STRATEGIC CHALLENGES OF
THE JAPANESE INVESTMENT BANKING INDUSTRY

by

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ABSTRACT

Since the collapse of the bubble economy in 1990, Japanese securities houses have suffered serious damage and have not been able to keep up with the progress of the global investment banking industry. During this period, foreign investment banks have grown rapidly, diversified the coverage of business, and expanded to the global market. Japanese investment banks were first developed in the late 1990s, after the "lost decade". They have competed with Japanese and foreign rivals mainly in the domestic market.

This thesis explores both the external and internal strategic challenges confronting a Japanese investment bank seeking to survive and become a global player in the industry.

First it confirms the findings of a recent stuffy of the Japanese investment banking industry and then explores two key lessons learned from historical experience in U.K. and U.S. financial markets. The current policy of Japanese government is also reviewed. With regard to the analysis of future challenges of Japanese investment banks, this thesis employs the game approach to understanding external challenges while the learning approach is applied to better understand internal challenges.
ACKNOWLEDGEMENTS

I wish to extend my sincere thanks and appreciation to Society of Sloan Fellows Professor of International Management D. Eleanor Westney for the very helpful and professional manner in which she guided me through my research activities.

I dedicate this thesis to my family, my wife Chihiro and son Ryusuke, who spent this wonderful year with me in Boston and have always supported me.

Yasutaka Suehiro
Boston, Massachusetts
June, 2004
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INTRODUCTION

The purpose of this thesis is to develop an analysis of the strategic challenges currently facing Japanese investment banks. I selected this theme because I sensed that there is growing demand among bank customers for a real customer-oriented investment bank, with a reliable management philosophy and business capability, and strong capacity to sincerely support customer needs as defined by the customers themselves.

While Japanese securities houses have not been able to keep pace with the progress of the investment banking industry, foreign investment banks have favorably grown during this period. They diversified the coverage of business and expanded it to the global market. In Japan foreign investment banks achieved strong performance in the ‘90s, mainly by providing innovative products such as derivatives trades with Japanese customers.

However, most of these banks could not maintain the profitability, as derivatives became commodity products towards the end of the 1990s. This led to large-scale rationalizations of branches and subsidiaries in Japan and revealed their lack of commitment to the Japanese market. Although the top tier could survive by changing their strategy from best products to total customer solutions through adoption of a customer lock-in approach, the aggressive approach to seeking short-term profits undermined the customers.

For these reasons, Japanese customers now expect the appearance of a real investment bank and they expect a Japanese investment bank to become it.

The investment bank business is a strong symbol of shareholder capitalism, and it is among the most difficult area for a Japanese company to mount a challenge. However, Japanese market is not so small that foreign investment banks can dominate it. Although it is
daunting, Japanese people must rise to the challenge. In that spirit, this thesis attempts to show a direction toward this difficult target with dynamic strategic thinking and learning, and significant changes in the corporate culture.

In Chapter 1, the history of Japanese investment banking industry is reviewed. Then, in Chapter 2, two lessons learned from financial histories in the U.K. and U.S. are applied to the Japanese experience to consider ways to efficiently bridge the huge gap between Japanese customers and their investment banking industries. One is the ‘Wimbledon Phenomenon’ after the original financial Big-Bang in U.K. and the other is the evolution process of U.S. investment banks.

Through its legislation, government has a great influence on the market and participants. Chapter 3 reviews the policies of the Japanese government.

In Chapter 4 and 5, future challenges of Japanese investment banks are studied from both external and internal perspectives, referring to results of reviews in previous chapters. In developing approaches to addressing future challenges, the game theory approach is employed for external ones in Chapter 4, while the learning approach such as the concept of Senge’s learning organization is applied.
CHAPTER ONE

OUTLINE OF JAPANESE INVESTMENT BANKING INDUSTRY

1.1 Appearance of Japanese Investment Banks

After the collapse of the Japanese bubble economy in the early 1990’s, the price of stocks and value of real estate dropped sharply to less than a third of the historical highs in 1989. Since then, the Japanese economy has plunged into an unprecedented depression from which it has been unable to escape even today.

In the securities industry, the depressed market caused securities houses serious deterioration of performance. The revelation of scams used by certain executives to cover up individual customer deficits in the early 1990’s made the situation even worse. Although rationalization, by way of 45% reduction in head-counts, was executed in the industry after the scandal, performance did not improve.

In 1997 a second scandal implicating Nomura Securities (‘Nomura’), the industry leader, caused the industry further losses of credibility. Finally, Yamaichi Securities (‘Yamaichi’), one of four major securities houses in Japan, collapsed that same year, bringing severe crisis to the industry.

In addition, the announcement of the ‘Japanese Financial Big-Bang’ (a program of financial industry large-scale deregulation) by the government created even further difficulties for the securities houses, as intense competition after the Big-Bang led to the inevitable reduction of brokerage fees.
As a result, securities houses were required to change drastically the conventional business model that heavily relied on brokerage fees from retail distribution networks and underwriting fees of equity finances.

During this period, the government also announced the need for critical changes in the Japanese financial system. This required a shift from the conventional industry finance model to a market finance model.

The system changes were based on assessment of the lessons of the bubble economy’s collapse. It became clear that the banking system could no longer support the risk of Japanese economy alone, and that others should share the risk. The government also hoped that the Japanese economy could escape from prolonged depression by supplying risk money to promising and emerging companies through the market.

Under the new system, securities houses were supposed to assume the following roles, expanding beyond the traditional role of principally supplying funds to large companies by collecting them from individual investors:

① Enhancing the liquidity in private equities and discovering and developing promising and emerging companies through IPOs;

② Advising a providing related services on capital strategy, securitization and liquidation of assets, spin-off, M&A, reorganization, B/S restructuring, and company restructuring;

③ Advising investors based on appropriate research and facilitation of individual investors’ participation in the financial market through asset management services;

④ Enhancing the trading and sales function to provide institutional investors with high quality services.
These services were the same as those expected of typical investment banks in US.

The businesses covered by US investment banks are shown in Table. 1-1.

Table. 1-1 Business Classification in U.S. Investment Banks

1. Securities Business
   1-1. Wholesale Securities
      (1) Investment Banking (IB business)
         Capital Markets Business
            Underwriting, origination, syndication, distribution of equities
            Underwriting, origination, syndication, distribution of debt securities
            Structured products such as securitization products
         Advisory Business
            Corporate finance such as capital strategy, IPOs
            Advisory assignments with respect to mergers and acquisitions,
            Divestures, corporate defense activities, and restructurings
            Real estate related products
         Principal Investment
      
      (2) Trading and Institutional Sales
         Equity trading and sales
         Fixed income trading and sales
         Foreign exchange / commodity trading and sales
      (3) Research
   
   1-2. Retail Brokerages

2. Asset Management

Regarding the four roles above, ① and ② belong to IB business, ③ to Asset Management, and ④ to Trading and Institutional Sales. That is, securities houses were supposed to turn into investment banks under the new system.

Facing the environmental changes above, the major Japanese securities houses were urged to strengthen businesses covered by US investment banks as the new business model. They executed large-scale reorganizations, such as mergers, business alliance, and set up
joint ventures, particularly for the enhancement of the wholesale securities function, which did not include retail and asset management.

Nomura introduced an internal company system in 2001 and it also established a global wholesale unit. Nikko Securities jointly established Nikko Citigroup Limited (‘Nikko Citigroup’) with Citigroup, while Daiwa Securities jointly created Daiwa SMBC (‘Daiwa SMBC’) with Sumitomo-Mitsui Bank.

Large banking groups soon followed this movement. Mizuho Financial Group (‘Mizuho FG’) established Mizuho Securities (‘Mizuho’), a wholesale securities house, and Mitsubishi-Tokyo Financial Group (‘MTFG’) established Mitsubishi Securities (‘Mitsubishi’), a retail and wholesale securities house.

In this paper these five wholesale securities houses are defined as Japanese investment banks and both retail brokerages and asset management are excluded from their businesses.

The group organization and the recent performance of each Japanese investment bank are shown in Figure. 1-1, and Table. 1-2 respectively.

As Table 1-2 indicates, Nomura is the dominant investment bank and, as we shall see later in this thesis, will be the key player in the future evolution of this industry. Each investment bank has improved its performance over the past year, with the exception of Mitsubishi, which is a temporary result of the merger process.
Figure 1-1 Group Organization of Japanese Investment Banks

( ) : Share %
Table. 1-2 Recent Performances of Japanese Investment Banks

<table>
<thead>
<tr>
<th></th>
<th>Net Profits</th>
<th>Revenues</th>
<th>Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nomura</td>
<td>139</td>
<td>91</td>
<td>366</td>
</tr>
<tr>
<td>Daiwa SMBC</td>
<td>41</td>
<td>15</td>
<td>152</td>
</tr>
<tr>
<td>Mizuho</td>
<td>37</td>
<td>23</td>
<td>79</td>
</tr>
<tr>
<td>Mitsubishi</td>
<td>29</td>
<td>-21</td>
<td>124</td>
</tr>
<tr>
<td>Nikko citigroup</td>
<td>24</td>
<td>32</td>
<td>115</td>
</tr>
</tbody>
</table>

Note) Mitsubishi includes retail business units.
1-2. Foreign Investment Banks in Japanese Market

During the 1990’s, as the Japanese financial institutions faced crisis in Japan, foreign investment banks and foreign universal banks in Japan were able to expand the business because of their innovative products and services, although they did not have an established customer base in Japan. Most of the profits in those banks were gained from derivatives business.

Some of foreign banks operating in Japan had gained a lot through gray derivatives trades, called by Japanese Financial Service Agency (‘JFSA’), which utilized imperfection in an accounting system and other regulations. Weakness of Japanese financial institutions and the opportunistic attitude of some speculative companies also assisted in this movement.

Derivatives became commodity products towards the end of the 1990’s. Foreign investment banks diversified into other profitable businesses, such as securitization, credit products, and asset management, to avoid competition with Japanese financial institutions.

Nowadays only major or niche foreign investment banks, which can provide cross-products advisory services, maintain high performance and their large offices in the Japanese market. Majors are Goldman Sachs Japan (‘Goldman Sachs’), Morgan Stanley Japan (‘MorganStanley’), and Merrill Lynch Japan (‘Merrill Lynch’). Their recent performances are shown in Table. 1-3.

Table. 1-3 Recent Performances of Japanese Investment Banks

<table>
<thead>
<tr>
<th></th>
<th>Net Profits</th>
<th>Revenues</th>
<th>Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goldman Sachs</td>
<td>50 15</td>
<td>93 100</td>
<td>43 85</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>35 22</td>
<td>93 84</td>
<td>58 63</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>5 -17</td>
<td>64 74</td>
<td>59 91</td>
</tr>
<tr>
<td>Lehman Brother</td>
<td>0 -17</td>
<td>34 25</td>
<td>34 42</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>-3 4</td>
<td>24 31</td>
<td>27 26</td>
</tr>
<tr>
<td>CSFB</td>
<td>-5 -20</td>
<td>31 32</td>
<td>36 52</td>
</tr>
<tr>
<td>UBS Warburg</td>
<td>-7 -9</td>
<td>35 32</td>
<td>42 41</td>
</tr>
</tbody>
</table>
CHAPTER TWO
LESSONS FROM FINANCIAL HISTORIES IN EUROPE AND U.S. and U.K.

2-1. ‘Wimbledon Phenomenon’ after the Original Financial Big-Bang in U.K.

UK government announced the Big-Bang in 1983 and executed reforms of capital markets such as liberalization of stock brokerage fees in 1986.

This reform succeeded well in revitalizing the capital markets in the U.K. and facilitated U.S. and Continental European financial institutions’ participation in the U.K. market. In the middle of the 1990’s, the London market had more than 500 foreign financial institutions and it had established an unshakable position within the international financial arena.

In the process of revival of London market, however, all U.K. investment banks were forced to leave the market. This is called ‘Wimbledon Phenomenon’. The ‘Wimbledon phenomenon’ refers to the fact that although Wimbledon is the site of the best-known tennis tournament in the world, it has not been won by a Briton for many years. England is still the location of the tournament, but the winners are foreigners. Similarly, London remains a global financial center, but the leading firms are all foreign-owned.

