Emergence of Foreign Financial Institutions in Japan

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1. The Coming Age of Global Finance

“Big Bang” Reforms Get Underway

It is now about a year and half since the Big Bang-financial market reforms-were announced. The following year has been volatile and marred by the bankruptcies among financial institutions, a serious credit crunch, and the issue of the questionable relationship between financial institutions and administrative authorities. But positive changes suggestive of a new emerging structure of the Japanese financial industry also started surfacing during this period.

The ban on financial holding companies was lifted in March 1998. It was followed by the introduction of the revised Foreign Exchange law and the new Bank of Japan law. Moreover, the Financial System Reform act was passed in the previous Diet session, clearing the way for the implementation of most of the “Big Bang” reforms by next December (Table 1)[1]

Table 1. “Big Bang” Reform Schedule

Schedule	Description
1998	
March	Abolition of the ban on financial holding companies, Repurchase and retirement of own stock using capital reserves by listed companies (Up to March 31, 2000), Expansion of the scope of market price accounting (pension assets of pension funds, banks and securities companies trading accounts, derivatives), Re-valuation of land.
April	Implementation of the revised Foreign Exchange law and the new Bank of Japan law. Introduction of the early corrective measures, Expansion of the scope of deregulation of brokerage commissions, Lifting of the ban on immediate purchase of Euro bonds by domestic investors, Lowering of the securities transaction tax and the stock exchange tax.
May	Passage of the Financial System Reform act.
June	Establishment of the Financial Supervisory Agency.
July	Deregulation of non-life insurance premium rates.
September	Implementation of the SPC law.
October	Lifting of the ban on sales of investment trust by banks.
December	Implementation of most the measures approved in the Financial System Reform law (switch from licensing to registration system for securities companies, Lifting of the ban on off-floor trading, Introduction of private placement of investment trusts and corporation type investment trusts, Approval of OTC securities derivatives, Establishment of a fund for the protection of investors, Establishment of a fund for the protection of insurance policy holders.
1999	
March	Introduction of the market value accounting system for life insurance companies trading accounts.
April	Expansion of the disclosure requirements for small offerings, Switch to consolidated basis disclosure.
October to end of March 2000	Complete deregulation of the scope of business of subsidiaries in individual financial sectors (Up to March 2001, when a law to that effect is scheduled to go into force, insurance subsidiaries of banks to be limited to the rescue of bankrupt firms.)
December	Reduction of the securities transaction tax and securities exchange tax, Rationalization of the capital gains tax.
By the end of the year	Complete deregulation of brokerage commissions.
March 2000	Introduction of market value accounting for the balance sheet.
Other important measures	Electronic Money law, Financial Services law, Defined Contribution Plan, Basic law governing corporate pension funds.

Source: Nomura Research Institute

1 Sadakazu Ohsaki, “Outline of Financial System Reform Act”, *Capital Research Journal*, Summer 1998, Nomura Research Institute.

In keeping with deregulation and the reform of the legal framework, it is important to notice that administrative authorities and some individual players have already adjusting themselves toward the new environment under the "Big Bang" reforms.

For instance, the Ministry of Finance, without waiting for the switch from the licensing to the registration system for securities firms, issued a license to D Brain Securities, a unique securities firm focusing on unlisted companies. This was followed by the establishment of several new securities companies. Angel Securities and Axes Securities were established in February 1998.

Moreover, the ban on off-floor trading will be lifted in December 1998. To cope with the expected increase in competition between stock exchanges, both the Tokyo and Osaka stock exchanges have started introducing extensive reforms. As a part of the reforms, the exchanges are trying to introduce more efficient trading facilities. Unlike floor trading, the norm in the past, computer network based trading is to be introduced.

Elsewhere, the reforms is creating opportunities for business corporations to enter new fields such as securities business, investment advisory services, electronic money, certain foreign exchange services, and insurance sales. New business opportunities in the financial sector, long considered to be a forbidden land to business corporations, are already emerging.

Foreign financial institutions attracted to Japan

In addition to the above mentioned reforms, the emergence of foreign institutions in the Japanese financial markets also deserves note. Of particular note is their presence in retail areas, such as foreign currency deposits and foreign currency denominated investment trust, in the wholesale area including derivatives, and securitization of non-performing debt. Also tie-ups and mergers and acquisitions with Japanese firms are emerging. (Table 2)

Table 2. Recent trends among foreign financial institutions in Japan

	Financial institution		Timing of Announcement or Implementation
Bank affiliated institutions	Citibank	Expanding rapidly by introducing 24-hour ATM, telephone banking, foreign currency deposits. Reinforcing credit cards, low interest housing loans, and private banking.	
		Announced a tie-up with Sumitomo Trust Bank in the development and marketing of savings type financial products.	September 1997
		Expansion of the branch network to main cities in regional areas.	October 1997
		Tie-up with Daiwa Securities for the development and marketing of foreign currency denominated investment trusts.	November 1997
	Chase Manhattan Bank	Announced a tie-up with Sakura Trust Bank in custodian services	January 1998
	Bankers Trust	Mutual share holding and a comprehensive tie-up with Japan Credit Bank.	April 1997
		Announced a hedge fund management tie-up with Daiwa Securities	September 1997
		Announced a tie-up in dollar denominated savings type products with Daiwa Securities	October 1997
	JP Morgan	JP Morgan Securities obtains a seat on the Tokyo Stock Exchange	July 1997
	Brown Brothers Harriman	Tie-up with Daiwa Bank in asset management	January 1998
	Credit Swiss	Derivatives subsidiary, CSFP (Credit Swiss Financial Products) obtains a bank license	April 1997

	SBC (UBS)	Cross share holding with the Long-term Credit Bank of Japan. Announcement of a joint venture securities firm.	July 1998
	Soeciete Generale	Agreed to buy 85% of Yamaichi Investment Management Co. Announced a tie-up with Mitsui Trust Bank to market investment trusts.	January 1998 February 1998
	ABN Amro	Reinforcing securities business in Japan, Plans to set up an investment advisory firm in Japan. Announced the purchase Yamayoshi Securities' seat on the Tokyo stock Exchange.	June 1997 September 1997
	Deutche Bank	Providing financial support to Dai Hyaku Bank through subscription to its subordinated loans; Considering tie-ups for assets management.	March 1998
	Commerz Bank	Securities subsidiary acquired seats on Tokyo and Osaka stock exchanges.	March 1998
	Dresdner	Entered into investment trust business jointly with Meiji Life. Simultaneously Dresdner RCM Capital Management and Meisei Capital Management, a subsidiary of Meiji Life, to merge	March 1998
	Jardin Fleming	Set up Nippon Investors Securities, a joint venture securities firm specializing in marketing investment trusts. The eleven joint venture partners include, Fuji Bank, Yasuda Life Insurance, among others.	April 1998
Securities Firms	Merrill Lynch	Took over former Yamaichi Securities' 31 branch offices and 2,000 employees. Established Merrill Lynch Japan Securities to expand into the retail area.	February 1998
	Goldman Sachs	Marked increase in investment trusts sales Announced a business tie-up with Yasuda Trust for real estate sales Purchased real estate collateralized debt from Tokyo Mitsubishi Bank Purchased and securitized Yamato Life Insurance's headquarters building	 October 1997 December 1997 April 1998
	Solomon Smith Barney	Announced the establishment of a joint venture with Nikko Securities in the wrap account area Announced a tie-up with Yasuda Trust Bank for real estate sales	July 1997 October 1997
	Morgan Stanley	Purchased 1,200 condominiums from Daikyo	March 1998
	DLJ	Daiwa Securities tie-up to engage in business related to securities transactions of US investment trusts	March 1998
Asset management company	Fidelity	To set up a large call centre in Tochigi prefecture Commenced direct marketing of investment trusts	December 1997 April 1998
	Putnam	Announced a tie-up, covering financial product development, asset management, and personnel exchanges, with Nippon Life	June 1997
	Capital Group	Announced a tie-up, covering development, management and marketing of investment trusts products, with Dai-Ichi Life Insurance.	March 1998
	Franklin Templeton	Announced a business tie-up with Sumitomo Life	June 1997
	Dreyfus	Announced a business tie-up with Tokyo-Mitsubishi Capital Management	January 1998
	TCW	Announced a tie-up for joint product development with Yasuda Fire and Marine Insurance Global Asset Management in relation to the latter's entry into investment management field.	February 1998
Insurance	American International	Established AIMIC Investment Trust Co. with Mitsubishi Trust. Considering the purchase of Aoba Life Insurance	February 1997 April 1998
	Unam Corporation	A major US casualty insurance firm. Established a tie-up with Chiyoda Life and DaiIchi Kangyo Bank for marketing non-life insurance products. Chiyoda Life considering re-insurance of Unam Japans casualty insurance policies.	April 1998
Others	GE Capital	Announced the acquisition of Koei Credit, Kofuku Bank's financial subsidiary. Announced the establishment of another life insurance company with Toho Life Insurance	December 1997 February 1998
	Beacon Group	A US based M&A company. Announced a tie-up, covering M&A, information exchange, and venture funds, with the Industrial Bank of Japan	April 1997
	Freeman Associates	A leading US consulting company. Established a joint venture asset management firm in the US with Fuji Bank. To market investment trusts in Japan.	November 1997

