Knowledge Management in Banking Industry: Comparative Analysis between U.S. and Japan

by

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Knowledge Management in Banking Industry: Comparative Analysis between U.S. and Japan

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ABSTRACT

Japanese banking firms have been in a turbulent period from the last decade due to deregulations and bad loans from collapse of a bubble economy. As a result, there have been many bankruptcies and merger & acquisitions (M&As) among Japanese banking firms. On the other hand, U.S. banking firms have already met with similar experiences from the 1970s to 1980s. After these turbulent eras, U.S. banks revived by restructuring and focusing on their core competence. They are strong from the viewpoint of profitability, size and stability. In this sense, it is generally said that U.S. banking firms are 10 years ahead from Japanese banking firms. Therefore, I think it is useful for Japanese banks to research and learn how U.S. banks corresponded to turbulence situations and how they revived.

In this thesis, I focus on knowledge management in banking firms, because human resource and both internal and external knowledge is one of the most important assets for banks. Even though banking firms have many business fields for which knowledge is useful, I pick up and examine following aspects by using comparative analysis between Japanese and U.S. banking firms.

1. Employment System and Organizational Structures
   The employment systems and organizational structures of banking firms are key to how they manage their knowledge because knowledge belongs to the employees and organizations.

2. Customer Relationship Management
   How to make the best use of customers’ knowledge is important for banks, and banks need to focus not only on internal knowledge but also external knowledge.

3. Outsourcing
   Acquiring knowledge and skills from outside sources is becoming more and more important for banks because of innovations in information technology and severe competition among many rivals.

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Title: Assistant Professor of Management
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Kazunori Yamagata
Brookline, MA.
May 2002
Chapter 1

Introduction

This thesis undertakes a comparative analysis of the U.S. and Japanese banking industries, with particular attention to ways the U.S. banking industry transformed itself during the past decade, and the lessons that might apply to the Japanese banking industry.

There are many important issues in the banking industry, but managing human resources is one of the most important. Banking firms have few tangible assets, and their service and products are essentially created by their employees. Also because of IT improvements such as network technology and the Internet, the importance of their tangible assets, i.e., the branch networks, has declined or changed in recent years.

Therefore my focus in this thesis is on managing knowledge in the U.S. and Japanese banking industries. In the next section, I briefly explain what knowledge management is and why it is needed in banking firms.

1.1 OVERVIEW OF THE JAPANESE AND U.S. BANKING INDUSTRIES

1.1.1 Japan

Traditionally, the Japanese banking industry had been protected by the government as a way to stabilize the economy. Under this protection, Japanese banks provided the same or similar financial products to all customers. Banks made few efforts to create new financial products or to differentiate themselves from other banks. Customers assumed the banks could not provide various products, so they did not demand much from the banks, and consequently there was little difference in service among the banks. Therefore the ranking of Japan’s bank was determined by economies of scale, such as the quantity of deposits and loans or the number of branches.

In 1996, then Prime Minister Hashimoto suggested that Japan’s financial market should be changed, so he eliminated regulation. Under financial deregulation, Japanese banks were now able to provide any kind of financial product and enter other types of business such as securities or insurance. While the banks now had many new business opportunities, the
wide open marked also encouraged greater competition. In addition, the newly deregulated environment, many large foreign banks recognized the opportunity to enter the Japanese financial markets to acquire large individual financial assets.

At the same time, many Japanese banks were burdened with a heavy load of bad debts that occurred as a result of the collapse in the early 1990s of the so-called “bubble economy”. In the 1980s, the banks had loaned money to many companies for real estate investment as the value of land rose to extraordinarily high levels, and companies invested this money aggressively. But after the collapse of the bubble economy, the value of land (i.e., the collateral guaranteeing the loan) dropped rapidly, and many companies were forced into bankruptcy. In the end, every Japanese bank was left holding a number of bad debts and their financial status declined—a situation that was only exacerbated by deregulation.

As a result of these factors, the landscape of Japanese banking industry changed dramatically. Whereas there were 13 banks in 1989, in 2002 there are now five (see Table 1.1). Furthermore, they have formed alliances and merged not only with domestic banks but also with domestic security companies, domestic insurance companies, and foreign investment banks. In addition, there are entrants from other industries, such as Ito-Yokado Bank, a large Japanese retailer. The result has been severe competition among Japanese banks in recent years.

<table>
<thead>
<tr>
<th>Table 1-1. Moves Made by Japanese City Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
</tr>
<tr>
<td>Daichi Kangyo Bank</td>
</tr>
<tr>
<td>Fuji Bank</td>
</tr>
<tr>
<td>Sumitomo Bank</td>
</tr>
<tr>
<td>Mitsui Bank</td>
</tr>
<tr>
<td>Taiyo Kobe Bank</td>
</tr>
<tr>
<td>Mitsubishi Bank</td>
</tr>
<tr>
<td>Bank of Tokyo</td>
</tr>
<tr>
<td>Sanwa Bank</td>
</tr>
<tr>
<td>Tokai Bank</td>
</tr>
<tr>
<td>Saitama Bank</td>
</tr>
<tr>
<td>Kyowa Bank</td>
</tr>
<tr>
<td>Daiwa Bank</td>
</tr>
<tr>
<td>Hokkaido Takushoku Bank</td>
</tr>
</tbody>
</table>

Source: Japanese Bankers Associates, 2002

1.1.2 United States
The U.S. banking industry experienced deregulation ten years before Japan. Prior to deregulation, there were many laws restricting and protecting U.S. banking firms, creating a banking environment similar to Japan’s. However, beginning in the 1970s, changes occurred. For instance, from the late 1970s to early the 1980s, regulations for interest rates on deposits were abolished; in the 1990s the stringent controls of the Glass-Steagall Act, which separates U.S. commercial banking from investment banks and securities management, were loosened.

U.S. banks had also experienced bad debts arising from loans made to developing countries in the early 1980s. In addition, information technology and the prevalence of direct financing among large companies created severe competition. As a result, the earnings ratio of U.S. banking firms went down from 11% in 1970 to 9.6% in 1985. By the late 1980s, even large money center banks were in financial crisis or had gone bankrupt (Rogers, 1993).

In order to escape the crisis, U.S. banks focused on their core competencies, reduced the number of employees, or entered into mergers. There were several large mergers among large U.S. banks in the 1990s, such as Chemical Bank and Chase Manhattan, CitiCorp and Travelers, or J.P. Morgan and Chase. As a result, U.S. banks, especially large money center banks and super-regional banks, began to revive in the late 1990s. Table 1-2 shows the recent

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Country</th>
<th>Tier One Capital (million US$)</th>
<th>Assets (million US$)</th>
<th>Return on Assets (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citigroup</td>
<td>U.S.</td>
<td>54,498</td>
<td>902,210</td>
<td>2.34</td>
</tr>
<tr>
<td>Mizuho Financial Group</td>
<td>Japan</td>
<td>50,502</td>
<td>1,259,498</td>
<td>0.31</td>
</tr>
<tr>
<td>Bank of America Corp</td>
<td>U.S.</td>
<td>40,667</td>
<td>642,191</td>
<td>1.84</td>
</tr>
<tr>
<td>JP Morgan Chase &amp; Co</td>
<td>U.S.</td>
<td>37,581</td>
<td>715,348</td>
<td>1.22</td>
</tr>
<tr>
<td>HSBC Holdings</td>
<td>UK</td>
<td>34,620</td>
<td>673,614</td>
<td>1.43</td>
</tr>
<tr>
<td>Credit Agricole Groupe</td>
<td>France</td>
<td>26,383</td>
<td>498,426</td>
<td>0.71</td>
</tr>
<tr>
<td>Industrial and Commercial Bank of China</td>
<td>China</td>
<td>22,792</td>
<td>482,983</td>
<td>0.13</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>Germany</td>
<td>20,076</td>
<td>874,706</td>
<td>0.72</td>
</tr>
<tr>
<td>Bank of Tokyo-Mitsubishi</td>
<td>Japan</td>
<td>20,050</td>
<td>675,640</td>
<td>-0.13</td>
</tr>
<tr>
<td>Sakura Bank</td>
<td>Japan</td>
<td>20,035</td>
<td>416,129</td>
<td>0.25</td>
</tr>
<tr>
<td>Bank One Corp</td>
<td>U.S.</td>
<td>19,824</td>
<td>269,300</td>
<td>-0.4</td>
</tr>
</tbody>
</table>

Source: Financial Times, 2001

Table 1-2. Ranking of World's Largest Banks

financial status among world's large banks. In terms of tier one capital, commonly used as an indicator of bank strength, the United States has four banks in the top five. Furthermore, U.S. banks have a high rate of return compared to other strong world banks.
1.2 WHAT IS KNOWLEDGE MANAGEMENT?

Throughout the 1990s, knowledge was recognized as an important corporate asset, a requisite for maintaining a competitive position, and many companies made serious efforts to manage knowledge. The concept of knowledge management was suggested by numerous scholars in the 1990s. For instance, Peter Drucker stated:

For like them, the typical business will be knowledge-based, an organization composed largely of specialists who direct and discipline their own performance through organized feedback from colleagues, customers, and headquarters. For this reason, it will be what I call an information-based organization (Drucker, 1988, p. 1).

Also Peter Senge, who suggested that the concept of a lean organization would be a core competence of innovation, pointed out:

As the world becomes more interconnected and business becomes more complex and dynamic, the world must become more "learningful." It is no longer sufficient to have one person learning for the organization, a Ford or a Sloan or a Watson. It is just not possible any longer to "figure it out" from the top, and have everyone else following the orders of the "grand strategist." The organizations that will truly excel in the future will be the organizations that discover how to tap people's commitment and capacity to learn at all levels in an organization. (Senge, 1990, p. 4)

Several penetrating intellectuals expect that knowledge will become a core competence that cannot be improved without organizational learning. Mr. Nonaka, one of the pioneers of knowledge management, focused on tacit knowledge while analyzing the success of several Japanese companies:

What is unique about the way Japanese companies bring about continuous innovation is the linkage between the outside and the inside. Knowledge that is accumulated from the outside is shared widely in the organization, stored as part of the company's knowledge base, and utilized by those engaged in developing new technologies and products. A conversion of some sort takes place; it is this conversion process—from outside to inside and back outside again in the form of new products, services, or systems—that is the key to understanding why Japanese companies have become successful. It is precisely this dual internal and external activity that fuels continuous innovation within Japanese companies. (Nonaka and Takeuchi, 1995, p. 6)
Thus, from the standpoint of both theory and practice, many companies and numerous people have tried to apply knowledge management and use it as a key factor for success.

Some say that U.S. companies were aware of the importance of knowledge management ahead of Japanese companies. Also, differences between U.S. and Japanese companies, such as greater emphasis on service in U.S. banking firms, meant that U.S. firms paid more attention to knowledge management. At the same time, however, most Japanese manufacturing companies were practicing knowledge management. And while U.S. companies focused primarily on information technology to manage their knowledge, Japanese companies focused mainly on the organizational aspects of using their knowledge.

1.2.1 Background

After the Industrial Revolution, capitalism controlled much of the world’s business and people thought material prosperity was the most important thing. Naturally, the value of companies was determined mainly by their tangible assets, such as buildings, infrastructures, and inventories, and various accounting methods were developed to evaluate the tangible assets of each company.

However, in recent years the situation changed. Companies that do not have much in the way of tangible assets still receive strong valuations and enjoy high stock prices—Microsoft, Intel, and some consulting companies are good examples. One reason for the high valuation was their intangible assets, such as employee knowledge or the firm’s organizational or marketing strategies. Those firms had many employees with unique and specialized skills; they had good management methods that organized their employees and their knowledge, including a strong and pervasive information technology infrastructure. Many also might have excellent ways of meeting customer needs. Other companies with lower valuations perhaps lacked such uniquely skilled employees, or management skills, or both.

During the 1990s, society became far more information-oriented, and skills and knowledge have become much more important. Traditional capitalists find it harder to succeed. Instead, money can still be made with fewer physical assets, and survival among strong competition is possible because of the knowledge and skills of managers and employees. Many companies now realize these facts and are beginning to pay attention to their intangible assets. But they also would like to know how to manage and control these assets and to improve their knowledge and skills. It is expected that the world will become a largely knowledge-based society during the 21st century. But for now, many companies are still struggling to maintain and manage their intangible assets.

1.2.2 Approach to Knowledge Management
There are two valuable approaches to knowledge management: one is information technology, the other a human resources (H/R) and organizational approach (see Figure 1-1).

**Figure 1-1 Approach to knowledge management**

(a) **Information Technology (IT) Approach**

One of the important issues of managing knowledge is to share it among employees. In order to share knowledge, companies need to know where the knowledge resides, who the skilled personnel are, and how to collect and accumulate the knowledge. Owing to improvements in information technology, such as the Internet and network infrastructures, firms can collect data from terminals across a widespread area. They can accumulate significant amounts of data by improving their database technology. Thus, IT plays an important role in knowledge management as a means to an end.

However, some companies that have tried to apply knowledge management to their organization tend to be satisfied simply by introducing the infrastructures and tools, especially information technology software. While knowledge management is heavily related to information technology, the companies that aim to apply knowledge management should make decisions based on who needs knowledge management, what kind of knowledge they need, or why they need knowledge management. This means developing a strategy that considers what kind of information technology they want to introduce in order to realize a useable and efficient knowledge management system.
(b) Human Resources/Organization Approach

Another approach to knowledge management is human resource management including the firm’s organizational structure. In general, people who have effective knowledge of their organization do not like to offer their knowledge without appropriate compensation. For instance, information about customers or sales technique is important knowledge for sales personnel who believe that they earn their salaries because of such knowledge acquired via one-the-job experience. So they are less inclined to share such information with other employees. Thus, companies need to find appropriate way to evaluate people who can offer such intelligence and harvest it into a knowledge management database.

To make the best use of these employees’ knowledge, the structure of the organization also becomes important. Some organizational structures obstruct the smooth interchange of knowledge, and are not suited for knowledge management.

1.2.3 Knowledge Management in the United States

Today almost all U.S. companies have introduced some form of knowledge management into their organizations. In the early 1990s, the growth rate of real GDP was negative and the economy went into recession. During this period, firms struggled to emerge from the painful situation, and afterward, they began implementing new management concepts, such as a learning organization, core competence, or reengineering, recognizing that knowledge was one of the most important factors for winning the competition.

There is another reason they paid attention to knowledge. Many U.S. companies underwent restructuring and reengineering, and fired many employees to reduce labor costs because of the recession. As a result, they lost considerable knowledge which walked out the door with laid-off employees. In order to prevent a major outflow of their core competencies, firms were compelled to pay attention to managing their knowledge.

Also, the turnover rate among U.S. employees tends to be high compared to that of other countries; therefore managers must prevent the outflow of such talent and develop methods for keeping knowledge in the company. Fortunately, the IT infrastructure, including PCs and Local Area Networks (LAN) is very high among American companies, so it was easy to introduce knowledge management software, such as knowledge database, knowledge mining software, or knowledge mapping software. They used existing facilities and began putting into practice some kind of knowledge management program. Also software vendors tried to provide a variety of knowledge management software. Therefore, knowledge management in many America’s companies is heavily based on information technology.
Another characteristic of knowledge management among American companies is that companies in service industries pay more attention to their knowledge. For example, consulting companies, such as Andersen Consulting or Ernst & Young, invested heavily in managing their knowledge. Some companies, especially those that originally provided hardware, changed their business style, moving from a hardware company to a more general service company because of customer requests in an information-oriented society. Examples of these companies are IBM, Motorola, and General Electric, each of which tried to acquire and preserve the knowledge gained from their 1990s consulting and information services, and who changed to general service companies that provide total consulting and service.

1.2.4 Knowledge Management in Japan

It is said that Japanese manufacturing companies are good at managing their knowledge (Nonaka and Takeuchi, 1995), and it seems that one reason for success in Japanese companies in the 1980s came as a result of good use of employee knowledge. For example, in case of Matsushita Electric Industrial Company, they developed “Home Bakery”, a new groundbreaking product, which incorporated knowledge from expert bread makers, a technique called socialization. In case of ‘City’ at Honda, a project manager used ‘Automobile Evolution’ as a metaphor to make the most of knowledge among the participants. As a result, they created the concept of ‘Tall Boy’ and developed “City” that became a big seller. There are additional examples of managing knowledge in Japan’s companies, such as Canon, Kao, Fujitsu and so on (Nonaka and Takeuchi, 1995).

Another characteristic of knowledge management in Japan is that firms focused on tacit knowledge but did not use information technology to manage that knowledge. The companies were good at managing tacit knowledge and using personal knowledge as organizational knowledge because of Japan’s cultural background. This organizational knowledge creation was a key innovation in Japanese companies and critical to the successes of the 1980s. Table 1.2 shows the characteristics of knowledge management in American and Japanese companies.

<table>
<thead>
<tr>
<th>Knowledge</th>
<th>Explicit</th>
<th>Tacit</th>
</tr>
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<tbody>
<tr>
<td>Business</td>
<td>Service</td>
<td>Manufacturing</td>
</tr>
<tr>
<td>Approach</td>
<td>Information Technology</td>
<td>Organizational improvement</td>
</tr>
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</table>

Source: author, 2002
1.2.5 Information Technology in Banking Firms

The banking industry is a typical industry for making good use of IT in doing business, and banking firms have spent significant quantities of money on upgrading and enhancing their IT infrastructure. When considering managing knowledge in banking firms, it is difficult to separate IT from knowledge management. Therefore I will explain briefly about the importance of IT in banking firms.

In the 1960s, owing to the prevalence of mainframe computers, the banking business became highly IT-oriented. Before this, banking had relied on manual skills, and all customers’ accounts were hand-written. In the beginning, the purpose of introducing IT in banks was to reduce time and save labor, which meant a reduction of costs. Therefore, investment for IT in those days focused mainly on branch terminals, deposit systems, and automatic teller machines (ATM).

After the 1980s, owing to innovations IT and deregulation in the banking business, IT investment in banking firms changed. From the banks’ point of view, the need for a management information system (MIS) that could collect data from many different databases and analyze that data became paramount because the banking business grew more complex as a result of deregulation. Also, owing to the progress of financial technology and globalization, requirements for risk management also became higher.

At the same time, a new type of IT architecture, called “client-server architecture” and based on Unix and PCs, played an important role in creating further innovation in the banking business. The architectures were much cheaper than mainframe computers, with more flexibility and better performance. For these reasons, banks spent considerable money on MIS rather than putting more into the traditional large mainframe computers of the 1980s.

During the 1990s and into today, owing to the prevalence of the Internet, banking firms began to focus on e-commerce. Internet banking caused banks to reduce the number of “bricks and mortar” branches, as did new entrants from other industries who did not have traditional banking structures. This trend means that interactions with customers are changing dramatically. While traditional banking business was based on business handled in branches, today’s trends indicate that banks need sophisticated home pages even more than traditional branches. Also it means that banking firms have become generally more technology-oriented. IT expenditures are now 15% to 20% of their non-interest expense, and from 2001 to 2002 the amount has grown 4% (Bank Systems & Technology, 2002).

