Investment Banking in Japan

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Good evening ladies and gentlemen. It is really a pleasure to see all of you here at the Columbia Business School. In addition, I would like to give my appreciation to Dean Feldberg and the sponsors, The Jerome A. Chazen Institute of International Business, The General Motors Distinguished Leaders Lecture Series, The Center on International Business Education, and The Center on Japanese Economy and Business.

Today, I would like to talk about the changes in Japanese investment banks under the title "Investment banking in Japan." In this 20-minute lecture, I will give you an overview of Japanese investment banking strategies during the 1980's, the United States' experience in the development of investment banking, and the new investment banking strategies in Japan.

Japanese Investment Banking Strategy in the 1980s

Until recently, Japanese securities firms focused mainly on brokerage activities. From the late 1980s through the early 1990s, Japanese broker/dealers were able to derive 60% of their net revenue from brokerage commissions (See Chart 1). There were a number of reasons for this.

First, with the exception of the oil crisis periods, the Japanese economy performed very well, achieving an annual economic growth of approximately 5%. Fueled by this economic growth and the Japanese government's easy monetary policy, which was adopted in response to

the appreciation of the yen in the latter half of the 1980's, the Nikkei Stock Average (NK225) reached almost 39,000 at the end of 1989 (See Chart 2). The trading volume of the Tokyo Stock Exchange also soared.

Second, the Japanese financial industry was heavily regulated during the 1980s. Although a number of foreign financial institutions entered the Japanese market, their reach was limited to the institutional market, and no institution could successfully penetrate the Japanese retail market (See Chart 3). The "convoy system" in particular was designed to protect medium-to-small brokers from competition through a system of fixed brokerage commissions. Although the table has been revised and trimmed several times since 1985, especially for large orders, this system remained in place without substantial modification until the Japanese "Big Bang" finally forced the abolition of fixed commissions (See Chart 4).

Under these circumstances, the best strategic option for Japanese broker/dealers was to focus on brokerage. Furthermore, the best way to generate profits without having to take risks, adopt advanced technology, or allocate large amounts of capital, was through commission driven business. In fact we, Nomura, could record a pre-tax return of 40% in 1989 with a financial leverage of 3 times. Too good to be true!

A third factor also forced broker/dealers to shift their resources toward retail business — the power of commercial banks. Until recently, Japanese commercial banks were at the center of the Japanese economy. As this slide shows, Japanese industrial companies, regardless of their size, depended highly on borrowing from banks and this relationship was reinforced by cross-shareholdings among them (See Chart 5). In addition, commercial banks could control the pace of bond issuance by participating in the issuing procedure and establishing the eligibility standards

for issuers

Finally, most Japanese households preferred to deposit their money in the bank (See Chart 6). In those days, financial regulations did not allow brokers/dealers to offer money market instruments to individuals because they competed directly with bank deposits. Thus, given their low risk, convenience, and fair yields, bank deposits were a reasonable choice. Now, Japanese investment banking strategies are beginning to change. But before explaining this, I would like to recall the United States' experience in investment banking.

Lessons from the U.S. Investment Banking Experience

If we follow the development of investment banking in the United States, it suggests a likely trend for Japan. First, ERISA was enacted in 1974. Then, commission liberalization, or MayDay, in 1975. In the late 1970s and early 1980s, a tax cut on capital gain and other measures to stimulate the economy were adopted.

If we examine the actions taken by our friendly competitor Merrill Lynch, we find that it went public in 1971, set up an asset management arm in 1976, introduced the Cash Management Account (CMA) in 1977, acquired an investment banking facility in 1978, and expanded its underwriting capabilities in 1984 (See Chart 7). This was a period of building up platforms for the investment banking business, and also for individual investors' asset management, the core of which were stock and mutual funds investment. In fact, Mr. David Komansky told me that it took more than 10 years to change this strategy. This graph clearly shows what happened to individual investors (See Chart 8). Stocks and mutual funds became increasingly important in the total financial assets of individuals.

In addition, the banks' bad loan problems in the late 1980s and early 1990s convinced people that the capital market was an important option for raising money (See Chart 9). We will see a very similar chart later. Figure 10 is a comparison of defined contribution plans and defined benefit plans. The introduction of ERISA in 1974, and several tax reforms that brought IRA, Keough, and 401(k) to the world, were important measures for broker/dealers. As this graph shows, the amount of defined contribution plans recently exceeded defined benefit plans (See Chart 10). These actions further stimulated the asset management business for both institutional and individual investors.

Although U.S. investment banks first sought profitability by expanding their capital intensive business, the volatility inherent in trading business later convinced some to seek stable revenue sources through brokerage and asset management (See Chart 11). If we examine the historical revenue composition of U.S. firms, the evidence is clear: the share of asset management and mutual funds rose dramatically over this twenty-year period (See Chart 12).

New Directions for Investment Banking in Japan

Economic stimulus packages adopted by the government, deregulation such as the abolition of fixed commission rates and the planned introduction of defined contribution plans, the bank loan problem, and the soaring volume of bond issuance, no longer tell the story of the United States alone, but also of Japan. In addition, the behavior of individual Japanese investors began to change toward securities investment after they experienced the collapse of Japan's major financial institutions and historically low interest rates. Public fears regarding cash flows stemming from the pension budget problem spurred this movement.

The new retail strategy of Japanese investment banks is a direct result of this new business environment. It has changed from commission driven business to portfolio advisory, or asset gathering (See Chart 13). For corporate business, the business opportunities are enormous. Recent deregulation has lifted the restrictions on bond issuance while the bank loan problem has forced Japanese companies to turn to capital markets for financing. Companies now issue more straight bonds than ever. This offers great business opportunities for investment banks (See Chart 14). In addition, companies suffering from low profitability and expanded balance sheets need restructuring plans based on advanced financial technology (See Chart 15).

Mergers and acquisitions between Japanese companies have already increased steadily. Chart 16 clearly shows this trend. Until 1990, Japanese companies were active in buying foreign firms. Now, merger and acquisition transactions between Japanese companies are high.

For individual investors, the need for lifetime asset planning is great. According to the Ministry of Health and Welfare, the proportion of people aged 65 and older will exceed 25% of the population by 2020. Japan's rapidly aging population will create huge business opportunities for investment banks in individual asset management and pension plans. Although Japanese pension funds are facing budget problems, they are still growing fast (See Chart 17). According to the Japan Center for Economic Research, securities products, especially investment trusts, form a growing part of personal financial assets. We expect the introduction of defined contribution plans to contribute to this movement (See Chart 18).

Japanese investment banks have begun to establish new strategies to meet their new business environment. I believe this strategic change is the right choice. Although Japan is now experiencing many economic and political difficulties, as was the case in the United States twenty

years ago, this environment will bring unprecedented and valuable business opportunities for Japanese investment banks.