Source: Nomura Research Institute

It was in the early nineties that the hollowing out of the Japanese financial market started becoming a critical issue. One of the signs of this impeding hollowing out was the start of an exodus of foreign financial institutions from Japan, owing to Japan's restrictive environment and punitive tax laws. Affected also in part by a sluggish market, moves by foreign financial institutions to pull out, some partially, from the Japanese market, and to transfer their operations to other Asian locations, such as Singapore, and to give up their seats on Tokyo Stock Exchange started to surface.

One of the important objectives of the "Big Bang" was to stem this exodus and to assure that Tokyo remained a major global financial centre. Now that foreign financial institutions have started to actively beef up their operations in Tokyo, at least this objective seems to have been achieved.

However, to assume that last year's trends were a result of the "Big Bang" alone, will be shortsighted. Many of the "Big Bang" reforms have long been implemented in the US and European markets quite a while ago. Japan is simply doing what should have been done ten years ago. While the "Big Bang" may be a major change for Japan, to the rest of the world it is nothing more than an island nation in the Far East trying to catch up. The current set of reforms does not in any way guarantee that changes comparable to those implemented in the US and European markets will be carried out and that Japan will become a competitive and attractive market. At a time when Japan is still embroiled in the "Big Bang" debate, the major developments, like mega mergers, in the US and Europe, seem to be widening the lead over Japanese market.

Then, why is that foreign financial institutions are expanding their operations in the Japanese market? To understand the logic behind such moves, one must interpret them against the changes in the competitive environment in which the US and European financial institutions find themselves.

Appearance of a truly global financial institution

While the changes in the competitive environment facing the US and European financial institutions may be analyzed from many different angles, the author want to emphasize that we are entering an age in which truly global firms are likely to appear in the world's financial industry.

The 20th century saw the emergence of global firms in many industries. A global firm may be defined as a firm possessing products, services or corporate philosophies honored the world over. Coca Cola, MacDonald's and Nestle etc. in the food industry, Ford, GM, Toyota and Honda etc. in the automobile industry, Shell and Standard Oil etc. in the oil industry, Microsoft and IBM etc. in computers, and Boeing etc. in aircraft, qualify as global firms.

As mentioned above, although global firms emerged in a variety of industries, we can say that a global firm has yet to appear in the real sense of the word in the financial industry. It is not that there are no internationally active firms in areas such as Euro syndicated loans and international bond underwriting. But the international activities of these firms were considerably limited.

Nevertheless, an age in which truly global firms will surface in the financial sector is close at hand as we move toward the 21st century. Why? First and most important is the progress on a global scale toward deregulation in the financial and capital markets. Although the level of regulation has varied with individual countries, throughout the world the financial industry has always been heavily regulated in comparison with the industry in general. However, there is a global trend toward deregulation and the freedom to expand is increasing in the financial industry.

Second, the financial industry is becoming more of an information technology industry along with the progress in information technologies. The network plays a decisive role in the information technology industry. Networks have no national boundaries and global business becomes technologically feasible. Moreover, there are the so called economies of the network and more the number of participants the higher its service value. In other words, such an industry increases the appetite for global services. Since it is also a very capital intensive industry, economies of scale are available. Becoming massive and going global brings down the fixed cost ratio. In other words, it promotes the development of global services.

A good recent example of deregulation and technology spurring globalization in the financial industry, is the US banks' signing up blue chip Japanese corporations for their global cash management service. The service underpinned by the deregulation in the form of the reform of the foreign exchange laws in Japan and technological advances in the form of global financial management systems, is expanding US banks' customer bases in Japan.

Emergence of global firms as a result of these factors is not limited to the financial industry alone. It applies equally to telecommunications. A few telecommunications operators much more global than today are likely to appear in the world as a result of deregulation and technological advances. Although late in coming, global firms are expected to emerge in the telecommunications and financial industries as we approach the 21st century.

2. Ability to withstand global competition - As seen in US financial institutions

From where should we expect global firms in the financial sector to emerge? If other industries are any guide, the number of such firms will be limited. We will wind up with a handful of global firms competing for dominance of the financial industry in the 21st century.

As of now, US financial institutions are the most likely to emerge as successful global players. This assumption is based on the conclusion that US players are the most well prepared from the standpoint of the various pre-requisites for becoming global winners.

The Underlying Strength of Securities Market Business

The first pre-requisite for success in the global financial market is competitive advantage in the securities market business. The underlying trend in the financial intermediary business indicates a move away from the traditional intermediary business such as banking which involved taking in deposits and loaning out the funds to a one characterized by financial intermediation based on securities markets. Obviously for a financial services company to succeed, it will have to be competitive in this area.

Evidently, the major players from this standpoint are US financial institutions since they have been operating in the world's largest and the most efficient securities markets. This is particularly true when it comes to investment banking. We can confidently say that unless a financial institution is able to join the ranks of the top player in the US, it can hardly expect to become the leading player on the world scene. European financial institutions have been actively entering the US market in an attempt to assure that they remain in the global league. Needless to say that winning recognition as an investment bank is no short-term task and therefore the European attempt does not seem to be yielding the desired results.

Going Beyond the Framework of Existing Financial Boundaries

The second pre-requisite is the ability to break out the traditional concepts of a bank, securities company, insurance company, or a capital management company, and provide optimum services required by customers. These constraints were placed on the industry from the top, that is administrative authorities and were not necessarily based on economic rationale. These individual sectors may have had economic rationale in the early stages after they emerged. Thereafter, each grew into independent sector in their own right and restrictions that came into force were nothing more than the ratification of existing situation.

Deregulation in countries around the world is causing changes from this standpoint. But even after deregulation, it is not easy to change the patterns of behavior and commercial practices that took root during the long period of heavy regulation. Obviously it is meaningless to stick to traditional ways which ignore customers' needs. What is required is to pre-empt these changes and make moves to spur deregulation through dynamic mergers and acquisitions that go beyond the traditional boundaries of individual financial sectors. U.S. firms, already active from this standpoint, seem to be uniquely qualified as financial institutions of the coming age.