Information technology has become recognized as a major tool for collecting customer information in recent years. As interactions with customer are automated through the use of the latest IT techniques, banks can obtain customer information easily. They believe that this kind of information is useful and necessary in order to build and improve customer relationships. Therefore the banks are developing customer relationship management (CRM) systems and investing significant amounts of money into top-notch information systems.
1.2.6 The Need for Knowledge in Banking Firms

The business of banking has both a service and a manufacturing component. Banks provide financial services, such as domestic and foreign remittances, automatic charge service, custody services, and settlement services. Banks also provide financial consulting service, e.g., they give advice to customers about investing. Some banks also give advice about mergers and acquisitions. At the same time, banks develop and sell (i.e., "manufacture") a variety of financial products, and the quality of those products has a strong effect on competition, especially under deregulation.

Thus, banks have both a service and a manufacturing aspect. As we have seen in the cases of the United States and Japan, managing knowledge is important in both industries. However, banks do not have plants and machinery, so their most important assets are their employees and branches, which are the interfaces for customer relationships. Therefore, managing employees and the customer relationships have become the banks' core competence. And that is why I strongly believe that knowledge is the most important asset for banks and why I chose it as the topic of this thesis.

1.3 ANALYSIS METHODS AND THESIS STRUCTURE

In this thesis, I apply the method of comparative analysis between the U.S. and Japanese banking industries. I focus on large companies, comparing Japanese city banks with U.S. large commercial banks such as money center banks and super-regional banks. These two types of bank have similar structures from the standpoint of scale, strategy, and circumstances. I will use the following methods to analyze knowledge and knowledge management in the banking industry.

1.3.1 Comparative Analysis

I use a comparative analysis method to compare Japanese banking firms with U.S. banking firms. Generally speaking, the Japanese banking industry is about ten years behind the U.S. when comparing the respective industries in terms of deregulation. Some large U.S. banks, such as money center banks and super-regional banks, successfully escaped from financial difficulties in the 1980s and early 1990s. So I will compare these two industries from the standpoint of knowledge and knowledge management.

1.3.2 Employment Systems and Organizational Structure
The employment systems and organizational structures of banking firms are key to how they manage their knowledge because knowledge belongs to the employees and organizations. In particular, the employment system reflects a company’s culture and background, which means there are undoubtedly significant differences between the U.S. and Japanese banking industries even though the competitive environments of both industries are similar. Also I will identify traditional employment systems and recent challenges facing them, and then compare recent trends in both industries.

1.3.3 Customer Relationship Management

CRM is a typical knowledge management method for banking firms. As customer preferences have become more diversified in recent years, it is necessary for banks to acquire those preferences and relevant information. In other words, how to make the best use of customers’ knowledge is important for banks, and banks need to focus not only on internal knowledge but also external knowledge.

In the United States, the concept of marketing used to be popular among banks, and they also began to realize the importance of CRM by the early 1980s. Therefore, it could be said that U.S. banks are pioneers in the use of CRM in the banking industry. On the other hand, Japanese banking firms have only recently realized the importance of CRM and are now scrambling to catch up. There are both successes and failures among U.S. banking firms, and I will use the research for this thesis to identify appropriate ways for the Japanese banking industry to make use of this earlier experience by investigating the reasons underlying these successes and failures.

1.3.4 Outsourcing

Acquiring knowledge and skills from outside sources is becoming more and more important for banks because of innovations in information technology and severe competition among many rivals. Improvements in information technology are making the banking business more efficient and banks themselves more technology-oriented.

Although there are several definitions for outsourcing, I define outsourcing as entrusting a company’s business models, human resources, and facilities to other companies. Therefore using consulting firms or temporary employment agencies are not included in this definition of outsourcing.

It is becoming increasingly difficult, however, for banks to remain current with the latest technologies inside their companies because of the high clock speed factor (Fine, 1998). Also because of severe competition among rivals, banks need to focus on their core competencies and the resources needed to support them.
Therefore some banks are outsourcing some aspects of their business to try and remain competitive. I will compare differences in acquiring this outside knowledge, and how U.S. and Japanese banking firms use outsourcing effectively.

1.3.5 Thesis Structure

In Chapters 2 and 3, I describe the background of the knowledge management and banking industries. In Chapter 4, I analyze the recent circumstances of large U.S. banking firms from the viewpoint of managing knowledge, and I do the same analysis with Japanese city banks in Chapter 5. In both chapters, I focus on same categories in the industry, such as employment system, organizational structure, customer relationships, and outsourcing. In Chapter 6, I compare the results of my analysis and analyze the differences. Finally, Chapter 7 summarizes the results and concludes the thesis.
Chapter 2

Background of the Banking Industry

2.1 The U.S. Banking Industry

2.1.1 Structures and Functions

The U.S. banking industry is divided into commercial banking and investment banking. In this thesis, I will focus only on commercial banking firms because the business conducted by investment banking firms is not comparable to that of Japanese banks, but to Japanese securities companies.

The main businesses of commercial banks are savings and loans. Loans at commercial banks are wide-ranging, including consumer, commercial, international, and real estate loans. Also, the banks play an important role with their settlement and payment systems, such as credit cards and check settlement. These are the core businesses of commercial banks. In addition, commercial banks finance foreign trade and provide trust services. Thus the commercial banking business is the financial heart of activities for every corporation and most individuals.

In general, U.S. commercial banks are classified into four groups: money center banks, super-regional banks, regional banks, and community banks. Examples of money center banks are Citibank and J.P. Morgan Chase. These banks traditionally engage in business with large corporations and international operations. Super-regional banks and regional banks handle a complete array of wholesale commercial bank activities, with a specific focus on regional financial activities in the United States. Because of deregulation, some regional banks do business across state lines, with the result that some regional banks became nationwide banks and large corporations through merger. These are the super-regional banks. Typical examples of super-regional banks are Bank of America, Wells Fargo, First Union, and Bank One. Banks that specialize in retail or consumer banking and adhere closely to a small region are called community banks. Even though the size of these banks is small, they enjoy greater flexibility to meet customer needs and to provide specialty regional information. They
compete with large financial corporation, such as money center banks or super-regional banks (Yoshisato, 2001).

Even though investment banks are called "bank", their business is different from a normal bank. Investment banks are prohibited for taking deposits or making loans. Their main businesses are underwriting and issuing securities, mediation of merger and acquisition activities, and trading in the bond, stock, and foreign exchange markets. In addition, they have begun to engage in the venture capital and fund business in recent years. In this sense, investment banks in the United States are equivalent to securities companies in Japan. However, while Japanese securities companies focus on brokerage businesses and have not diversified their business, U.S. investment banks handle a variety of businesses and can offer financial consulting to their customers. They have a wide range of financial businesses that are very helpful for customers.

From a historical point of view, May 1975 was a turning point for investment banks. Before that date, their profits came primarily from the brokerage business. But because brokerage services were declining owing to deregulation, profits from the brokerage business decreased, thus requiring the investment banks to shift to another source of business. Some investment banks, such as Merrill Lynch and Smith Barney, focused on asset management; others such as Lehman Brothers and Salomon Brothers, concentrated on trading or mediating M&As. Companies offering extremely low brokerage costs through the use of online trading, also appeared, including Charles Schwab and E*Trade. Recently, the method utilized by companies to raise funds has changed from indirect funding to direct funding. In this regard, the role of investment banks will become more and more important in the near future, superseding the role of commercial banking.

2.1.2 Period of Regulations (1930s to early 1970s)

From the 1930s until the 1970s, in order to avoid panic among financial firms or waves of bank failure, the U.S. commercial banking industry was protected by the government through various laws. Competition among the financial firms was restricted, and the banking industry as a whole was considered safe and stable. Table 2-1 shows some of the laws and regulations that were put in place for the financial industry.
Table 2-1 Regulations and Establishment in U.S. banking industry

<table>
<thead>
<tr>
<th>Name of Act</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>The McFadden Act</td>
<td>Limiting interstate banking</td>
</tr>
<tr>
<td>The Glass Steagall Act</td>
<td>Separated U.S. commercial banking from most forms of investment bank and securities management</td>
</tr>
<tr>
<td>Regulation Q</td>
<td>Set ceiling for interest rates on deposit</td>
</tr>
<tr>
<td>The Douglas Amendment to Bank Holding Company Act</td>
<td>Strengthened the McFadden Act</td>
</tr>
<tr>
<td>FDIC*</td>
<td>FDIC insures deposits up to $100,000</td>
</tr>
</tbody>
</table>

* Federal Deposit Insurance Corporation

Source: Author, 2002

During this period, U.S. banks were not allowed to establish branches in other states within United States, nor could they provide securities or insurance. Because of these laws, commercial banks were protected from competitors such as insurance companies, securities companies, and other non-bank firms. At the same time, banks could not enter into new businesses or provide new types of financial products. So their profit came primarily from the difference between the interest rates on loans and mortgages and the interest rates on deposits. Consequently, interest rates on deposits were set relatively low, so commercial banks could obtain relatively high profits. There was no need to create innovative products or invest in their organizational culture. The amount of deposits and loans determined a commercial bank’s profit directly.

Needless to say, commercial banks also paid attention to the dividend paid to owners in order to keep their stockholders and critics satisfied. However, because of their standardized products and lack of competitive initiative with other companies, many banks lost their competitive edge during this era.

The banks also maintained a bureaucratic organization that was structured pyramidally. There were many layers, including tellers and front office employees who opened accounts in branches, and specialists who judged the adequacy of mortgages and managed branch work remotely (Hunter 1999; Rogers 1992). Banks needed this type of organization, which could manage fixed-form jobs without mistakes, rather than a flexible organization that could create innovative products and services. As bank observers noted, “American bankers for decades operated by the 3-6-3 rule: pay depositors 3% interest, lend money at 6%, and tee off at the golf course by 3 P.M. Profits were steady and certain.” (Rogers 1992, p. 7)

In the early 1960s, U.S. commercial banks were still protected by the government
and various laws. However, fluctuations in the American economy— inflation and volatile interest rates—affected the banks. Market interest rates became higher than the upper limits of interest rates on deposit as determined by Regulation Q. Soon customers began to buy other financial products that offered higher interest rates, like money market funds offered by securities companies. This represented the first shift of customers away from traditional deposits in commercial banks. As customers withdrew, commercial banks gradually lost their source of profit, and their financial status declined. Ironically, the very regulations that had long protected these firms was now causing their deterioration. Regulation Q, which determined the upper boundaries of interest rates on deposit, was abolished in 1980, and with deregulation of interest rates on time deposits in 1983, deregulation for all interest rates was virtually complete (Hisahara 2000).

2.1.3 Period of Turbulence (1980s to Present)

In the 1980s, U.S. commercial banking entered a turbulent period caused by deregulation, the globalization of financial markets, and technology innovations. Early in this period, many commercial banks struggled with financial uncertainty, and eventually some large banks fell victim to the turbulence and went bankrupt. Also, large mergers occurred between banks that had failed to manage or had created inappropriate strategies and other successful financial firms. This period was “undoubtedly the most turbulent period in banking since the Great Depression” (Berger et al., 1995).

Deregulation in the banking industry proceeded through 1980s and into the 1990s. After the Glass Steagall Act and the Douglas Amendment Act were abolished in 1980 and 1983, respectively, commercial banks were able to provide all kinds of financial products, including insurance, securities, or mutual funds through holding companies. Customers became sensitive to interest rates, so developing products that met customer demand became a priority for commercial banks.

On the other hand, the banks now had to manage the risk associated with these products. Products that have high interest rates usually have high risk, and many banks had little knowledge about managing these risks. Also, deregulation led to commercial banks being threatened by new competitors, including investment banks, insurance companies, and retail firms like Sears and JCPenny. According to a Gartner Group report (1999), not only commercial banking but also investment banking, brokerages, and insurance companies, began to realign into new groups, such as chain store franchises, affinity or niche providers, brokers and content aggregators, and mono-lines.

Finally, as a result of deregulation, the traditional banking industry found itself facing
severe competition. Banks could no longer remain competitive simply by depending on traditional businesses and structures. Commercial banks were being forced to reconsider their core competencies and restructure their organizations.

The globalization of financial industry had a huge impact on American commercial banks. U.S. commercial banks began to expand into foreign countries. This expansion created wonderful opportunities for earning profits. In addition, the euro-dollar market allowed banks to escape from U.S. regulations. However, there was also more risk in these new activities, which required firms to manage (or learn to manage) the risks. At the same time, many foreign banks began to enter the U.S. banking market and become new competitors. The U.S. government required relatively less capital for foreign banks, so these banks, especially Japanese banks, found it easy to get into the U.S. market (Rogers 1992).

Improvements in information technology also had a major impact on commercial banking firms. With the addition of the latest information technology such as mainframe computers, many commercial banking businesses became automated. Front-office and back-office operations also became automated. This meant that useful customer information needed for customer relationship management (CRM) could be automatically collected through the banks’ information systems. Automated teller machines were introduced to branches, so customers who came to a branch to make deposits or obtain cash no longer had to go to a teller window.

Information systems also played an important role in the trading arena. Because financial products were becoming more complex, the banks were required to manage market risk quickly. Thus, banking firms became IT-oriented firms, and wins and losses were determined by the quality and quantity of investment into IT systems and technology. Moreover, in recent years, due to the rise of the Internet and e-business, commercial banks have been forced to introduce new types of banking channels and new business models to their customers. All this has meant that banks have had to make major investments in information technology almost continuously over the past two decades in order to maintain their competitive positions.

Thus, U.S. commercial banks faced higher competition with firms from other industries and from foreign countries, and they had to make huge investments in information systems. Moreover, with the development of financial markets like the commercial paper market, enterprises in good standing that were also good customers for commercial banks preferred to raise money from directly from the market rather than from commercial banks as they had done in the past. Many banks lost good customers during this period. Figure 2-1 the shift in household financial assets—a rapid decline in bank deposits and a corresponding increase of mutual funds.
In order to maintain profit levels, many commercial banks began lending to developing countries and for leveraged buyouts (LBO) and real estate loans (Rogers 1992). As a consequence, their financial status actually worsened, and their competitiveness gradually weakened through the 1980s and into the early 1990s. During this time, many commercial banks, even money center banks such as Citicorp and Bank of America, went into financial crisis.

Many commercial banks began devising new strategies to escape this bad situation, and one solution was mergers, the other was restructuring. Apparently one reason for the crisis was the total number of banks. Under regulated conditions, many banks were needed because each bank had its own role in its own location. However, when regulations were loosened, there was no longer a reason for so many banks. Table 2-2 and Figure 2-2 show mergers and changes in the number of commercial banks in United States during this time.
Figure 2-2 Changes in Number of Commercial Banks in U.S

Source: Statistics on Banking, 1997

<table>
<thead>
<tr>
<th>Year</th>
<th>Acquiring Firm</th>
<th>Assets</th>
<th>Acquired Firm</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Chase Manhatten</td>
<td>$98,064</td>
<td>Manufacturers Hanover</td>
<td>$61,530</td>
</tr>
<tr>
<td></td>
<td>Fleet Financial Group</td>
<td>$32,507</td>
<td>Bank of New England</td>
<td>$20,434</td>
</tr>
<tr>
<td></td>
<td>First Union</td>
<td>$40,781</td>
<td>Southeast</td>
<td>$13,390</td>
</tr>
<tr>
<td>1992</td>
<td>Society Crop</td>
<td>$25,599</td>
<td>Ameritrust</td>
<td>$10,181</td>
</tr>
<tr>
<td></td>
<td>Comerica Incorporated</td>
<td>$14,530</td>
<td>Manufacturer National</td>
<td>$13,544</td>
</tr>
<tr>
<td></td>
<td>BankAmerica</td>
<td>$186,933</td>
<td>Security Pacific</td>
<td>$76,411</td>
</tr>
<tr>
<td>1993</td>
<td>NationsBank</td>
<td>$119,805</td>
<td>MNC</td>
<td>$17,001</td>
</tr>
<tr>
<td></td>
<td>BancOne</td>
<td>$61,332</td>
<td>Valley National</td>
<td>$11,497</td>
</tr>
<tr>
<td>1994</td>
<td>BankAmerica</td>
<td>$186,933</td>
<td>Continental</td>
<td>$22,601</td>
</tr>
<tr>
<td></td>
<td>KeyCorp</td>
<td>$32,648</td>
<td>Society</td>
<td>$59,664</td>
</tr>
<tr>
<td>1995</td>
<td>Fleet Financial Group</td>
<td>$48,727</td>
<td>Shawmut</td>
<td>$32,652</td>
</tr>
<tr>
<td></td>
<td>First Union</td>
<td>$77,314</td>
<td>First Fidelity</td>
<td>$36,214</td>
</tr>
<tr>
<td></td>
<td>PNC</td>
<td>$77,551</td>
<td>Midlantic</td>
<td>$13,305</td>
</tr>
<tr>
<td></td>
<td>First Chicago</td>
<td>$65,900</td>
<td>NBD</td>
<td>$47,111</td>
</tr>
<tr>
<td>1996</td>
<td>Bank of Boston</td>
<td>$47,397</td>
<td>BayBanks</td>
<td>$12,066</td>
</tr>
<tr>
<td></td>
<td>Chemical</td>
<td>$182,296</td>
<td>Chase Manhattan</td>
<td>$121,173</td>
</tr>
<tr>
<td></td>
<td>Wells Fargo</td>
<td>$50,316</td>
<td>First Interstate</td>
<td>$58,071</td>
</tr>
<tr>
<td></td>
<td>National City</td>
<td>$50,587</td>
<td>Integra</td>
<td>$14,391</td>
</tr>
<tr>
<td></td>
<td>CoreStates</td>
<td>$29,729</td>
<td>Meridian</td>
<td>$14,740</td>
</tr>
<tr>
<td></td>
<td>Fleet Financial Group</td>
<td>$84,973</td>
<td>National Westminter</td>
<td>$30,094</td>
</tr>
<tr>
<td>1997</td>
<td>NationsBank</td>
<td>$174,533</td>
<td>Boatmen's</td>
<td>$41,844</td>
</tr>
<tr>
<td></td>
<td>NationsBank</td>
<td>$240,400</td>
<td>Barnett</td>
<td>$44,700</td>
</tr>
<tr>
<td>1998</td>
<td>First Union</td>
<td>$153,700</td>
<td>Core States</td>
<td>$48,500</td>
</tr>
<tr>
<td></td>
<td>NationsBank</td>
<td>$315,000</td>
<td>BankAmerica</td>
<td>$265,000</td>
</tr>
<tr>
<td></td>
<td>Bank One</td>
<td>$116,000</td>
<td>First Chicago</td>
<td>$114,000</td>
</tr>
<tr>
<td></td>
<td>Norwest</td>
<td>$93,100</td>
<td>Wells Fargo</td>
<td>$93,200</td>
</tr>
<tr>
<td></td>
<td>Deutsche Bank</td>
<td>$673,700</td>
<td>Bankers Trust</td>
<td>$156,267</td>
</tr>
<tr>
<td></td>
<td>Travelers</td>
<td>$420,000</td>
<td>Citicorp</td>
<td>$331,000</td>
</tr>
</tbody>
</table>

Source: Shull and Hanweck, 2001
In addition to mergers and restructuring, the banks changed their strategies to adapt to the changing financial environment. Specifically, their strategies were usually explained as a ‘focus strategy’ and as ‘re-bundling’. During the severe competition, they realized the importance of core competence and began to focus on this, i.e., some banks focused on retail banking, others focused on wholesale banking. With the success of the focus strategy, the banks began to combine financial functions that were once separate in order to attain a focused strategy (i.e., re-bundling).