Since Japanese financial institutions have more or less similar traditional culture and craftsmanship as compared to UK’s, the causes of Wimbledon phenomenon are quite suggestive to Japanese investment banks considering competition with U.S. investment banks after liberalization.
The following analysis shows future implication for Japanese investment banks. The analysis is done clarifying the situation in Japan, by each of the five causes of Wimbledon phenomenon raised by Augar (2000).

2-1-1. Adherence to Market Competition of Financial Authorities and Imperfect Regulations

Augar condemns the fact that the government and regulatory authorities exposed immature U.K. financial institutions to equal footing competition with U.S. investment banks that had a strong orientation toward free market competition. Imperfect regulations also accelerated the problem.

Augar also insists that the collapse of Barings and withdrawal of NatWest Markets would not have arisen if appropriate regulations had been in place.

Regarding regulations, the current situation in Japan is much better because many improvements have been made in risk management and compliance areas since the middle of ‘90s. As external audits have been also strengthened, the possibility of scandals could be reduced.

The attitude of the Japanese government and regulatory authorities would be basically the same as that of the U.K since the Japanese Big-Bang imitated the U.K’s Big-Bang. In practice, Sanyo securities and Yamaichi Securities collapsed without any assistance from the government in 1997.

2-1-2. Change and Friction of Corporate Culture

In the process of integration of brokers and jobbers into merchant banks or commercial banks, the parent banks could not establish a new culture, which was to replace
existing partnerships. Since the partnership in brokers and jobbers had supported loyalty, teamwork, and long-term interest in the staff, the failure to establishment a new culture in the parent banks accelerated the outflow of staff.

Moreover, the difference in reward system between the parent commercial banks and new subsidiaries also became a serious problem.

This suggests that similar issues would arise if Japanese investment banks could not produce the system and the culture to motivate the staff.

In fact, the outflow of staff to foreign financial institutions in Japan increased during the crisis period of 1997 and 1998. However, the movement has settled down since then. This is due to reduction of needs from foreign financial institutions rather than attractive changes of systems and cultures in Japanese investment banks.

Loyalty, teamwork, and long-term interest have been excellent in Japanese companies for a long time. However, these commitment are currently less firm because companies can not effectively adjust themselves in accordance with changes in the surrounding environment. This is particularly the case in the Japanese financial institutions exposed to unprecedented changes within a short period.

Therefore, internal reformation, on such issues as corporate culture and employment systems is required to revive the organization. Otherwise it would be very difficult to prevent losing loyalty and positive views, and excellent staff choosing foreign financial institutions that offered them an aggressive reward system.

2-1-3. Pressure from Institutional Investors Requiring Short-term Performance
The withdrawals of NatWest and Barclays from the investment banking arena were caused by tremendous pressure from institutional investors requiring short-term performance.

In the case of Japan, pressure from institutional investors demanding short-term performance is still less than in the U.K. and U.S., although reforms of financial markets, such as liquidation of equity sharing, review of main-bank systems, and increase of foreign shareholders, have been accelerating.

As a result, the pressure requiring short-term performance on foreign investment banks in Japan is also greater than that on Japanese investment banks.

This means that in the short-term, foreign investment banks need to select only profitable trades while Japanese investment banks can select even low-margin trades to establish long-term customer relationships.

Unless both pressures from shareholders are equalized to some extent, this difference will prevent the occurrence of Wimbledon phenomenon in Japan. The pressure on foreign investment banks is too high, while that on Japanese investment banks is too low.


According to Augar, good performance of U.S. investment banks in their domestic market gave them power to expand their businesses in the U.K. This was especially true in the human resources market in the City.

U.S. investment banks aggressive recruitment of the best talent caused serious problems in the City. Competition to acquire the best talent undermined team spirit in U.K financial institutions and raised costs as well. This was not the case in Japan.
The reasons why they did not expand the business in Japan as much as in the U.K. are considered below.

First the Japanese economy has been too unstable for them to take the risk. Furthermore, it has been very difficult for them to understand the reality of Japanese customers because of unclear accounting systems and business practices for them.

Second it has been also very difficult for them to establish a wide range of customer relationships because the main bank system has been in place in Japan for so long and most customers have been linked with the main bank. Also as mentioned above, the difference in pressures from shareholders is a factor.

In short, it seems difficult for foreign investment banks to execute the same approach as in U.K. considering a lot of differences, including differences in language between U.K. and Japan.

Because of these factors, most foreign investment banks have not been able to give full commitment to the Japanese market in their global strategy while they were able to do so in the U.K. market. As long as this situation continues, the risk of a Wimbledon phenomenon in Japan will remain low.

According to Augar, there is a rule in investment banking that investment banks can control only smaller markets than the mother market. This can be interpreted to suggest that the performance of investment banks is also supported by the customer relationship just as with commercial banks.

It also implies that Japanese investment banks aiming to become global players must strengthen Japanese markets and customers. Revival of the Japanese market and customers is essential for the future of Japanese investment banks.
2-1-5. **Globalization and Scale Expansion of Financial Institutions**

Mega-mergers, such as that of Citigroup, Travelers, and Salomon Smith Barney, increased the minimum size required to be a global player, and forced smaller investment banks to abandon the idea of becoming a global player.

This is also the case for Japanese investment banks. It forced some of them to aim to become a Japan-focused global player instead of a real global player and some of them to seek alliances and further integration with other financial institutions.

Further integration among Japanese financial institutions is one potential strategy to strengthen their global position. Also integration between Japanese and foreign institutions could be pursued although various differences in the business environment as mentioned above constrain possible integration options.

2-1-6. **Suggestions for the Future of Japanese Investment Banks**

- Japanese government will take a nonintervention approach to each investment bank in crisis much as in the U.K.

- Reform of internal structures, such as corporate culture and employment systems, is required to produce staff’s loyalty, teamwork, and long-term interest, and to activate Japanese investment banks.

- Less pressure from the shareholders provides Japanese investment banks with competitive advantage against foreign investment banks.
• Difficulties, such as Japanese bad economy and the lack of customer networks, provide Japanese investment banks with barriers against entry of foreign investment banks.

Further integration involving Japanese financial institutions striving to become global players may be anticipated.

2-2. Evolution Process of U.S. Investment Banks

2-2-1. Business Diversification of U.S. Investment Banks

From an historical point of view, U.S. investment banks developed as financial institutions specializing in underwriting of equity and debt securities issued by U.S. companies. U.S. investment bank had strong relationships with major U.S. companies such as General Motors.

As institutional investors increased the market presence by developing mutual funds and pension funds after WW II, U.S. investment banks began institutional sales. Until the May Day liberalization of stock brokerage fees in the mid 1970’s, both underwriting business and brokerage business had generated stable profits.

After May Day, however, the profitability of brokerage business dropped due to intense competition among brokerages as deregulation progressed through the 1980’s and early 1990’s.

Then, U.S. investment banks actively expanded their proprietary trading business to make up the deficit in brokerage business. This facilitated restructuring of the industry, as this type of risky business required large capital as a cushion.
In the early 1990’s U.S. investment banks increasingly migrated their core businesses to trading and institutional sales.

In 1994, U.S. investment banks were required to review their businesses again due to huge losses incurred in their trading business when the FRB raised the interest rate.

In response, U.S. investment banks began to seek new profit sources unrelated to market movement. At that time the asset management market was growing due to the aging baby boomer population and reformation of the pension system. After 1996, M&A and IPO activity sharply increased because of rising stock prices and active M&A by the high technology and media industries.

Starting in the 1990’s, U.S. investment banks began investing their energies in financial advisory business such as M&A, asset management, and retail sales, in order to stabilize their performance.

The mergers between wholesalers and retailers were also executed to stabilize profits and enhance synergies. The merger between Morgan Stanley and Dean Witter in 1997 represented in this type of strategy.

The poor performance of trading businesses due to a series of financial crisis such as the Asian crisis, LTCM crisis, and Russian crisis accelerated the movement toward diversification of business.

2-2-2. Globalization of U.S. Investment Banks

In the late 90’s globalization significantly developed among the top 10 U.S. investment banks. These banks aimed at establishing global sales networks to provide customers with a wide variety of products. The current business capabilities of U.S.
investment banks, which are increasingly becoming global in their reach, are shown in Figure 2-1.

![Figure 2-1. Business Capability of Investment Banks](image)

(Source: Ryo Watabe (2003), The Nature of the Anglo-Saxon Model)

This expansion resulted in high system costs. In addition, high personnel costs put significant pressure on the overall cost structure. As a result, the integration of financial institutions involving investment banks accelerated as explained in previous section.

2-2-3. Emergence of Conglomerates in U.S. and Europe

Within the international financial industry, the merger and acquisition trend spread to a broader group of businesses such as bank, securities, insurance, and credit card business, while diversification of businesses in U.S. investment banks simultaneously progressed. Many believe that these trends were accelerated by 3 factors: integration of currencies in EU, deregulation in U.S., Europe, and Japan, and the development of IT.

In the U.S., the trigger of the merger and acquisition trend was revision of the FRB rule in 1996, which raised the upper limit of operating profit of securities subsidiaries from 10% to 25% of that of holding company. This gave flexibility to the banks to enter the
securities and asset management businesses. This also gave investment banks the chance to recruit capital and to stabilize profits.

These efforts were propelled by enforcement of the GLB law in 1999, which enabled financial institutions to execute bank, securities, and insurance businesses through subsidiaries under financial holding companies. As a result, financial conglomerates began to emerge through mergers and acquisitions across a number of types of business.

The reasons to form conglomerates were assumed to be as follows.

- Capital Reinforcement for risky businesses
- Economy of Scale in IT investment
- Realization of One Stop Shopping
- Diversification of risks and P/L volatility

This approach seems similar to the financial super market strategy of the 1980’s. According to Allen and Gale, however, there is one major difference in that the purpose of forming conglomerates this time is to enhance competitive power as a whole group while the purpose in 1980’s was only to enhance individual entity’s competitive power separately without cooperation among them following legal partition.

However, the new conglomerates raised the possibility of significant conflicts of interest since one company controlled all of the financial value chains involving businesses for the company and for the customers.

2-2-4. Collapse of Internet Bubble and Bankruptcy of Enron and WorldCom
The bankruptcy of Enron and WorldCom, and the ensuing scandals put shareholder capitalism into a crisis, and the U.S. investment banks involved suffered huge financial losses and loss of credibility. Critical problems revealed included:

- Insufficient control of corporate governance
- Perfunctory business audit by Non-executives
- Unclear disclosure and accounting system
- Concealment of loss using SPV (Special Purpose Vehicles)
- Failure of rating companies to relegate in a timely manner
- Positive evaluation by securities analyst in favor of issuers
- Abuse of stock options by management
- Collapse of pension system by investing 401k plan into own stock
- Actions involving significant conflicts of interest by major financial institutions

After the scandals, the Sarbanes-Oxley Bill was enacted in 2002 and in 2003, the 10 major U.S. investment banks agreed to a host of reforms of business practices.

2-2-5. After Enron and WorldCom

After the collapse of the Internet bubble and bankruptcy of Enron and WorldCom, U.S. investment banks again started to expand their trading business as the stock market decline reduced M&A and IPO trades. Some investment banks separated their asset management subsidiaries because profits from pension funds were not as good as expected and alternative investment businesses did not expand.
2-2-6. Implications for the future of Japanese Investment Banks

To sum up, the history of US investment banks has been a 50 year record of continuously creating profitable markets and products in keeping with changes in the external environment.

Considering that the function of investment banks is to correct the inefficiency of corporate management through M&As or to correct distortion of market prices through arbitrage, creating profitable markets and products continuously would be the nature of investment banks.

The current trend of strategies in U.S. investment banks can thus be summarized as the diversification of business to stabilize the profits and integration for globalization.

This trend has also been observed in financial institutions. Conglomerates such as Citigroup and JP Morgan-Chase are examples. In Japan, Nomura, Daiwa SMBC, and Nikko-citigroup basically follow strategies similar to those of U.S. investment banks, while Mizuho and Mitsubishi try to follow the strategy of Citigroup.

