ABSTRACT

Japanese Banking in the U.S. —
From Transient Advantage to Strategic Failure

Japanese banks instantly became major players in world financial markets when the 1985 Plaza Accord doubled the value of the yen. Access to cheap capital and long-term relationships with Japanese firms doing business abroad allowed them to undercut overseas rivals and achieve early success. However this quick-term overseas strategy lacked a defined long-term outlook.

Based upon the author's interviews with 61 Japanese bankers, this paper examines the failure of Japanese banks to create and sustain competitive advantage. Their lack of "soft" resources, such as international experience, knowledge about local markets, and management expertise, have all contributed to their recent retreat.

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JAPANESE BANKING IN THE UNITED STATES: FROM TRANSIENT ADVANTAGE TO STRATEGIC FAILURE

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I. INTRODUCTION

When catapulted onto the world scene in the mid-1980s, Japanese banks instantly became major players in world financial markets. In a political move by the Group of Seven Industrialized Nations to redress the balance of payments between Japan and its trading partners, the 1985 Plaza Accord doubled the value of the yen and, as a result, thrust the already sizable Japanese banks into the top league of international banking as they looked for new loan and investment opportunities abroad. By 1988 Japanese banks held seventeen out of the top twenty-five rankings worldwide and completely dominated the world's top seven positions in terms of assets [Fortune, July 30, 1990: 324].

With their meteoric international rise, alarms were sounded by politicians and pundits alike who foretold the imminent global dominance of Japanese banks. Academics cautioned that if American companies weren't careful, Japanese banks, despite their inexperience, would soon become formidable competitors and take over the world financial industry, just as Japanese automotive and electronic firms had done a decade before [e.g., Aggarwal, 1992; Wright and Pauli, 1987]. However, what Wright and Pauli called "Japan's global assault on Financial Services," was a short-lived skirmish rather than the beginning of a new economic world war. Other studies, offered a more beneficent view of Japanese finance as a useful, if not necessary,

source of capital for the U.S. [Rose, 1991]. Contrary to these earlier expectations, the giant and seemingly invincible Japanese banks ultimately had feet of clay.

Even with their initial advantages of lower cost of capital and long-established relationships with Japanese client firms investing overseas, Japanese banks were woefully unprepared to succeed in an international role, more than they themselves may have realized at the time. Flush with new wealth, they responded quickly to international opportunities with strategies which, although definitely global in reach, lacked a defined long-term outlook. With only very limited experience and knowledge about banking practices outside of their own country, many Japanese banks set about establishing their first sustained contacts with London, New York, Hong Kong, and other foreign markets. In a short time writers in the popular press were foretelling the imminent global dominance of Japanese banks. Just as quickly, however, Japanese banks overseas seemed to falter and "success" soon turned to failure.

In this paper, we first describe, from an historical perspective, the internationalization of the Japanese banking industry, focusing primarily on their penetration of the American market. Second, we analyze what turned sure success into the failure of Japanese banks in the United States. This discussion includes the insider viewpoints of Japanese bankers as to the events of that period and how these past experiences are now shaping current expectations. Drawing on recent developments in the strategy literature, notably the resource-based theory of the firm, we frame our analysis of why Japanese banks failed to sustain their competitive advantages vis-à-vis their international competitors. Although we acknowledge that there were environmental changes which hastened or accentuated the problems of many of the Japanese banks in the United States, we argue in this paper that the most important contributing factors were the banks' own fundamental organizational weaknesses, including a lack of long-term planning, conflicting objectives with local partners and acquired firms, and finally, the lack of knowledge of local market conditions, compounded by ineffective human resource management practices which failed to capitalize on the knowledge and expertise held by both their American and Japanese employees.

Methodology

We base our conclusions on extensive empirical data drawn from multiple, in-depth interviews with sixty-two Japanese respondents. Interviews were conducted with executives at seven city banks, including the top six (*kigyo-shudan* affiliated) banks and a former specialized bank; two of the three long-term credit banks; three regional banks; two trust banks; one foreign-owned bank; and a government-owned bank. In addition, interviews were conducted with officials from the Ministry of Finance (MoF), Ministry of International Trade and Industry (MITI), and six other regulatory and bank service organizations (see Appendix). These interviews were conducted during an eighteen-month period by one of the authors between 1992-1993, at a time when many Japanese bankers were just beginning to carefully reflect on their American experience.