As a result of these strategies, large money center banks and super-regional banks, such as Citigroup and Bank of America, appeared on the scene and their profitability improved rapidly (see Figure 2-3). By the late 1990s, owing to the sluggish performance of Japanese and European banks, many large U.S. banks became highly successful in the international market.

Figure 2-3 Net Incomes of Commercial Banks

![Net Incomes of Commercial Banks](image)

Source: Statistics on Banking, 1996

2.2 Background of the Japanese banking industry

2.2.1 Structures and Functions

Banking firms in Japan are normally classified into three categories: ordinary banks, trust banks, and long-term credit banks.

- **Ordinary banks** are also known as **city banks**, of which there are five. Also included in ordinary banks are regional banks, including member banks with a secondary association
to regional banks that were formerly among the mutual loan and savings banks. In general, the operations of ordinary banks correspond to commercial banks in the U.S. City banks and regional banks are distinguished on the basis of their head office location as well as the size and scope of their operations. In this thesis, I have chosen some city banks for further study.

City banks are generally considered to be the largest and most influential group of banks in Japan. These banks are based in large cities, such as Tokyo and Osaka, and operate on a nationwide scale through networks of branch offices. To support the overseas activities of their client corporations, city banks tend to engage in overseas operation. City banks have traditionally emphasized their business with large corporations, including the major industrial companies in Japan. However, in light of deregulation and other competitive factors, many of these banks have increased their emphasis on other markets.

With some exceptions, the regional banks tend to be much smaller in terms of total assets than the city banks. Each regional bank is based in one of the Japanese prefectures and then extends its operations into neighboring prefectures. Its customers are mostly regional enterprises and local public utilities, although they also lend to large corporations. In line with the recent trend among financial institutions toward mergers or business tie-ups, some regional banks have announced or are currently negotiating such an integration, usually to enable the bank to undertake huge investments to information technology.

➢ Both long-term credit banks and trust banks are engaged primarily in providing long-term loans to Japanese industry., principally with funds obtained from the issue of debentures (in the case of long-term credit banks) and beneficial certificates (in the case of trust banks). Recent changes in the financial markets have adversely affected the traditional function of long-term credit banks, two of which were temporarily nationalized in 1998 following their financial failure. Such changes have also affected trust banks, which are also trying to effect mergers or alliances with other trust banks or with city banks.

2.2.2 Period of Regulations (1940s – 1980s)

After World War II, Japanese banks were protected by the government and several laws. This situation was similar to that of the U.S. banking industry. Early in this period, Japan was occupied by the U.S., and the Japanese government enacted similar types of banking restrictions in Japan, such as Glass-Steagall-type act separating commercial and investment banks. Just as in the U.S. banking industry at the time, Japanese banks had little competition
and the amount of deposits and loans determined the ranking of Japanese banks. Moreover, Japan was in the midst of a high-growth economy until the early 1970s, so many Japanese companies needed money to grow further, and there was a constant shortage of resources. The Japanese banks were able to expand the number of loans easily and collect deposits because there were no other saving products except for bank deposits. As a result, Japanese commercial banks dominated the financial system (Hoshi and Kashyap, 1999).

During this period, Japanese banks were required to provide money to Japanese industry, which in turn promoted economic growth. Therefore the Japanese banks found themselves over-extended and to continually borrow money from the Bank of Japan. They paid attention only to loans and deposits that are assets and liabilities on their balance sheets and did not pay attention to their own equity.

These trends shaped the nature of the Japanese banking business: low equity capital rate and low profitability, such as low Return on Equity (ROE) or low Return on Asset (ROA) (see Figure 2-4). That is, they did not take care of their shareholders but did take care of their relationships to the government and the Ministry of Finance.

In mid-1970s, however, the strong growth of the Japanese economy ended and some important changes occurred in the banking industry. First, because of the economic slowdown, investment in businesses also slowed. The prior shortage of resources among firms dissolved, as they could now acquire money directly from the financial market which had developed and improved. Also, Japanese households began investing in other financial products that became available during this period, because other financial firms, especially securities firms, provided attractive products like money market mutual funds. Consequently, Japanese banking firms saw the source of their profits begin to dwindle, forcing them to find new borrowers and increase the number of loans in the real estate business. The enormous number of such loans created the so-called “bubble economy” of the late 1980s and would ultimately become bad loans in 1990s.

From the late 1980s to the early 1990s, Japan enjoy the bubble economy, which was characterized by unusually high land prices and abnormally high stock prices. During this period, Japanese commercial banks loaned money to borrowers, especially real estate businesses, with guarantees of land or securities as collateral. Table 3-3 shows the increase of loans for the real estate business.
Figure 2-4 ROA in Japanese City Banks and U.S major banks.

![Graph showing ROA for Japanese and US banks over fiscal years 1976 to 1996.]

Source: Hoshi, Kashyap, 1999

Table 2-3 Loans for real estate business through the bubble era

<table>
<thead>
<tr>
<th></th>
<th>To manufacturing</th>
<th>To real estate</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>1984</td>
<td>647,185</td>
<td>192,855</td>
<td>2,508,261</td>
</tr>
<tr>
<td>1985</td>
<td>673,524</td>
<td>235,480</td>
<td>2,751,413</td>
</tr>
<tr>
<td>1986</td>
<td>660,256</td>
<td>309,864</td>
<td>2,981,302</td>
</tr>
<tr>
<td>1987</td>
<td>629,341</td>
<td>364,441</td>
<td>3,266,132</td>
</tr>
<tr>
<td>1988</td>
<td>616,206</td>
<td>411,068</td>
<td>3,501,051</td>
</tr>
<tr>
<td>1989</td>
<td>613,832</td>
<td>469,020</td>
<td>3,846,247</td>
</tr>
<tr>
<td>1990</td>
<td>614,651</td>
<td>484,833</td>
<td>4,087,909</td>
</tr>
<tr>
<td>1991</td>
<td>628,241</td>
<td>506,251</td>
<td>4,210,834</td>
</tr>
<tr>
<td>1992</td>
<td>616,835</td>
<td>524,418</td>
<td>4,223,604</td>
</tr>
</tbody>
</table>

Source: Mitsuhashi, Uchida, Ikeda, 2001
2.2.3 **Collapse of the Bubble Economy and Deregulation (1990s -)**

About the mid-1990s, the Japanese banking industry began to experience a period of turbulence. First the bubble economy collapsed, which caused many loans to go into default. But another reason was deregulation itself and the Financial System Reform, the so-called "Big Bang" which was intended to make the Japanese financial markets "free, fair, and global". Still today, however, many Japanese banks are caught in this tempest and struggling to escape. I will discuss these events in more detail below.

The collapse of the bubble economy had a major impact on the banking industry. As I mentioned earlier, Japanese banks made a large number of loans to real estate businesses through the bubble period. But after the bubble burst, and because of the economic recession, many Japanese firms encountered financial difficulties and could not repay their outstanding loans to the banks. At the same time, land prices dropped and the market price of the real estate collateral no longer covered the amount of the outstanding loans, and they became bad loans. By 1998, bad loans comprised an estimated 7% of GDP (Hoshi & Kashyap, 1999). Taking into account the banks' low equity capital rate, some banks could not retain their standing and they too went bankrupt.

To avoid the whirlwind sweeping through both the banking industry and the general Japanese economy, in 1999 the government decided to introduce a system of public funds to help rescue the banks. Almost all Japanese city banks, except for Bank of Tokyo-Mitsubishi, applied for this money and received ¥7.4592 trillion in public funds (Mitsuhashi et al., 2001). In order to obtain these funds, the banks had to submit restructuring plans that includes eliminating 20,000 workers, closing 10% of their branches, and increasing profits by 50% over the next four years (Hoshi & Kashyap, 1999). To avoid further disruption to the financial system, the government enacted the Financial Reconstruction Act of 1996 which included a tenet stating that weak banks would be nationalized and restructured.

Deregulation in the Japanese financial market proceeded apace. Although the interest rates of the interbank market were deregulated in the late 1970s, and regulations for other interest rates (except bank deposits) was abolished in the 1980s, the interest rate for bank deposits was still regulated by the government. However, in 1993, this restriction was also eliminated and all interest rates in Japan were deregulated.

To make the financial markets free, fair, and global, the government decided to introduce a program of Financial System Reform, the so-called "Big Bang", of 1996. At the time, although the Financial System Reform of 1993 permitted banks to enter the securities and trust businesses through their subsidiaries, the operation of each subsidiary was severely restricted. However, with the advent of the Big Bang, banks were permitted to establish
holding companies, and the restrictions were eliminated. Before the Big Bang, the barriers regulating entrance into the banking business were handled by the government for companies in other industries; after the Big Bang, other companies were permitted to enter the banking business. Soon there were many new entrants from other industries, and the banking business immediately became more competitive. In addition, the restrictions enacted by the Ministry of Finance are scheduled to be abolished and the Deposit Insurance Law will be eliminated sometime in 2002.

The Big Bang had a major impact on the Japanese financial markets. Many banking firms faced severe competition, some commercial banks went bankrupt or were nationalized, and several large financial firms went bankrupt. For example, Hokkaido Takushoku Banks, one of the city banks, suspended its operations; Yamaichi Securities, one of the largest securities firms, went bankrupt; Sanyo Securities defaulted in 1997 (see Table 2-4).

<table>
<thead>
<tr>
<th>Institutions</th>
<th>Date (Press Release)</th>
<th>Terms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nissan Life Insurance</td>
<td>Apr-97</td>
<td>The Ministry of Finance of Japan ordered the company to suspend its operation</td>
</tr>
<tr>
<td>Sanyo Securities</td>
<td>Nov-97</td>
<td>The company filed an application for rehabilitation</td>
</tr>
<tr>
<td>Hokkaido Takushoku Bank</td>
<td>Nov-97</td>
<td>The Ministry of Finance of Japan ordered the company to suspend its operation</td>
</tr>
<tr>
<td>Yamaichi Securities</td>
<td>Nov-97</td>
<td>The Ministry of Finance of Japan ordered the company to suspend its operation</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>Feb-98</td>
<td>Merrill Lynch takes some branches and employees of Yamaichi Securities and establish a new company.</td>
</tr>
<tr>
<td>Industrial Bank of Japan and Nomura Securities</td>
<td>May-98</td>
<td>Establish two joint venture companies</td>
</tr>
<tr>
<td>Nikko Securities and Salomon Smith Barney</td>
<td>Jun-98</td>
<td>Establish two joint venture companies</td>
</tr>
<tr>
<td>Sumitomo Bank and Daiwa Securities</td>
<td>Jul-98</td>
<td>Daiwa Securities will transform into a holding company which holds subsidiaries specializing in retail business</td>
</tr>
<tr>
<td>Tokai Bank and Asahi Bank</td>
<td>Sep-98</td>
<td>Comprehensive alliance. (Merge outlet and ATMs, reorganize overseas operations and make a holding company)</td>
</tr>
<tr>
<td>Fuji Bank and Daiichi Kangyo Bank</td>
<td>Oct-98</td>
<td>Merge trust bank subsidiaries</td>
</tr>
<tr>
<td>Daiwa Bank</td>
<td>Oct-98</td>
<td>Suspend its overseas operations. (Become super regional bank in Kansai area)</td>
</tr>
<tr>
<td>Mitsui Trust and Chuo Trust</td>
<td>Jan-99</td>
<td>Merge</td>
</tr>
<tr>
<td>Sanwa Bank and Toyo Trust</td>
<td>Jan-99</td>
<td>Are forming comprehensive alliance around the pension business</td>
</tr>
<tr>
<td>New Japan Securities and Wako Securities</td>
<td>Mar-99</td>
<td>Merge</td>
</tr>
<tr>
<td>Industrial Bank of Japan and Fuji Bank and Daiichi Kangyo Bank</td>
<td>Aug-99</td>
<td>Are forming a holding company (restructure their business until 2002)</td>
</tr>
<tr>
<td>Sumitomo Bank and Sakura Bank</td>
<td>Oct-99</td>
<td>Merge</td>
</tr>
<tr>
<td>Sanwa Bank and Tokai Bank and Toyo Trust</td>
<td>Jul-00</td>
<td>Are forming a holding company (restructure their business until 2002)</td>
</tr>
</tbody>
</table>

Because of the amount of bad loans, the Long-Term Credit Bank of Japan and Nippon Credit Bank were nationalized in 1998. Also, to survive the competition, large mergers and alliances occurred, not only among small regional banks but also large city banks and companies in other industries such as securities companies. As a result, the number of Japanese city banks was reduced from 13 to 6 in 1989 and 2002, respectively (see Table 1-1 and Table 2-4).

At that time, the banking industry also began to see new entrants from other industries, such as securities and insurance, and non-financial industries such as retail firms like Ito-Yokado Bank and manufacturing firms like Sony Bank. Financial companies from foreign countries also began aggressively entering the Japanese market, aiming to obtain a significant portion of personal financial assets which had not yet been effectively exploited.
In this chapter, I discuss general theories of knowledge management. As noted in Chapter 1, after the Industrial Revolution, managers in many companies believed that tangible assets, such as plants, land, and equipment, were the most important prerequisites for success, so they tended to invest significant amounts of money into tangible assets rather than intangible assets. However, as the economy matured, attention began to focus on employees and their knowledge. Owing to this change of focus, several theories of knowledge management were published in the early 1990s.

3.1 KNOWLEDGE-BASED SOCIETY

In recent years, knowledge has been recognized as one of the most important assets a firm can possess. According to a 1994 OECD report, the knowledge creation activity increased from 29% in 1958 to 34% in 1980. Also OECD reported that there is "a clear trend in OECD countries towards an economy where the share of the labor force handling tangible goods is becoming much smaller than the share engaged in the production, distribution and use of information" (OECD 1996, p. 15 and 16). With the rapid spread of the Internet and the development of network technologies, people can easily obtain many kinds of complicated and diverse information. As a result, companies can no longer satisfy their customers with products. They need to add other value to their products and make distinctions that set themselves apart from other companies' products. Many companies, such as IBM or HP, have chosen to provide a service business. And because the markets are changing drastically, technologies have become diversified, and products are becoming more rapidly commonplace.

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1 In its report, OECD defined the knowledge creating activity as five categories of industry; education, communications media, information machines, information services, and other information activities.
This means companies must find or develop and then implement innovations in order to survive in this severe competition.

While all companies pay attention to their tangible assets, in the past most thought of their employees as accompaniments of these tangible assets. However, in today’s economy, it is apparent that knowledge plays an important role for societies, industries and companies, and most companies now realize that the best source of innovation is knowledge that is inherent in their employees and organization. Lester Thurow (1999) referred to today’s economy as a “third industrial revolution”. Markets also recognize the importance of company knowledge and they incorporate such knowledge as intangible assets in the overall evaluation of a firm.

Margaret Blair of the Brookings Institute calculated the relationship between tangible assets and market values of manufacturing and mining companies in the U.S. (Rollo and Clarke, 2001). In 1982, tangible assets were 62.3% of market value; however in 1992, the percentage had declined to 37.8%. The percentage in high-technology companies and service companies is much lower. Also Rollo and Clarke (2001) calculated and compared the market valuations of Microsoft and General Motors (GM). Although GM had an employee turnover rate that was 15 times greater than that of Microsoft, GM’s market capitalization was only 12% of Microsoft’s. These facts indicate that many people recognize company knowledge and intangible assets as an important source of strength and economic value.

Drucker (1988) pointed out that the knowledge worker is the most important asset for companies in a knowledge-based society. The competitive strength of a firm is determined by its quantity and quality of knowledge workers. However, knowledge, unlike physical assets, usually belongs to the workers. If companies have no plan in place to make the most of their workers’ knowledge, then that knowledge cannot contribute to maintaining the companies’ strength. To understand how to make the best use of knowledge, I will discuss theoretical aspects of knowledge management in the next section.

### 3.2 KNOWLEDGE MANAGEMENT

Knowledge is different from data and information. Knowledge is richer and more complex than these other valuables. Although there are many books and articles that define knowledge, I believe the following is appropriate:

Knowledge is a fluid mix of framed experience, values, contextual information, and expert insight that provides a framework for evaluating and incorporating new
experiences and information. It originates and is applied in the minds of knowers. In organizations, it often becomes embedded not only in documents or repositories but also in organizational routines, processes, practices, and norms. (Davenport & Prusak, 1998, P. 5)

The relationship among knowledge, information, and data is shown in Figure 3-1. Data is a raw valuable. For instance, even though we collect a significant amount of data, these data are not useful without refinement. After refining data, its value becomes information. There are refining processes, such as gathering data, calculating data, or removing errors in data. According to the definition of knowledge, after people or organizations use information, and experience and learn something from it, information then changes to knowledge.

![Figure 3-1 Knowledge, Information and Data](Image)

Source: Rollo and Clarke, 2001

In some cases, knowledge is intangible for organizations or employers. It is difficult for them to realize and manage knowledge, but it is necessary to do so to make the best use of knowledge in a knowledge-based society. According to Nonaka and Takeuchi (1995), using knowledge is not enough to maintain competitive advantage and develop an innovation. They suggest that companies should create knowledge continuously.

Knowledge has two aspects: explicit and tacit, and there are four different processes for converting knowledge: socialization, externalization, combination, and internalization. Through these processes, companies can create knowledge continuously (see Table 3-1).
Socialization is a process in which tacit knowledge belonging to an individual worker is spread to a group or organization. Tacit knowledge crystallizes into explicit knowledge through a concept, an analogy, or a metaphor. This process is called externalization. The combination process combines some explicit knowledge through communications, such as conferences, documents, or e-mails. Internalization is a process of embodying explicit knowledge. Usually this process occurs through "learning by doing".

**Table 3-1 Four Processes of Knowledge Conversion**

<table>
<thead>
<tr>
<th>Process</th>
<th>From</th>
<th>To</th>
<th>Explanations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Socialization</td>
<td>Tacit</td>
<td>Tacit</td>
<td>A process of sharing experiences and creating tacit knowledge inside an organization. In this phase, a tacit knowledge belongs to an individual and spreads to an organization.</td>
</tr>
<tr>
<td>Externalization</td>
<td>Tacit</td>
<td>Explicit</td>
<td>A tacit knowledge, intangible knowledge, crystallizes into an explicit knowledge through a concept, an analogy, a metaphor, and so on.</td>
</tr>
<tr>
<td>Combination</td>
<td>Explicit</td>
<td>Explicit</td>
<td>A process of combining explicit knowledge through communications, such as conferences, documents, e-mails, and so on.</td>
</tr>
<tr>
<td>Internalization</td>
<td>Explicit</td>
<td>Tacit</td>
<td>A process of embodying explicit knowledge. Usually, this process occurs through &quot;learning by doing&quot;. The rapid-prototyping method is one example of this process.</td>
</tr>
</tbody>
</table>

Source: Nonaka, 1995

Among these improvement processes of knowledge creation, knowledge transfer is one of the most important and most difficult processes. The transfer usually occurs through communication among knowledge workers, such as conversations, e-mail, or from a database. Therefore, some companies actually prepare a physical space where their employees can talk with each other or use their network infrastructure to exchange and store an individual's knowledge. Other firms offer a variety of tools, such as e-mail, bulletin boards, chat rooms, or databases, to help transfer knowledge. In some Japanese companies, employees tend to dislike sharing their knowledge through e-mail or a database. They prefer to expand their knowledge through *nomikai*, or an after-work dinner (Davenport & Prusak, 1998).
In order to transfer knowledge, organization style and the organization itself play an important role. Companies should consider their organization style, whether it encourages employees to communicate with each other easily and provides an appropriate method for transferring knowledge. Moreover, they should pay an attention to cultural differences. There are some who believe style is the best avenue for knowledge creation. For instance, Nonaka and Takeuchi (1995) suggest that a “hypertext” organization\(^2\) and a “middle-up-down”\(^3\) management is the best structure. On the other hand, Drucker (1988) recommends that the flat organization accommodates itself to a knowledge-based economy, and that knowledge should move to a lower layer. Moreover, he believes that the middle manager is no longer needed. It seems that the “best” organizational structure depends on various cultural and industry issues. Therefore there is no one correct answer for an appropriate organizational structure.