Just as the scandals caused by Enron and WorldCom in the U.S. market also gave warning to Japanese market, the future success of U.S. investment banks and conglomerates will help to divine the future success of Japanese investment banks.

However, the need to increase the marginal size of a global investment bank will require Japanese investment banks to fundamentally reassess their global strategies.
CHAPTER THREE

VISION OF THE JAPANESE FINANCIAL SYSTEM OF THE GOVERNMENT

3-1. Background of Japanese Financial System

The Japanese financial system was originally designed by the government to provide sufficient money to grow industries effectively. The bank played a central role in the system by absorbing money through individual deposits and distributing it to companies as loans.

As people were encouraged to make deposits in the bank, they did not have to think about asset management. Also companies could borrow funds from the bank with costs kept low through government control.

During growth periods in the Japanese economy, this system became a strong advantage. However in periods of decline, this system became weak point. Most people did not invest in risk products, nor companies pay risk premiums because they were accustomed to low cost financing.

As a result, banks held most of the credit risks. After the collapse of the bubble economy, this risk clearly materialized in a form of non-performing loans as the value of real estate as collateral sharply dropped. In the aftermath, a new financial system that could support a maturing Japanese economy was sought by the government.

In July 2002, the report titled ‘Future Vision of the Japanese Financial System and Policies’ was published as the future guidelines for finance policies.
This report was drawn up by the Roundtable Committee on the Vision of the Japanese Financial System and Policies in the Future, which was a private committee of the Finance Minister.

The concept then was outlined in ‘the Medium-term Vision for the Future of the Japanese Financial System’, a formal report of the Financial System Council. It was finally presented to the Prime Minister in September 2002.


The outline of the report is as follows.

Changes in the Economic Environment surrounding the Financial System

The existing financial system, which operates according to the Industry Finance Model (‘IDM’), and involves financing mainly through intermediation based on bank deposits and lending, can not support substantially increasing economic risk in Japan.

Prospects for the Future

In the future, the role of the Market Finance Model (‘MFM’), which depends on market functions and pricing mechanisms for funds distribution, will become important, while the Industry Finance Model will continue.

Future Vision

It is necessary to reconstruct the Japanese financial system to harness both IFM and MFM, with market functions set at its core. The IFM will remain viable but the role of the MFM will become more important.
In order to realize this new system, the following three features will have to be developed by intermediary institutions.

1. Ensuring Returns based on Proper Risk Assessment

2. Promotion of functional differentiation and specialization, instead of type of business such as banks, securities, and insurance, of intermediary institution.

3. Offering of a wide range of products to individuals in accordance with their risk preference and life cycle

Under the new system, wholesale business would function as follows.

Loans are essentially replaced with securities, and the expansion of project finance and syndicate loans provides continuity between securities and loans.

The importance of IB business, which focuses on analyzing company’s balance sheets and reconstructing cash flows, increases.

Bridging to such vision, necessary innovations include:

- Promotion of one stop service. There is now recognition that the sales channel is important to facilitate individuals’ access to capital markets.

- Reformation of investors mindset. The report proposes that this should be enhanced by both the public and private sectors.

- Aggressive and flexible government attitude to new entrants from other industries in order to facilitate financial innovation to the industry.
3-3. Promotion of One Stop Service

At the end of 2003 the report titled ‘Towards a Financial System led by Market Functions’ was drawn up by the First Subcommittee of the Financial System Council, a formal committee of Financial Services Agency (‘FSA’) in Japan. It was based on the above vision and it proposed necessary and practical reformations in light of developments after the ‘Financial Big-Bang’.

One stop service led by banks is proposed to allow banks to lead individuals and small and middle class companies to securities houses. This is because the bank is the most familiar window for individuals, and the most knowledgeable institution for small and middle class companies.

The purpose of this proposal is to lead individuals financial assets to risk products such as stocks. Currently the balance of individuals financial assets in Japan is about Yen 1,400 trillion and the breakdown is shown below in Figure. 3-1.
3-4. Impact on Investment Banking Industry

The future vision suggests that bank loans are basically replaced with securities in the wholesale business. In practice, however, it is assumed that, for the time being, bank loans will continue to have a significant role in the Japanese financial system. This is because the relationship between companies and banks still clearly exists and it takes long time to develop the secondary market.

On the other hand one stop service in the bank will certainly expand the number of investors for risk products. But those products are unlikely to be stocks, but rather they are expected to be market products like investment trusts. Thus, the new Japanese financial system is anticipated to be an indirect finance system based on MFM involving intermediaries such as banks.

Based on this recognition, the impacts on investment bank’s business are assumed to be as follows.

Increase of Capital Market Business

It is expected that the vision will lead to increases in the underwriting role of corporate bonds. However, it might be more practical to expect the expansion of businesses securitizing bank loans. The current rate of outstanding bank loans in Japan is about Yen 500 trillion while corporate bonds in total comprise only Yen 50 trillion.

Increase of IB Business

As mentioned in the future vision, IB business, which focuses on analyzing company balance sheets and reconstructing cash flows, will be increase.
Increase of Mass Business

As a result of the introduction of bank-based one stop service, people will become more familiar with risk products. This will give the wholesale investment banks chances to create new products and distribute them through the retail channels.
CHAPTER FOUR

STRATEGIC CHALLENGES OF JAPANESE INVESTMENT BANKING
INDUSTRY - EXTERNAL ANALYSIS

In this chapter the strategic challenges of Japanese investment banking industry are analyzed with a particular focus on the external strategic actions of Japanese investment banks, actions undertaken to make external environment change favorable for the banks.

4-1. Industrial Structure Analysis of Japanese Investment Banking

Fig. 4-1 describes the industry structural analysis of the Japanese investment banking industry based on Porter’s five forces diagram.
Figure 4-1 Industry Structural Analysis of the Japanese Investment Banking

**Barriers to Entry: (High)**
1. Major capital investments
2. Deep product knowledge, wide experience, and ability to provide competitive quotes
3. Reliability and credibility
4. Expensive IT and personnel cost
5. Customer base and channel
6. Close relationship with the top management of customers
7. Highly skilled talent
8. Global network

**Rivalry among Competitors: (High)**
1. High expected growth rate
2. Fluid business model
3. Quick commoditization of products
4. Quick imitation of business model
5. Similar size of participants
6. Strong domestic group networks of Japanese investment banks
7. Strong global group networks of foreign investment banks

**New Entrants**

**Suppliers**

**Power of Suppliers: (Low)**
1. Low liquidity and small size of job-change market
2. Increasing candidates due to recent redundancy of foreign investment banks
3. Few talented professionals in profitable area

**Industry Competitors**

**Substitutes**

**Power of Buyers: (Medium-High)**
1. Expectation to expanding customer base
2. Low price sensitivity and high loyalty in tailor-made services and products
3. Educated large corporate customers
4. Increasing accessibility to market and competitors information

**Buyers**

**Availability of Substitutes: (Low)**
1. Business expansion of commercial banks
2. Entry of trading companies and non-banks into revitalization business
3. Emergence of online investment banks
(1) **Barriers to Entry (High)**

It seems very difficult for new entrants to enter the industry because major capital investments, reliability and credibility, strong customer base, close customer relationship, global network, and high level of product knowledge, experience, and trading skills are required.

(2) **Power of Suppliers (Low)**

Suppliers are mainly considered to be the staff of the firm. Although the job-change market for the financial services industry is bigger than any other industry in Japan, it is far less active than that in the U.S. or U.K..

The recent reduction in small or medium-sized foreign financial institutions has made this situation worse.

Although there seems reasonable level of job offers from top level foreign investment banks, few talented persons matching the requirements exist.

(3) **Availability of Substitutes (Low)**

Since major commercial banks transferred their investment banking businesses to their securities subsidiaries, it may not be practical for them to substitute the business at the moment. Other financial services companies and trading companies may be able to replace with a part of the businesses such as revitalization business. Online investment banks might have a chance to replace with traditional capital markets business such as underwriting business.
(4) **Power of Buyers (Medium-High)**

Since the customer base is expected to expand as Japan’s financial system moves to MFM, the power of buyers is distributed. In the case of large companies, the tailor-made services, such as financial advisory business and global finance, are accepted with high loyalty and low price sensitivity. However, educated customers and intense competition among investment banks should make the negotiation power of customers strong in traditional capital market trades such as equity finance. Also customer price comparisons among rival banks will strengthen customer leverage, especially in the case of mass or simple products.

(5) **Rivalry among competitors (High)**

Although a high growth rate is expected in the industry, a fluid business model and quick commoditization of products make the competition intense. This means that the current structure of competition involves two closely linked steps: 1) development of profitable business by foreign investment banks and 2) imitation and commoditization of such business by Japanese investment banks.

In terms of their other, more supplemental functions, Japanese investment banks have advantages in domestic markets as a result of group networks which provide them with stable retail based profit, while foreign investment banks have an advantage in their global networks which enables them to engage in prestigious and profitable global finance. However, this division of labor may not be sustainable because both aim to enter into the other’s market.
4-2. Strategic Analysis of Major Players

4-2-1. Classification and Basic Data

The major players in the Japanese investment banking industry are roughly classified into four categories based on capital structure: 1) traditional securities companies; 2) joint ventures; 3) newly established, bank group subsidiaries, and 4) foreign financial institutions.

Nomura represents the first, Daiwa SMBC and Nikko Citigroup represent the second, Mizuho and Mitsubishi represent the third, and Goldman Sachs, Morgan Stanley, and Merrill Lynch represent the final category.

Each company's basic data is summarized below in Table. 4-1.

Table. 4-1 Basic Company Data of Major Investment Banks in Japan

<table>
<thead>
<tr>
<th></th>
<th>Capital Account</th>
<th>Shareholders</th>
<th>Employee</th>
<th>Establishment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nomura</td>
<td>726</td>
<td>100% Nomura Holdings</td>
<td>9,300 (group)</td>
<td>1925</td>
</tr>
<tr>
<td>Daiwa SMBC</td>
<td>348</td>
<td>60% Daiwa 40% SMFG</td>
<td>1,780</td>
<td>1999</td>
</tr>
<tr>
<td>Nikko Citigroup</td>
<td>152.9 (paid-in)</td>
<td>51% Nikko 49% Citigroup</td>
<td>1,200</td>
<td>1999</td>
</tr>
<tr>
<td>Mizuho</td>
<td>274.4</td>
<td>100% Mizuho FG</td>
<td>1,321</td>
<td>2000</td>
</tr>
<tr>
<td>Mitsubishi</td>
<td>370.4</td>
<td>56% MTFG 44% Others</td>
<td>3,795</td>
<td>2002</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>64.3</td>
<td>100% Goldman Sachs(U.S.)</td>
<td>1,200</td>
<td>1974(rep) 1983(branch)</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>36</td>
<td>100% Morgan Stanley(U.S.)</td>
<td>1,050</td>
<td>1999 1984(branch) 1970(Rep)</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>87.8</td>
<td>100% Merrill Lynch (U.S.)</td>
<td>n.a.</td>
<td>1998 1972(branch) 1964(rep)</td>
</tr>
</tbody>
</table>

Note) Nomura and Mitsubishi include other businesses such as retail.
4-2-2. Analysis by Business Types

In this section, each player’s market positioning in major business area is examined based on typical strategic guidelines, developed by Greenwich Associates in 2001, and also on recent share and popularity rankings.

JB Business

Each player’s market share ranking in Domestic SB and Samurai Bond, M&A, ABS and RMBS, Equity/Equity-linked products is shown in Table. 4-2, 4-3, 4-4, and 4-5.

