Because the United States has the world's largest service economy, and the fastest growing U.S. exports are those related to the services, trade experts are now preoccupied with seeking ways to guarantee the free flow of international trade in services.

Trade in services such as banking, insurance, data communications and processing and telecommunications accounted for about one-fourth of the global trade flow in 1979. In 1980, the U.S. exported services worth over $45 billion compared to merchandise exports in that year of $225 billion.

Thus, it comes as no surprise that with over a score of U.S. banks having branches in Tokyo, the question of banking reciprocity between the two nations has been raised in several forums.

In the Jones Report* of January, 1979, discrimination against foreign banks in Japan was spotlighted as one barrier to the proper flow of trade in services between the two nations. The report states:

"Although Japanese banks have been given open access to operations in the U.S. market, United States and foreign banks in Japan face restrictions not imposed on domestic banks. Since banks can and do encourage trade between countries, it is possible that these restrictions have contributed to the trade gap between Japan and the United States."

While in retrospect, such attitudes did exist several years ago and could for the most part be substantiated, the mood among foreign bankers in Tokyo is that reciprocity in principle has been reached, or at least the issue of reciprocity is not the burning issue of only a few years back. The foreign banking community is in basic agreement that there currently exist no overt or substantial barriers in the way foreign banks are treated vis-a-vis Japan's city banks.

Yet while Japan's new Banking Law of 1982 and other recent legislated changes in the banking and capital market sector have gone a long way to ameliorate the allegations of foul play in past years, there still remain significant stumbling blocks related to differences in culture and banking traditions. As one visiting head of a major American bank appropriately commented: *"It's not that the banking markets are closed in Japan, it's just that the markets are different and you have to understand the difference."*

* Task Force Report on United States-Japan Trade, January 1979, Subcommittee on Trade of the Committee on Ways and Means of the U.S. House of Representatives, quote from page 26.

Changing Times for Foreign Bankers in Japan

By Dennis Holden

Dennis Holden, now in Tokyo as an economic consultant and a free-lance writer on business and banking, was born in 1947 and graduated from the University of Ohio.

As recipient of the university's School of Journalism's Lasher Award, he jointed the Associated Press in Tel Aviv from 1972 to 1973. He stayed with Reuters in New York from 1973 to 1980 until he came to Japan as a fulbright scholar for 1978-1979 to study Japanese economy and business community.

The gradual internationalization of Japan's financial markets points to more attractive and diversified opportunities for foreign banks in Japan, especially in view of the new Banking Law which became effective this April and represents a wholesale revision of the 1927 Banking Law. The relaxation of government control over capital markets has already prompted foreign banks to seek out new areas of banking activity such as liability management and providing multinational corporation services from their base in Tokyo.

"Given Japan's political stability, rich banking tradition, and competent managerial, administrative, and clerical skills, Tokyo seems to have all the needed attributes of an international money center. However, Japan still retains its image, despite its earnest efforts, as a country of excessive banking regulations, controls, and guidance," according to Alfred Brittain III, Chairman of Bankers Trust of New York.

With Japan now entering an economic scenario of stable but slowing growth, the foreign bankers here realize that the days when they were the sole suppliers of foreign currency loans to the booming Japanese export industry are gone. Slower growth has also reduced corporate fund demand, and more and more Japanese corporate treasurers have begun to shy away from increasing bank borrowings in their already highly-leverage balance sheets. They have instead turned to raising capital and equity in the Euro-markets.

"After the War, foreign banks to start with were openers of letters of credit, not lenders of dollars. Japanese banks, by regulation, could not open letter of credit departments, so we really functioned as their letter of credit departments," said Tim McGinnis, General Manager of Chase Manhattan's Tokyo Branch, adding that "the impact loan market soon opened up for us and we made lots of impact loans during that period."

However, with the loss of their special niche of impact, or foreign currency, loans due to the entry of Japanese banks in this sector two years ago, the foreign bankers realize they have entered a new era in Japan where they must compete head-on with the powerful Japanese city banks. "We are certainly being tossed around on rough seas as far as earnings are concerned with no special ability to deliver something unique at this moment. So each foreign bank must now work to determine what its own special niche will be in this market, and by no means will all of the foreign banks have the same niche," McGinnis said.