Many theories of knowledge management have been published in recent years, each attempting to analyze several examples and provide appropriate answers. However, there are differences among the experts, especially between Japanese experts and experts from Western countries. I believe knowledge management is highly dependent on cultural issues, even in today’s global economy, because each company has its own background. Therefore it is not possible to apply successful examples of U.S. companies to Japanese firms directly or vice versa. Companies need to identify their own style of knowledge management by applying a variety of theories and via trial and error.

### 3.3 INFORMATION TECHNOLOGY IN KNOWLEDGE MANAGEMENT

As mentioned above, corporate culture and organization structure are important to knowledge management. On the other hand, information technology also plays an important role in the practice of knowledge management. Before discussing information systems and knowledge management software, we should first define a knowledge management system accurately.

A knowledge management system cannot treat knowledge itself, because knowledge is not in the knowledge management system but in the humans themselves who use the management system. Therefore, the knowledge management system provides efficient

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\(^2\) This is a non-hierarchical, self-organizing structure that works in tandem with a formal hierarchical structure. (Nonaka and Takeuchi, 1995: 166).

\(^3\) This process puts middle managers at the center of knowledge management, positioning them at the intersection of vertical and horizontal flows of information within the company. (Nonaka and Takeuchi, 1995: 127).
information for the knowledge worker and should be considered merely as a tool for knowledge management.

There are many types of knowledge management software on the markets. Typical examples are relational databases (such as Oracle or Sybase), groupware (such as Lotus Notes), document management systems, and database search engines. Companies introduce software on their intranet or the Internet and connect their legacy systems to collect appropriate information in a timely manner. These systems are useful for both internal and external use. Internally, knowledge management systems are effective in collaborative development, data and document storage, learning services, and searching for best practices. Externally, they are useful in customer relationship management (CRM), obtaining competitive intelligence, outsourcing, and cooperating with partners (Rollo and Clarke, 2001).

3.4 EXAMPLES OF KNOWLEDGE MANAGEMENT

Table 3-2 shows several companies that have recognized the importance of knowledge and during the 1990s applied various methods of knowledge management. For instance, in the case of consulting firms, their selling points are knowledge and a specialty owned by the company. Therefore consulting firms realized importance of knowledge relatively early and undertook efforts to make the best use of their employees' knowledge and information.

Even among consulting companies, however, there is more than one way to apply knowledge management. In the case of Andersen Consulting and Ernst & Young, they use a codification strategy for their knowledge management. This strategy collects and stores significant amounts of information and reuses this stored knowledge. Naturally, they tend to invest heavily in information systems. On the other hand, McKinsey & Company and Bain & Company focus on communication among knowledge workers. This strategy is called a "personalization strategy." They pay attention to tacit knowledge and stress meetings and one-on-one training. Their IT investment has been moderate (Hansen et al., 1999). Thus, even in one industry, there is no single way to apply knowledge management.
### Table 3-2 Knowledge Management

<table>
<thead>
<tr>
<th>Industry</th>
<th>Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td></td>
</tr>
<tr>
<td>Foods</td>
<td></td>
</tr>
<tr>
<td>Chemicals</td>
<td>Corning, The Dow Chemical, Monsanto, Hoffmann-La Roche, Pfizer, Buckman Laboratories International, Eisai</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td></td>
</tr>
<tr>
<td>Biotechnology</td>
<td></td>
</tr>
<tr>
<td>Energy</td>
<td>BP Amoco p.l.c, Chevron Chemical, Shell Oil, Bechtel</td>
</tr>
<tr>
<td>Engineering</td>
<td></td>
</tr>
<tr>
<td>Banking</td>
<td>Skandia Insurance, World Bank, Canadian Imperial Bank, Canadian Imperial Bank of Commerce, Bank of Montreal, Westpac Institutional Bank, Chase Manhattan</td>
</tr>
<tr>
<td>Financial Services</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td></td>
</tr>
<tr>
<td>Information Technology</td>
<td>IBM, Hewlett-Packard, Texas Instruments, Unisys, Fujitsu, Lucent Technology, Intel, Microsoft, AT&amp;T, Deutsche Telekom, Pacific Bell, NTT, NTT Data, Recrut</td>
</tr>
<tr>
<td>Telecommunications</td>
<td></td>
</tr>
<tr>
<td>Consulting</td>
<td>Ernst&amp;Young International, Booz Allen &amp; Hamilton, KPMG Consulting, McKinsey, PricewaterhouseCoopers, Arthur Andersen</td>
</tr>
<tr>
<td>Aerospace</td>
<td>Boeing, BAE Systems, Rolls-Royce, United Technologies</td>
</tr>
<tr>
<td>Defence</td>
<td></td>
</tr>
</tbody>
</table>

Source: Rollo and Clarke, 2001; Nonaka and Konno, 1999

Nonaka and Takeuchi (1995) point out that Japanese companies, especially manufacturing firms, traditionally understand how to use their tacit knowledge effectively.

The explanation of how Japanese companies create new knowledge boils down to the conversion of tacit knowledge to explicit knowledge. Having an insight or a hunch that is highly personal is of little value to the company unless the individual can convert it into explicit knowledge, thus allowing it to be shared with others in the company. Japanese companies are especially good at realizing this exchange between tacit and explicit knowledge during the product development. (p. 11)

Many Japanese companies used their tacit knowledge effectively to create and implement innovations during the revival of the Japanese economy after World War II. That is, these companies managed their knowledge intuitively, long before the trend toward knowledge management and without the use of information systems.
Therefore, it can be supposed that the most important factor for managing knowledge is not information technology but organizational structure and management methods. Information technology merely supports knowledge management.

The companies listed in Table 3-2 found success via the use of knowledge management. Before these successes, they have struggled and gone through trial-and-error before finally identifying the best answer for the company. However, knowledge, information and a company’s environment, including such factors as customer preferences or information technologies, change all the time. Therefore firms need to continually check their knowledge management style and improve their strategies.

3.5 KNOWLEDGE IN BANKING FIRMS

Before moving on to knowledge in banking firms, I would like to define and explain the characteristics of banking firms.

Banks have two aspects: a financial service, and a manufacturer of financial products. First, they provide financial information and consulting to their customers. In the past, with government protection, banks did not need to provide such services because they could earn their profits from their traditional banking products, such as deposits, loans, and mortgages. However, in recent years the environment of the banking industry has changed. After deregulation, competition became intense among not only traditional banks but also new entrants into the industry, and banks were forced to develop and offer additional services and provide more information to their customer in order to sustain their competitiveness. These circumstances forced traditional banks to become financial service firms. In this sense, the banking industry is a service industry.

On the other hand, banking firms also have an aspect of manufacturing. They are the inventors and producers of financial products. Recently, financial products have become more and more complex. Also, they had to develop and maintain an information system and an e-commerce system because operations in banking firms are highly dependent on information technology. Thus, banks have the aspect of manufacturers and information technology firms.

The banking industry in both Japan and the U.S. is engaged in severe competition because of deregulation and improved information technology (I will go into greater detail about the current situation of the industries in Chapter 3). Therefore, banking firms in both countries need to constantly create new products and value for their customers, or they will not survive. These changes are financial innovations. In order to develop innovations
continually, the knowledge inherent in their employees is important to banks. Before deregulation, banks paid little attention to their employees' knowledge. Banks offered typical products, did not innovate, and were prohibited by the government from providing a wide array of products and services. However, after deregulation there were many new entrants from other industries, such as securities companies, insurance companies, investment banks, and retail sellers. These companies introduced fresh financial products and services, and suddenly traditional banks needed to create their own innovative services and products in order to compete with these new rivals. The traditional view is that one of a bank's most important assets is its employees because they do not have plant and equipment like manufacturing companies. But it would be difficult to say that banks made the best use of their employees in the era prior to deregulation.

There are several specific fields where knowledge plays an important role in banking firms. Customer relationships are probably the most important issue for commercial banks. Almost all large banks, such as Japanese city banks, U.S. money center banks, or U.S. super regional banks, realize the importance of customer relationships in retail and wholesale banking. Banks are constantly seeking sources of profit, and it is well known that there are significant amounts of individual assets that have not been captured by banks in both the United States and Japan. In order to sustain profitability, banks need to focus on customer relationships and manage them carefully—the classic definition of customer relationship management (CRM).

Knowledge about their customers tends to be held by front officers who work for a bank branch and are in charge of the retail or wholesale banking operations. However, each officer's knowledge is not sufficient to understand all customer needs well because customers may use the bank via various interfaces, such as branches, ATMs, call centers, websites, and so on. Therefore, if banks wish to offer appropriate products and services to customers, they need to collect and analyze information from customers and knowledge from employees, which will enable sales officer to conduct their business on the basis of this information and relevant analyses. Also, as financial products become more complex, it is difficult for branch officers to be completely familiar with every product. Sales personnel cannot offer the proper products to customers without a deep knowledge of the available products. One solution is to communicate with those who are in charge of product development and obtain their knowledge and information about the products.

The concept of customer knowledge is also an important way to improve service and products provided by banks. Basically, a bank's services and products are provided based on customer preferences. In the past, banks did not pay much attention to customer preferences because of government regulations, which kept all products and services virtually the same
from one back to the next. After deregulation, however, banks began to realize the importance of customer preferences, and the concept of acquiring customer knowledge is one a fundamental issue in CRM.

Knowledge in the development process is also important for banks. For instance, information systems are critical to sustaining the banking business, so development and maintenance of such systems is one of the most important jobs in the company. There are two issues involved in the development and maintenance of banking information systems. First, because of improvements in information technology, banking firms have difficulty keeping current with the latest technology internally. It is impossible for banks to educate all the appropriate workers because they are not specialists in this field. Therefore banks tend to outsource or hire skilled personnel to acquire the latest knowledge from outside sources. Second, during maintenance, banks should consider knowledge transfer. They almost always use superior workers for the development phase, but in the maintenance phase other workers are in charge of maintenance because the superior workers have moved on to other projects. Therefore banks should consider methods of knowledge transfer to maintenance personnel after development is completed. The same situation can be seen in the development of financial products such as derivatives.
Chapter 4
The U.S. Banking Industry Today

In this chapter, I discuss the U.S. banking industry from several perspectives: its organizational structure, management of knowledge, human resources management, and outsourcing issues.

As I mentioned in Chapter 2, after the mid-1960s, U.S. banking firms encountered severe competition during an unstable period, with each bank developing and implementing various strategies. Some firms tried to provide a wide range of financial services; some focused on niche market and products to survive the competition; many mergers occurred during this period as the industry underwent a major restructuring.

At the time, the banks needed a new type of knowledge, not just knowledge of the financial business, such as insurance, mutual funds, or financial derivative products, but also knowledge of information technology, which was important for managing risk and customer relations. Banks tried to restructure the knowledge they already owned—knowledge about banking loans and deposits, and knowledge about managing their widespread branch network. This knowledge was their core strength, enabling them to compete with invaders from other industries, such as investment banking, insurance companies, and retail financial firms.

4.1 The Employment System in Commercial Banks

In general, employee turnover rates, especially among highly skilled workers, are higher in the U.S. than in other nations. According to a survey report in 2001, the turnover rate among U.S. banking firms was 25.8% (Institute of Management & Administration, 2001). This number was second only to the retail and wholesale sales industry. By comparison, Japanese statistics indicate that the turnover rate in the Japanese banking industry was 13.9% and 16.1% in 1999 and 2000, respectively (Ministry of Health, Labor and Healthcare).

The higher turnover rate in the U.S. has been attributed to the fact that employees are
offered higher salaries and positions from several companies, so they tend to think that changing companies is the best way to succeed and to improve themselves. The net effect, however, is that employees in U.S. companies tend to feel little loyalty for their companies. Also, because of the high turnover rate, U.S. banking firms tend not to train their employees nor do they attempt to acquire their knowledge from outside. The recent trends of downsizing and re-engineering mean the banks are less interested in cultivating and training employees. Large U.S. banking firms, such as money center banks or super-regional banks are in similar situations.

Bank employees can be classified into three general categories: branch officers, platform employees, and specialists (i.e., traders for foreign exchange market or IT specialists).

➤ **Branch officers** include tellers who are in charge of withdrawals and deposits from customer accounts. Some higher-level tellers also have the authority to open and close accounts and consult with customers about their deposits. Other branch officers are the clerks who work in the loan department as a credit analyst or loan officer, and are responsible for lending money to enterprises and consumers. They need a solid understanding of how the banking system works as well as good sales skills.

➤ **Platform employees** include branch managers, who are responsible for overseeing all activities at the branch including opening new accounts, loan origination, solving customer problems, foreign exchange, and safe deposit boxes. Those who work at the head office are also platform employees. This includes employees who work for the Planning Division and are responsible for developing the company’s future vision or next year’s budget. Employees in the Human Resource division are responsible for all company personnel issues, and they make decisions regarding moving employees among the branches.

➤ **Specialists**: As banking business has evolved in recent years, specialists have become highly important for banks. Because the banking industry depends on technology, banks tend to hire many IT specialists. These employees must have knowledge not only about the latest technologies but also about the banking business itself. And, as financial products become more complex, banks need financial specialists such as traders and financial product developers.

In the following sections, I discuss each of these categories of employees in greater detail.

4.1.1 **Branch Officers**
In the past, branch officers, tellers, and clerks needed only a high school education in order to become bank employees. Once they began working, the bank sent them to training programs provided by an official banking organization.\footnote{Such as American Institute of Banking (AIB), American Bankers Association, Institute of Financial Education (IFE), or Bank Administrative Institution.} Also they became part of the internal labor pool and part of the job pyramid. Tellers and clerks who had a college degree or had participated in special programs offered by the company, could take a managerial position.

With the advent of cutting-edge information technology and new banking strategies, changes occurred in the banking industry in the early 1990s. At that time, most banks were transaction-oriented as a way to deal with costs and high turnover. To reduce costs, they hired part-time employees rather than full-time, and spent as little as possible on training front-office employees. By 2000, 11% of employees were part-time workers (U.S. Department of Labor, 2002). And instead of spending money for training, banks made their work process highly segmented, and opted to spend their resources on information systems (Keltner and Finegold, 1996). As a result, many clerks and tellers knew only one job.

By the mid-1990s, a different trend occurred, the so-called “customer-centric” or customer relationship management (CRM), in which banks provided relationship-based service. In order to satisfy customer requests, it was necessary for banks to provide a variety of financial products and services. This meant having bankers who could speak knowledgeably about a wide range of financial products to the bank’s customers. In other words, the banks trained not only personal financial advisors who worked in the head office but also tellers and clerks who worked at the branches (Keltner and Finegold, 1996).

Today the number of employees who work for branches is declining because of automation, better information technology, and a bank strategy that includes call centers to handle customer inquiries (U.S. Department of Labor, 2002). At the same time, the demands placed on branch officers and the knowledge requirements have become more difficult and complex in the recent years.

4.1.2 Platform Employees

According to research conducted by Hunter, et al. (Mar 2001), some changes also occurred that affected platform employees in commercial banking firms. Before 1980, most commercial banks tended to hire college and high-school graduates. Even money-center banks, such as Citibank, Morgan, and Chase, rarely recruited people with an MBA or other
advanced degree (Rogers 1992). There are two reasons. First, in those days banks did not need to hire people with advanced degrees or special knowledge. Second, students with advanced degrees had little interest in commercial banking which was protected by government regulations.

After 1980, however, the situation changed. With deregulation came the need for special knowledge about finances and customer relationships, so commercial banks sought people with MBAs or at least a four-year college degree. These employees became key to the banks’ customer relationship strategy, and the employees were expected to become not just product specialists but also consultants for customers. In order to reduce their training costs, commercial banks also hired outsiders who had relevant knowledge about customers and products.

4.1.3 Specialists, Traders, and Dealers

In recent years, as bonds, foreign exchange, and securities have become more complex, banking firms have hired traders who have a different set of skills. In the 1980s, there were few derivatives products, and customer needs were simpler, so it was enough for traders to know a few markets and be familiar with macro- and micro- economic trends. These positions were relatively uncomplicated, and required much less specialized knowledge, so people with an economics degree or even high school graduates could become traders.

By the 1990s, however, as financial derivatives have become popular and customer demands more complex, traders needed many more skills. This included not just knowledge of economics and markets but also mathematical analysis and computers. The best traders also have an intuitive sense for market trends. Furthermore, to create new financial products that met customer demands, traders had to work with other employees in marketing and other financial markets.

Some companies hired traders who work well in teams (Jenna 1992). These people require several types of knowledge, and banks found it difficult to find that kind of knowledge in people who had recently graduated from college. What the banks needed were traders who had experience and a good track record. That was tricky, however, because it is difficult to learn about a trader’s real performance; thus most traders were hired on the basis of their reputation (Ronan 1996). Today some banks, especially investment banks, have special training program for new graduate employees. Figure 4-1 shows the typical process of employment in U.S. investment banks and the investment banking divisions of U.S. money center banks.
4.1.4 IT Specialists

The number of specialists with IT skills is simply not sufficient because virtually every industry depends on their information system and the desire to remain current with their technology. Almost all companies need people who are fluent for computer languages such as C++ or Java, new infrastructures such as Unix or WindowsNT, or database administration. According to Collective Technologies’ president, Ed Taylor, 18,000 new Unix system administrators and 29,000 new WindowsNT systems engineer were needed in 1996 (Fryer 1998).

The development of front office, middle office, and back office IT systems means that banks find themselves in a similar situation. In the past, especially in case of mainframe computers, it was enough for system engineers to know about operating systems, databases and applications; the financial business they had to learn was relatively easy. However, the situation has changed today, and system engineers need to know about a variety of IT environments as well as complex financial products. Rupinder S. Puri, Vice President of Chase Manhattan Bank, said: “The old world is gone where job functions like programming and database design were separate and distinct. Today we need people with a multitude of technology skills and an understanding of business needs—who can build and integrate the required applications” (Sheila 1994).

It has been my experience that it takes three or four years to learn about all the technology environments and then three or four years later most of them have changed
completely. Of course, there are not enough engineers in the banking industry to fill the
demand, so banks look everywhere for knowledgeable people, whether they come from the
banking industry, other industries, or even from other countries. Many banks find people in
other industries, such as IT firms, airline companies, or companies like UPS and Federal
Express (Sheila 1994). Beyond the in-house need for technical experts, many commercial
banking firms also provide information and services through the Internet, which requires
employees who have advanced skills in web-based technology. This trend will undoubtedly
continue, and indeed grow, because the banking industry has become a thoroughly
IT-oriented industry.