Table. 4-2 League Table on Domestic SB and Samurai Bond

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Share (%)</td>
<td>Share (%)</td>
</tr>
<tr>
<td>1 Nomura 20.2</td>
<td>1 Nikko Citigroup 30.1</td>
</tr>
<tr>
<td>2 Daiwa SMBC 18.5</td>
<td>2 Mitsubishi 16.2</td>
</tr>
<tr>
<td>3 Mizuho 14.5</td>
<td>3 Morgan Stanley 15.4</td>
</tr>
<tr>
<td>4 Nikko Citigroup 13.7</td>
<td>4 Nomura 15.3</td>
</tr>
<tr>
<td>5 Mitsubishi 10.7</td>
<td>5 Daiwa SMBC 12.4</td>
</tr>
<tr>
<td>6 UFJ Tsubasa 5.2</td>
<td>6 Deutsche 2.5</td>
</tr>
<tr>
<td>7 Goldman Sachs 3.4</td>
<td>7 Goldman Sachs 2.4</td>
</tr>
<tr>
<td>8 Morgan Stanley 3.0</td>
<td>8 Mizuho 2.3</td>
</tr>
<tr>
<td>9 Shinko 2.2</td>
<td>9 UFJ Tsubasa 0.8</td>
</tr>
<tr>
<td>10 Merrill Lynch 2.2</td>
<td>10 JP Morgan 0.7</td>
</tr>
</tbody>
</table>

(Thomson DealWatch)

Table. 4-3 League Table on M&A

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount ($)  Share  # of Issues  Year  Rank</td>
<td># of Issues  Share  Amount ($)  Year  Rank</td>
</tr>
<tr>
<td>-------------------------------------------------</td>
<td>-------------------------------------------------</td>
</tr>
<tr>
<td>1 Citigroup 22,819 26.1 30 2 1 Nomura 117 7.3 14,571 1</td>
<td>2 Merrill Lynch 18,134 20.8 11 15 2 Mizuho 106 6.6 15,147 2</td>
</tr>
<tr>
<td>3 Nomura 17,966 20.6 121 1</td>
<td>3 Daiwa SMBC 57 3.6 10,416 3</td>
</tr>
<tr>
<td>4 Deutche 17,253 19.8 6 8 4 UFJ 55 3.4 8,697 5</td>
<td>5 MizuhoFG 15,348 17.6 108 6 5 Nikko Cordial 47 2.9 712 4</td>
</tr>
<tr>
<td>6 Mitsubishi-Tokyo 14,463 16.6 47 11 6 Mitsubishi-Tokyo 41 2.6 13,453 6</td>
<td>7 Daiwa SMBC 11,454 13.1 66 3 7 Citigroup 26 1.6 22,819 9</td>
</tr>
<tr>
<td>8 Lehman 11,412 13.1 9 24 8 KPMG 25 1.6 2,745 13</td>
<td>9 JP Morgan 9,868 11.3 15 7 9 PWC 21 1.3 548 12</td>
</tr>
<tr>
<td>10 UFJ 8,641 9.9 56 19 10 Morgan Stanley 18 1.1 4,700 7</td>
<td>10 Goldman Sachs 18 1.1 11737 11</td>
</tr>
</tbody>
</table>

(Source: Thomson Financial)
### Table 4-4 League Table on ABS and RMBS

<table>
<thead>
<tr>
<th>Asset Back Securities (Jan-Dec 2003)</th>
<th>RMBS (Jan-Dec 2003)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount 2002 (JY bils)</td>
<td>Rank</td>
</tr>
<tr>
<td>------------------------</td>
<td>-----</td>
</tr>
<tr>
<td>1 Mizuho</td>
<td>543</td>
</tr>
<tr>
<td>2 Daiwa SMBC</td>
<td>429</td>
</tr>
<tr>
<td>3 Merrill Lynch</td>
<td>394</td>
</tr>
<tr>
<td>4 Morgan Stanley</td>
<td>326</td>
</tr>
<tr>
<td>5 Shinsei</td>
<td>289</td>
</tr>
<tr>
<td>6 UFJ Tsubasa</td>
<td>199</td>
</tr>
<tr>
<td>7 Nikko Citigroup</td>
<td>196</td>
</tr>
<tr>
<td>8 BNP Paribas</td>
<td>156</td>
</tr>
<tr>
<td>9 Mitsubishi</td>
<td>149</td>
</tr>
<tr>
<td>10 Nomura</td>
<td>142</td>
</tr>
</tbody>
</table>

(Source: Bloomberg)

### Table 4-5 League Table on Equity/Equity Related

<table>
<thead>
<tr>
<th>Global Equity/Equity Related (Jan-Dec 2003)</th>
<th>Global Common Stock (Jan-Dec 2003)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount 2002 ($ mil)</td>
<td>Share</td>
</tr>
<tr>
<td>---------------------</td>
<td>-------</td>
</tr>
<tr>
<td>1 Nomura</td>
<td>11,992</td>
</tr>
<tr>
<td>2 Nikko Citigroup</td>
<td>6,621</td>
</tr>
<tr>
<td>3 Daiwa SMBC</td>
<td>5,051</td>
</tr>
<tr>
<td>4 Goldman Sachs</td>
<td>4,088</td>
</tr>
<tr>
<td>5 Morgan Stanley</td>
<td>2,279</td>
</tr>
<tr>
<td>6 UBS</td>
<td>1,976</td>
</tr>
<tr>
<td>7 Merrill Lynch</td>
<td>1,800</td>
</tr>
<tr>
<td>8 Mitsubishi-Tokyo</td>
<td>665</td>
</tr>
<tr>
<td>9 Mizuho</td>
<td>612</td>
</tr>
<tr>
<td>10 CSFB</td>
<td>435</td>
</tr>
</tbody>
</table>

### Global Initial Public Offering (Jan-Dec 2003)

<table>
<thead>
<tr>
<th>Amount 2002 ($ mil)</th>
<th>Share</th>
<th># of Issues</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Nomura</td>
<td>1,789</td>
<td>25.4</td>
<td>29</td>
</tr>
<tr>
<td>2 Nikko Citigroup</td>
<td>1,709</td>
<td>24.3</td>
<td>18</td>
</tr>
<tr>
<td>3 Daiwa SMBC</td>
<td>1,669</td>
<td>23.7</td>
<td>25</td>
</tr>
<tr>
<td>4 Morgan Stanley</td>
<td>838</td>
<td>11.9</td>
<td>2</td>
</tr>
<tr>
<td>5 Mitsubishi-Tokyo</td>
<td>281</td>
<td>4.0</td>
<td>6</td>
</tr>
<tr>
<td>6 Merrill Lynch</td>
<td>207</td>
<td>2.9</td>
<td>5</td>
</tr>
<tr>
<td>7 Mizuho</td>
<td>162</td>
<td>2.3</td>
<td>5</td>
</tr>
<tr>
<td>8 Shinko</td>
<td>108</td>
<td>1.5</td>
<td>10</td>
</tr>
<tr>
<td>9 JP Morgan</td>
<td>49</td>
<td>0.7</td>
<td>1</td>
</tr>
<tr>
<td>10 UFJ</td>
<td>38</td>
<td>0.5</td>
<td>6</td>
</tr>
</tbody>
</table>

### Global Secondary Offering (Jan-Dec 2003)

<table>
<thead>
<tr>
<th>Amount 2002 ($ mil)</th>
<th>Share</th>
<th># of Issues</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Nomura</td>
<td>7,787</td>
<td>43.4</td>
<td>63</td>
</tr>
<tr>
<td>2 Nikko Citigroup</td>
<td>4,154</td>
<td>23.1</td>
<td>50</td>
</tr>
<tr>
<td>3 Daiwa SMBC</td>
<td>3,136</td>
<td>17.5</td>
<td>31</td>
</tr>
<tr>
<td>4 Morgan Stanley</td>
<td>1,440</td>
<td>8.0</td>
<td>2</td>
</tr>
<tr>
<td>5 UBS</td>
<td>640</td>
<td>3.6</td>
<td>4</td>
</tr>
<tr>
<td>6 Merrill Lynch</td>
<td>212</td>
<td>1.2</td>
<td>6</td>
</tr>
<tr>
<td>7 Mizuho</td>
<td>164</td>
<td>0.9</td>
<td>12</td>
</tr>
<tr>
<td>8 Shinko</td>
<td>162</td>
<td>0.9</td>
<td>11</td>
</tr>
<tr>
<td>9 Mitsubishi-Tokyo</td>
<td>88</td>
<td>0.5</td>
<td>7</td>
</tr>
<tr>
<td>10 UFJ</td>
<td>81</td>
<td>0.5</td>
<td>7</td>
</tr>
</tbody>
</table>

(Source: Thomson Financial)

39
Nomura dominates the Equity/Equity-linked products market including initial public offerings and public offerings. Next in ranking are Nikko Citigroup and Daiwa with about half of Nomura’s market share respectively. This shows traditional strength and relationships are still effective and valuable in this business.

Foreign investment banks have an advantage in the large volume of trades by blue-chips like Sony, which require global network power. Although the actual number of trades is not large, foreign investment banks enjoy a strong position in this area, between the top three and Mizuho or Mitsubishi.

Nomura has demonstrated good performance in the M&A market based on the number of trades. The reason why Merrill and Deutsche are ranked second and forth respectively is that both participated in a special trade with Risona Group. Thus, five major Japanese investment banks are competing for market share. Mizuho and Mitsubishi rival for Nomura in this business.

In important M&A and equity underwriting, investment banks’ credibility rest heavily with the CEO and BODs. Strong capability and the continuity of the relationship manager result in confidence. Since winners take almost all and tend to remain winners in these businesses, the situation will not change for the time being.

Although Mizuho dominates the securitization market followed by Daiwa SMBC, the market size is still inactive and smaller than expected. Since the relationship with banks is
effective in this business, this is one of the most promising areas of possible future investment for Mizuho and Mitsubishi.

**Fixed Income**

Judging from the ranking of JGB successful bidders ranking, Table. 4-6, major Japanese investment banks led by Nomura dominate the secondary market. It is, however, noted that Morgan Stanley is jumping up and BNP Paribas and Goldman Sachs are included in top ten.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Nomura</td>
<td>11,690</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Daiwa SMBC</td>
<td>8,472</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Mizuho</td>
<td>6,816</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>5,412</td>
<td>8</td>
<td>-</td>
</tr>
<tr>
<td>Nikko Citigroup</td>
<td>4,579</td>
<td>3</td>
<td>7</td>
</tr>
<tr>
<td>UFJ Tsubasa</td>
<td>3,251</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Mitsubishi</td>
<td>3,203</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Shinko</td>
<td>2,493</td>
<td>9</td>
<td>8</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>2,344</td>
<td>10</td>
<td>9</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>2,228</td>
<td>-</td>
<td>10</td>
</tr>
</tbody>
</table>

(Source: Quick)

In this business the top 3 dealer status for the customer is key.

Delivering continuously effective sales service, by understanding customers’ individual objectives and constraints, relating trade ideas to their needs, and demonstrating a long-term commitment through a range of actions, are highly desired.

In particular, institutional sales require high quality research. In this respect, Nomura has been excellent among both Japanese and foreign institutional investors, followed by Nikko Citigroup, as shown in Table. 4-7.
Table. 4-7 Analyst Ranking

<table>
<thead>
<tr>
<th>Nikkei 15th Analyst Ranking 2003</th>
<th>2003 Institutional Investor All-Japan Team</th>
</tr>
</thead>
<tbody>
<tr>
<td>02</td>
<td>01</td>
</tr>
<tr>
<td>1</td>
<td>Nomura</td>
</tr>
<tr>
<td>2</td>
<td>Nikko Citigroup</td>
</tr>
<tr>
<td>3</td>
<td>Daiwa Research</td>
</tr>
<tr>
<td>4</td>
<td>Deutche</td>
</tr>
<tr>
<td>5</td>
<td>Morgan Stanley</td>
</tr>
<tr>
<td>6</td>
<td>UBS Warburg</td>
</tr>
<tr>
<td>7</td>
<td>Mitsubishi</td>
</tr>
<tr>
<td>8</td>
<td>Merrill Lynch</td>
</tr>
</tbody>
</table>

**Derivatives**

Trust and great service are key factors in this business.

Many banks and firms offer competitive pricing capabilities in mainstream and exotic derivatives and now offer customers a wide choice of alternatives. In this kind of competitive environment, excellent service is key, but strong relationships count for just as much.