Ability to Advice Clients

The third pre-requisite is the flexibility to provide suitable advice to different types of customers. A financial institution will have to provide a wide range of products and services to a variety of customers if it is go global.

In this sense the US has been experienced. It has a variety of customers within its own borders and this has placed US firms at an advantage. What needs note is that a new type of customer, that is growing baby boomers or Generation X, is emerging in the US as will be discussed further later. US financial institutions are building up know-how in providing new products and services to this customer bracket. This know-how will be a powerful weapon for global expansion, where servicing a wide variety of customers is required.

Marketing Prowess and Technological Strength

Today, marketing prowess and technological strength have become imperative in the financial industry. In the past, when the financial industry was overly protected by regulation, customers were not necessarily given sufficient options when it came to asset management and fund raising. This meant that, from the standpoint of financial institutions, there was no particular need to make efforts to attract customers. Naturally the marketing concept did not take root in this industry. Now that deregulation is ushering in competition in various forms, it is becoming important to device ways to appeal one's products and services to prospective clients. US financial institutions are already in that stage.

At the same time, now that the financial industry is taking on the characteristics of the information technology industry, technological strength is becoming an important parameter in determining the success/failure of a financial institution.

US financial institutions find themselves in a favorable environment from both the marketing and technological standpoints. This is because the US is in the leadership position in both marketing theory and information technology.

Managerial Excellency and Corporate Governance for Achieving Superior Performance

But, just to satisfy the above parameters is insufficient. What is required is the ability to fuse these to achieve superior performance. External checks sustain and foster the will and the ability to realize these goals. Particularly, US corporations are under intense pressure from shareholders and others and their performance is under constant review. Under the circumstances, US financial institutions can hardly let down on continued strengthening of business foundations. Going global does not mean involvement in a variety of businesses without proper strategy and operating on a global scale. Companies capable of restructuring where necessary and achieve optimum redistribution of corporate resources will alone be able to survive. However, this is difficult to achieve internally since it accompanies much pain. External pressure is required.

3. Changes in the Composition of Clients and Changes in the Financial Industry

Earlier, we pointed out that one of the pre-requisites for survival was the ability to provide suitable advice to a variety of different types of customers. We would like take up this point in more detail.

Composition of the Customer Base

Customer profiles and financial institutions' methods of dealing with them may be broadly classified as shown below. The horizontal axis in Figure 1 shows investor profiles. The farther you go to the right the higher the ability of the investor to take responsibility for his investment decisions. On the other hand, the farther you go to the left on the horizontal axis the lower the awareness of self responsibility on the part of the investor. The vertical axis shows the level of advice by financial institutions to their clients. The ability to provide sophisticated advice increases as we go up along the axis. The lower the position on the axis the less advice is provided.

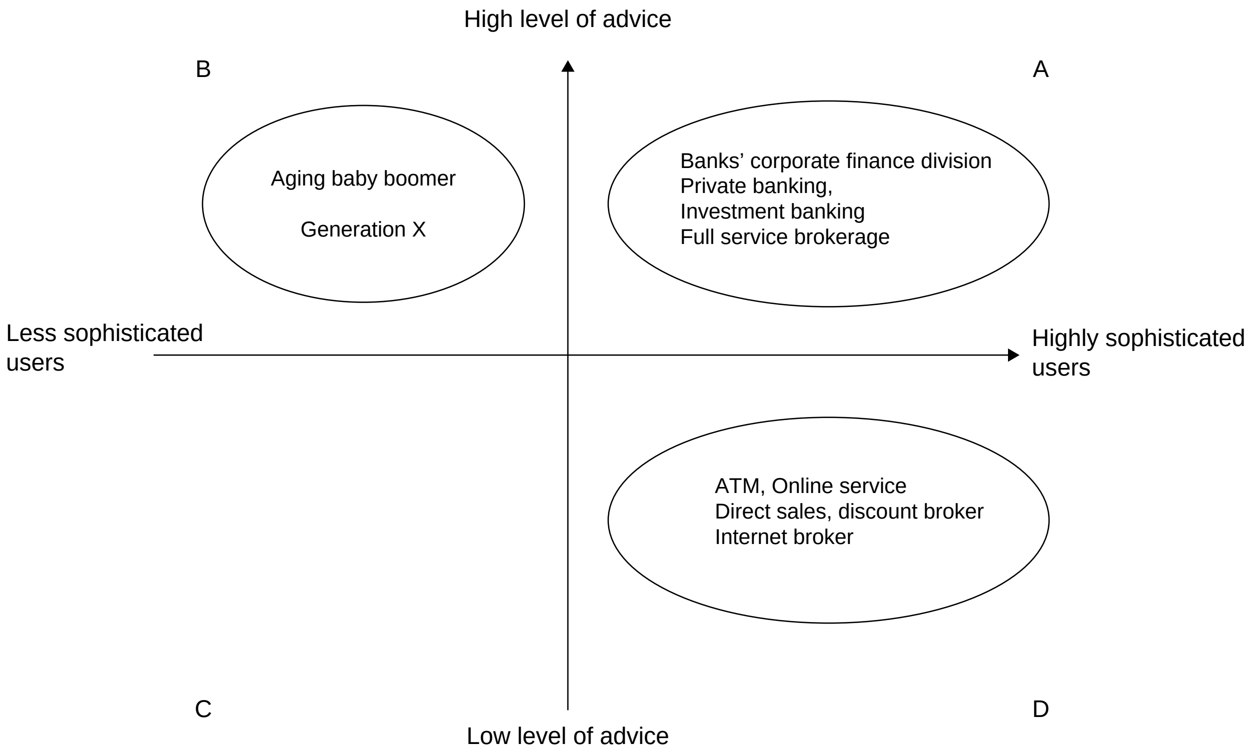
The four quarters are labeled A, B, C, and D in the counter-clockwise direction, starting from the upper right quarter. When this model is applied in its simplified form to the U.S. we find that in the past there were only two classes -A and D- in that country. In category A, financial institutions marketed products while providing advisory services to customers who were experienced to a certain extent. This sphere could be described as that of full-service brokers or a world of finance in which professionals were dealing with each other. Wholesale business falls in this category.

There is another aspect of the financial world in the U.S. that falls in category D. Here, the investor is well aware of his responsibility and does not need advice. Such customers make their own decisions, select the products they want and place orders directly with brokers by telephone or other means. Since they are well versed in investment, advice is not required. Naturally, they tend to choose brokers that offer the most competitive commission rates and most convenient services.

This can be likened to services provided by companies, like Fidelity, which market their products directly through toll free lines. Discount brokers, Internet brokers, Internet banking and other similar emerging areas fall in this category.

In Japan, direct marketing of mutual funds, is often seen as a means of diversifying the delivery channels in order to facilitate mutual fund purchasing by individuals. However, in the U.S., direct marketing is not directed at the general public but at sophisticated investors. In other words, these are investors who can take management decisions on their own, without advice. Given the nature of the customers, direct marketing is the most suitable method.

Figure 1. U.S. market profile



Source: Nomura Research institute

Emergence of a New Type of Investor

Evidently only two categories mainly existed in the U.S. financial industry. Emergence of and the increasing weight of the category B investor is a recent important change. This change can be explained as follows. As baby-boomers approach the retirement age they start thinking seriously about retired life and start considering stock and mutual fund investments. Luckily the market is also booming and spurring the inflow of the baby-boomer money. This in turn is pushing up stock prices. This phenomena is not limited to baby-boomers alone. Those in a still lower age bracket -35 and younger- called the generation X have already started thinking about retired life and have seriously start considering stock and mutual fund investments.

They are, however, amateurs when it comes to investments and therefore fall into unsophisticated investor category. Being amateurs they need plenty of advice. This customer group is expanding rapidly. It has become important for financial institutions to attract this type of customer.