4.1.5 Compensation Systems

The public believes that most U.S. bankers earn a high salary. In some cases, this is
true, but in fact the average earnings of bankers prove otherwise—the wages of American
bankers are relatively low (see Figure 4-2). This illusion comes from a small group of
bankers who have sophisticated skills, such as trading or IT skills. In the past two decades,
the earnings differential between highly educated people with IT or financial derivatives
skills, and less-educated people became even greater (Hunter, et al., 2001). This occurred
not only as a result of new technology itself but also because of changing organizations and
strategies among banks because of new technology. Table 4-1 shows the average earnings of
U.S. each type of banking occupation.

In particular, compensation for traders has increased because service and income
from trading plays an important role in banking firms, and many believe there are only a few
excellent trader who perform well all the time. They need these traders’ knowledge, which is
mainly tacit knowledge, because most all their knowledge is intuitive, such as intuitions for
market trends and mathematical analysis. So banks offer higher compensation to these
traders, hoping to retain their loyalty and to fend off other competitors (Ronan 1996).
Figure 4-2 Transition of wages among U.S. industry

Source: Bureau of Labor Statistics (Web Site)

Table 4-1 Average Hourly Earnings in U.S. banking forms

<table>
<thead>
<tr>
<th>Occupation</th>
<th>Average Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computer Software Engineers</td>
<td>$33.43</td>
</tr>
<tr>
<td>General and Operations Managers</td>
<td>$29.41</td>
</tr>
<tr>
<td>Financial Managers</td>
<td>$32.22</td>
</tr>
<tr>
<td>Financial Analysts</td>
<td>$25.20</td>
</tr>
<tr>
<td>Loan Officers</td>
<td>$19.92</td>
</tr>
<tr>
<td>Credit Analysts</td>
<td>$19.32</td>
</tr>
<tr>
<td>Securities, Commodities, and Financial Sales A</td>
<td>$26.96</td>
</tr>
<tr>
<td>Customer Service Representatives</td>
<td>$11.83</td>
</tr>
<tr>
<td>New Account Clerks</td>
<td>$11.10</td>
</tr>
<tr>
<td>Tellers</td>
<td>$9.21</td>
</tr>
</tbody>
</table>

Source: U.S. Department of Labor, 2002
In the case of system engineers, due to a shortage of engineers, their compensation has also increased. Traditionally, banks pay less salary to system engineers, but recently they have begun to realize the importance of IT, so to maintain motivation and avoid losing good employees, banks have also raised compensation for system engineers (Sheila, 1996)

4.2 ORGANIZATIONAL STRUCTURE OF BANKS

Large U.S. banks typically have the structure of their parent company. That structure came from two banking industry regulations: restrictions on doing business across state lines, and regulations on business among banking, securities, and trusts. For example, Bank One is one of the largest super-regional banks in the United States. It has branches in 33 states. Its method of expansion is to purchase a small regional bank and combine it under the umbrella of the holding company. This strategy means that each bank retains its independence but joins Bank One's group (Hisahara 2000). Other super-regional banks, such as Bank of America, have a similar strategy.

Another example is CitiGroup. This is one of the largest money center banks with a goal of building a financial supermarket that can provide every kind of financial product, from traditional banking products to securities and insurance. To achieve this goal, CitiGroup needed to make an alliance with an investment bank and an insurance company. In 1998, Citicorp (the forerunner of CitiGroup) merged with Travelers, a large insurance company. At the time, Travelers had an investment bank, Salomon Smith Barney, under its group umbrella. After the merger, CitiGroup became the holding company and it now has several financial functions under its umbrella. Figure 4-3 shows the organizational structure of CitiGroup. Other large money center banks, such as J.P. Morgan Chase, also have this type of organizational structure.
In general, it is said that a holding company has a following demerit. As each subsidiary is independent organization and a holding company has no power to coordinate among subsidiaries, it is difficult for a whole company to make a synergy effect. However in case of banking industry, banks have been regulated to do their business across some states or financial products, therefore they had to have such kind of structure. It is actualities that many large banks, which have holding companies, make managerial efforts to avoid inefficiencies of structure of holding company.

4.3 CUSTOMER RELATIONSHIP MANAGEMENT (CRM)

4.3.1 The Need for CRM in the U.S. Banking Industry

As I discussed earlier, the U.S. commercial banking industry faced severe competition in the 1980s because of deregulation, globalization, and new technologies. In order to mitigate the competition, many U.S. commercial banks began to realize the importance of meeting customer needs and the need for focused marketing to learn about what customers were seeking. In addition, customers began to learn about other financial firms, such as investment banks and insurance companies that also provided financial
products that were often more attractiveness that the banks' product. The banks found that they needed to listen to and understand their customers' voices, which meant learning about and then focusing on a new method known as Customer Relationship Management (CRM) as well as mass customization of their financial products and services. Especially in retail banking, many commercial banks believed they could improve their profit and satisfy customer needs by listening to and analyzing those needs.

During this time, the banks were also being threatened by new entrants—small and fast-growing financial companies like Capital One. These new entrants focused on niche markets, and their target customers were smaller groups of customers, because if the new entrants focused on the same target customers as the large financial corporations, they could not compete with the large banks. Also the new entrants provided fewer types of financial products which made it easier to collect and analyze customer information, whereas the large commercial banks provided a wide range of financial products aimed at many kinds of customers.

Traditionally, U.S. banking firms focus on marketing. However, all the large banks provide similar kinds of financial products to their customers, and their marketing tended to target all kinds of customers, the so-called “mass marketing”. But as customer needs became more diversified, the concept of “mass customization” was introduced into marketing. This meant that a company could offer products that satisfy its customers’ needs while also gathering customer data, analyzing it, and creating new products. This method is what became known as CRM. Table 4-2 shows the difference between mass marketing and CRM.

<table>
<thead>
<tr>
<th>Table 4-2. Differences between Mass Marketing and CRM</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mass Marketing</strong></td>
</tr>
<tr>
<td>Sell one product to many customers</td>
</tr>
<tr>
<td>Differentiate products</td>
</tr>
<tr>
<td>Acquire a constant stream of new customers</td>
</tr>
<tr>
<td>Focus on product features</td>
</tr>
<tr>
<td>Discontinuous customer interaction</td>
</tr>
<tr>
<td>Customer research</td>
</tr>
<tr>
<td>Physical collaboration with suppliers</td>
</tr>
<tr>
<td>Short-time focus</td>
</tr>
<tr>
<td>Economies of scale</td>
</tr>
</tbody>
</table>

Source: Tiwana, 2001
The new niche market entrants found it easy to become CRM experts, while large banking firms needed to compete not only with other large banks but also these new entrants. To avoid losing customers, the large banks were forced to invest heavily in developing CRM systems during the 1990s. And indeed, some large banks did increase their revenues by focusing on CRM and by introducing CRM infrastructures and software.

The move from mass marketing to CRM was caused by changes in customers and markets. When banks were able to begin providing more kinds of financial products after deregulation, and as information technology improved rapidly, customers became more interested in financial products and could easily obtain information about products and companies via the Internet. As a result, customer needs tended to become diversified in recent years. At the same time, many banks realized that the potential profitability of each customer varies widely, and only 10% or 20% of customer actually result in profit. And as banks add more and more charges to their service business, this tendency may accelerate. Therefore, to maintain profitability, banks need to differentiate their customers and the services to customers. For instance, a remittance fee could be determined by the size of the balance on deposit, or the interest rate for deposits could be determined by the transaction record of each customer. Figure 4-4 illustrates these needs.

Figure 4-4 Customer valuation and need for CRM

Source: Tiwana, 2001
To achieve these goals, banks need to gather and analyze information about their customers. However, banks have many communication channels with customers, such as branches, ATMs, call centers, or a website (see Figure 4-5), so it was not easy to merge the information into one database because the information came from several different systems. Also, large banks have huge amounts of information and a wide array of products; therefore it is not easy for them to identify relevant data that will be useful. It was apparent that banks needed to make a major investment in information systems and make changes to their system organization or they could not understand and predict the effects of CRM.

Figure 4-5 Consumer use of channels among banks offering access

![Bar chart showing consumer use of channels among banks offering access over time.]

Source: Gartner Report, 1999

4.3.2 Examples of CRM Use Among U.S. Banking Firms

There is no doubt that banking firms face difficult conditions and that customer loyalty is an important factor for them. Gartner Group noted in a 2001 report that “products, which are increasingly commoditized, are longer key differentiators. Banks are, instead, maximizing the value of relationship by cross-selling more products and encouraging customer loyalty.” Thus, CRM became a buzzword in the banking industry, and many banks invested huge amounts of money on CRM system throughout the late 1990s. Moreover, researchers forecast that investments would grow in the future. According to Meridien Research, total investments among the 500 largest financial firms on front-office sales technology was $281 million in 2001 and will be $485 million by 2004 (Bank Systems & Technology, 2001). Also, eMarketer, a New York-based provider of Internet statistics,
pointed out that banks spent 1.05% of their revenue on CRM, about double the percent of revenue spent by media and healthcare companies (Rombel, 2001). But 79% of these investments were spent by retail-oriented banks aiming to retain individual customers. Figure 4-6 shows the proportion of these investments.

Figure 4-6 Allocation of CRM Spending by Financial Companies in 2001

Source: Rombel, 2001

In the next three sections, I provide brief examples of how CRM is being used in large commercial banking institutions.

a. Chase Manhattan Corporation

Chase Manhattan Corporation (Chase) developed its own customer relations management system (RMS) in 1994. In those days, Chase was one of the largest commercial banks in the U.S. and it had 650 relationship managers, each of whom managed 30 to 60 relationships with customers. They spent time collecting customer data from several independent information systems in the bank. But it was difficult to evaluate the profitability of each customer because Chase's information systems were product-oriented, not customer-oriented. This situation eventually caused Chase to develop a new CRM.

Chase's system only improved customer relationships but also improved relationships between the front office staff and the middle and back office managers. The aim was to create and improve their knowledge through the use of this information system. Before launching it, Chase had several cultural barriers within the organization, which
interfered with reciprocal communication and knowledge creation. These barriers also created independent sources of information, which meant the customer relationship managers had difficulty accessing all the relevant information about their customers. To remedy this situation, the relationship managers and IT experts, as well as the risk management experts and trading experts, joined in the development and maintenance of the new system. In addition, a Relationship Management advisory board, a 60-member formal organization, evaluated the enhancements proposed by every participant. This cross-functional input enhanced the power to the ultimate solutions. Total investments in this system amounted to $12 million by 1995.

After 18 months of operation, Chase saw an increase in its revenues and a reduction of $11 million in its costs as a result of using the new system. According to Chase, they expect to reduce costs by 40% and increase their revenues by 20% (Rollo and Clarke, 2001).

b. CitiGroup

CitiGroup was created in 1998 as the result of a merger between Citicorp, a traditional large commercial bank, and Travelers Group, the parent company of Salomon Smith Barney, Travelers Life and Annuity, and Primerica Financial Services. Knowledge interchange and information sharing were important results of the synergistic effects of the merger. Specifically, the merger had three major goals: one-stop shopping, cross-selling within and across their business lines, and leveraging each other's information systems.

In the case of cross-selling, the introduction of a CRM system was necessary. CitiGroup now had the opportunity to sell every kind of financial product because they owned a commercial bank, an investment bank, an insurance company, and a financial service company. So, for instance, they could offer Travelers' auto insurance to the customer who has a new auto loan from Citibank. However, without knowledge or information interchange, it is difficult for the sales personnel to sell the variety of financial products available as a result of the merger. The sales force needed appropriate knowledge and information about their products and customers. Therefore, CitiGroup decided to develop and introduce a new sophisticated CRM system.

The system was called the “Champion Management Engine” and it can analyze the length of the customer relationship, each customer's use of specific banking channels, customer demographics, a history of previously purchased products, and the profitability of each customer.

When questioned how they are able to manage all the products and services being
offered, which exist across most banking firms, the response by Tower Group was, “Citigroup is at the top of the convergence list, doing it slowly but doing it right” (Bank System & Technology, 2001). A managing director of Citigroup said, “We are at the beginning, in the infrastructure phase. The next stage will be the full leveraging of it and the third phase will be reinvention, because this isn’t about innovation, it’s about reinvention” (Bank System & Technology, 2001).

c. Bank of America

Before its merger with NationsBank, Bank of America (BOA) was a pioneer among U.S. banks in the area of database marketing and CRM. In the mid-1980s, BOA realized the importance of a customer-centric strategy and the need for a customer information database. BOA introduced a new customer information database at that time, and continued to improve its contents throughout the late 1980s. The database contains more than 4000 columns of data. The database is linked to the bank’s key business applications, such as its branch incentive system, a marketing analysis system, the branch staff forecasting system, and a portfolio analysis system (Banking Management, 1996).

The bank used this database to improve customer services. For example, it determined that people with both checking accounts and credit cards carried more daily balances than average daily balances. So the bank devised a strategy of eliminating its credit card annual fee for these customers (Banking Management, 1996). Also BOA found that 91% of its customers who had eliminated foreign travel and purchased wine at a wine shop, would also take out a mortgage in 18 months. The bank used this information to bolster its marketing for mortgages, and soon its share grew from 8% to 30% (Nissei Research Institute, 2001).

BOA made good use of its customer information database to become one of the largest super-regional banks. However, after its merger with NationsBank, investment in CRM nearly stopped, as its top priority investment became building a common platform between the two merged entities (Kiesoski, 1999). This was necessary in order to provide service and financial products to both BOA and NationsBank customers.

4.3.3 An Evaluation of CRM in the U.S. Banking Industry

While banks have paid considerable attention to CRM and spent significant amounts of money developing CRM system, research indicates that many executive managers are suspicious of CRM results. Indeed, nearly 70% of organizations were unsure whether CRM had had any impact on their customer profitability or their ability to cross-sell products
(Jonathan, 2001). Even though many banks invested quantities of money to establish new IT systems to support CRM and to customize financial products and services, a University of Michigan survey of bank customers found that from 1995 to 1999 their level of satisfaction had actually declined (McKinsey Quarterly, 2002).

It is not easy to evaluate the effects of CRM, but at present it seems difficult to say that the implementation of CRM among U.S. banks has been successful. While most would not dispute that the concept of CRM is important for banks, and that banks should focus on their customers' voices and requirement, it also seems to be the case that if banks also focus on their IT systems rather than a narrow focus on CRM and organizational structure for customer-centric policies, then the effects of CRM become more apparent. In other words, banks need to pay attention to both their IT systems as well as their customer-centric concepts, and together there is a noticeable improvement in CRM.

4.4 OUTSOURCING

4.4.1 Outsourcing Trends

U.S. banking firms are frequent users of outsourcing. This trend came from deregulation in the late 1970s. As I mentioned, U.S. commercial banks faced managerial problems which came from reduction of margin for loans and deposits derived from deregulation of interest rates. As a provision against low margins, banks took a strategy of expansion. They tried to expand the number of financial products and businesses, such as loans to South American counties and loans to real estate business which had high risks as well as high returns. As a result, U.S. banks had many bad loans in the late 1980s. However, U.S. commercial banks revived in the early 1990s by doing reengineering and focus strategy. By reflecting failure of loans for high-risk business, U.S. banks focused on risk management and profitability of each business. As a result of understanding risks and profitability of each business, banks realized that they could not make profits from all businesses and needed to keep low costs operation in a certain business which could not bring profits. The concept of outsourcing came from this background because using outsourcing made banks to keep low costs operation rather than doing a business internally. In addition, the innovation in IT accelerates the trend of outsourcing among banks. Even though IT brought new business chance to banks, it was difficult for banks to catch up new technology. Therefore banks tended to outsource IT department to outside vendors. Figure 4-7 shows the relationship between an outsourcing trend and environments. Also U.S. banks outsourced their business
which is difficult to differentiate among competitors, such as affairs, operations of information systems, and settlement operations. On the other hand, they keep core businesses internally such as service business for customers which could differentiate a bank from its competitors. (Sanwa Bank and Sanwa Research Institute, 1999).

The concept of outsourcing among U.S. banks is not new. Most began to use outsourcing in the 1970s. However, in recent years, because of consolidation among banking firms, downsizing of information technology, newcomer from other industries, and pressures to increase stakeholder revenue, many U.S. banks now make more use of outsourcing. Especially in new delivery channel fields, such as Internet banking, debit cards, and mobile phone banking, banks find it difficult to develop and maintain these new delivery channels by themselves. At the same time, customers expect banks to provide such service channels, so banks cannot refuse to provide them. According to *American Banker*, 39% of all U.S. banks and thrifts outsourced some part of their activities in 1998 (FRB of New York, 1999).

Figure 4-7 Movement of focus strategy among U.S. banks

<table>
<thead>
<tr>
<th>Deregulation</th>
<th>IT Innovation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Severe Competition / Deterioration of profitability</td>
<td></td>
</tr>
<tr>
<td>Diversification of products / Increase of investment for IT</td>
<td></td>
</tr>
</tbody>
</table>

- Re-recognition of strength and weakness
  - Managing profitability and risk
  - Respect for quality of management

<table>
<thead>
<tr>
<th>Focus Strategy</th>
<th>Traditional Way</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Concentration to core competence</td>
<td></td>
</tr>
<tr>
<td>- Outsourcing</td>
<td></td>
</tr>
<tr>
<td>Doing everything themselves</td>
<td></td>
</tr>
</tbody>
</table>

Source: Sanwa Bank and Sanwa Research Institute
This trend is seen not just in the U.S. banking industry but also globally. Outsourcing is huge and rapidly growing market. In 1998, total global expenditures on outsourcing reached $180 billion an increase of 23%, and by 2001 had reached more than $300 million (FRB of New York, 1999).

During the early stages of outsourcing, the main purpose was simply cost reduction. Outsourcers had many specialists and considerable knowledge of the field and how to achieve economies of scale, so they could help banks reduce their costs via an outsourcing contract rather than the banks doing it themselves through internal processes. As outsourcers became more diversified and concentrated their internal resources on the banks’ core competencies, their knowledge and skill became important factors in the banks’ decisions to outsource. Banks develop innovative products and services based on their core competence and use these to maintain their competitive position among rivals. Therefore the banks prefer to inject their scarce internal resources, especially personnel, into enhancing their core competence. To do this effectively means outsourcing core activities such as information systems, business processes, and internal auditing, which have not been core bank competencies in recent years. In the past, they did not outsource such core activities, only non-critical activities. Table 4-3 illustrates the kinds of businesses banks outsourced in 1996.

<table>
<thead>
<tr>
<th>Outsourced Activities Among 300 U.S. Banks (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposit product</td>
</tr>
<tr>
<td>Consumer loan</td>
</tr>
<tr>
<td>Customer information file</td>
</tr>
<tr>
<td>General ledger</td>
</tr>
<tr>
<td>Cheque processing</td>
</tr>
<tr>
<td>Credit card issuance</td>
</tr>
<tr>
<td>Merchant acquirer processes</td>
</tr>
<tr>
<td>ATM/EFTPOS switching</td>
</tr>
<tr>
<td>Mortgage processing</td>
</tr>
<tr>
<td>Payroll/Human resources</td>
</tr>
<tr>
<td>EDI</td>
</tr>
</tbody>
</table>

Source: Merrill Lynch, Feb 1997
(Original Source: American Banker/ 1996 Survey of Bank Technology)

Other research found that the most outsourced activity among banking firms is some aspects of information technology, and the next is business processes, such as internal audits,
back-office operations, and human resources (FRB New York, 1999).