The 71 foreign banks in Japan, which include most of the top 50 of the world banking league, hold roughly 3% of all the assets in the Japanese market and only about 1% of the deposits—extremely low by international standards. Over the past few years, however, foreign banks have been placed on nearly equal footing with Japanese banks. And while in theory reciprocity between U.S. and Japanese banks is now on an equal keel, the national treatment of foreign banks is for all practical purposes a reality in Japan. Foreign banks can now tap the interbank bill or swap markets, they can make conditional sales of government or corporate bonds on the secondary or *gensaki* market, and since 1979 they have been permitted to issue certificates of deposit. Thus, overall the supply of funds is not the problem as it was in the past. Yet according to Tait Ratcliffe, President of the Tokyo-based think tank, International Business Information, "Foreign banks have to adopt a new marketing strategy in a market that has become generally more competitive."

In other words it is not as easy to blame the system as it was only a few years ago. The powerful Ministry of Finance (MOF) in an unofficial paper recently circulated among the foreign banking community states directly that "with current treatment, recognized problems regarding foreign banks have been solved. Remaining requests and criticisms from foreign sources, if any, are either based on misunderstandings and outdated knowledge of the Japanese financial system and administrative statement, or are attributable to the fact that the Japanese financial system and practices are not identical to those of their home countries."

Now, if that sounds like something straight out of George Orwell's Ministry of Love for its logic of suppressing all possible debate, don't despair, because the statement continues, "with regard to possible misunderstandings, we intend to further facilitate mutual communication and understanding."

Chikara Higashi of the MOF echoes this statement when he says: "In several ways, foreign banks are now treated more generously than Japanese banks." A former Brookings Institute fellow recently named Advisor to the Ministry of Finance, Higashi said, "There may still exist some differences in economic and capital market structure, and customs and traditions, but if we see or hear of a real case of discrimination, we will gladly hear it out." As a policy stance, the name of the game in Japan for foreign banks is reciprocity and equal treatment, he added.

Such a situation is due in great part to two far-reaching changes which have taken place in Japan's legal structure recently: One was the newly amended Foreign Exchange and Trade Control Law of December 1979, which liberalized in principle Japan's financial dealings and capital transactions with the rest of the world and was a strong impetus for Japanese authorities to loosen some of their tight controls on the domestic, and thus the foreign, banking community. The second change came in April of 1982 when the new Banking Law went into effect representing the first revision of the Banking Law in Japan in 54 years. One premise of the new law was the need for Japan to face up to the realities of world banking and to review its long traditions of financial management, particularly that of administrative guidance. The new Banking Law incorporates traditionally vague methods of financial administration and control into a clear law, and overall, gives greater flexibility to bank activities while placing greater emphasis on the independence of bank management. Most importantly for foreign banks, the new law allows them in principle to purchase Japanese banks or branches and gives them greatly expanded possibilities for branch banking. It also contains special provisions which guarantee that foreign banks are treated on a fair and equal basis with ordinary Japanese banks.

Foreign banks are not new to Japan. They have been here throughout the postwar period, with a particularly large influx in the early 1970s, and they are still coming. The Chartered Bank of the U.K. opened in Japan 102 years ago with a branch in Yokohama in 1880. According to T.G. Lightfoot, the Chartered Bank's Manager in Japan, the bank sent its Hong Kong manager to Japan in 1875 to scout out the banking market, but it took five years before the bank decided to open in Yokohama. It soon followed with a branch in Kobe.

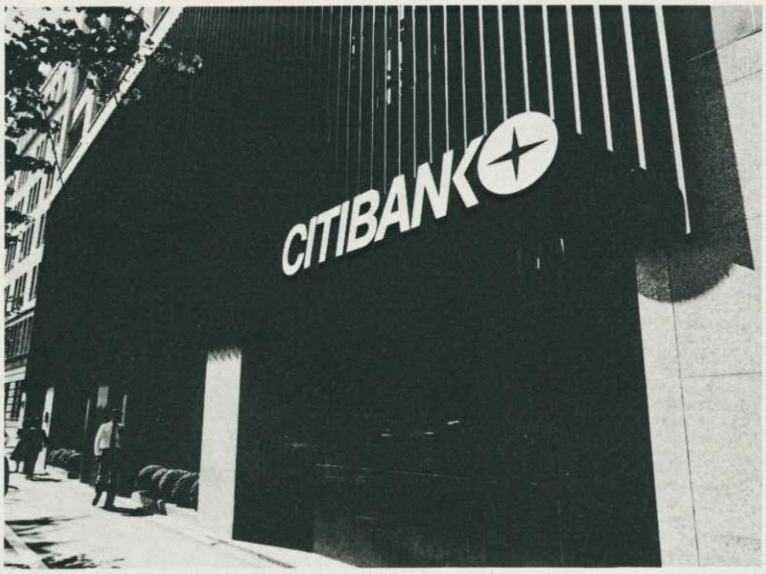
"A true and very serious problem that confronts us now, and in all likelihood will for the ensuing decade, stems from the fact that foreign banks in Japan have been and are marginal suppliers of credit," according to Alfred Brittain III, Chairman of Bankers Trust. Marginal suppliers of credit benefit greatly in an economic environment where the economy is growing quickly as was seen during the high-growth economy of Japan through 1973—a period during which the foreign banks' basic pattern of business was to create loan assets. However, today Japan's economy is going through a transitional phase as it moves into an era of slow economic growth with credit demand often below supply, and consequently squeezing marginal providers of credit. Reflecting such changes, the competition among foreign banks in Japan and Japanese banks seems to be increasing so that easy spread income can no longer be the mainstay for profit generation. The return on average assets for all foreign banks operating in Japan has shown a constant decline from 1.12% in 1975 to 0.33% in 1979.