We can safely assume that for the past ten years U.S. financial institutions have concentrated on developing new products and services for this type of customer. While doing so, U.S. financial institutions managed to acquire the know-how for providing appropriate products and services to variety of customers, from types A and D to B.

Individual Firms Response

What strategies are available to financial institutions to attract the type B customer? Since the primary need is to build up assets for retirement, the key words are 'Retail' and 'Asset Management'.

To establish a firm foothold in this area, financial institutions who had largely operated in area A, started entering area B (Figure 2). For instance Merrill Lynch has traditionally been a full-service broker focusing on customers who could deal at their own responsibility. But Merrill has also sensed the presence of this amateur investor. While giving full play to its traditional concept of the financial consultant, Merrill instead of focusing on trading commissions shifted emphasis on annual fees based on the size of the customers assets. At the same time Merrill acquired Hochikis and Mercury to reinforce its fund management capabilities.

Morgan Stanley acquired Dean Witter, known for its strength in the retail area. Morgan also acquired asset management firms like Wolfenson. Solomon Brothers also, although a leader in the wholesale area merged with Smith Barney, whose parent company is Traveller's. Smith Barney has a strong position in the retail field; Wrap accounts that need advisory services in particular. Solomon had to transform itself from being a purely whole sale house to a company strong in the retail area also.

JP Morgan's, a wholesale bank, acquisition of American Century to expand into the fund management business, underscores the rapid growth in this above B area.

Evidently, firms originally strong in area D now need to target area B also. Here Charles Schwab has been following somewhat of unique strategy. It is targeting financial planners around the country for several years. Financial planners have ample clients to whom they provide advisory services.

On the other hand Scudder Stevens Clark, a company specializing in direct marketing of mutual funds, introduced a system called 'The Scudder institute" to enlighten 401(K) clients concerning investments and financial matters. The company is focusing on laying the foundations of building up a firm base among the employed for mutual funds.

In addition to expansion in area B, important changes have also occurred in areas A and D. Banks are actively entering the securities business as the traditional banking business is increasingly less profitable. The network age is bringing about changes in area D. A variety of different types of financial institutions, beyond their traditional preserves, are being linked through web sites. This is evidenced by the shared web site produced by E-trade and BancOne.

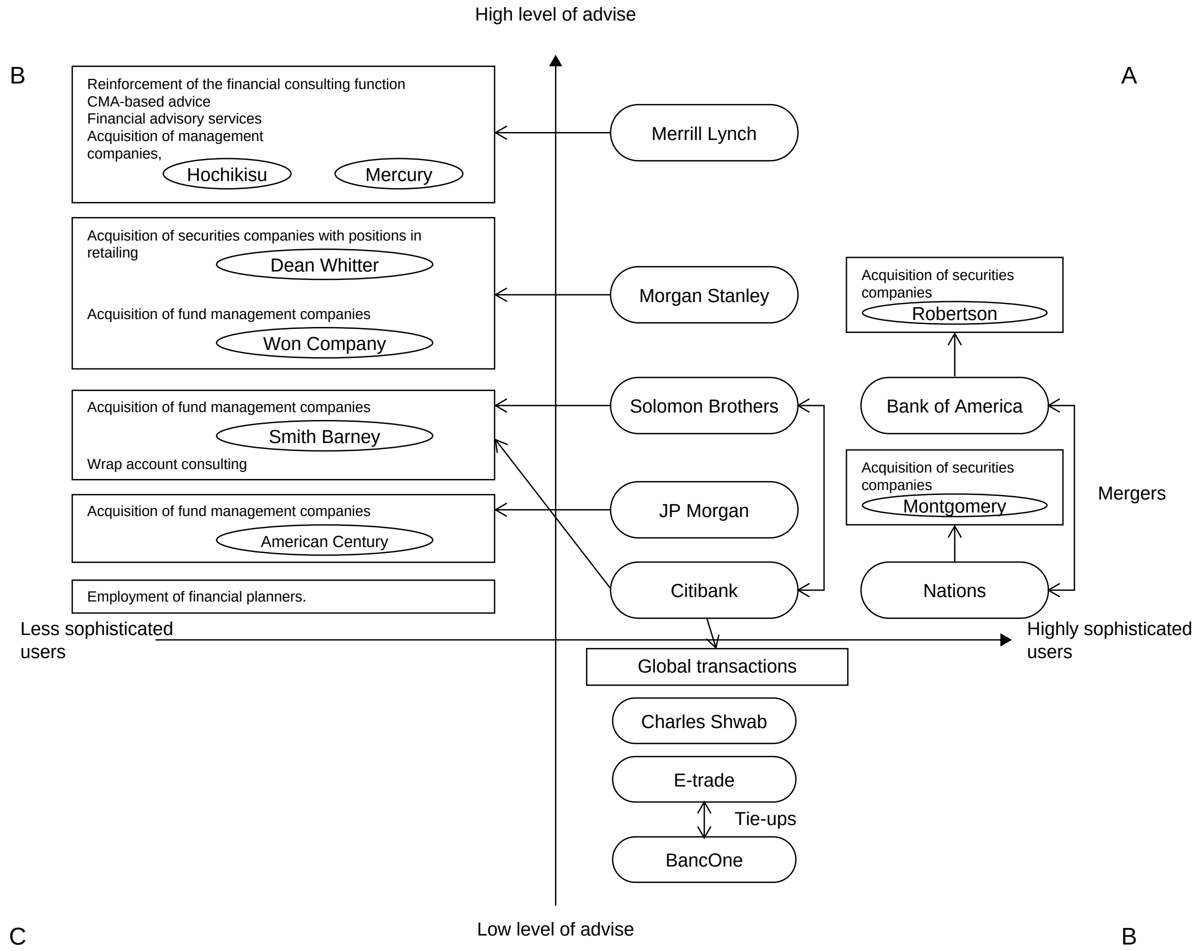
Products and Services by Areas of Specialization

Let us have a closer look at what type of products and services are being offered in each of the areas. (Figure 3)

Needless to say area A is where the performance as a professional will be in question. Private banking falls largely in this area. In the case of certain customers the service extends to area B. The focus is on order-made products, unique products and information, securities underwriting, and unique asset management abilities.

In area D, instead of unique products, services, or asset management performance, the focus on commissions and convenience. Instead of hard selling own products and services, that is guiding the clients, the focus should be on simply offering a variety of options to customers. That is to say