Methods of outsourcing have changed in recent years. Traditional outsourcing is based on a contractor-like relationship. The target is a certain business or development, and the contract term is relatively short. After finishing the specific task or development, the contract expires, and no relationship remains. Another type of outsourcing is based on a partnership or strategic alliance/joint venture. Here the contract is relatively long and the scope of outsourcing tends to be wider (FRB New York, 1999).

It is apparent that U.S. banks use outsourcing frequently to reinforce their core competence by putting their limited resources into their core competence (Sanwa Bank and Sanwa Research Institute, 1999). Banks in other countries, especially European countries, followed this strategy and outsourcing has now become a global trend. Outsourcing was one reason for the success of the U.S. banking industry in the mid- and late 1990s. Many researchers predict that this trend will continue, and that the outsourcing market will continue to grow. Table 4-4 provides examples of outsourcing examples in the U.S. banking industry.

4.4.2 Examples of Outsourcing

In this section I provide some examples of outsourcing in the U.S. banking industry. Because U.S. banks have been pioneers in the use of outsourcing, some of the latest methods are among these examples.

a. Traditional Outsourcing: Continental Bank

In the mid-1980s, Continental Bank was in crisis; in the 1970s it had invested a significant amount of money into Penn Square, an energy-related investment, and in the mid-1980s, Penn Square was in dire straits and Continental Bank was in poor financial condition. Continental received assistance in the form of an FDIC bailout, but the bank was still struggling in the early 1990s. To escape this situation, Continental needed to reduce its costs immediately. They began with the relatively easy parts: first spun off their food services, security services, messenger, property management, and legal services. This measure was not particularly innovative, and other banks might have done the same kind of spin-off.
Table 4-4 Outsourcings in U.S. banking industry

<table>
<thead>
<tr>
<th>Bank</th>
<th>Outsourcer</th>
<th>Form of outsourcing</th>
<th>Field</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Continental Bank</td>
<td>Integrated Systems Solutions Corporation</td>
<td>Contractor-like</td>
<td>IT</td>
<td>1992</td>
</tr>
<tr>
<td>First Chicago NBD</td>
<td>AT &amp;T, ISSC, National Computer Services IntraNet</td>
<td>Strategic Partnership</td>
<td>IT</td>
<td>1994</td>
</tr>
<tr>
<td>Bank of America</td>
<td>M&amp;I Data Services</td>
<td>Contractor-like</td>
<td>remote deposit processing creation of new retail product</td>
<td>1995</td>
</tr>
<tr>
<td>Chase Manhattan Bank</td>
<td>Fiserve</td>
<td>Strategic Alliance</td>
<td>check processing operation</td>
<td>1995</td>
</tr>
<tr>
<td>First Union</td>
<td>Electric Data System</td>
<td>Contractor-like</td>
<td>IT</td>
<td>1996</td>
</tr>
<tr>
<td>NationsBank</td>
<td>Alltel Information Services</td>
<td>Contractor-like</td>
<td>IT</td>
<td>1996</td>
</tr>
<tr>
<td>KeyCorp</td>
<td>Alltel data center</td>
<td>Contractor-like</td>
<td>consumer lending operation</td>
<td>1996</td>
</tr>
<tr>
<td>Chase Manhattan Bank</td>
<td>First Data</td>
<td>Contractor-like</td>
<td>card processing</td>
<td>1996</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>First Data</td>
<td>Joint Venture</td>
<td>merchant credit card</td>
<td>1996</td>
</tr>
<tr>
<td>State Street Boston</td>
<td>Fiserve</td>
<td>Strategic Alliance</td>
<td>bank's item processing</td>
<td>1996</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>J.P Morgan</td>
<td>Andersen Consulting</td>
<td>Strategic Alliance</td>
<td>IT</td>
<td>1996</td>
</tr>
<tr>
<td></td>
<td>Bell Atlantic Network Integration</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>AT&amp;T Solutions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prudential</td>
<td>IBM Global Services</td>
<td>Contractor-like</td>
<td>IT management</td>
<td>1997</td>
</tr>
<tr>
<td>BancOne</td>
<td>AT&amp;T Solutions</td>
<td>Contractor-like</td>
<td>IT management</td>
<td>1998</td>
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<tr>
<td>CitiGroup</td>
<td>AT&amp;T Solutions</td>
<td>Contractor-like</td>
<td>IT management</td>
<td>1998</td>
</tr>
<tr>
<td>Bank of America</td>
<td>Exult</td>
<td>Service contracts and equity participation by BOA</td>
<td>human resource for BOA provision of BOA service to BOA &amp; clients</td>
<td>2000</td>
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</table>


Next, they decided to outsource their entire information technology division. This was the first time a large money center bank had ever done this. Continental's information technology unit had some problems—the mainframe system was not flexible enough to satisfy customer needs and it needed to replace its information system with one that was more flexible. To develop and maintain a new technology-based system, the bank also needed to find and hire top technical people. However, these people were not interested in
joining a banking firm because the industry did not focus on information technology. Also banks would need to invest considerable money into infrastructure, equipment, and people not only for new development but also just to maintain existing systems. With these factors in mind, and as the result of considerable discussion and simulations of outsourcing, the bank decided to outsource its entire information technology unit to an outside source.

The outsourcing proposal was offered to three companies. Although there were many selection criteria, three were especially critical: the ability to use new information technology, an issue regarding the bank’s staff, and the price of the contract. After some consideration, Integrated Systems Solutions Corporation (ISSC) of Ernst & Young won the contract.

According to ISSC estimates, the outsourcing would result in a $10 million cost saving to Continental. ISSC hired more than 400 former bank employees. Because the company now employing these former bank employees was a technology-focused company, the former bank employees found that their career opportunities had widened.

Thus it seemed that outsourcing had many advantages, not only for Continental but also for its employees (Huber, 1993).

b. Best-of-Breed Outsourcing: J.P. Morgan

In 1996, J.P. Morgan decided to outsource one-third of its information technology operations and infrastructure. However, their requirements for outsourcers were difficult to fulfill with just one company. Therefore, they chose a “best-of-breed” type of outsourcing that included relationships with Computer Sciences Corporation (CSC), Andersen Consulting, Bell Atlantic Network Integration (BANI), and AT&T Solutions. This outsourcing is a so-called “pinnacle alliance” and it provided the following services:

- Mainframe and mid-range data center operation
- Desktop and LAN-distributed system support
- Global telecommunications maintenance
- Application development

Table 4-5 shows the role of each participant.
Table 4-5 Roles of each company in pinnacle alliance

<table>
<thead>
<tr>
<th>Company</th>
<th>Roles</th>
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<tr>
<td>J.P. Morgan Corporate Technology</td>
<td>- Set the overall strategy and direction.</td>
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<td></td>
<td>- Work closely with parent company</td>
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<tr>
<td>CSC</td>
<td>- Lead companies in this outsourcing</td>
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<tr>
<td></td>
<td>- Mainframe and mid range management</td>
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<td></td>
<td>- Distributed operations worldwide</td>
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<td></td>
<td>- Application delivery service</td>
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<tr>
<td>Andersen Consulting</td>
<td>- Application development</td>
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<td></td>
<td>- Management of corporate, wide applications;</td>
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<tr>
<td></td>
<td>(middleware applications and interface to market data providers)</td>
</tr>
<tr>
<td>AT&amp;T Solutions</td>
<td>- Responsible for global voice system, data network</td>
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<tr>
<td></td>
<td>trader voice operations</td>
</tr>
<tr>
<td>BANI</td>
<td>- Support distributed computing services;</td>
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<tr>
<td></td>
<td>(desktops, LANs, and servers)</td>
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<tr>
<td></td>
<td>- e-mail and productivity tools</td>
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</tbody>
</table>

Source: Gartner, 1998

Although best-of-breed outsourcing structures are typically "separate and equal" or "prime and sub," the characteristic of a pinnacle alliance is a team relationship among the participant companies. These two structures have difficulty making the most of participants' abilities because the participants tend not to cooperate each other. They have either a vertical or a horizontal relationship. On the other hand, because of its team structure, a pinnacle alliance has both vertical and horizontal relationship. This structure has the possibility of synergy effects and can support best-of-breed outsourcing.

As a result, J.P. Morgan was able to attain its original purpose. It reduce IT-related costs by using this outsourcing. Also the bank met and interacted with IT experts more than before and its own IT professionals spent a great deal of time in future business planning.

c. **New Type of Outsourcing: Bank of America**

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2 Many best-of-breed contracts involve multiple vendors, each with a separate relationship (and contract) with the client organization (Gartner, 1998).

3 Other best-of-breed outsourcing engagements are structured as a prime/sub contracting model, where one vendor owns responsibility for the partners (Gartner, 1998).
In October 2000, Bank of America (BOA) and Exult, a provider of Web-enabled technology, announced they had reached an outsourcing agreement focused primarily on BOA's HR management. Exult would build and maintain BOA's HR management system using Exult's Web-based technology. The outsourcing included payroll, benefits, human resources, service delivery including the call center for human resources and employee benefits information.

In addition, the contract also covered two other issues. BOA would acquire five million shares of Exult stock, and BOA would provide its services and financial products to Exult's customers through Exult's website. They also announced that BOA could expect a 10% reduction in its HR costs and would gain in excess of $1 million in revenues as a result of the Exult contract.

While this contract is one type of outsourcing, it could also be called a partnership or strategic alliance. Chris Blum, an analyst at Edward Jones, pointed out that the "new relationship between the two companies suggested a partnership, not simply outsourcing" (Zimmerman, 2001). Thus, this example indicates that outsourcing in U.S. continues to evolve and that its structure is becoming more complex and diversified.
Chapter 5
Structure of the Japanese Banking Industry

In most Japanese companies, management has been traditionally characterized by "life-long employment" and a strong "seniority system". It is likely that these management characteristics came from Confucian concepts. Shotoku Taishi, a statesman who enacted the first Japanese constitution, originated a version of Confucianism in China in the Sixth Century which has dominated the Japanese mindset for many years. One of its basic concepts is respect for elders, and it is this concept that has sustained the Japanese seniority system. The first chapter of the Japanese constitution begins: "Wa wo Motte Toutoshi to Nasu", which means that harmony among people is the most important precept. So, too, the Japanese employment system has been sustained by these kinds of historical values.

5.1 Employment System in Japan

In general, the employment systems and organizational styles have contributed to the competitive strength of Japanese companies, especially the manufacturing companies. Toyota's Kanban-Houshiki system is one famous example. These systems were supported by other features of Japan's employment system, such as "life-long employment", "job rotation" and the "seniority system". In Japanese companies, jobs and the employees who engage in the jobs are kept separate and are rotated periodically, so that every employee becomes knowledgeable about virtually every job and can share his/her tacit knowledge. On the other hand, because of the relatively short amount of time spend in each job, most employees cannot become specialists. In this system, most employees become generalists (Keizer 2000).

The life-long employment system means that employees work for one company from immediately after graduation until retirement age. It is widely believed that most Japanese employees, especially those who work for large companies, are or would prefer to be, part of this system. However, according to Takanashi (1999), the statistics do not support this
assumption; in fact, only about 20% of all Japanese employees work for one company from graduation to retirement, which supports my belief that most employees prefer to change jobs in order to improve their skills or to increase their earnings.

Still, Japanese employees do have a tendency to stay in the same company as long as possible (Takanashi 1999). However, because of a lack of appropriate positions for senior workers, most companies reduce the number of senior workers in order to maintain their hierarchical organization. To achieve this purpose and to satisfy the desire for life-long employment, Japanese companies use Shukko (a temporary transfer to a subsidiary) as well as offering early retirement.

Another trend is an increase in the number of part-time workers hired to reduce labor costs or meet a temporary need. In some business, such as manufacturing, retail, and services, part-time worker handle these jobs as well as regular employees, and at less cost.

The incentive system in Japanese companies is different from that of Western countries. Most Japanese firms do not immediately pay high incentives to their employees who have done distinguished jobs. Managers assess their employees over a long-term period, rather than biannually or annually as is customary in the U.S. Each employee is evaluated by more than one person as the employee rotates through various jobs. Therefore an employee’s total abilities are evaluated from different points of view. This system is known as the “late-selection system”. As the timing of promotion is determined by the entrance year, a large portion of each year’s cohort is promoted at the same time, especially at first selection. This means it is difficult for an employee to be promoted over his or her senior who has maintained a good record and received a high evaluation. Therefore, since the organization of Japanese companies is usually a pyramid structure, the seniority system is obviously popular among Japanese companies.

However, according to Sako and Sato (1997), these systems have begun to change, for several reasons: difficulty sustaining such a high number of promotions, increases in the number of graduates recruited, the slow growth of the Japanese economy, and company profitability concerns. To counter these problems, many companies have created specialist positions rather than line management positions, implemented merit-based promotions, and/or limited the number of years in the same post. Thus, while the system has not been changed drastically, a few modifications have been applied to adapt to the present-day situation, which has resulted in gradual change in the Japanese employment system.
5.2 Employment Systems in Japanese Banks

The employment systems in Japanese banking firms are similar to other Japanese firms, as discussed in the last section. Traditionally, life-long employment, the seniority system, and late selection are characteristics of Japanese banks. In the past, because banks were protected by the government and hence did not need innovations to fight competition, the traditional system worked. However, the environment surrounding banks has changed drastically in the last decade, and it has become necessary for banks to change their traditional structures.

5.2.1 Recruitment and Promotion

Japanese city banks hire many new graduates from first-class universities, such as the University of Tokyo, or Hitotsubashi University, or Keio University. According to Hisahara (2000), 20% of new graduates from the Economic Department at the University of Tokyo took jobs at Japanese banks. Those employees work as clerks at branches before being promoted to a managerial position.

After hiring these employees, banks screen them through severe competition during their career, the so-called “rat races”, in order to identify a small number of potential candidates for executive officer and life-long employment. These competitions and screenings are done using the late-selection concept. Figure 5-1 shows the typical promotion path in Japanese city banks.
There are several promotion times for each employee as part of the late-selection system. Employees who joined the company in the same year may be promoted in the same timing for the first screening. But as screenings proceed, fewer people remain in the top group. Finally, the one employee remains in his timing group had he becomes CEO of the bank. This means that CEOs in Japanese banks are not management specialists but have simply risen to the top among their timing group. This promotion procedure occurs in every division of the bank, not only in the commercial banking section, but also trading or IT development. And because banks also pursue job rotation, they need to provide the same opportunities to all employees.

As almost all employees are excellent before joining banks, and the bank industry is traditionally conservative, the method of evaluation involves scoring by deducting points. This system leads strong competition among employees. As a result, many bankers are afraid of failure and therefore do not like to take risks. Also, the primary purpose for doing a job is to win the competition among fellow employees. It is difficult to make innovative products or services in such a competitive culture. Table 5-1 outlines the pros and cons of the late-selection system.
Table 5-1. Pros and Cons of the late selection system

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<tr>
<td>Long-term motivation to develop and improve skills</td>
<td>Assessments become more accurate.</td>
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<td>Time-consuming and a waste of training costs</td>
<td>Induces a competitive attitude</td>
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</tbody>
</table>

Source: Sato, 1997

5.2.2 Generalist vs. Specialist

Another characteristic of Japanese city banks is that they tend to give high evaluations to generalists rather than to specialists. Table 5-2 shows the career paths of executive managers in a Japanese city bank. According to this table, almost all executives experienced five or six different business areas, which indicates that the background of almost all executive managers in Japanese city banks is generalist.

In banking, a generalist is someone who knows about the overall banking business, i.e., retail banking, corporate banking, loan decisions, foreign exchange, stocks, planning, and affairs management. But as they move to other divisions or branches every three or four years, it is difficult for bankers to obtain deep knowledge about every aspect of the banking business.

Table 5-2 Career Paths of Executive Managers in Japanese City Banks

<table>
<thead>
<tr>
<th></th>
<th>Branch</th>
<th>Retail Banking</th>
<th>Corporate Banking</th>
<th>Trading</th>
<th>Investment Banking</th>
<th>Overseas</th>
<th>Operation</th>
<th>IT</th>
<th>Planning</th>
<th>HR</th>
<th>Others</th>
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<td>Chairman of Board</td>
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Source: Yakuin Ichiran, 2001
This table shows that executive managers move up the ranks as employees, and do not come from outside the company, which means that executive managers are not specialists in management but have simply attained the top position as an employee. It is said that top executives in Japanese city banks have less knowledge about management than do their counterparts in U.S. banking firms. In the case of U.S. banking firms, board members hire a management specialist into the executive positions, frequently someone from outside the company. John Reed, former CEO of Citigroup, once said that it would be difficult to imagine that Japanese city banks playing an important role in global financial markets because they have serious problems in their domestic businesses and do not have superior executive managers. While this may be true in banking, there are obvious exceptions in other industries, particularly Japanese manufacturing companies that operate in global businesses, such as Sony or Toyota (Nikkei Business, 1999).

In some cases, especially small city banks or regional banks, there are many cases where senior bureaucrats find employment after retirement with banks that were formerly under their jurisdiction. Most of these bureaucrats (Amakudari) worked for the Ministry of Finance or the Bank of Japan before their retirement. These executives have little in the way of management skills, but they do have strong relationships with their former organizations. Before deregulation, banks were protected by the government; so it was very helpful to have a connection to the Ministry of Finance and the central bank. However, after deregulation, there was less need for the connection, and more need for strong leadership and a superior manager to lead the company. Amakudari is no longer needed for Japanese banks.

5.2.3 Job Rotation

Japanese banks use the job rotation system for almost all employees, from branch officer to those who are in charge of trading or the banking system. There is some merit to the job rotation system. First, it makes the banks share tacit assets such as knowledge and information. By gathering together people who have various types of knowledge, the bank creates dynamism and efficiency in its business. Also this system makes the best use of the bank’s human resources.

On the other hand, job rotation tends to create generalists rather than specialists. Before deregulation, many bank businesses were the same and generalists held important roles. However, as banking has become more complex, generalists are no longer enough to maintain competitiveness. Therefore, employees who develop information systems or handle trading and have been out of the job rotation system tend to remain in the same division for a long time.
5.2.4 Compensation Systems

As I mentioned in Chapter 4, the employment system in U.S. banks depends on the nature of the business, whether the bank does commercial or investment banking. In commercial banks, they hire new graduate employees who have a four-year college degree and then train in-house and wage differences are small. Investment banks hire employees who have MBA degrees or experience in the same field. A significant incentive is paid to employees who performance well, so wage differences among employees are greater.

However, in Japanese city banks, although they too have various businesses, they apply the same wage system to all employees, and almost all employees have a four-year college degree or a Masters degree. Also they apply the seniority system to all divisions. In commercial banking, this system works well because the business is relatively homogeneous and well defined. On the other hand, the same compensation and seniority systems do not work well in fields that require specialization. People with specialized knowledge are not satisfied with the system, and many foreign exchange and bond traders who formerly worked in Japanese city banks have now moved to foreign-affiliated companies because they can earn more salary at those companies.