The primary objective of this research was to produce a fine-grained study of Japanese banking practices [Lawler 1985]. Using the Grounded Theory approach [Glaser and Strauss 1967], we employed a focused semi-structured open-ended question technique in face-to-face interviews [Merton, Fiske, and Kendall 1956] with the Japanese respondents. A snowball sampling technique (referred introductions) [Bailey 1978] was employed in widening the pool of respondents. Wherever possible we attempted to cross-validate information given by a respondent by interviewing more than one respondent at each institution, obtaining multiple perspectives on the same set of questions. We also interviewed a number of former employees of particular institutions to get their perspectives (see the appendix for a detailed description of the research methodology). We conducted a total of 109 interviews (186.5 hours) with 62 respondents, each interview totaling 1 hour, 43 minutes, on average. Among the major institutions included in the study, (city, and long-term credit banks), we interviewed an average of 4.1 respondents per bank. Fifty-six interviews (2 hours each on average) were conducted with the 37 respondents in these major banks. All interviews were tape recorded and transcribed to ensure proper interpretation and accuracy of quotes. In addition, we cross-validated our initial conclusions from the data by circulating a draft report to thirty-eight banker respondents in January 1994. The data gathered from respondents' responses to this initial report are also included in this paper.

II. HISTORICAL OVERVIEW OF THE INTERNATIONALIZATION OF JAPANESE BANKS

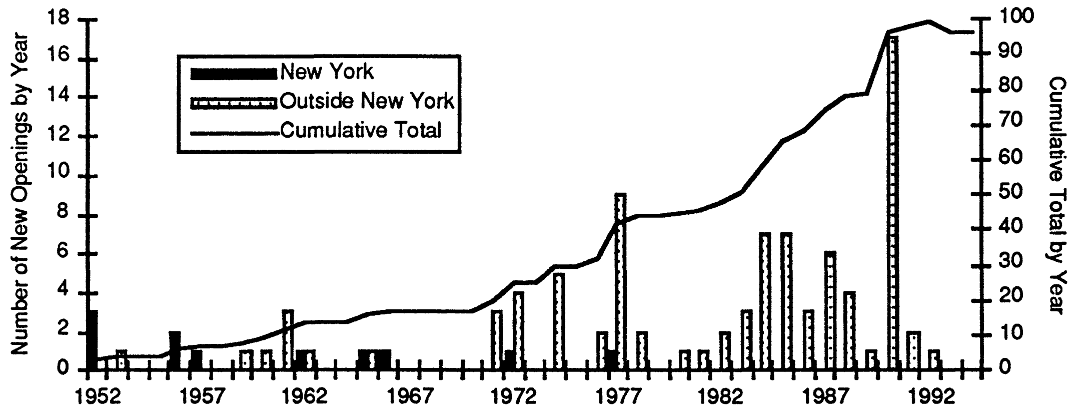
Typically, the primary roles of any foreign-owned bank's operations outside of its own home-court market have been to: 1) finance foreign trade and facilitate foreign exchange; 2) finance overseas investment; 3) take advantage of interest rate differentials by raising funds in markets that have lower rates. In the case of Japanese banking, each of these functions assumed importance in different stages of internationalization. In fact, the experience of Japanese banks followed the general pattern set by Western banks in terms of the historical development of objectives and response to international growth opportunities.

Like Western banks, Japanese banks first internationalized their operations in order to finance trade. Then, as Japan's international trade boomed, they set up expanded international lending and investment finance operations, Finally, cash-rich thanks to yen revaluation and over-leveraging of capital, they expanded to finance and service direct foreign investment. It was at this juncture that the history of Japanese banking in the U.S. went awry, and opportunity became transformed into opportunism. This period ended with a new sobering in the bursting of the Japanese "bubble." It is also important to keep in mind that behind the apparent monolith of the Japanese banking industry is a complex diversity of sometimes cooperative, sometimes competing interests among Japanese institutions that reflect national versus regional, large versus small, private versus public interests sectors, each with varying degrees of influence and autonomy.

