and implicitly admitted that its business model was inappropriate for Japan. It said that it would in the future rely on door-to-door visits by its salesmen, which is the traditional way of selling financial products in Japan, instead of having clients visit its branches (Financial Times 2002, The Asian Banker 2002).

[48] At the end of June 1998 there were sixty-eight foreign securities companies (ninety-eight branches) operating in Japan, of which thirty-one were American, twelve English, seven German, five French, and two each Canadian and Swiss.

[49] For the Japanese "investment banks" the term securities houses might be more appropriate. We speak of foreign and Japanese investment banks in this paper in order to keep things simple.

[50] Daiwa is present in eleven European countries, Nomura in five. After the September 11 terror attack in New York, there were rumors that Japanese banks were thinking about giving up their New York offices.

[51] Recently it was announced that UBS won the mandate to sell the shares of West Japan Railway together with Nikko Salomon Smith Barney and that Goldman Sachs will do the same together with Nomura for East Japan Railway. Together, these sales account for $4.5 billion of shares and ¥9 billion in fees for the four banks.

[52] Recent Bank of Japan data show that lending by Japanese commercial banks has continuously decreased since at least 1999 (Bank of Japan 2001). Meanwhile lending by foreign banks has fluctuated and grown significantly at least in some periods (such as from the end of 1999 to the beginning of 2001).

[53] This might be true in a positive but also in a negative sense. For instance Goldman Sachs, which was involved in the NTT as well as NTT DoCoMo deal, was threatened by the MOF with being barred from further deals because of disputed deals it had done in Europe. The

discussions around these deals threatened its credibility. Goldman Sachs was strongly criticized in Japan at that time. Some people said that its managers behaved arrogantly and imposed a Western style on Japan in a culturally insensitive way, although other people said that it served as a scapegoat for the “sins” the Japanese observed in foreign banks in Japan. This is a good illustration of the fact that the global role of local players can promote them in good times but that negative developments can also spread geographically, especially in environments where credibility is very important.

[54] Obviously the evaluation of the market position of foreign banks in Japan depends strongly on the variable one is looking at: overall numbers of deals, numbers of deals as lead underwriter, or volumes.

[55] We should keep in mind that usually several underwriters are involved in one deal.

[56] A lead manager or lead underwriter is the bank with primary responsibility for organizing the issuance (finding other underwriters, creating the syndicate, negotiating terms with the issuer, and assessing market conditions). Sometimes there are several lead underwriters, but in that case there will most of the time be only one bookrunner. This is the bank which is responsible for managing the books of an offer (collecting the orders, pricing, allocating tranches, etc.).

[57] While UBS’s position was quite promising, the serious mistakes for which it was responsible in the recent Dentsu initial public offering may have cost it a significant part of its reputation in Japan.

[58] Empirical research has shown that the failure rates of cross-cultural joint ventures are higher than 50 percent, which does not give cause for much optimism. Since we have only one example, our predictions are obviously not well-supported.

[59] Of course, the difficult situation of the ailing financial sector can have two types of effects: deterring foreigners from entering Japan’s markets or encouraging them, as market shares may be easier to grab in times of crisis. Credit Agricole seems to be a recent example of a player in the second group. Despite the huge sums of non-performing loans and losses on securities holdings, it acquired a 5 percent stake in the pensions and corporate trust operations of Daiwa Bank (Financial Times 2002h).

[60] For instance the number of foreign financial institutions who perceive the environment as attractive to exploit their skills, the number of foreign-listed companies, the number of foreign market participants, the intensity of decision-making that is related to activities happening elsewhere (regional headquarter functions), the amount of foreign assets managed, the size of the local expert labor market.

[61] There are still significant differences between New York and London as well, which mainly concern the fact that New York has a wide American hinterland as a center for the securities industry in particular, but also that the United States seems to be much more multicentric in its structure than is true for either Europe or Asia. Nonetheless, the above definition certainly fits both London and New York.

[62] Similar doubts might be relevant for foreign firms, which try to benefit from local expertise by appointing senior Japanese managers to leading positions.

[63] For instance, as regards the choice of a lead underwriter by an issuer, Kimura and Pugel (1992) state that it does not seem to be related to the pricing of the underwriting service, but

rather the ability of the underwriter to increase the market price of the issuer's previously issued stock (to a moderate extent). While there are different ways to achieve this, the big four Japanese securities houses seemed to have advantages of reputation in the past because it was observable that their participation alone served to increase demand and stock prices. Whether foreign firms might be able to achieve a similar effect because of their global reputation is an open question.

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