Figure 2. Strategies at Individual Companies



Source: Nomura Research institute

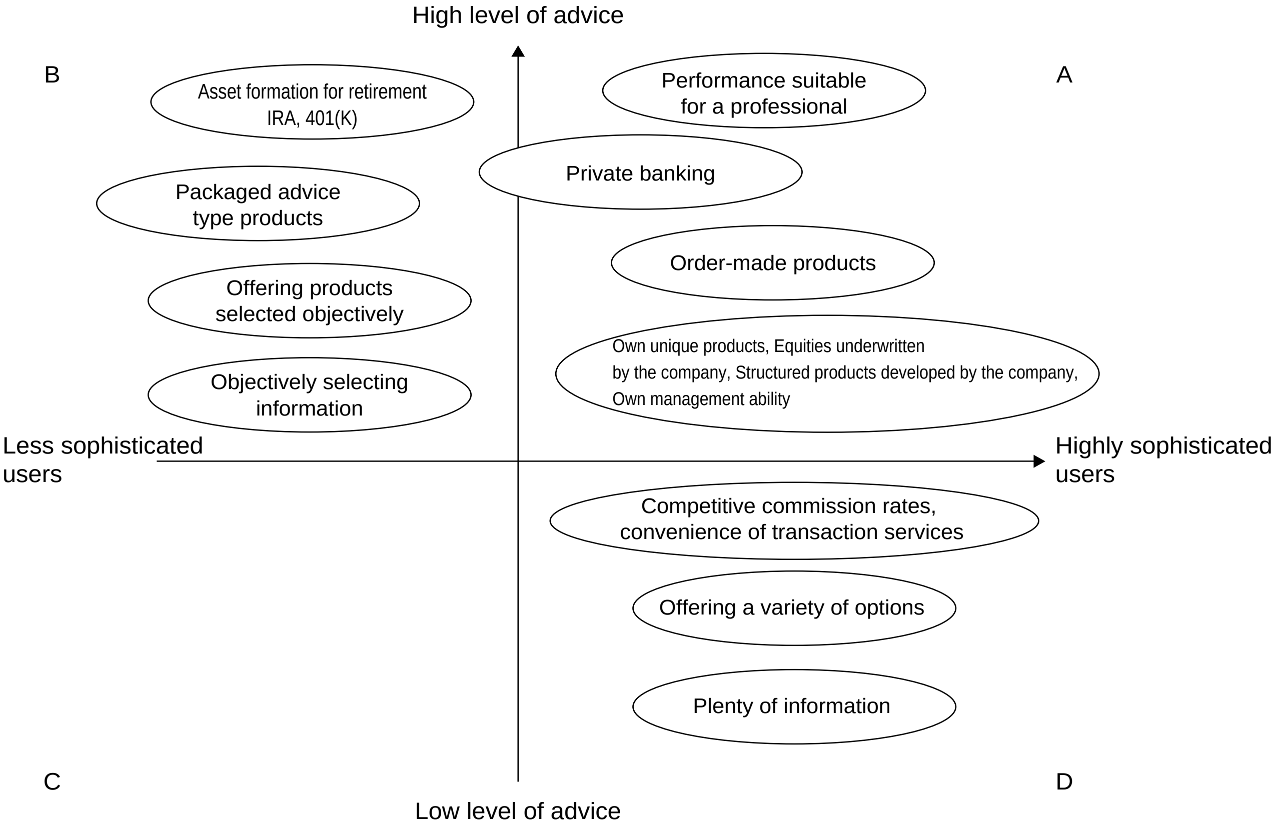
that customers in this area do not necessarily demand investment advice and are able to select products and services at their own discretion.

In B, an emerging area, most are individual investors. Their principal need is asset formation for retirement. Products like 401(K) plans are important. Moreover, detailed advice is also required.

However, unlike A, it is more of a retail area and accounts tend to be small. Time consuming service is not feasible. This is an area where products which can be sold with somewhat of a standardized advice package are important. Wrap accounts are typical examples of such products. Merrill is realizing this through easy-order products, like the CMA and Financial Advantage, which feature the advice factor.

One of the important factors with respect to the products and services in this category, is to provide products and information selected by professionals and matching the needs of the customer, instead of offering a broad range of options to clients. The customers here differ from those in area D, more so because they are amateurs. Needless to say the information provided to them needs to be filtered first. But unlike A, the products in this area need not be unique. What is necessary is to select products and services objectively from the standpoint of customer needs. Since this type of customer feels that he is also amateurs in the selection of the proper financial institutions, he is likely to be cautious about hard selling tactics. Proper appeal to the customer is therefore necessary. For instance, even though Merrill has its own mutual fund subsidiary, in addition to the sub-

Figure 3. Products and Services by Areas of Specialization



Source: Nomura Research Institute

sidiaries' products, offers financial products of other companies if the needs of the customer make it a better option. In other words Merrill's own mutual fund is no more than one product on the shelf. Nevertheless, when it comes to product line up, it is better to offer a limited number of carefully selected products instead of carrying an everything like a supermarket. This is the major difference from the company operating in area D.

Differences in Marketing Strategies

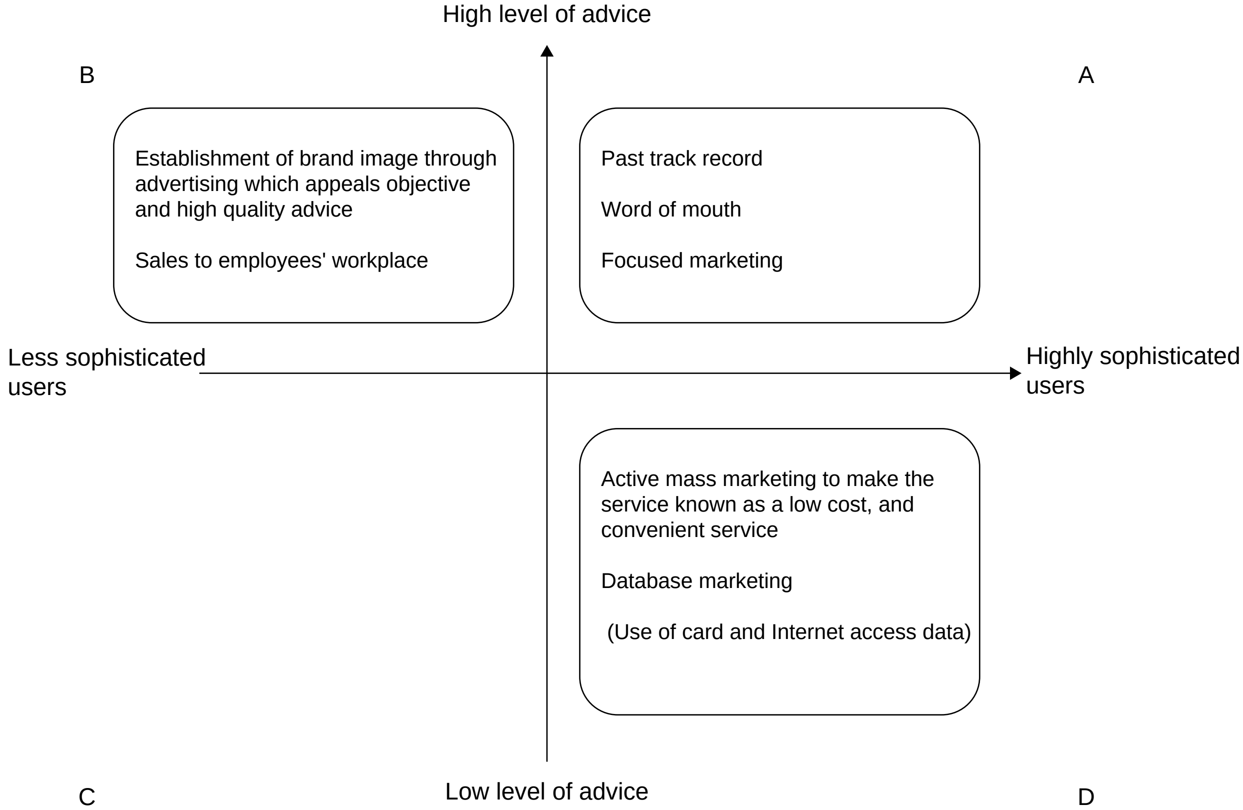
As mentioned earlier, marketing is an important aspect in the financial industry. The choice of the marketing strategy will be dictated by the area in which the financial institution is operating (Figure 4).

Since the transactions in area A are between professionals, performance is the only criteria. Therefore direct customer visit where a sales pitch backed by performance is presented should be the standard marketing format. Word of mouth instead of advertising, is important in private banking also.

Although performance is an important factor in area B, objectivity and brand are also equally important considerations. Objectivity, as was pointed out in the comment on mutual fund line up, that is the fact that the company is working for the interest of the client must be emphasized with concrete facts.