What are some of the reasons for this

Timothy McGinnis, Vice President & General Manager, Chase Manhattan Bank, N.A., Tokyo branch

Bank of America


Morgan Guaranty



Citibank


Midland Bank

Deutsche Bank


Union Bank of Switzerla

Tokyo branches of overseas banks

lack of striking success here? According to John G. Harris, Director and Chief Executive of the Midland Bank, the reasons are (1) the close control exerted by the Ministry of Finance and Bank of Japan over foreign banks in the past and (2) lack of a meaningful retail banking base, which meant the absence of an effective wholesale market for deposits and left the foreign banks dependent for their funding on money market transactions and lines of credit provided by Japanese banks. Harris further notes that in a market where the overall structure of interest rates is still determined by the authorities, these funding arrangements inevitably pose problems as lending opportunities are restricted by the relatively high and variable cost of funds.

Another difficult hurdle that foreign banks have to overcome, according to Tim McGinnis of Chase Manhattan, is the cultural problem of the enclosed trading group structure of the Japanese business sector whereby the traditional links between Japanese banks and their borrowers in the same grouping make it difficult for foreign banks to break in. "The group bank will act as the major lender, major deposit receiver, and major opener of doors for its corporate group clients making it very hard for any non-group bank to penetrate," McGinnis said, quickly adding that both foreign banks and Japanese non-group banks face this same problem.

Morgan Guaranty Trust Company's Tokyo Branch Vice President and Chief Peter Culver comments along the same lines. He claims the main problem for foreign banks in Japan "is inherent in the nature of the society—most Japanese companies would rather borrow from a Japanese bank, if they had the choice." Culver adds that: "There is no way that any foreign bank will be a really significant part of any one Japanese corporation's domestic banking activities in the foreseeable future. However, the same would apply with the relationship between American corporations and Japanese banks in America, and it's a situation we have to acknowledge and work with."

Harris of Midland Bank partly questions such an outlook by saying that "the trading group relationship is, after all, a very visible characteristic of the Japanese society and one that obviously has to be taken into account in studies made before entering the market. On the other hand, it is not an essential feature of the economy, as other major new companies unaffiliated to any of the traditional groups have come to front as a result of the technical progress of the 1970s."

In discussing the current market situation, Peter Hand, General Manager for Japan at Grindlays Bank, said: "The whole situation in Japan's capital markets is very liquid at the moment. We have by and far very few deposits, so we rely on arbitrage to bring in yen at rates below the discount rates. The Japanese banks have no funding problems as they have yen in their large current account savings base and can substantially tap into the money markets. Their overall cost of funds is below ours."

Andreas R. Prindl who was General Manager of Morgan Guaranty's Tokyo

Branch from 1976 to 1980 writes in his recent book on the Japanese capital market, *Japanese Finance:* "There have been problems of prohibited access to funding in the past but these are now largely over. Foreign banks can compete on an almost equal footing with (Japanese) city banks in yen money markets and the problem is more one of artificiality in those markets rather than exclusion. Officials are sensitive to the discrimination issue and it is unlikely that foreign banks will find themselves in such a position again."