Derivatives dealers that are able to cross-sell product and fulfill customers' other banking needs, have a huge competitive advantage. In that sense, banks and bank subsidiaries have a great advantage and particularly Mitsubishi has established strong presence in this business. The main-bank relationship is important in this business.
4-3. Survey of Each Player's Wholesale Strategy

Finally each player's strategy is surveyed before the strategic challenges of Japanese investment banks is analyzed.

4-3-1. Nomura

Nomura is the leading independent securities house in Japan. Nomura is also the leading Japanese investment bank with a global network especially in London and New York. As a result of reorganization in 2001, three business units--Domestic Retail, Asset Management, and Global Wholesale--were introduced and the investment banking business was put together in Global Wholesale.

Traditionally Nomura has had strong distribution power in the retail market. This has enabled it to maintain the predominant position in the equity and debt primary market by establishing strong relationships with issuers.

Based on these strengths and its global network, Global Wholesale sets the goal to establish a strong presence in Japan that is focused on global business. The strategy to realize this is to build collective strength through cooperation with Domestic Retail and to promote Japan-focused globalization.

The key concept of collective strength is collaboration between strong distribution power in the Japanese retail market and global underwriting network. Japan-focused globalization takes a three-step approach to become a genuine global player. The first step is to consolidate its position in Japan and the second is to establish a solid presence in Japan-cross border businesses.
Nomura focuses on the industrial revival business in Japan, providing customers with total on-time solutions.

4-3-2. Daiwa SMBC

Daiwa SMBC is a joint venture of Daiwa Securities Group (60%) and Sumitomo-Mitsui Banking Group (40%). Daiwa SMBC is a joint venture between Daiwa Securities Group, and Sumitomo-Mitsui Banking Group. The firm was established in 1999, by combining wholesale functions of Daiwa with the investment banking operations of Sumitomo-Mitsui Bank.

Since Daiwa Securities, a domestic retail group company, has strong distribution power next to Nomura, Daiwa SMBC takes a similar approach to collaboration between retail and wholesale. An Alliance with Sumitomo-Mitsui Bank also results in competitive advantage in respect of the bank’s customer base and products development. Good performance from the alliance has been particularly evident in IPO and Straight Bond issue.

Although trading performance is growing, the performance needs to be enhanced since Nomura’s performance is even higher. Trading performance can be enhanced through expansion of foreign currency bonds and structured bonds related transactions.

The key strategy of Daiwa SMBC is to enhance the alliance with Sumitomo-Mitsui Bank for expanding the coverage of their base. A staff exchange-program with the bank and a reciprocal set-up of new teams are to be developed.

In the group’s mid-term plan ‘Best Brand Daiwa 2005’, the enhancement of high value-added product development and supply power is raised as one of five action plans.
Another action plan relating to the investment banking business is to improve Daiwa’s presence in the Japanese economy revival business.

However, Goldman Sachs’s relief capital investment into Sumitomo-Mitsui Bank in 2003 made the cooperation relationship with the bank complicated.

4-3-3. Nikko Citigroup

Nikko Citigroup is a joint venture between Nikko Cordial Corporation (51%), and Citigroup (49%). The firm was established in early 1999, by combining the Equities, Fixed Income, Research and Investment Banking Divisions of Nikko with the Tokyo operations of Citigroup's investment banking arm.

Nikko Cordial Securities, a domestic retail group company, also has strong distribution power in the retail market next to Nomura and matching to Daiwa Securities. Thus, the collaboration between retail and wholesale is considered an important source of growth for the group. The strategy of Nikko Citigroup is based on an alliance with Citigroup. The business model is designed as follows.

High credit rating
- To provide superior products exploiting high credit rating of Aa2

Strong product development power and trading capability
- To promote large-size block trades and AGTs supported by the strong sales force
- To expand profitability with wider products lineup generated by high credit rating and product development ability

Cooperation with retail business operation
To become a lead manager for large size equity finance and provide products to retail business

To address companies needs for IR business aimed at individual investors

Also, a collective effort of group companies such as Nikko Cordial Securities and Nikko Principal Investments is targeting promotion of the corporate revitalization business.

4-3-4. Mizuho

Mizuho Securities is a wholesale securities house of Mizuho Financial Group. The firm was established in 2000 as a result of the merger of three banks’ securities subsidiaries, Dai-Ichi Kangyo, Fuji, and IBJ Securities.

Mizuho Financial Group (‘Mizuho’) has the largest customer base in Japan. In the securities industry, Mizuho has Mizuho Investors Securities, a brokerage subsidiary, and Shinko Securities, an affiliated securities house covering mid-class wholesale and brokerage. The total distribution power of the two houses almost matches that of Nikko and Daiwa. Like Nikko and Daiwa, enhancement of collaboration among entities is key to expand retail business.

Mizuho Securities has strong presence in customer business in fixed income, M&A, and structured finance. ABS utilizes its historical banking relationship with customers, to enhance its trading business.

The strategies of Mizuho Securities are as follows.

- Project M – To enhance strategic core business and to build a global investment bank in the future

- Global network management controlled by Mizuho securities
- Construction of global IT infrastructure
- Global risk management
- Diversification and stabilization of funds raising
- Original human resources system
- Establishment of strategic subsidiaries
- Promotion of revitalization business with Mizuho entities

4-3-5. Mitsubishi

Mitsubishi Securities is a securities house of Mitsubishi-Tokyo Financial Group (‘MTFG’), which has both retail and wholesale functions. Mitsubishi Securities was established in 2002 as a result of the merger of the group’s securities houses, such as Tokyo-Mitsubishi Securities and Kokusai Securities.

In 2003 most of the investment bank units including overseas subsidiaries in Bank of Tokyo-Mitsubishi (‘BTM’), were transferred into Mitsubishi Securities. As a result, Mitsubishi Securities became a core securities house in the group. In the beginning of this year the group’s new business plan strengthening consolidation management of the group was published. Mitsubishi Securities plans to cooperate tightly with BTM or Mitsubishi Trust Bank (‘MTB’).

As a part of this plan, Mitsubishi Securities expanded shared branches with BTM or MTB.

In line with the group strategy, the wholesale unit in Mitsubishi Securities covers the roles set out in the group by each customer segment, Listed / Public Company, Large / Middle Company, and Local Public Organization, Public Corporation, Financial Institutions.
The wholesale unit promotes the following three as growing business,

- Securitization - Group’s sourcing power, REIT
- Derivatives - Business expansion through group’s channels
- Revitalization Business - Cooperation with BTM

Also the wholesale unit intends to expand the equity business, approaching customers in BTM and Mitsubishi Trust Bank and enhancing total services linking between issuers and investors.

4-3-6. U.S. Investment Banks (Goldman Sachs, Morgan Stanley, Merrill Lynch)

The strength of US investment banks is the variety of advanced financial services and risk taking capability that they offer. On the other hand, the weak point is their insufficient customer base in Japan.

Since the banks retain their customers through long-term relationship under the Japanese financial system based on IFM, it is difficult for them to link with customers other than through blue-chips and companies that have close relationships with their sales staff.

The customer relation strategies of U.S. investment banks can be classified into four categories.

- First, it is the establishment of the relationship itself. Since all three investment banks have more than 1,000 staff, they can concentrate on this approach. The advantage in the approach is that they don’t have to consider differences in corporate culture and management approach with alliance partners.

The establishment of good customer relationships does not change the need to continue finding profitable niche areas, such as targeting blue-chip trades, seeking chances to
provide large companies with high value-added services, or establishing strong personal relationships with small or middle sized customers. This is because it becomes difficult for U.S. investment banks to achieve their risk returns if they are competing with Japanese investment banks targeting lower ones.

Second is the establishment of business alliances with Japanese financial institutions for specific products.

Third is development of capital relationships with Japanese financial institutions. The case of Nikko Citigroup represents this approach.

Finally is establishment of customer relationships through merger and acquisition of Japanese financial institutions. This approach is most common in US. It, however, has been difficult for them to judge the healthiness of Japanese financial institutions because of unclear non-performing loans and the huge potential risk.

Strategies of US investment banks could be also classified by the risk taking approach. U.S. investment banks aggressively take risk while European banks do not. The difference in this attitude seems to decide both fates in the recent performances. Only U.S. investment banks have maintained their strong performances.

4-4. Strategic Challenges of Japanese Investment Banking Industry

In forecasting the strategic actions of major players in the Japanese investment banking industry, the concept of co-opetition, developed by Brandenburger and Nalebuff based on game theory, is employed. In this concept, a participant must find strategies to change one or more elements of the game in its own favor.

Then, based on the participant’s current positioning and the strategic considerations
mentioned above, five elements of the game—players, added values, rules, tactics, and scope (PARTS for short), are assessed to find ways to change the game effectively. The Value Net, which is a map that describes all the interdependencies in the game, is shown in Figure 4-2. This figure describes customers, providers, competitors, and complementors relative to Japanese investment banks.

Figure 4-2 Value Net of A Japanese Investment Bank

**Customers:**
Equity finance customers, Debt issuers, M&A / financial advisory customers, IPO / P/E customers, Credit businesses customers, Revival business customers, Banks and other financial institutions as source provider for credit businesses, Banks and other financial institutions as source providers for revival business, Institutional Investors, Hedge Funds, Other corporate investors for bonds / equities, Individuals investors, Financial institutions, Asset management companies, Derivative customers

**Substitutors:**
Other Japanese Investment Banks, Foreign Investment Banks, Banks and other financial institutions, Other Group’s brokerages, Accounting firms, M&A boutiques, Trading Companies

**Complementors:**
Banks with retail / wholesale customer relationship, Brokerages as retail distributors, Banks as retail distributors, Secondary market participants, Other investment banks for market development, Revival / MBO Fund, Accounting firms, Law firms, Human resource agencies

**Suppliers:**
Staff, Management, Shareholders, Credit Providers, Liquidity providers
4-4-1. Analysis of Players

The Value Net suggests potential opportunities for Japanese investment banks to compete or cooperate with other players.

- Cooperation with Banks and Other Financial Institutions as Source Providers for Revival and Credit Business

In the case of revival business and credit business such as securitization, ensuring the originators is key. As banks and other financial institutions hold a lot of loans to be revitalized or to be securitized, if investment banks can cooperate with banks, expansion of businesses is expected. Considering that revival business is one of the major strategies for all major investment banks, this cooperation is very important. However, since the business will not continue for a long time, quick actions are required.

Since expansion of credit businesses, such as securitization and loans trading, is expected by the government under new MFM, this cooperation is also promising. But only a few actual cases of cooperation have been observed in the market because loans held by banks are still evaluated according to different price mechanisms than those used for the bonds market in Japan.

- Cooperation with Banks with Retail and Wholesale Customer Relationships

In the case of Japan, banks have established strong customer relationships under the Industry Financial Model. As a result, banks have a lot of information, which leads to opportunities for investment banks to offer various financial services such as strategic financial advisory business and capital management.

In addition, later this year when banks will be permitted for the first time to offer one-
stop service, they are expected to expand individual investment in compound risk products like investment trusts rather than stocks.

Thus, cooperation with banks is extremely promising to investment banks. The approach taken by Citigroup, which is unifying its investment bank business with its corporate bank business, might be more attractive to the Japanese market.

Currently Mizuho, Mitsubishi, and Daiwa SMBC seem to be exploring this business model. Further integration with the corporate banking sector in the bank is the key for them while other investment banks would seek opportunities to cooperate with banks.

In the case of Nomura, cooperation with various local banks, which do not belong to mega-banking groups, should be tried. This would help reduce the power of complementors.

- **Cooperation with Foreign Investment Banks**

  As Nikko and Citigroup did, cooperation between Japanese and foreign investment banks offers a potential opportunity. This is because both are basically complementary to one another. Foreign investment banks have strength in innovative services and global networks while Japanese investment banks have strength in customer base in Japan.

  However, in the short run, cooperation with foreign investment houses is not so attractive to Japanese investment banks because currently, the bad economy in Japan has made for few cross-border trades and they are forced to strengthen their domestic business.

  Also from the viewpoint of the foreign investment banks, considering the bad Japanese economy, it is not easy to invest aggressively in Japanese financial institutions.