Brand name is important, since often one must compete in highly efficient markets, it is not always possible to make superior performance a strong selling point. For instance, a mutual fund can hardly be expected to be the performance leader year after year. Moreover the fact that past performance cannot be predicting future returns has been amply evidenced by research. What is

Figure 4. Important Marketing Concepts and Their Implementation



Source: Nomura Research Institute

important to customers is a well-known fund, which is well advertised, has a good, not necessarily the best track record and is easy to understand. In view of these considerations, it is important to focus on building a brand name among the general public.

Since the customers in this area are amateurs, it is important to try to educate the customer through marketing.

In area D, several important factors must be taken care of prior to promoting performance and brand. What is important is to make the product and service known. There is no need for a nation-wide branch or broker network. Communication with the customer should be promoted through toll-free lines and Internet. For this purpose it is important that the method of access be well publicized. Availability, and products and services should be made known. Appeal should focus on low cost and conveniences.

Since the primary objective is to make the service known, mass marketing much more powerful than the ones employed in A and B will be required. Advertisements of Internet brokers flood the screen when you turn on the TV in the US. Internet bank is one good example. In certain cases advertising has become the single most important cost item.

Since one of the characteristics of this area is distribution through telephone and Internet, it is easier to profile the customer from a statistical stand point (no face-to-face contact with the customer). On the contrary, we can say that this is the only information on which we can rely. Therefore a marketing strategy based on segmenting the customer base using the above data and creating proper mailing lists etc. are important.

Differences in technology strategies

Earlier we pointed out that technological strength was just as important as the marketing prowess. But the importance of technology varies with each area (Figure 5).

The factor common to areas A and B is that products are sold and services are provided by salesmen. Therefore a system to support these individuals who actually market the products and services is important. The recent trends from this standpoint are toward the integrated work station. Customer account data can be input and analyzed using the work station. All types of data, including market data, news, research reports, and various types of forms to be generated can be input and analyzed. The work station may also support the audio and video functions. All these functions can be tapped to make presentations to customers. The system is being further integrated to enable enter orders from this terminal.

In parallel with the trend toward this type of advanced integrated terminal, advanced risk management and portfolio management systems are being developed for area A, where the interaction is between professionals.

Another trend in this area that will possibly continue for next five years is likely to be the global STP (Straight Through Processing), STP is designed to electronically process all the steps in a securities transaction, from investment decision making, order placing and execution to confirmation, clearing and settlement.

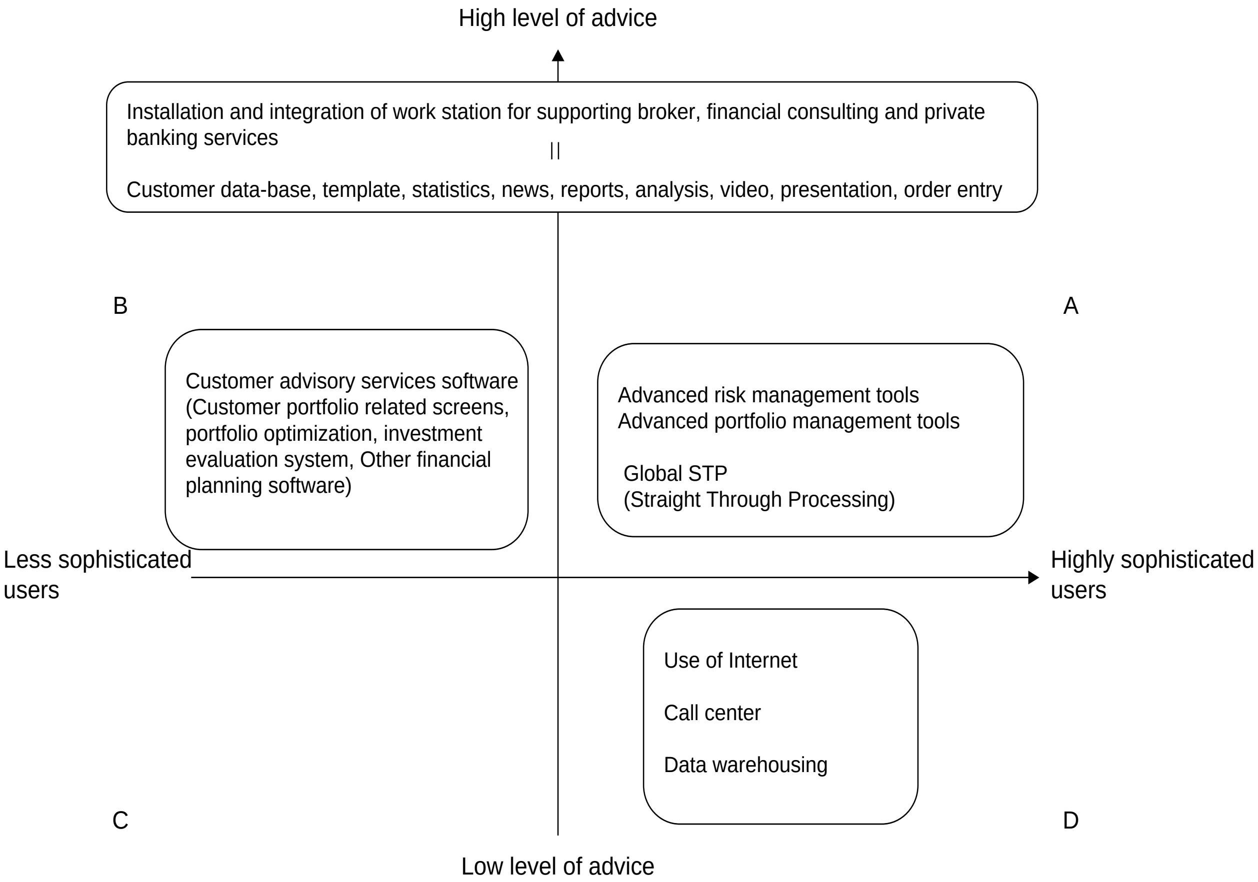
STP seems to have made considerable progress in the US, due in part to the popularization of the FIX protocol. However, there is still plenty of room for progress in STP at the middle-office and the back office levels. Moreover, STP has yet to advance to a level where it can handle global multi-currency accounts.

Such technological advances are likely to emerge from area A and then spread to areas B and D. This means that work station level functions that were integrated into the trading desk when it appeared a generation ago will now be available for Internet trading by individuals.

With respect to the technology in area B, packaged advice will be required in addition to the above integrated work station. This means that user-friendly software designed to provide adequate advice will be important. This will include software for portfolio optimization, evaluation, analysis and mutual funds selection as well as software for other financial planning services.

Area D will literally be the battlefield of technologies. Areas of competition will be the synthesis of the computer and telephone technologies, and the Internet. Internet technology developed first in area D, is now finding applications in areas A and B. In other words, the technology got it starts in retail trading but is now being used for transactions between institutional investors and securities companies (like at Solomon Brothers). Solomon Brothers is also using it for research delivery. Similarly 24-hour answering services and web-based services are taking on added importance in private banking that falls in area A. In area B, Internet-based account inquiry service is also gaining popularity. It is being offered as an additional service for customers in need of advisory services. That is the applications of the technology and know-how that got their start in area D are now spreading to areas A and B.