In his book, Prindl lists six areas where foreign banks can now fully compete:

- A wider range of yen facilities
- Multicurrency-option impact loans and loans in a variety of exotic currencies
- Foreign-exchange expertise
- International financial expertise and advisory services including special transactions such as parallel loans, four-party swaps, and very long-dated forward transactions
- Merchant banking (defined as transaction oriented rather than advisory), and
- Overseas services

McGinnis of Chase in commenting on some of these points said: "Yes, we now have a wider ability to generate more yen. We have CDs as well as the *gensaki* market available, so we can offer more yen facilities.

"We have done multi-currency impact loans all along. If someone wants to borrow in dollars, fine. If they want to borrow in Swiss francs or marks, fine. Even in some of the exotic Middle Eastern currencies, there is no problem.

"I don't think our foreign exchange expertise and business has changed at all. But Japanese banks are becoming more international and opening in countries where they haven't been before. So, it turns out, they get the business with Japanese corporations there that we used to have.

"Fully utilizing our international financial network and expertise would be one immediate advantage of offshore banking in Tokyo as the American banks are not active in merchant banking here. With offshore banking facilities we could book syndicated loans offshore."

When asked if Chase could offer a high yield yen-based deposit instrument in Japan if it wanted to, McGinnis said "No, because that is one area where all banks are restricted in Japan." However, he said "I think it would be great to have an open market for yen deposits and offer what the going rate was that would attract funds, but we can't now because of regulations. And many visiting bankers ask me that same question. But allowing this would bring about the end of the low interest rate scenario for Japan. And that means that Japanese corporations which are already highly leveraged by international standards would have to borrow at international interest rates. So it is impossible to change decades of low interest rates so fast. Yet, with Japanese corporations beginning to tap the Eurobond and overseas equity markets and shying away from bank debt—Toyota and Sony, for instance, have literally no bank debt—gradually change in this low interest rate scenario will begin to appear."

When asked if branch banking in Japan will be an important question for the foreign banks during the 1980s, McGinnis replied: "For some of us it will be, and there will probably be some of us who will consider and possibly acquire some Japanese banks. But, first it will take a long range decision that retail banking here will be profitable, If I want to put more branches in I can; if I want to acquire a bank I can do it—but you have to first decide where your strengths are and build on them. And besides, there is just not a wide selection of banks for sale here, and any available would most likely have a problem or cost a lot more than we would want to pay."

In responding to the same questions, Grindlays' Peter Hand stated: "We could certainly open a branch network here if we want to, but you'd have to quantify why you need to do that. There is a lot of business in the smaller cities and in the countryside, but some of the other major cities, such as Osaka, in my opinion, are overbanked. There are opportunities, but they are lending opportunities; the opportunities seem not to be in the deposit market. Also the primary problem would be the cost involved for staff. These would be permanent and on-going costs. But it is now no longer a problem to get permission to open branches; the problem is to justify it."

In a recent luncheon speech before the American Chamber of Commerce in Japan, Richard Flamson, Chairman of Security Pacific, holding company for the 10th largest bank in the U.S., said: "It is absolutely true that we have had conversations at official levels in Japan about the possibility of buying a Japanese bank. We think that the economy of Japan and the strength of this nation is not a fiction and we want to be a part of it. The new Banking Law as I understand it would allow a foreign bank to acquire a Japanese bank. And while we are not in the process of discussing at this moment with any Japanese bank, it certainly remains on our list of things to investigate here because of our deep interest in participating in the growth of this country."

Asked from the audience if he really thought there were serious sellers of Japanese banks, Flamson replied that while Security Pacific hasn't tested the waters yet, "there appear to be no legal restrictions to stop us." But if there were "subtleties involved that we could not overcome—such as a subtlety that no Japanese banks were, in fact, for sale—then we would be back to square one," he concluded.

Chase Manhattan Bank's Tokyo branch.

Discussing if the development of a Tokyo offshore dollar market similar to the International Banking Facility of New York would be beneficial to Japan's foreign banking community, McGinnis replied that he whole-heartedly feels that Tokyo should have an offshore banking facility and with Japan's rich banking tradition Tokyo seems to have all the necessary attributes. "I'd like to see it start for both yen and foreign currencies," McGinnis added, saying "if we could bring in dollar or other foreign currency investments here through an offshore banking facility, we could establish dollar assets. This could give us a multi-currency base here in Tokyo and we could even get involved with Euro-yen."