- **Cooperation with Other Japanese Investment Banks**

  This is also viable combination. In particular, it might produce synergy between ex-
securities houses and bank's subsidiaries, like Daiwa SMBC.

Although both Mizuho and Mitsubishi are enhancing their reputation in the Japanese market, at the moment, they seem to lack the power in their equity business even to aim at becoming a Japan-focused global player.

On the other hand, Nomura and Nikko-citigroup would find bank customer bases attractive, especially considering the new Japanese financial system.

- **Cooperation among Japanese Investment Banks on human resource issues**

  It may be possible to implicitly control the reward and incentive system among Japanese investment banks. This gives power over staff and enables banks to keep the cost within reasonable level.

- **Competition with Foreign Investment Banks**

  Competition with foreign investment banks will focus on efforts by the Japanese investment banks to take away their Japanese customers, or narrow considerably the services for which those customers use the foreign banks. This is because the risk of counterattack by foreign investment banks is small in the Japanese market since shareholders require them to achieve short-term and higher risk returns.

  In other words, the competition for the Japanese market is not on an equal footing between Japanese and international investment banks. Japanese investment banks should aggressively exploit this advantage. This challenge is particularly important for Japanese investment banks in order to build their reputation and engage in trades with blue-chips or large companies. In any case, Japanese investment banks must confidently be able to provide a similar level of service. However, the judgement whether to compete depends on
effectiveness, price and the degree of competition with other Japanese investment banks.

- **Advance to Supplier Area**

  The basic training function is necessary to ensure the stable supply of young talent to Japanese investment banks. However, such training could become preparation for foreign investment bank’s headhunting.

- **Advance to Customer Area**

  In order to facilitate private equity market, investment banks can be investors in private equity or private equity funds. This is the case for principal investment business. Some investment banks also have asset management business in the same group although in this arena care needs to be taken to avoid conflicts of interests.

- **Advance from Customer Area**

  The bank can trade many investment bank’s businesses such as derivative, M&A, and securitization. However, opportunities in this area may be limited since most banks have transferred such businesses to their securities subsidiaries.

- **Advance from Suppliers**

  Although some staff start up the hedge funds or private equity funds, this would not cause practical conflicts with investment banks.

4-4-2. **Analysis of Added Value**

- **Seeking Win-Win Strategy**

  Since all of strategies in (1) lead to expansion of the customer or staff market,
Japanese investment banks should strengthen their own customer or staff loyalty, rather than competing with other banks customers or staffs. This would result in a win-win situation for all banks.

- **Added Value of Japanese Investment Banks and Foreign Investment Banks**

  **Customer’s Perspective**

  At the moment, customers do not have clear judgement criteria in choosing an investment bank. Some respect the continuity of long-term relationships with the investment bank while some prefer innovative new products.

  **Complementor’s Perspective**

  The added value of investment banks is governed by the quality and the quantity of products, while the added value of channel providers is based on the customers.

  However, the influence of this perspective on the game is limited because the links between channel providers and investment banks are pre-determined by the particular group.

  **Supplier’s Perspective**

  Staff who respect strong performance-based incentives and their own career formation recognize higher added values in foreign investment banks while those who respect long-term stability and collective culture prefer Japanese investment banks.

  Similar to customers’ judgement, from the staff viewpoint, the added value of investment banks is still fluid at the moment.
From the investment bank’s viewpoint, the added value of staff depend on their professional skills. However, this idea is not widely accepted because of the immaturity of the Japanese job-change market.

Substitutor’s Perspective

To sum up, from foreign investment banks’ viewpoint, the added value of Japanese investment banks is their large customer base and distribution system of mass products through the group’s channel while, from Japanese investment banks’ viewpoint, those of foreign investment banks are innovative service and global network. Among Japanese investment banks, added values are recognized in all of them.

- Trade-on Relationship

Trade-on relationships with customers could be recognized in cooperative arrangements between banks and investment banks-- if both can provide well-organized sales activities to the customer, offering cross products in accordance with customer requests. Also return for customer loyalty can be delivered in a wide range of group services within legal limits.

4-4-3. Analysis of Rules

- Required Profitability

Required profitability is different between Japanese and foreign investment banks. Japanese investment banks have relatively weak pressure from the shareholders for short-term profits while foreign investment banks face strong pressure. This makes the game completely different from the rules perspective. Although the situation is changing, it will take a long time for that difference to disappear.
• **Government Rules**

Regarding the legal rules, Japanese investment banks have the advantage in Japanese markets because they have a closer relationship with government, which can decide the rules. In practice, the movement toward MFM, which would expand the customer base in investment banking industry, is proceeding as mentioned before. It is also anticipated that such a movement might provide special advantage to investment banks with special relationships with banks.

• **Influence on the Government**

The bank and securities subsidiaries would request that government relax the current banking and securities rules to facilitate cooperation among banks. The power to lobby government is shifting to the bank.

• **Substitutors Reactions to the Rules**

Investment banks other than those with a special relationship with banks would seek cooperation with banks if such advantage is recognized. However, more intimate relationships, for example, mergers and acquisitions would have to be sought, considering that four mega-banking groups already have their own investment bank.

Starting in 2006, foreign companies are to be allowed to acquire Japanese companies by the way of share-exchange. This may become a chance for foreign investment banks to acquire Japanese financial institutions.

• **Employment Rules**
Many staff hope the changes in the Japanese employment system will ensure the possibility of future job-change while Japanese investment banks currently are deliberating on it.

4-4-4. Analysis of Tactics

- Customer Recognition

One benchmarks used to measure customer recognition of particular investment banks is a popularity ranking by Nikkei. As of January 2004, the results were as follows.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Total</th>
<th>Consistency &amp; Credibility</th>
<th>Information Service</th>
<th>Financial Technology</th>
<th>Cross-border Reliability</th>
<th>M&amp;A Advice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nomura</td>
<td>475</td>
<td>544</td>
<td>755</td>
<td>201</td>
<td>182</td>
<td>239</td>
</tr>
<tr>
<td>Daiwa SMBC</td>
<td>382</td>
<td>277</td>
<td>610</td>
<td>136</td>
<td>65</td>
<td>142</td>
</tr>
<tr>
<td>Nikko Citigroup</td>
<td>308</td>
<td>218</td>
<td>505</td>
<td>124</td>
<td>99</td>
<td>123</td>
</tr>
<tr>
<td>Mitsubishi</td>
<td>144</td>
<td>130</td>
<td>249</td>
<td>48</td>
<td>33</td>
<td>41</td>
</tr>
<tr>
<td>Shinko</td>
<td>135</td>
<td>68</td>
<td>252</td>
<td>50</td>
<td>-</td>
<td>31</td>
</tr>
<tr>
<td>UFJ Tsubasa</td>
<td>96</td>
<td>60</td>
<td>180</td>
<td>37</td>
<td>21</td>
<td>33</td>
</tr>
<tr>
<td>Mizuho</td>
<td>58</td>
<td>38</td>
<td>131</td>
<td>24</td>
<td>20</td>
<td>30</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>51</td>
<td>32</td>
<td>-</td>
<td>-</td>
<td>53</td>
<td>31</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>47</td>
<td>-</td>
<td>-</td>
<td>43</td>
<td>53</td>
<td>38</td>
</tr>
<tr>
<td>Mizuho Investors</td>
<td>43</td>
<td>30</td>
<td>82</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Each Japanese investment bank should consider the level and kinds of recognition that are desirable and which recognition levels need to be changed. For example, Mizuho and Mitsubishi should improve their recognition on international business matters because both have strong commitment to the business.

However, it is difficult from the Nikkei ranking to understand the banks’ reputation among specific customers such as blue-chips. In practice, blue-chip companies clearly
recognize the innovative and global capability of foreign investment banks. Even Nomura is facing hard fights in this customer layer.

Japanese investment banks, aiming to become a global player, should challenge this recognition, winning such trades with strong commitment and confidence.

- **Substitutors Recognition**

  Foreign investment banks recognize that the game is to find out deal prospects with high profitability through special relationships with target customers and to pursue them exclusively. This is because they do not have a large customer base in Japan and are required by the shareholders to achieve higher risk returns than Japanese investment banks.

  Therefore, for foreign investment banks, it is essential to respond to specific customer needs appropriately and establish strong brand image to avoid the risk of imitation by Japanese investment banks.

  U.S. investment banks also recognize that the game is aggressively to pioneer new businesses if reasonable risk returns are expected.

  On the other hand, Japanese investment banks recognize that the game is to participate in many deals through long-term relationships with customers. This is because they have a large customer base and are allowed by the shareholders to set up long term relationships with lower risk returns than foreign investment banks.

  In addition, they recognize that now is the time to strengthen their domestic constituency. Thus, it is important for Japanese investment banks to ensure customer base by strengthening their relationships with group firms.

  The positive attitude toward taking risk is most often observed in ex-securities houses rather than in bank subsidiaries. Strong commitments of Japanese investment banks
pioneering new risky businesses are to be considered. Such commitments will negatively affect the strategy of U.S. investment banks in Japan by reducing their added values and strengths.

- **Complementor’s Recognition**

  Particularly the banks recognize the importance of investment bank’s business and positively try to cooperate with investment banks. However, there are some conflicts between products such as loans and corporate bonds. That is why the cooperation rule among each group is so important.

- **Staff’s Recognition**

  Senior staff tend to keep the organization closed while junior staff do not. However, the preparation for open organization among staff is progressing steadily.

**4-4-5. Analysis of Scope**

Japanese investment banks are mainly participating in the game of the Japanese securities industry and the game of the Japanese financial industry. On the other hand, foreign investment banks are participating in the game of the global investment banking industry and also in the game of the global financial industry.

Japanese investment banks naturally have full commitment to the Japanese market. However, foreign investment banks can not have such full commitment since the level of their commitment depends on their global strategies.

Foreign investment banks would like to expand the game to their global base, but it is not practical at the moment, because the slumping Japanese economy and companies does
not produce cross-border trades and makes Japanese investment banks take a Japan-focused approach.

Although the game is currently focused in the Japanese securities industry for the time being, it is inevitable that the game shortly will expand to the Japanese financial industry, including banks, if the cooperation with banks is recognized as an effective strategy. Obviously the bank considers the game as being part of the Japanese financial industry.

In addition, Japanese investment banks aiming for a global or Japan-focused global player have to take the game of global investment banking industry and the game of global financial industry into consideration. In this case the marginal size and stability of profits seem to be essential judging from the current trend in U.S. investment banking industry.

4-4-6. Summary of Analysis

Considering the expected expansion of the customer base due to financial system changes, Japanese investment banks first should establish the loyalty of their own customers and staffs as a strategy to seek win-win situations for the time being.

Such an approach will also help win over to Japanese investment banks, customers and staff who now have fluid criteria in selecting an investment bank. In addition the following chances should be sought to expand the customer base and ensure new sources of IB business quickly. It is assumed that even trade-on situations will be produced if the cooperation is well coordinated and efficiency is pursued. This is particularly, important under circumstances in which all Japanese investment banks strengthen domestic business.

- Cooperation with banks and other financial institutions as source providers for revival and credit business
- Cooperation with banks with retail and wholesale customer relationships
- Cooperation with foreign investment banks
- Cooperation with other Japanese investment banks

On the other hand, the competition with foreign investment banks, narrowing customers to those exclusively trading with them, is generally effective for Japanese investment banks. This is because the risk of counterattack by foreign investment banks is small in the Japanese market since shareholders require them to achieve short-term and higher risk returns.

However, the judgement whether to compete depends on effectiveness, price and the degree of competition with other Japanese investment banks.

At the moment Goldman Sachs, Daiwa SMBC, Mizuho, and Mitsubishi have already started to enhance cooperation with banks while others are seeking opportunities for that.

In understanding future trends in the industry, the action taken by Nomura is particularly important, since it is the leading and the only independent Japanese investment bank. Nomura would take a wait and see approach because it has predominance in the domestic market and its position in the cross-border market will not change quickly. Commitments of Mizuho and Mitsubishi, which potentially have a huge customer base, to the global strategy make it credible.

However, if Nomura makes alliances with banks aiming to become a global player, it would become the strongest Japanese investment bank with large capital, a steadfast domestic customer base, and a global network to support Japan-focused business.