Figure 5. Differences in Technology Requirements



Source: Nomura Research Institute

Required Management Skills

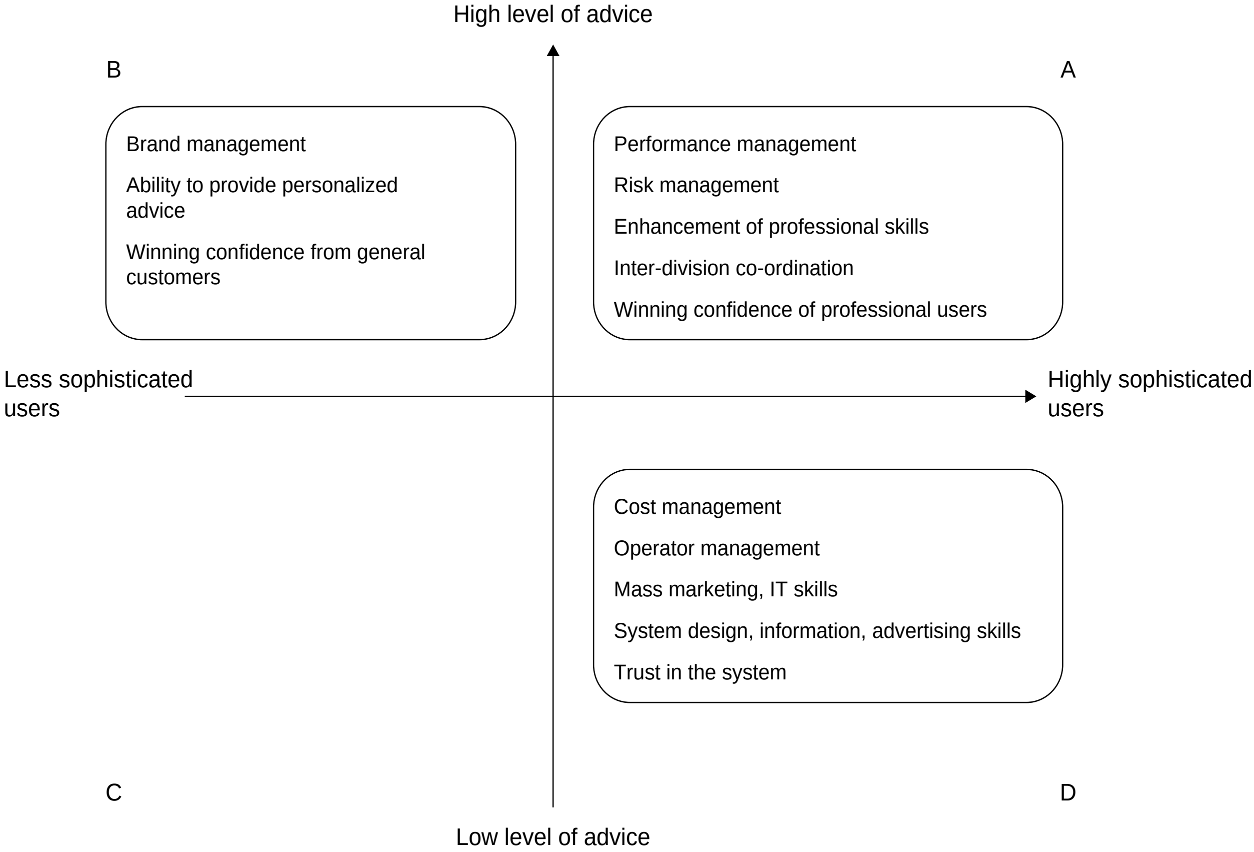
Evidently, products, services, marketing methods and technologies vary in A, B and D. What it means is that a different set of management and business skills are required in each of these areas. (Figure. 6)

Enhancing performance management, risk management and professional skills is important in area A. Moreover creating a system of co-ordination between professionals and winning the trust of professional users is also imperative.

Brand management is most important in area B. Moreover winning trust of investors at large through personalized advisory services is also important.

On the other hand technological skill is the key in area D. Cost management is also important here. A call center has a large staff of operators. Providing incentives and motivating the operators to achieve high cost efficiencies is the key factor here. Advanced system know-how and marketing skills are required here. Qualified staff in these areas is a must from this standpoint.

Figure 6. Required Management and Business Skills



Source: Nomura Research Institute

4. The Japanese market in an age of global finance

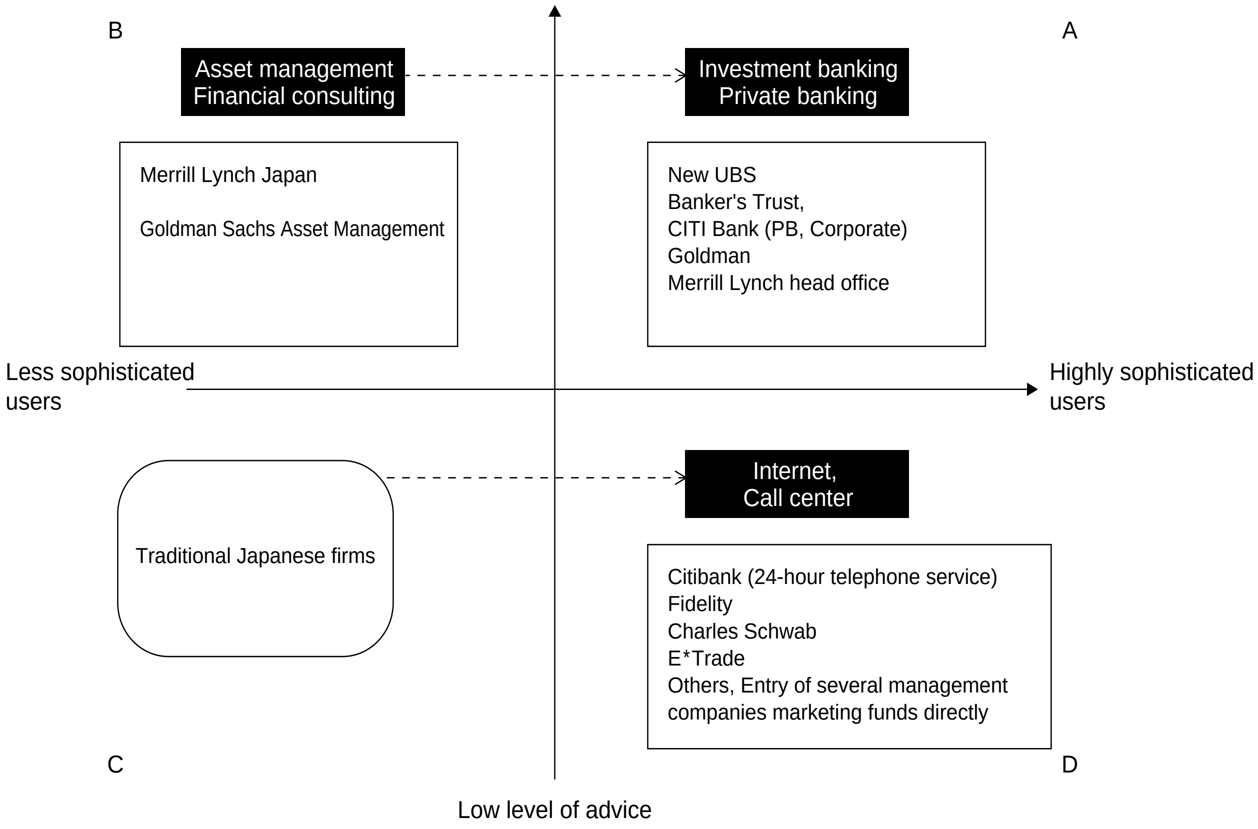
The current status of the Japanese market

So far we analyzed the US market structure using two parameters, the level of sophistication of the investor and the level of advice financial institutions would provide. If we apply this model in its original form to Japan, we find that the Japanese market falls in area C. (Figure 7).

To start with, we must admit that the Japanese investor is not particularly sophisticated. A recent survey by the Central Council for Saving Plomotion revealed that only 19.5% of insurance policy holders make their own decisions on the choice of insurance policies. "Don't know" and "I am not Responsible" were the predominant responses. Only 25.6% would make their own choices when it comes to bank deposits, 29.9% for the choice of bond funds, 33.4% for derivatives and 36.5% for foreign currency denominated savings accounts. The figure for stock investments was 52.1%. It is the only category in which more than half the individuals polled make their own decisions.