5.2.5 Changes in Japanese City Banks

To fix the problems in their employment system, the city banks have tried to change it in recent years. For instance, one city bank introduced a new personnel system in 2000. The basic concepts of the new system are as follows:

a) The bank reviewed its evaluation system for specialists and changed its evaluation system. The new evaluation system includes a new evaluation system for specialists and another for generalists—a dual-ladder system.

b) Before this change, the Human Resources Office was responsible for most training programs. However, the bank realized the need to train specialists so it decentralized its training programs into each business unit.

c) Prior to the change, the Human Resources Office controlled all personnel transfers and retained ultimate authority in the evaluation process. The bank decided to decentralize this power into each business unit.

d) The wage structure was changed. Wages for each employee are now based on their record and responsibilities.

Thus, Japanese banks are aware of internal problems and are trying to fix them.
However, it would be dangerous for the banks to make drastic changes to their employee structure just to imitate the U.S. bank structure. Banks should think about their background and core competencies and then deal with the problems deliberately.

5.3 ORGANIZATIONAL STRUCTURE

In the past, Japanese banks adopted a functional organization. During the regulated period, bank management tended to be conservative, and head office functions such as planning, human resource management, and loan supervision, were concentrated in one division, and each division had authority for a specific area. The centralized loan supervisory function sets the criteria for bank loans, and information is transferred efficiently because of frequent job rotation. So it would seem that this highly centralized organization works well. However since the 1980s, the banking environment has changed dramatically, as noted, and banks began to realize that this type of organization would not work in certain conditions, say, when speed was required.

Therefore, many large city banks moved to a business unit system in the 1980s (Hisahara, 2000). At present, four large city banks have implemented the business unit system and have parent companies. The organization structures of these banks are similar to those of U.S. money center banks. Figure 5-2 shows the organization structure of a typical city bank.

As these banks aim to provide securities and trust products, they need to have parent companies that have securities companies and trust banks under the parent company’s umbrella. They also use the business unit system. Basically each business unit is determined by the nature of its customers and businesses. Head office functions, such as planning, human resource management, and IT planning, are diffused to each business unit. One of the big problems with the business unit system is lack of communication among the business units. City banks have only recently begun to apply the business unit system to their banks, so there are few results at present. However, because of the current turbulent period for banks, results should begin to appear relatively soon.
5.4 CUSTOMER RELATIONSHIP MANAGEMENT (CRM)

5.4.1 CRM in the Japanese Banking Industry

It is said that Japanese banks traditionally have paid little attention to their customers. As long as banks were protected by the government, they did not have to compete among themselves and because of government regulations, there were few differences among the competitors, because their services were virtually the same. Customers could detect few differences among the Japanese banks, so they chose a bank simply because of its size, or its location, or on the basis of past dealings.

In recent years, however, because of the "Big Bang", this laissez faire attitude changed as the banks began to develop and provide various kinds of financial products in response to customer interest and demand. Besides basic financial services, such as interest...
rates, service charges, and settlement services, banks now offer trust products, insurance, securities, and pension funds. Also through their credit card businesses, they are becoming more closely aligned with the retail industry. These changes have compelled the banks to recognize the importance of their customers, and to realize that unless they build and keep satisfaction with their customers, they will not earn profits or remain competitive.

Banks also realized that only 10 or 20\% of customers produced profit for the bank, which meant that the services provided to the rest of their customers cost the bank to provide them. While all customers are important to the banks, banks need to make money in order to maintain their presence among Japanese banks and foreign competitors. Before deregulation, banks offered the same banking services to both profitable and unprofitable customers. In recent years, however, they have begun to realize the need to differentiate between these two types of customers. Unless they give profitable customers excellent treatment, their profits will not improve and banks may even lose customers.

Japan has the world’s second largest amount of individual assets (the first is the U.S.), and half of these assets are invested to bank deposits. Compared to other developed countries, this statistic is unusual because in the developed countries most individual assets are invested in securities, including investment trusts, while just 10\% of the assets are in bank deposits (Mitsuhashi et al., 2001). Many banks, both Japanese and international, are aiming to capture these assets, which has caused the arrival of many banking institutions into the Japanese retail banking industry.

Given this situation, Japanese banks are slowly beginning to focus on CRM, to introduce a CRM application and a new branch system that is aligned with the customer-centric strategy already being used in retail banking. However, many banks are still struggling with bad loans caused by the bursting of the bubble economy and the ongoing economic recession in Japan, which made it difficult for them to invest in CRM systems in the 1990s (see Figure 5-3). Also Japanese banks focused on rationalizing their operations to save labor costs, so they were reluctant to adopt CRM systems, choosing instead to put their resources into mainframe systems and ATMs.
Figure 5-3 Growth Rate of IT Investment in U.S. and Japanese banking industry

Source: Kubo, 2001
Original Source: Nichigin Tankan and Tower Group

After realizing the need for CRM, in the late 1990s some banks announced that they were developing CRM systems and investing money into CRM. Because of their size, however, it is difficult for large city banks to create a customer information database and develop analysis software. In contrast, some regional banks that are relatively small, responded quickly and created an appropriate CRM. For example, Suruga Bank, a regional bank in Shizuoka Prefecture, introduced its CRM system in August 1999. In their system, the bank separated its customers into three segments and does different marketing to each segment. As a result, profits from the most important customer segment increased 12%, and the number of products per customer increased by 1.34 products (Kubo, 2001). Suruga Bank was successful in its application of CRM, and is currently making even more improvements in the system.

So it must be said that Japanese banks do realize the importance of CRM and are trying to introduce CRM systems and new types of organization. And while they still lag behind U.S. and European banks in this area, they are try to catch up.

5.4.2 Examples of CRM Use in City Banks

In recent years, several large city banks have introduced CRM systems. In this
section, I present examples of CRM systems that have been implemented in four large Japanese city banks: Sumitomo-Mitsui Bank (created by merger between Sumitomo Bank and Sakura Bank), and UFJ Bank (created by merger between Sanwa Bank and Tokai Bank), both of which are making progress with their CRM systems. For comparison, I present two other banks—Bank of Tokyo Mitsubishi and Mizuho Financial Group—which are running behind in their implementation of CRM.

a) UFJ Bank (Sanwa Bank)

In 1999, Sanwa Bank developed and introduced a new customer database that would become the basis of its CRM system. The system covers 10 million customers and 1,500 items for each customer. However, 1,100 of the 1,500 items come from the bank’s mainframe system, and these data are not enough to analyze their customers’ behaviors and preferences. Also, it is difficult for the bank segment the customers using this database. Therefore UFJ needed to collect more information that would come not only the mainframe system but also the customer information system.

To improve the content of the database, Sanwa Bank and its partners announced the creation of the “Financial One”\(^1\) brand and joint venture in 2000. The joint venture company plays a gateway role for Financial One companies in the retail banking industry. Figure 5-4 illustrates the concept of a gateway company. Basically, the gateway company issues credit cards and provides customer information which is obtained through the credit card business. This information is shared among Financial One companies. Thus, Financial One is not only a gateway but also an outsourcer of CRM for Financial One companies. The company provides a financial portal site and a joint call center that connects directly to each company’s call center. As a result of this scheme, UFJ Bank is able to efficiently receive detailed customer information.

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\(^1\) Financial One group is composed of Nippon Koa Insurance, UFJ Bank, UFJ Trust Bank, The Taiyo Mutual Life Insurance, Daido Life Insurance, and Tsubasa Securities.
b) Sumitomo-Mitsui Banking Corporation

Prior to its merger with Mitsui, Sumitomo Bank paid considerable attention to its retail banking business, and injected money into the development of a customer information database containing 10 million accounts and a CRM system. According to Sumitomo’s 2000 annual report, 40% of its IT investment was related to retail banking. This percentage is relatively high compared to other city banks and is closer to what U.S. super-regional banks invest.

Sumitomo-Mitsui also announced that the role of each branch would change over the next three or four years. Basically, financial products will be sold through low-cost channels such as a call center or the Internet, and branches could offer financial consulting. This new business style means a more complex sales channel, so a CRM system with a customer information database is even more needed. The database already contains the history of
transactions, acquisitions, and maintenance costs for all individual customers. Figure 5-5 illustrates the bank's customer information database.

Figure 5-5 Customer Information Database at Sumitomo-Mitsui Banking Corp

At the moment, the improvements at Sumitomo-Mitsui Bank have fallen behind schedule because of the merger. However, Sumitomo Bank is traditionally an innovative bank, among the first to adopt new concepts. Therefore, in the case of a CRM, the bank is likely to move quickly to become a pioneer of this new concept among Japanese city banks.

c) Bank of Tokyo-Mitsubishi

Bank of Tokyo-Mitsubishi has always been considered conservative (Hisahara, 2000). So when thinking about a CRM system, the bank disliked the idea of being a pioneer among the city banks, preferring to the moves of other banks. However, it finally began to realize that CRM was necessary for the bank's retail banking strategy, so it decided to develop a new CRM system, as well as changing its organization to fit the new customer-centric strategy. Prior to the organizational change, branches were in charge of sales to individuals and corporate customers in its area.

In 2000, in order to provide additional value to its customers, the bank changed its
sales structure. Branches were separated into two types: a Retail Banking Branch (RBB) and a Commercial Banking Branch (CBB). RBBs solely in charge of individual customers, and CBBs are in charge of corporate customer. Furthermore, specialists in the head office were allowed to support the branches’ activities. Under this structure, the bank said it could offer more sophisticated services and financial products to its customers (Annual Report, 2000).

However, this structure is not sufficient to provide high-level services. The bank needed another tool, one that could provide appropriate customer information, to support its new branch structure. Therefore, the bank developed a new CRM system called FORSE. It has three databases: a customer information database, a business information database, and a knowledge box database. Using this system, customer information can be shared among employees in the RBBs, CBBs, and the head office.

Developing this system is just the beginning of the bank’s CRM process, and for now, it is simply an information-sharing tool. But it is also important for the bank to learn how to analyze the information accumulated in this system so the bank can make the best use of the information, analysis, and results.

d) Mizuho Financial Group

This bank also focused on CRM, with an announcement that the bank would develop a customer information database during the 2001 fiscal year. However, as the bank became involved in a merger with three large banks (Industrial Bank of Japan, Dai Ichi-Kangyo Bank, and Fuji Bank) in 2000, Mizuho Financial Group has had divert its money and attention to completely the merger. Therefore their strategic investment is currently behind that of other city banks. As of March 2002, there was no additional information available, nor any announcements about their CRM or customer information database.

5.5 OUTSOURCING

5.5.1 Trends in Outsourcing

In general, outsourcing in the Japanese banking industry is behind that of the U.S. banking industry. In fact, many Japanese banks have their own subsidiaries and outsource their business to these subsidiaries. These subsidiaries are separate from the parent bank from a financial point of view, so they represent one type of outsourcing. Table 5-3 shows the number of bank subsidiaries grouped by business fields and the year they were established.
Subsidiaries whose businesses were prohibited from doing business with the parent companies are not included in this table. For instance, securities subsidiaries or insurance subsidiaries are not counted in the number indicated in the table.

Table 5-3 Subsidiaries of Japanese City Banks

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Information Systems</td>
<td>2</td>
<td>3</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td></td>
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<tr>
<td>Software Development</td>
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<tr>
<td>Maintenance / Operation</td>
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<td>1</td>
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<tr>
<td>System Development</td>
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<td>4</td>
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<tr>
<td>Back Office Operation</td>
<td>2</td>
<td>5</td>
<td>10</td>
<td>6</td>
<td>3</td>
<td>5</td>
<td></td>
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<tr>
<td>Branches</td>
<td></td>
<td></td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>5</td>
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<tr>
<td>Branch Operation</td>
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<tr>
<td>Loans</td>
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<td></td>
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<tr>
<td>Guarantee Management</td>
<td></td>
<td></td>
<td>3</td>
<td>3</td>
<td>5</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Foreign Exchange Operation</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Loan Operation</td>
<td></td>
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<tr>
<td>General Affairs</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Temporary Employment</td>
<td>1</td>
<td></td>
<td></td>
<td>8</td>
<td></td>
<td></td>
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<tr>
<td>Welfare</td>
<td></td>
<td></td>
<td>1</td>
<td>3</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property Management</td>
<td></td>
<td>1</td>
<td>1</td>
<td>5</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>General Affairs</td>
<td></td>
<td></td>
<td></td>
<td>1</td>
<td></td>
<td>2</td>
<td></td>
</tr>
</tbody>
</table>

Source: Sanwa Bank and Sanwa Research Institute, 1999

The reasons for establishing a subsidiary can be classified into the following five groups.
- Managing the costs of competition
- To secure specialists
- Outside ordering ability
- Restructuring
- Maintaining a number of posts

However, these subsidiaries do not enjoy some of the usual advantages of outsourcing. First of all, as the subsidiary tends to receive orders from the parent company, it has no scale of economies, and it cannot adjust demand fluctuations internally. In general, outsourcers receive orders from many companies, so economies of scale are possible which lowers the cost of doing business. Also, because the bank subsidiaries are relatively unknown in their business fields, other potential sources of business will not outsource to the subsidiaries. Thus many bank subsidiaries have less skill compared with other outsourcers. Taking these points into consideration, I believe establishing subsidiaries is not an effective or satisfactory outsourcing method.
Also, when the banks establish subsidiaries for outsourcing, it prevents a new outsourcer from entering the banking industry to provide services. As we saw in the U.S. outsourcing examples, there are many large outsourcers, such as Alltel, Bisys, Computer Service, EDS, etc. Japanese banks also need large outsourcers to whom they can outsource their business, but there are none in the domestic banking industry. Banks, especially small ones, use joint ventures and alliances to concentrate on their core competence, and they continued to do business by themselves. Only recently have banks begun a transition to using outsourcing more effectively, and they have begun to realize the importance of intrinsic outsourcing.

In next section, I discuss some examples of outsourcing in the Japanese banking industry.

5.5.2 Cases of Outsourcing in the Japanese Banking Industry

a) Joint Venture: Daiwa Bank

In 1997, Daiwa Bank and IBM Japan announced that they had established a joint venture company, and Daiwa Bank would outsource its information system division to the joint company. The name of the joint venture is D&I Information Systems. The company is managed by people from both companies, which means the company has both knowledge of information technology and knowledge of the financial business.

Daiwa Bank is a Japanese city bank, but in the early 1990s, the company became mired in financial difficulties in its New York branch and its financial status was precarious at the time. Its rank in both scale and profitability was among the lowest of the Japanese city banks, and the company needed to change its global and business strategies to focus on its core competence. Unless it could narrow its business, it would face bankruptcy by the late 1990s.

The establishment of the joint venture was one of its business focus strategies. This made Daiwa Bank reduce its IT costs, secure IT pools, and acquire new technology. Also the company injected more employees into its core business than ever.

This example indicates that outsourcing the culture of the Japanese banking industry has improved gradually. Before this, all Japanese banks tried to handle their businesses by themselves, including their subsidiaries. Some banks, especially small ones, realized that they could not conduct their business in a vacuum because the entire finance field was becoming more complex and competition ever more fierce.
b) Joint Venture: Asahi Bank and Tokai Bank

Asahi Bank and Tokai Bank established a joint venture company with Sogo Keibi Hosho and Fujitsu. The new company was in charge of maintaining and overseeing the banks’ ATMs, its cleaning business, and operating its physical distribution services, such as internal mail.

In some business where economies of scale are important, rather than the latest technology or some specialized knowledge, there are cases in which banks make a partnership and establish a new venture company with other companies. It is important for banks to cooperate each other because one bank cannot gain great advantage in these kinds of business.

c) Business Transfer: Asahi Bank and Bank of Tokyo-Mitsubishi

In 2001, Asahi Bank agreed with Bank of Tokyo-Mitsubishi that Asahi Bank would transfer its overseas operations to Bank of Tokyo-Mitsubishi and they would cooperate in their customers’ deals. The agreement included: first, Asahi Bank would withdraw from its overseas operations and shift its business to the overseas branches in Bank of Tokyo-Mitsubishi. Also, if Asahi Bank’s customers want to do overseas business after Asahi’s withdrawal, Bank of Tokyo-Mitsubishi would support the customers.

Asahi Bank is a city bank that focuses on the retail banking business in domestic markets. Therefore, the bank decided to withdraw from foreign countries and concentrate on its core competence. In this case, because there was no appropriate outsourcer, Asahi Bank outsourced its business to Bank of Tokyo-Mitsubishi, one of the largest city banks with a strong presence in overseas business.

This type of outsourcing among the banks has increased in recent years. In other cases, some large banks have received orders to establish and maintain a disaster recovery site for some of the regional banks. This is an example where a large bank can become an outsourcer.
Chapter 6
Comparison and Analysis

In this chapter, I compare and analyze how U.S. and Japanese banking firms manage their knowledge, based on the results of my research discussed in Chapters 4 and 5. Table 6-1 summarizes the research.

6.1 EMPLOYMENT SYSTEMS

Given the still entrenched traditional Japanese employment system, including life-long employment, late-selection, the seniority system, and a comparatively low turnover rate, the basic concept of employee training among Japanese banks is internal training through practice. On-the-job training (OJT) is preferred among most of the banks.

6.1.1 Knowledge Acquisition and Transfer

Frequent job rotation also contributes to the creation of internal knowledge. Typically, Japanese bankers change their job every three or four years. Under these circumstances, Japanese bankers unconsciously transfer knowledge and information to other employees and they themselves develop by acquiring knowledge from others. However, these systems tend to make generalists and people with homogeneous knowledge. Indeed, before deregulation, these traditional systems seemed to work reasonably well and generalist bankers played an important role. My research shows that Japanese banking firms tend to make use of internal knowledge rather than acquire outside knowledge, in contrast to U.S. banking firms. During the turbulent period of the mid-1990s, Japanese banks needed specialists with sophisticated knowledge in certain businesses such as foreign exchange, as well as bond traders, IT specialists, and customer relationship specialists. In addition, the basic organization structure was in need of change, which required specialists with executive management skills.
### Table 6-1 Comparisons between the U.S. and Japanese Banking Industries

#### Employment System

<table>
<thead>
<tr>
<th>United States</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>- High turnover rate</td>
<td>- Life Long Employment</td>
</tr>
<tr>
<td>- Highly classified jobs</td>
<td>- Late Selection</td>
</tr>
<tr>
<td>- Branch Officers</td>
<td>- Seniority System</td>
</tr>
<tr>
<td>Graduates from high school</td>
<td>- Hire from high class universities (including master degree)</td>
</tr>
<tr>
<td>Low wages</td>
<td>- Severe career competition among employees</td>
</tr>
<tr>
<td>Internal education</td>
<td>- Generalists Oriented (Homogenous Employees)</td>
</tr>
<tr>
<td>- Platform Employees</td>
<td>- Executive managers are promoted internally rather than hiring from outside</td>
</tr>
<tr>
<td>M.B.A graduate (4 + years Univ)</td>
<td>- Frequent Job Rotation</td>
</tr>
<tr>
<td>Internal education</td>
<td>- Many banks are trying to change their system</td>
</tr>
<tr>
<td>- Traders</td>
<td>Focus on Specialists</td>
</tr>
<tr>
<td>Hire from outside</td>
<td>Evaluation based on actual results</td>
</tr>
<tr>
<td>High incentives (depend on records)</td>
<td></td>
</tr>
<tr>
<td>- IT Specialists</td>
<td></td>
</tr>
<tr>
<td>Hire from outside</td>
<td></td>
</tr>
<tr>
<td>High incentives (depend on records)</td>
<td></td>
</tr>
</tbody>
</table>

#### Organizational Structure

<table>
<thead>
<tr>
<th>United States</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Holding Companies</td>
<td>- Holding Companies</td>
</tr>
<tr>
<td>- Business Units</td>
<td>- Business Units</td>
</tr>
</tbody>
</table>

#### Customer Relationship Management

- Pioneer of CRM
- Traditionally pay attention to Mass Marketing
- Change the strategy to CRM from late 1980s
- Heavy IT investment in CRM through 1990s
- Customer Centric Organization and Strategy
- Results
  - Disputable results of CRM
  - Slowdown of labor productivity
- Behind other countries
- Traditionally neglect importance of marketing
- Realized importance of CRM and started to introduce CRM system from late 1990s.