Therefore, the action taken by Nomura will decide the future of the Japanese investment banking industry in the long run.
CHAPTER FIVE

THE STRATEGIC CHALLENGES OF JAPANESE INVESTMENT BANKING INDUSTRY - INTERNAL ANALYSIS

As reviewed in Chapter 2, internal reforms, such as in corporate culture and employment systems, are required to revive organization in Japanese investment banks.

In this chapter the strategic challenges of Japanese investment banking industry are analyzed highlighting the intangible assets of Japanese investment banks. Such assets are accumulated in the organization as knowledge value through learning activities.

This is because, particularly, for an intellectual service industry these are often more important than tangible assets such as capital, brand power, and customer base.

Generally speaking, since it is not easy to specify intangible assets of the company from outside or even inside, the management tends to undervalue this kind of asset. Actually, however, many Japanese companies survive in the world using the intangible asset as a competitive advantage.

As analyzed in Chapter 4, it is possible to realize further reorganization of Japanese investment banks in the future through mergers and alliances. Actually, it is beyond the scope of this paper to forecast practical internal aspects of all cases contained herein.

Therefore, the forecasting in this chapter highlights the possibility of an evolution in intangible assets held by Japanese investment banks. This is because the success of this development enables them to establish Japanese-style investment banks, which can be sustainable to compete with rivals and be also applicable to global expansion.
Before considering intangible assets held by Japanese investment banks, general internal aspects in U.S. investment banks are reviewed as a global de facto standard in the industry.

5-1. **Analysis of Internal Aspects in U.S. Investment Banks**

The characteristics of organizational design in U.S. investment banks are as follows.

- **Business Line-based Structure**
  
  Each front business line executes the business management, including the management of revenues and expenses. Individual rewards are linked with performance of the business line.

- **Global Structure**
  
  The front business line exists beyond the borders of a particular country and the business is managed on a global basis by each front business line. As there is another reporting line to a local head for compliance matters, this becomes a matrix reporting system.

- **Flat Structure**
  
  The number of hierarchical levels in the organization is small, and that of titles is also limited. This enables the bank to make quick decisions.

The distinguishing characteristic of organizational culture in U.S. investment banks is considered to be a strong profit-seeking mindset. Since this mindset is shared with the staff, there is no room for bureaucracy. The power resides in profit makers. This mindset is supported by strong performance-based incentive systems.
The staffs have a strong commitment to work hard and compete with each other. They also have loyalty to the firm because most U.S. investment banks are considered to be prestigious brands.

While great pressure on the staffs for achieving the target becomes dynamics of excellent performance, it sometimes leads to unethical trades, which exploit the imperfection of regulations and systems—or even engage in illegal trades. There seems no end for investment banks to participate in such trades in the world.

In the case of the branches or subsidiaries in Japan, loyalty of staff tends to be lower than those in the U.S. since the bank’s commitment to the Japanese market is obviously less than U.S. or U.K. Instead, staff is mainly motivated by personal reward, which also might include acquisition of experiences, growing responsibility, and advanced financial technology.

In terms of teamwork, it is generally difficult to function in investment banks because it is assumed that the staffs tend to be egotistical—a characteristic perhaps that is endemic to people with high professionalism.

However, this is not the case among top level U.S. investment banks. For example, Goldman Sachs is famous for the teamwork culture. In terms of business principles, Goldman Sachs explains its teamwork culture as follows.

‘We stress teamwork in everything we do. While individual creativity is always encouraged, we have found that team effort often produces the best results. We have no room for those who put their personal interests ahead of the interests of the firm and its client.’
The reason given for the success of teamwork has been the influence of the partnership system, which provided the staff with long-term incentive, in the bank. After the public offering in 1999, the culture has not been badly affected.

The culture of teamwork is also maintained in Japanese companies. Although there is a difference in the role of Japanese staff, who are mainly responsible for customer relationships, and expatriates staff, who are mainly responsible for group network relationships. Ad-hoc task forces are often organized beyond business lines.

This pattern illustrates the case that a strong profit-seeking mindset can help to unify the team consisting of individuals with different professional backgrounds.

Since the team's major concern is profits, the team becomes very sensitive to changes in the surrounding business environment. However, this means that the team tends to be insensitive to changes unrelated to profits.

The reason why individuals with high professionalism work well as a team is assumed as follows.

Goldman Sachs adopts professionals, who are talented and team players.

As mentioned above, it is generally very difficult to find people who can satisfy both conditions. But prestigious brand power enables Goldman Sachs to do that.

The common sense understanding of how the team will create value, by making profits, is very clear and produces no room for egoistic actions, even under individualism.

5-2. Historical Background of Internal Aspects in Japanese Financial Institutions and Securities Companies

In reviewing internal aspects of Japanese investment banks, the historical background
of those in financial institutions and securities houses are first reviewed because most Japanese investment banks have characteristics more or less inherited from those institutions.

5-2-1. Japanese Financial Institutions

The organizational structure of traditional Japanese financial institutions has been in the form of a pyramid. These institutions have a very complicated authority system from outside and it takes a long time to make decisions because a lot of co-ordination with related departments is required. However, the action is quick and well-balanced once it is agreed and decided.

The corporate culture of Japanese financial institutions has given priority to keeping harmony based on fellowship. This places too much emphasis on human relationships.

However, the harmony is kept only in the group whose members can share their sense of value and can maintain cooperation with other members. In other words, people who cannot satisfy the conditions are isolated even if they are capable. This harmony facilitates good communication among the organization. In the case of other industries, this has even made it possible for the lower level of the organization to adjust itself to the environmental changes through learning like Toyota.

However, this adjustment function has never been requested of financial institutions and Securities Houses. The industry was protected by regulations and only minor changes were expected during the high growth period of the Japanese economy.

The culture has been effective because it formed a well-ordered and well-disciplined hierarchy with a sense of unity by producing close relationships among staff. This was also enhanced by the lifetime employment system in addition to the peculiar carefulness and strong commitment of the Japanese.
5-2-2. **Japanese Securities Houses**

Regarding securities companies, they also need a strong central control system to make sales staffs more likely to achieve their targets. Their aggressive reward system is based on performance and it has supported the commitment of the staff.

Therefore, the culture of securities companies has been the combination of harmony based on fellowship and strong central control system supported by strict rules.

This is because their business model was based on strong retail sales power and acquisition of lead manager status in equity finance, backed by the distribution power. In this model selling a large quantity of specific stocks within short period in the retail market had to be core competence. This did not require sales staff professional knowledge.

5-2-3. **Crisis in Securities Houses**

After the collapse of the bubble economy, the fundamentals of the Japanese economy changed. As a result, securities companies were required to strengthen their investment bank’s business around 1999-- after the crisis period caused as mentioned before. This required them to make a large-scale change, since the culture required by this new business was completely different from before.

At that time, Nomura had caused the second large scandal in the 1990s and completely lost credibility in the market. Since it was the biggest crisis since its establishment, Nomura was forced to make a fresh start. It led to renew the whole top management team and to execute the bold rejuvenation.
Fortunately this seemed to produce a sense of crisis among the staff. Nomura started to pursuing open and transparent U.S. style management philosophy, in order to eradicate the conventional gray image on brokerages.

In 1999 Daiwa and Nikko separated their wholesale businesses from the body and established a joint wholesale securities house with Sumitomo-Mitsui Bank and Citigroup respectively. At the same time both new companies adopted flat organizations, a simple command line, and different employment systems from the group’s retail company. These were epoch-making changes.

As a result Nomura became the only major securities house with a traditional Japanese employment system although the system was modified to include adjustments, such as performance-based appraisal and employment of external professionals.

This is because Nomura respected a sense of belonging to overcome difficulties after the scandal. Although Nomura experienced further difficulties such as huge trading loss during the period, it managed its revivial supported by the sense of crisis among the staff.

Considering that one of the major strategies for all Japanese investment banks is now to strengthen cooperation between retail and wholesale, this approach might have been right.

In 2001 Nomura established the holding company and set up the global wholesale unit for investment bank business. In 2003 the global wholesale unit then set a target to realize flat and network organizations for quick information exchange and coordination, and to high added value organizations for research and development.

5-3. Study of Required Changes in Internal Aspects in Japanese Investment Banks

5-3-1. Process of Organizational Evolution in Japanese Companies
Drucker predicted the emergence of information-based organizations or organization for knowledge specialists in 1988. Considering the nature of investment bank’s business, the current organization of U.S. investment banks might be a typical example of this.

Orihata, referring to Drucker’s concept, examined the process of organizational evolution in Japanese companies such as Sony, which was presumed to have executed the best practices in ‘90s, and proposed hypothetical steps as follows.

1. First Step Evolution

   Traditional structure with centralization of power is dismantled and a distributed structure with delegation of authorities and responsibilities is introduced. The typical formation is a multi-company system.

2. The Second Step Evolution

   Construction of crossing coordination over distributed structure.

   Introduction of matrix management.

   This is intended to remove bad effects, such as lack of cooperation and communication beyond business lines, which are brought by the introduction of distributed structure.

3. The Third Step Evolution

   Spontaneous individual connection for intellectual creation.

   Individuals spontaneously connect with each other beyond the framework of organization for intellectual creation.
Each evolutionary step requires large scale changes. In the case of Japanese companies he observed, accumulation of learning and flexibility in system changes made it possible.

Orihata also regards the above evolution as a self-organizing process as follows:

1st Step: Evolution from independence to relation within each business line;

2nd Step: Evolution from relation within each business line to relation between business lines;

3rd Step: Evolution from relation between business lines to relation among spontaneously gathering individuals.

In the process of three-step evolution, Orihata stresses the necessity of learning organization. Above all, the necessity of external environmental pressure is an important factor at each evolutionary step for undercutting the power of negative mental models.

In addition, the existence of catalysts, which lead actual large scale changes, is considered to be necessary in the organization.

Considering that the highly special, creative, and changing nature of investment bank business, organizational evolution to the third step would be desirable to compete with rivals.

Applying the hypothesis to Goldman Sachs, it might help to explain the type of organization it has become-- it has positive and talented staff with high creative tension,
strong common profit mindset, ad-hoc teamwork culture, and openness to external world through the high profit sensitivity, as mentioned before.

Applying the hypothesis to Nomura, it is assumed that the first step was in 2001 when Nomura introduced its multi-company system, and the second step or the third step started in 2003 when the organizational change was proposed in the global wholesale unit.

This means that Nomura needs to have five disciplines for developing a learning organization and catalysts in the organization. What is then required for Nomura to achieve the reformation?

In the next section, lessons are sought from the example of Toyota Motors ('Toyota'), which has a unique corporate culture based on harmony and control and has continually succeeded in the global competition, coping with changing business environment.

Although it might not be practical for Japanese investment banks to follow what Toyota is doing because of the differences between the two industries, the basic concept, which enables Toyota to keep changing, could be applied.

5-3-2. **Toyota Motors**

According to Shibata and Kato, the key feature of corporate reforms in Toyota is that the informal and spontaneous group, organized by the member’s personal network, realizes new ideas.

That is, the current management is executed through formal and pyramid-shaped organization similar to the organizational structure of other Japanese companies, while the preparation for the future is executed through spontaneous internal and external networks of staff.

This system is supported by seven common practices as follows:
1. To consider anytime how to make profits and how to defeat competitors;
2. To try first;
3. To listen to what others say and venerate the field;
4. To consider what is a question and repeat why 5 times;
5. To encourage and propose;
6. To act as a team and consult with fellows;
7. To consider based on facts.

Comparing these practices in Toyota with the five disciplines of the learning organization proposed by Senge, the following relationship is observed.

Personal Mastery: Staff who spontaneously produce creative tension by setting challenging targets and trying to achieve creatively
Systems Thinking: Practice questioning five times based on facts
Shared Vision: Common sense of value to consider anytime how to make profits and how to defeat competitors
Mental Models: Practice to try first
Team Learning: Informal and spontaneous group activity

Furthermore, especially 'To try first' is the keystone of Toyota’s innovation and consists of the following four steps.