What kind of advice do Japanese financial institutions provide to these customers? The advice provided does not seem to have been very professional. It is often pointed out that here have been times when churning to boost commissions was quite common in the securities industry. Criticism about the way mutual funds were handled is also quite common. In the case of insurance products, marketing was based more on friendly contacts than on the merit of the product being offered.

Figure 7. Battle Fields in Japan



Source: Nomura Research Institute

Some of the criticism may not be justified and some of the reporting may also have been overblown. Here we have noted the issues as reported and have classified them simply.

If Japan is in area C, we can assume that the Big Bang will start nudging Japanese investors toward areas D and B. If adequate advice is not forthcoming, some investors will start moving toward D, assuming that it is about time to start making their own decisions. They will make their own decisions and start entering orders on their own. Since such customers will have given up on advice, they will be looking for competitive rates since they will be doing most of the homework on their own.

At the same time, there will be customers who will be shifting to area B. The Big Bang will bring about a rush of products and the choice of products will become even more difficult. While many new financial institutions will set up shop, there will others who will go under. In an age like this, investors will willingly bear the cost of advice if it is good.

As Japanese investors start making a mass movement from area C, Japanese financial institutions are trying to establish a foothold in area D by establishing call centers and offering Internet trading facilities. They are also shifting emphasis from the commission business to asset management. Financial institutions are also strengthening their financial planning services functions. Thus they are actively taking measures to establish firm positions in area B.

Appearance of Foreign Financial Institutions

As explained above, Japanese investors will be moving from area C to areas B and D. Just as Japanese financial institutions are gearing up to do business in these areas, foreign financial institutions, American ones in particular, well experienced in these areas in their home countries have started to enter the Japanese market one after the other.

For instance, in area D, Citibank started offering 24-hour service as far back as 1993. Fidelity started telemarketing mutual funds. The purchase of a large plot of land in Tochigi prefecture by Fidelity is said to be for the purpose of reinforcing its call center operations. Charles Schwab and E*Trade, known for large market shares in Internet-based brokering will be entering the Japanese market in the next twelve months. As explained above there is a rush of many other types of direct marketing fund management firms into the Japanese market.

In area B, Merrill Lynch Japan awaits Japanese investors. So far Merrill Lynch has established itself in Japan as a professional in area A. But as the mass exodus to area B started in Japan, it established a separate entity (by acquiring former Yamaichi's branch network and work force) to focus on area B services.

Goldman Sachs Asset Management's mutual funds also have been gaining popularity. The company's strategy could be said to be focused on area B. That is while the company does not directly advice investors, it does advice securities companies marketing its mutual funds on proper marketing strategies.

Appearance of foreign financial institutions is not limited to areas B and D only. It applies equally to area A. In Japan, new needs have emerged in area A. Good examples are the purchase and securitization of bad debt, cross-border M&A, international investment banking, advanced risk management, global asset management by professional fund managers, private banking and alternative investments. In many instances, Japanese financial institutions do not have adequate know-how in these areas.

Japan as the Major Battle Ground for Global Financial Institutions

Japan is still one of the virgin market in the world from the standpoint of foreign financial institutions. Moreover, it is the second largest financial market in the world. We mentioned earlier that global institutions will emerge in the financial industry. Whether a company is in a strong position in the Japanese market will be the key factor in winning recognition as a global financial institution in the 21st century.

As discussed earlier, there is good possibility that US financial institutions will emerge as powerful players in the Japanese market. European institutions will also be giving more weight to their Japan strategies. European financial institutions, having entered the US market, have learned that it is not all that easy to compete with US institutions. Moreover, their high level of commitment to the Asian markets has also become a burden. It is against this backdrop that the establishment of a certain level of presence in Japan has become critical for recognition as a global player.

The Big Bang reforms in Japan are likened to the Meiji Restoration. The Meiji reforms did not come about because of domestic factors alone. Like the changes in the closing days of the Togugawa shogunate, powerful Western forces are trying to invade the Japanese market as a part of their global strategy.

In addition to the deregulation brought about by the Big Bang reforms, the historical and structural moves by global finance will change the Japanese financial markets in a fundamental manner.

Japanese Financial Institutions' Competitive Strategies

As explained earlier, Japanese financial institutions also operate in areas A, B and D in order to keep up with changing times. But in what areas and with whom are they planning to compete is not yet clear. Under the circumstances, no clear cut strategies and tactics have emerged.

While the debate over the arrival of foreign companies is ranging in Japan, we must keep in mind that one cannot lump all foreign financial institutions into a single category. Some are strong in area A, while others have found a niche in area B. Still others are focusing on area D. As explained earlier, the type of products and services offered, marketing strategies and technological prowess required, and the management and business skills necessary differ in each of the areas. Merrill's approach in Japan is to separate the entities in areas A and B. This is a rational approach since required strategies, and management resources differ significantly.

In foreign firms it is not unusual to find several virtually independent organizations within the same company. For instance, Charles Schwab focuses primarily on area D. But it is divided into four virtually independent groups-international enterprise, general investor enterprise, active investor enterprise, and affluent investor enterprise. Each of these enterprises has marketing departments of their own. In this connection it should be noted that marketing professionals in these departments typically have at least ten years experience in reputed Wall Street firms before they are considered for employment by the company. Evidently Schwab considers specialists indispensable for every job category and corporate function.

These factors apply equally to Japanese financial institutions. For instance, what areas-A, B, or C-are they planning to operate in, what sub sectors in these areas are they focusing on, what resources are required for the same, what are the manpower requirements, how is the organization structured, what are their strategies and tactics. Evidently there are constraints on how far it is possible to operate in all the areas, A, B, and C, with same management and the same set of employees, identical corporate and organizational structure, and similar wage and incentive systems. In other words a system that is simply as extension of the traditional system will not do. On the other hand, foreign institutions are entering the Japanese market with manpower and systems optimum for the individual business lines.

Japanese companies are seriously constrained since they are not in a position to offer radically different wage packages in areas A, B, and D and that personnel movements between different business areas are a norm. At times Japanese companies are seen offering the Internet trading facility to customers in area A, that is customers demanding professional advise. In other cases Japanese companies are found trying to educate customers in area D (that is customers who want to make their own investment decision), just like that for customers in area B. Evidently, it is not clear in which area they want to compete and how.

As we move toward the 21st century, the battle between financial companies from around the world will intensify in the Japanese market as these companies try to win recognition as global players through this market. Only a handful of Japanese institutions will be ready to take up the challenge.

Needless to say that becoming a global player is not the only way to survive as a financial institution. Moreover, classifying financial institutions as Japanese or foreign will become meaningless as tie-ups, and mergers and acquisitions between them will increase. The character of individual institutions rather than its nationality will take on added importance.

Not withstanding what path individual financial institutions choose to take, what will be increasingly important is-after one's mission has been defined and resources identified-to make the right choice of services to be offered, to accurately gauge one's rivals in that area, and to continue to change in an optimal fashion to respond precisely to the changing needs of customers while keeping the competition at bay.

What is amply clear is that the time for debating whether the Japanese or the Anglo Saxon style of management is suitable for the financial industry is long past. An age in which businesses structured differently are locked in intense competition in the same market is already here. Which model is superior should become clear in less than five years.

There were businessmen who made a name for themselves during the turbulent times in the closing days of the Tokugawa government (before the Meiji Restoration). There is no reason to doubt that there will again be resourceful companies that will wedge their way to the top in this age of truly open financial market.