#### Outsourcing

<table>
<thead>
<tr>
<th>United States</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Aggressive use of outsourcing</td>
<td>- Unwilling use of outsourcing</td>
</tr>
<tr>
<td>- Many major outsiders</td>
<td>- Created subsidiaries and outsourced their business</td>
</tr>
<tr>
<td>- Outsource their business except for the core competence</td>
<td>- No large outsourcer</td>
</tr>
<tr>
<td>- The purpose of outsourcing changed from saving costs to focusing on core competence</td>
<td>- Large city banks still negative to use outsourcing mainly because of its risk issues.</td>
</tr>
<tr>
<td>- The structure of outsourcing changed from outsourcing to just one company to making an alliance or a joint venture company</td>
<td>- Small city banks realized necessity of outsourcing because they needed to focus on the core competence and did not have enough resources inside the company</td>
</tr>
</tbody>
</table>
6.1.2 Specialists

The question must be asked whether Japanese banks can foster specialists internally. It seems difficult for the banks to provide appropriate training programs because the environment surrounding banks is changing rapidly and training does not remain current with the changes.

I believe banks need to separate their businesses into two fields: traditional banking and businesses that require the latest technology. In the latter field, banks need to hire people from outside who have sophisticated knowledge about a specific field. Unless this is done, it seems certain that Japanese banks cannot survive among their strong rivals solely on the strength of their internal knowledge; they need to acquire outside knowledge more effectively.

U.S. banking firms have changed their employment structure and have hired many specialists from outside, such as IT specialists and traders, and have offered them high incentives. At the same time, U.S. banks have hired high school graduates for tellers or branch officers and offered relatively lower wages, with relevant training programs for tellers and other branch workers. It seems that U.S. banking firms understand the importance of both fields—cultivating internal knowledge and acquiring outside knowledge—and they have applied the appropriate human resource strategies to the right aspects of the business. This employment system appears to be highly sophisticated and efficient.

However, from the standpoint of knowledge, there are problems with high employee turnover rates. Because of re-engineering, restructuring, and the need for specialized workers, the turnover rate in the U.S. banking industry has grown since the mid-1990s. This means an outflow of internal knowledge and more difficulty accumulating it. Some banks have introduced knowledge management software to prevent the outflow of knowledge, but this software accumulates only explicit knowledge. In general tacit knowledge belong to individuals and it is difficult for banks to make it explicit without employee cooperation.

It is hard to say which banking firms have the better employment system. However, I would say with fair certainty that the traditional employment system prevalent among Japanese city banks does not fit today’s business environment. And the U.S. employment system is not perfect either. Both sides need to improve their systems from the standpoint of knowledge management, retrieval, and retention.

6.2 ORGANIZATIONAL STRUCTURE
6.2.1 Functional Structure

Large U.S. banking firms and Japanese city banks have a similar organizational structure—or perhaps Japanese city banks imitated the structure of U.S. banking firms. They both use a combination of business units with a holding company, which is inevitable because the governments in the U.S. and Japan still do not permit banks to sell insurance products or run securities businesses; indeed, permission to run such businesses through their subsidiaries has only recently occurred. Therefore a holding company and subsidiaries are still the common organizational structure.

Traditionally, banks have been organized in a functional structure with a customer-centric organization. Each division was in charge of certain function such as planning, human resource management, and credit, and all other banking business was handled through the divisions. The businesses did not compete within the divisions, and all employees communicated with the other divisions.

6.2.2 Business Unit Structure

Under the business unit structure, each business unit has almost all the functions, so they do not need to communicate with other business units. The one exception is the IT unit in Japanese city banks. Furthermore, as Chandler advocated, an organizational structure follows a strategy, so the banks' structure is based on the customer-centric strategy which is followed by banks in both countries.

From the standpoint of knowledge, there are some problems with the business unit structure. First, because each business completes within a single business unit, employees have no need to communicate with other business units. As a result, it tends to extinguish relations among the units. Also personnel change between two business units may contribute a lack of communication. The business unit structure is more efficient than the traditional functional organization, and is the best structure for training specialists. But the structure also eliminates exchange of information and knowledge.

It is difficult to say that banks make the best use of their resources. Nonaka and Takeuchi (1995) recommended that so-called "hypertext organizations" could eliminate the disadvantages of the business unit structure:

A hypertext organization, which is the dynamic synthesis of both the bureaucratic structure and the task force, reaps benefits from both. The bureaucratic structure efficiently implements, exploits, and accumulates new knowledge through internalization and combination, while the task force is indispensable for generating new knowledge through socialization and
externalization. The efficiency and stability of the bureaucracy is combined with the effectiveness and dynamism of the task force in a hypertext organization. (p. 170)

It seems there are many theoretical solutions for the business unit problem. However, theoretical solutions often do not apply to the real world, so the banks should apply a trial-and-error approach to fix this problem.

6.3 CUSTOMER RELATIONSHIP MANAGEMENT

Based on my research, I believe large U.S. banks and Japanese city banks are currently in different phases. The large U.S. banks realized the importance of a strong customer information database and CRM in the 1980s and introduced these information systems in the 1980s and early 1990s. However, it was difficult to precisely define the specifications at launch, so there was a period of trial-and-error while they used and then improved the system. During this period, U.S. banks invested a significant amount of money in CRM. However, recent reports point out that these investments did not contribute to overall bank profitability and productivity. Today CRM in the U.S. banking industry is in the mature phase and seems to be at a crossroad.

In comparison, CRM in the Japanese banking industry is still in the beginning phase. Although some small regional banks have introduced CRM strategies, many large city banks have begun to develop a customer information database (which is not enough) or to introduce a primary CRM system. Furthermore, Japanese banks have not yet become accomplished at acquiring customer knowledge. They do not understand customer preferences because there was no need to do so prior to the “Japanese Big Bang”. To apply a CRM strategy, they need to understand how to acquire customer knowledge. In this sense, the Japanese banking industry is perhaps fifteen years behind the U.S. banking industry.

It would be useful for Japanese banks to learn not only how large U.S. banks applied CRM but also why it has been less than successful. According to a McKinsey survey (2002), one reason is that although customers care most about reliability, service, and interacting with institutions they can trust, banks have provided too many services and financial products that are not necessary for their customers.

From the standpoint of knowledge, I have tried to explain this phenomenon in Figure 6-1. In the CRM concept, there are three types of capital:

1. **Human capital** is represented by the knowledge or skills of each employee, which
necessary to fulfill the demands of customers.

2. **Structural capital** is bank knowledge that is created by integrating the intellectual capital of all employees.

3. **Customer capital** is the knowledge or information that is in the banks’ customers.

By rotating these three types of capitals, a bank improves its customer relationships and can win customer loyalty. Figure 6-1 shows that an important point of CRM is how to take customer capital inside the company and make the best use of it. In CRM, the banks’ knowledge is not only inside the companies but also in their customers.

Based on some successful examples of U.S. banking firms, it seems that the loop worked well, and the banks created appropriate customer relationships in the beginning phase of CRM. However, for some reason, the loop did not continue to work well, and banks began providing irrelevant products and services to their customers, perhaps for reasons of severe competition or lack of appropriate knowledge about their customers. As a result, they misunderstood the customers’ preferences and ultimately they may fail with organizational learning.

**Figure 6-1 Intellectual Capital Models in CRM**

Focus Groups
With Customers

Survey on
Customer Preference

Human Capital

Leveraging the
Learning in
The Organization

Knowledge
Value
Creation

Customer Capital

Structural Capital

Define Affection able
Segments

Build Customer Profitability Model

Develop Marketing Databases

Source: Rollo and Clarke, 2001
Original Source: Saint-Onge, 1996
Another reason for low profitability or productivity is poor balance between the CRM system and the organizational structure. If banks apply a CRM strategy, they need to change their organizational structure from product-centric to customer-centric; it is not enough to introduce a new CRM system. Traditionally, banks have had product-centric structures; which means they must change their structure. However, banks, especially large money center banks or super-regional banks, have large and complex organizations, it is difficult for their organization to make such changes smoothly.

6.4 OUTSOURCING

Outsourcing is an important element in the banks' strategy, especially during recent turbulent situations. Recent severe conditions caused strong competition between traditional banks and new entrants from other industries, as well as deregulation and rapid improvements and changes in IT. Therefore, banks needed to focus on their core competence. As a result, they had to change their strategy from handling their problems internally to making the best use of outside firms. Table 6-2 shows the advantages and disadvantages of outsourcing.

<table>
<thead>
<tr>
<th>Problem: Which businesses should be outsourced?</th>
<th>Outflow of internal knowledge</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Solves the problem of insufficient internal knowledge</td>
<td>• No internal accumulation of knowledge</td>
</tr>
<tr>
<td>• Becomes a resource for other strategic businesses</td>
<td>• Potential for breach of confidence</td>
</tr>
<tr>
<td>• Makes use of current technologies</td>
<td>• Loss of quality control</td>
</tr>
</tbody>
</table>

Banks can easily acquire useful knowledge from outside by outsourcing without the need for internal training or recruitment. They can adapt their knowledge to a changeable environment and throw their power into businesses that make use of their core competencies. On the other hand, banks also run the risk of knowledge outflow, an inability to accumulate internal knowledge, and the loss of quality control when outsourcing is used. Furthermore, one of the major difficulties with outsourcing is deciding which business should be outsourced. In general, companies should outsource businesses that are part of the core business. But in
the case of the banking business, with its customer-centric strategy, the businesses are intertwined and it is difficult to separate one business from the others.

As indicated in Chapter 4, U.S. banks use outsourcing frequently. In the early stages of outsourcing, the banks simply decided on the business and sent it to an outsourcer. Today, in order to diminish risk, the process has changed. Banks make an alliance, or a partnership, or establish a joint venture company with the outsourcers. This is done not just to hedge risk but also to achieve synergies among the participants. In many cases, participants come from various other industries, such as IT, consulting, or security, so they have different knowledge and skills that get passed on to the company, thus improving its knowledge base. A good example of this is the pinnacle alliance among JP Morgan and three other companies.

There are many large outsourcers in the U.S., and as these companies have in excess of 60 percent of market share (Sanwa Bank and Sanwa Research Institute, 1999), they can have the advantage of both scale of economies and accumulation of knowledge about banking business. Their existence makes the decision to outsource much easier for U.S. banks.

By contrast, few Japanese banking firms use outsourcing. While some have begun to realize the importance of outsourcing and tried to use it in recent years, the number of such banks is limited. Those that have realized the importance of outsourcing are or recently were in crisis, and the crisis led them to outsourcing, as was the case with Daiwa Bank or Asahi Bank.

Most banks still rely heavily on internal knowledge. They create subsidiaries to outsource businesses such as IT or back-office operations, but they remain inside the parent company. Why? First, because Japanese banks do not understand their core competence and have difficulty determining which businesses to outsource. They believe every business should be handled internally. Second, Japanese banks take a negative view of outsourcing. The general perception is that outsourcing is the forerunner of restructuring and a reduction in the labor force. In addition, Japanese bankers usually graduate from top universities which are said to create elitists who cannot trust outsiders. The banks are afraid of risk and the drawbacks of outsourcing. Finally, there are no large outsourcers in Japan.

For all these reasons, a bank's subsidiary has a good possibility of becoming a successful outsourcer if it is able to obtain orders not only from its parent company but also other banks.

6.5 SUMMARY
It is a fact that as technology and business become more complex, knowledge will become more widespread, and it will no longer be possible for banks to handle all their business internally. They need to acquire outside knowledge and make the most of it, creating a knowledge network that will enable them to compete with their rivals. In this sense, U.S. banking firms appear to use outside knowledge more effectively, in the form of outsourcing, hiring IT specialists, or traders from the outside. They have identified their core competencies and can focus on their core businesses. Throughout the 1990s, the banks threw their resources into their core competence and outsourced other businesses and functions aggressively. As a result, I believe that U.S. banking firms can create a knowledge network that includes outside companies, and strike a balance between internal knowledge and external knowledge.

In comparison, Japanese banking firms do not try to use outside knowledge and skills but depend on internal knowledge. One reason is the corporate culture of Japanese banks. Because Japanese banking firms are based on traditional systems, such as life-long employment, late-selection, and the seniority system, these systems do not fit with recruiting outside specialists. This lack of fit may come from both the employees and the employment system itself. Many banks are now trying to change their employment systems to be able to hire specialists from outside and to give high evaluations to these people. However, the banks tend to emphasize internal promotion rather than promoting excellent outsiders.

The relatively smaller labor market in Japan is another problem. Japanese workers prefer to join a large company and then continue working for that company until retirement age. This means the Japanese labor market remains relatively small compared with that of the United States.

One last issue that I have not touched on before is the problem of language. Japanese workers mainly speak Japanese and seldom use English; indeed, many Japanese cannot speak English at all, and it is difficult for Japanese companies to find excellent workers or a partner outside of the country.

Japanese banks have begun to realize many of these problems and are beginning to take steps to eliminate the obstacles and bring about change. However, it would be unreasonable and unrealistic to expect that the companies will change radically overnight. The changes, as they occur, will come gradually.
Chapter 7
Conclusion

My research found that Japanese city banks tend to rely on internal knowledge and do not try to acquire or use outside knowledge. They hire excellent graduates from top Japanese universities and educate them internally, gradually generating high competition among the employees. This is a trend that has been in place since the 1950s and it has resulted in a certain elitism among Japanese bankers. That elitism grew during Japan's period of high growth when the banks played an important role. In those days, Japanese companies were growing rapidly and were always short of funds. The banks were able to loan money without any problems and they enjoyed strong power as money suppliers. Because of these circumstances, Japanese bankers tended to believe they were different from other people who worked for other companies. I believe that elitism has obstructed Japanese banks from using outside knowledge effectively.

Also Japan's employment systems, such as life-long employment and internal promotion, have dominated the banks for many years, and these systems also prevented the banks from acquiring outside knowledge. Their organizational pyramid is dependent on these employment systems, and employees tend to make much of Wa, or harmony among people. These systems have also made difficult for banks to hire people with enough experience or to give them higher incentives than other employees who have worked for the bank longer. Indeed, while these systems sustained high growth in the 1960s and 1970s and produced continuous innovation in the 1980s, almost all the successful companies were in the manufacturing industry, and the growth of Japanese banks during those periods came as the result of government regulations and the growth of other industries. In other words, it seems that the typical employment system among Japanese banks works well in conservative situations but does not work in during periods of reform, change, or upheaval.

Both language and the presence of a single homogenous race may also contribute to the problem. In general, most Japanese cannot speak English or any other languages, and Japan is composed of a single race. Because language is the most important factor for
transferring information and knowledge, Japanese banks tend to find partners in Japan and have considerable difficulty finding overseas partners.

From the viewpoint of customer relationships, Japanese banks do not use their knowledge of customers effectively. Before the 1980s, there was little need to listen to the customer voice, and as a result they did not pay attention to customer needs or try to improve customer satisfaction. However, in recent years, customer are now able to choose their bank based on different services and financial products, because with deregulation and IT innovations, new products and services are being offered by the banks and other banking firms. Today, banks need to take care of customer requirements and make the best use of their knowledge in order to retain and expand each bank’s market share.

Many of these traditional systems began to change in the 1980s, but it is clear that Japanese banks still need to change their views of the knowledge creation process, from one that is internal-oriented to one that is more outside-oriented; if they fail to change, they will never catch up with the financial and IT innovations that occurring rapidly.

In order to maintain their competitiveness, banks need to identify and concentrate on their core competence and acquire external knowledge, such as customers’ knowledge, vendors’ knowledge, and that of outside experts.

In comparison, large U.S. banking firms use external knowledge effectively. It is generally believed that the United States is a country in which people change jobs easily and there is a high job turnover rate in comparison with other countries. In addition, United States is a nation with advanced financial and information technologies and many specialists in those fields.

Furthermore its native language is English, and the country has accepted many immigrants. This means U.S. companies can gather excellent employees who come from many countries, bringing with them fresh ideas and a constant stream of new knowledge.

The U.S. banks also experienced a downturn in the late 1980s, but they revived through focused strategies and restructuring. They understood their core competencies and concentrated on them by injecting resources extensively. In addition to the core competencies, they made the difficult decisions to drop irrelevant businesses in fields that did not contribute to their core competence, or outsourced those businesses to other companies.

Today, as technology becomes more complex and customer requirements more complicated, the knowledge that is required of each employees is also becoming more complex. U.S. bankers have changed from generalists to specialists, with the result that many large U.S. banks have revived and are now enjoying enjoyed strong performances throughout the 1990s. It is likely that their strategy for managing knowledge was also successful during this period.
However, according to some theories of knowledge management, the treatment of knowledge among large U.S. banks has some problems. First, there is the issue of internal accumulation of knowledge. Because of a high turnover rate among skilled employees, it may be difficult for U.S. banks to accumulate knowledge internally. Second, because of many jobs are highly specialized, the exchange of knowledge may become difficult for U.S. banks. Some have already realized these defects and have introduced IT infrastructures and knowledge management software. But such systems manage only explicit knowledge and cannot accumulate tacit knowledge. As we have seen in the case of Japanese manufacturing companies, tacit knowledge plays a major role in some cases. I believe U.S. banking firms need to focus on their tacit knowledge and discover how to accumulate tacit knowledge internally.

Since new entrants from other industries will increase, and customer requirements will escalate, competition in the banking business will become even stronger. Also due to continuing innovations in IT and financial technologies, banking firms increasingly need special knowledge to remain current with these technologies. It is apparent that banking firms cannot sustain their competitiveness simply on the basis of internal knowledge; they must also acquire and use the best external knowledge they can find. In addition, banks need to accumulate external knowledge internally in order to maintain continuous growth. In this sense, large U.S. banking firms are one step ahead of Japanese banking firms, and Japanese city banks can learn many things from the U.S. banks.

In order to make the most of both internal and external knowledge, the banks need to consider their cultural background and organizational history. As each banking firm in the U.S. and Japan has a different background and history, their strategy for knowledge management should be different and cannot simply imitate strategies adopted by other banks. In order to remain competitive in the global banking industry, each bank must try to use both internal and external knowledge, while taking into account their core competence and cultural background. As long as these banks continue to build strong infrastructures, including human resources, they will remain strong in the future by managing knowledge successfully.
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