1. Presentation of Concept
A concept which seems impossible at first glance but might be possible, is proposed timely without fearing any objection.

2. Creation of Original Ideas

Since the concept is quite difficult, new ideas, based on completely different methods, may suddenly occur to someone.

3. Production of Prototype

The idea is developed into a prototype through trial and error in the field.

4. Persuasion and Promotion

Adoption of the new method is promoted through persuasion of related departments and companies.

The staff who leads each step is considered to be a catalyst although the quality of the reform is different from that in previous section. Toyota depends on spontaneous staff in the role. That is, Toyota has many catalysts in realizing reformation.

To sum up, Toyota has the necessary internal factors, nature of learning organization and catalysts, to keep changing. The former depends on informal networks and positive corporate culture supported by seven practices, and the later depends on existence of change leaders as catalysts. The management framework also encourages challenges and informal activities, and raises change leaders.

5-4. Strategic challenges of Internal Aspects in Japanese Investment Banks

Regarding organizational structure, it goes without saying that introduction of flat organization and a simple command line is essential for this business.
As suggested in Chapter 3, creation of attractive corporate culture, which actually enables the staff to share real vision about issues other than money, and to keep loyalty, teamwork, and long-term interests, is required if Japanese investment banks are to avoid the spread of mammonism among the staff.

One of the approaches to realize these goals is to create the changing organization applying Toyota’s model based on harmony and control, as examined in the previous section. The reasons why Japanese investment banks can take this approach are as follows.

First most profits are raised by systematic and collective activities supported by a large customer base of investment bank activities except trading activities. Japanese investment banks are generally hesitant to promote completely fluid employment systems for all staff such as the de facto standard taken by U.S. investment banks. Although this does not necessarily maintain lifetime employment, it is more effective to enhance organizational power than to gather talented professionals at this stage. It is essential for investment banks to adopt talent anytime to compete with rivals in the industry, but all of them do not have to be talented professionals.

Second the liquidity in the job-change market will not improve for the time being. The needs from foreign investment banks are basically limited to customer relationship staff, while Japanese investment banks have few incentives to facilitate the expansion of the job-change market since the cost increase is inevitable.

Finally the relative advantage of advanced products and services in foreign investment banks declined as Japanese investment banks caught up with them. The difference between both products and services has been reduced in each product level.
What kind of practical actions should Japanese investment banks consider in achieving this?

Different from Toyota, Japanese investment banks do not satisfy all conditions to become changing companies. Therefore, they must create a new corporate culture that does not resist changing, and to find catalysts, which lead the actual reformation.

Referring to the example of Toyota, the basis of the new culture is considered to be positive thinking. According to Shibata and Kaneda, one of the roots of Toyota’s positive thinking was recognized in informal workshop activities in Toyota’s early days. The workshop discussed the future of the company without any norm. The members were organized by spontaneous staff’s personal network.

Based on this concept, it might be a good idea for the top management to start such informal discussions among themselves first and to bend their ears to positive and new ideas. If the top management show it to the middle level of management and drive on some of them to have similar discussions at that level, it would be a great success.

Once positive thinking has grown up in the organization, then the following actions should be considered to create new corporate culture based on five disciplines in the learning organization.

1. Personal Mastery

In order to encourage high creative tension in each staff, the top management have to produce an atmosphere respecting constructive opinions. For this purpose the top management are required to put in a good word for such opinions and to support really creative good ideas. Since Japanese management are generally weak on such actions, the top management should pay some attention to this.
Also risk taking has to be evaluated and failure has to be permitted with few penalties in the organization. Otherwise no staff can afford to take risk.

A trigger to activate the staff is to seek external information about such matters as services and products of competitors in the case of Japanese investment banks. The staff is required to be greedy and sensitive for the investment banks. Since the speed of change is amazing in the industry, this choice would be appropriate as a scope of learning.

2. Systems Thinking

The introduction of systems thinking has to be tried when analyzing external information, through a series of processes such as scenario making, reflection, and feedback. And this needs to be enhanced by training to apply it to other areas.

The result of this analysis should be fully respected in spite of the fact that Japanese companies sometimes tend to ignore rationality, giving priority to emotional and spiritual judgement.

Also, in addition to the usual feedback loops, the possibility of structural change of the system should be considered anytime.

3. Shared Vision

For most Japanese people, working is not a way to live but a way to realize themselves. They see the company as a community of people sharing not only their interests but also their will for the future.

Therefore, the shared vision should be based not only short-term interests but also on long-term will, as a Japanese investment bank prospering in conjunction with customers.
In order to find such vision, it might be important to look back through the history and the primary role of each investment bank in order to recognize the origins of current organization.

4. Mental Models

Recognition of changes in external environment, based on systems thinking, would help the staff conquer the conventional mental model.

However, the most important practice is to try first as Toyota does.

Although this is the most difficult discipline for Japanese a company, Japanese investment banks still have real life lessons learned from the experience of U.S. investment banks. These advanced experiences should be also applied to the future strategy.

An increase in the employment of external professionals would also help the staff conquer the conventional mental model.

5. Team Learning

One of the most important lessons in Toyota’s example is to use informal team networks. In the case of investment banks, the viewpoint of each customer or each deal can drive creation of such informal networks, as the example of Goldman Sachs shows.

Since most institutions are organized by product line at the moment, this would definitely help enhance team learning and informal networks as the first step.

6. Catalyst
Finding catalysts might be most difficult since most current management does not fit the innovator role. This is because traditionally, staff who bring up a lot of questions tended to be evaluated unfavorably in traditional Japanese companies, such as financial institutions.

The most important point is for the top management to have the strong desire to execute reforms, and to show their commitment to the staff. The success of reform depends on how many middle managers the top management can win over to change.

A good judge of such serious middle managers, who can be or change to catalysts, is required within the top management.

An approach after finding such serious middle managers is to provide them with special education and experience. Their involvement in free discussion with top management or in corporate management policy matters from the beginning would be effective to encourage their sense of participation.

Through these activities the managers could realize the total vision of the bank and have a keen awareness of any problem. Then the problem is discussed informally among a middle managers group and the idea of a solution is presented to the top management. A series of movements should be the target.

5-5. Summary of Analysis

Serious problems which Japanese financial institutions are recognized as lack of innovation, proclivity to avoid taking risk, little sense of crisis, irresponsible attitude, and tendency to delay decision-making on problems.

The situations of most Japanese investment banks, however, are supposed to be better than other financial institutions such as banks because Japanese investment banks developed
after serious crisis in 1998 with staff having a strong sense of crisis and strong profit mindset inherited from securities houses.

Therefore, this is a good opportunity for them to seek their own internal models exploiting all the staff with a strong sense of crisis. Application of Toyota’s way, shown above, is one of the solutions to this. If Japanese investment banks can create a model that adapts their unique cultural traditions, for fellowship culture, they can realize a strong and sustainable competitive advantage. Toyota also has proved this.

The success in developing their own internal model would also help Japanese Investment banks with their global expansion since establishment of their own model will give them an axis of their sense of value. It becomes also an axis of that when they go abroad and increases in persuasion to local staff with different cultural background.
CHAPTER SIX
CONCLUSION

This thesis examined the strategic challenges of the Japanese investment banking industry, highlighting both external and internal strategies of investment banks, based on a game and a learning approach respectively.

The reason why these approaches were employed is that big changes were assumed in the environment surrounding the industry, such as changes in Japanese financial systems and deregulation. It was assumed that the dynamic approach was suitable to the situation.

In Chapter 1, the recent history of Japanese investment banking industry was reviewed. Also the definitions of both the number and the business coverage of Japanese investment banks were defined.

Then many suggestions for the Japanese investment banking industry were distilled from histories in U.S. and European financial markets in Chapter 2 and 3. They are as follows.

From Wimbledon Phenomenon in U.K. Big-Bang

- Nonintervention from the government on behalf of each investment bank even in crisis
- Necessity of reformation in internal aspects of organization to activate Japanese investment banks
- Competitive advantages due to lower pressure from shareholders
- Existing entry barriers against entry of foreign investment banks
- Possible further integration involving Japanese financial institutions
From evolution process of U.S. investment banks

- Continuous creation of profitable markets and products for more than 50 years
- Diversification of business and integration for globalization at the moment
- Same trend in financial institutions and appearance of conglomerates
- Increase in the marginal size of a global investment bank

From visions of Japanese financial system

- Transition to new financial system mainly supported by MFM
- Promotion of one stop service led by the bank
- Increase of capital market, IB, and mass businesses

The strategic challenges of the industry were considered in Chapter 4 and 5 referring to these suggestions.

Regarding the external strategic challenges of Japanese investment banks in Chapter 4, the industrial structure was first analyzed based on Porter’s five forces. The analysis clarified that high entry barriers exist along with, low staff power, low availability of substitutions, medium customer’s power, and severe rivalry.

Second the strategic analysis of major players explained the predominance of Nomura in almost all businesses, followed by two ex-securities houses and two bank subsidiaries. Also it showed that foreign investment banks have the advantage in large amounts of trade with blue-chips. They focus only on only profitable businesses.
Third the survey of each player’s strategy disclosed that all Japanese investment banks respected cooperation with retail units and revival business while foreign investment banks sought chances to access customers.

Based on the suggestions and results above, the following actions were proposed for Japanese investment banks.

- Considering the expected expansion of the customer base due to financial system changes, Japanese investment banks should establish the loyalty of their own customers and staffs first as a strategy to seek Win-Win situations for the time being.
- In addition, chances to cooperate with the bank, foreign investment banks and other Japanese investment banks should be sought to expand the customer base and ensure the source of IB business quickly.
- On the other hand, the competition with foreign investment banks, narrowing to customers exclusively traded by them, is generally effective for Japanese investment banks. However, the judgement whether to compete depends on effectiveness, price and the degree of competition with other Japanese investment banks.
- The actions taken by Nomura will decide the trends within the Japanese investment banking industry in the long run.

Then in Chapter 5, the internal strategic challenges of Japanese investment banks were analyzed.
In the beginning, internal aspects in U.S. Investment Banks as a de facto standard were reviewed. The analysis showed three features of the organizational structure, which are business line based, global, and flat, and distinguished characteristic of organizational culture,--a strong profit-seeking mindset. Also an example of Goldman Sachs was reviewed for its unusual teamwork culture.

Second the historical background of internal aspects in Japanese financial institutions and securities companies was reviewed as a root of current internal features of Japanese investment banks. It explained the pyramid shaped organizational structure and peculiar harmonized corporate culture of Japanese financial institutions. In addition, strong central control system supported by strict rules was shown as the culture of securities houses.

Third changes, required for a changing company, on the internal aspects in Japanese investment banks were studied. It demonstrated three steps for Japanese companies to evolve to companies constantly engaged in change, and sought hints from Japanese investment banks such as Nomura and companies like Toyota. From the study, factors corresponding to the five disciplines for learning organizations proposed by Senge were confirmed and also the necessity of catalysts was recognized.

Finally strategic challenges of the internal aspects of Japanese investment banks were considered applying Toyota’s model to a Japanese investment bank. The reasons why Japanese investment banks can take this approach were assumed as follows. First most of profits were raised by systematic and collective activities. Second the liquidity in the job-change market will not improve for the time being. Finally the advantage of advanced products and services in foreign investment banks has relatively declined.
In applying the Toyota model to Japanese investment banks, fostering positive thinking was considered as the first step. With regard to actions corresponding to the five disciplines and finding catalysts, triggers were mainly considered reflecting actual operations and peculiarity of Japanese companies.

Throughout these processes, the involvement of the top management was emphasized. This required management to execute demonstration, explanation, and praise.

There are more criticisms about the lack of strategies in Japanese companies than we can count. However, considering the current changing environment surrounding the industry, it is extremely difficult to develop original strategies and it is also difficult to avoid rival’s imitation of it.

The strategic approaches, game and learning, taken by this thesis have a lot of potential in that the flexible, autonomic and innovative actions in both the management and the field level can manage such changing environments.

Although it is quite ambitious for Japanese investment banks to recover their 1980 position quickly in the global financial industry, I hope that analysis provided by this thesis will enable them to realize the desire in conjunction with their strong challenge spirits.
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