Peter Hand of Grindlays noted that Tokyo could rival New York as an international financial market and "certainly has the capacity to far exceed Singapore and Hong Kong." He added that "it has only been in the past few years that the Japanese banks have had the (MOF) brakes taken off, so they are currently as desperate for assets as are the foreign banks. Each foreign bank in Japan must find its competitive edge, and even if they have not been successful finding it, they still have to hang in there because in the real sense Tokyo will become a huge financial market when the yen becomes a truly international currency ...but, I add, it will happen at their own speed."

When I mentioned that the Jones Report of about three years ago listed banking reciprocity between Japan and the U.S. as one of the key issues facing Japan, McGinnis replied: "The issue of reciprocity is not that important an issue today for foreign banks with branches in Japan, so that when one of the larger banks or one of the banks that has a branch here talks about reciprocity, we don't make it a major point." McGinnis continued, "when people say let's liberalize the banking market in Japan, I don't really know how you fully liberalize it. What do you do? Do you order Japanese companies to borrow from foreign banks? You can't do that. So it is simply an issue of time."

Could you give us some areas where you think there is still room for further liberalization or reciprocity improvement?

"Well, all things considered, we may be a little better off in Japan than Japanese banks, especially due to the fact that we are not required to buy low-yielding Japanese government bonds as are Japanese banks. However, you have a market here that is highly structured, highly regulated and governed by a low-interest rate scenario. So it is my opinion that to really get Japan into the mainstream of the world's financial markets you'll have to end that low interest rate scenario," McGinnis observed.

We often hear that foreign banks in Japan are treated even more generously than Japanese banks. Why is this?

"This point is obviously made for two reasons: First, as I mentioned, we are not force-fed Japanese government bonds, and, second, our certificate of deposit limit is based on our loan portfolio assets, which gives us a larger limit than Japanese banks whose limit is based on their equity. But I hasten to add this is not a major advantage."

What are the points where a Japanese bank may have an advantage?

"Japanese banks have an advantage over us in that many of them belong to industrial groupings so they have a natural borrowing market place and yen deposit base. Then there is the cultural advantage in the sense that we are foreigners and they don't like to deal with foreigners. I mean obviously how could 71 foreign banks here have only 3% of the loan market? And it has never been significantly larger or smaller than that. Why? It's a rather unique situation. There is no other country in the world where you could have 71 foreign banks and have only 3% of the loan market."

When asked if there is anything that Security Pacific would like to do in Japan that they're not now able to do, Flamson said, "We would like eventually to be able to offer a very broad range of financial services. That includes servicing the consumer, and in many ways there are no restrictions today that keep us from doing that, as we do have a finance company here. But there are restrictions and limitations on the way we finance this company, that, for example, Japanese banks do not face in the U.S., and such restrictions do limit our operational ability."

Peter Hand said he'd like to have more access to the rediscount facilities of the discount bank window and bigger CD limits, which are set for each bank twice a year as a percentage of certain assets. "We all have different limits, but I would like to see overall expansion of this market. We do make money here, but we don't make money because of our assets management, but rather because of our liability management." McGinnis commented "We prefer to be totally unregulated and we are still not allowed to issue long term debentures; I can't get long-term yen. So to compare us to the Japanese city banks is not a fair comparison. I think the comparison should be broadened to bring in the long-term banks."

As to recruiting, do the foreign banks have any particular disadvantages?

"No, we all recruit at the university level. I recruit every year young Japanese men and women from the university, and we do attract some very fine talent. But looking at it on the other side of the coin, how many graduates of Harvard or Cambridge in the U.S. would go to work for a Japanese bank in New York? So we are well off in this regard," McGinnis said.

Do you offer lifetime employment?

"Yes, we are a Japanese bank in that sense. We are highly unionized, we offer lifetime employment, and we have the bonus system. In fact, if I looked at our benefits and compared them with the Bank of Tokyo or Fuji Bank, there would be no substantial differences."

Yoshiro Araki, President of Fuji Bank, one of the nation's top ranking commercial banks, is quoted as saying "We have been told frequently about the need to open up the Japanese financial market to foreign banks, but I can't figure out specifically what they want. I do not necessarily subscribe to the argument that the Japanese financial market is closed." Do foreign bankers agree with that statement?

"That's a fairly valid statement. If you go back five years, I'm sure the market was much more closed than today," McGinnis concluded.

Flamson in his closing remarks to the Chamber luncheon guests said: "I think that over time, if you have the patience and believe in the country the way we do, that tremendous opportunity exists here. I'm sure I am not alone in that viewpoint because all you have to do is look at the other financial institutions and banks that are here—I think they are here because they all feel there is a vast opportunity here." ●