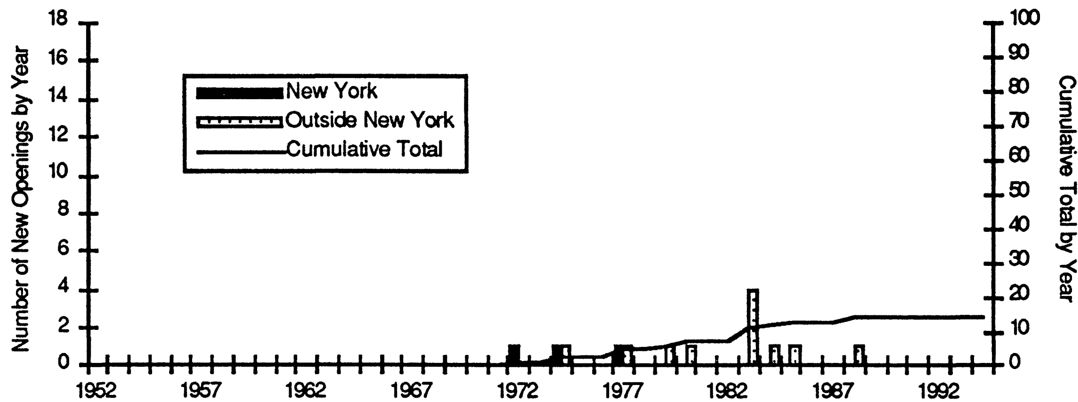
Phase I — Trade

Japanese banks first established U.S. offices in the late 19th century, maintaining them until the beginning of the War in the Pacific. In September 1952, following the signing of the San Francisco Peace Treaty which formally ended World War II, the Bank of Tokyo re-opened its branch offices in New York and London. It was soon followed there by the larger Japanese city banks (see Graph 1). The remaining city banks arrived in New York during the next decade. During the 1950s and '60s it was only the Bank of Tokyo that maintained a presence outside of New York because it held the exclusive franchise from the Japanese Government to transact foreign exchange. In the early 1970s MoF began to allow Japan's remaining fourteen city banks, large commercial banks with a domestic nationwide network (today reduced by merger to eleven),

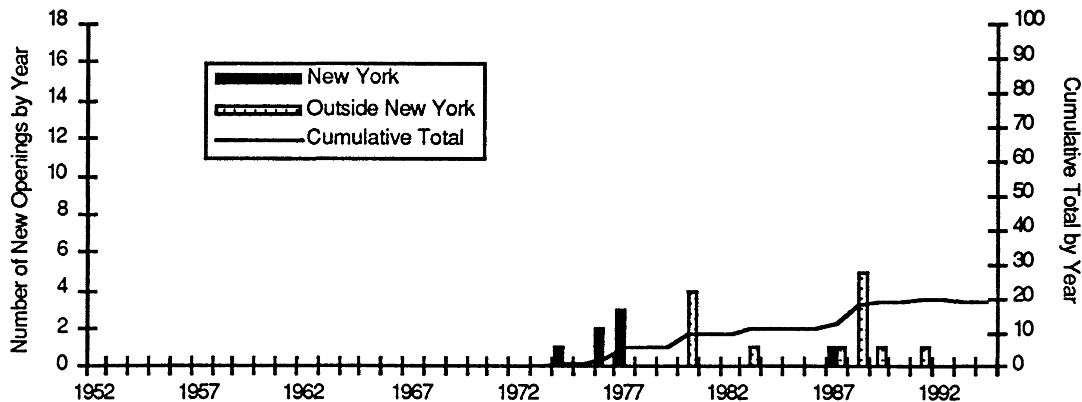
Graph 1: City Banks — Yearly and Cumulative Openings of U.S. Branches and Representative Offices, 1952-1994



Graph 2: Long-Term Credit Banks — Yearly and Cumulative Openings of U.S. Branches and Representative Offices, 1972-1994



Graph 3: Trust Banks — Yearly and Cumulative Openings of U.S. Branches and Representative Offices, 1974-1994



SOURCE: Statistical data for graphs compiled by the author from *Kinyu Zaisei Jijo*

to transact foreign exchange so that several of the larger city banks opened branches in other U.S. cities as well. An expanding level of transaction business, principally in supplying letters of credit and financing import-export trade, justified this first spurt in overseas operations. At this point, Japanese banks abroad existed largely to serve the foreign trade needs of the rapidly globalizing Japanese business community.

Phase II — Finance and International Lending

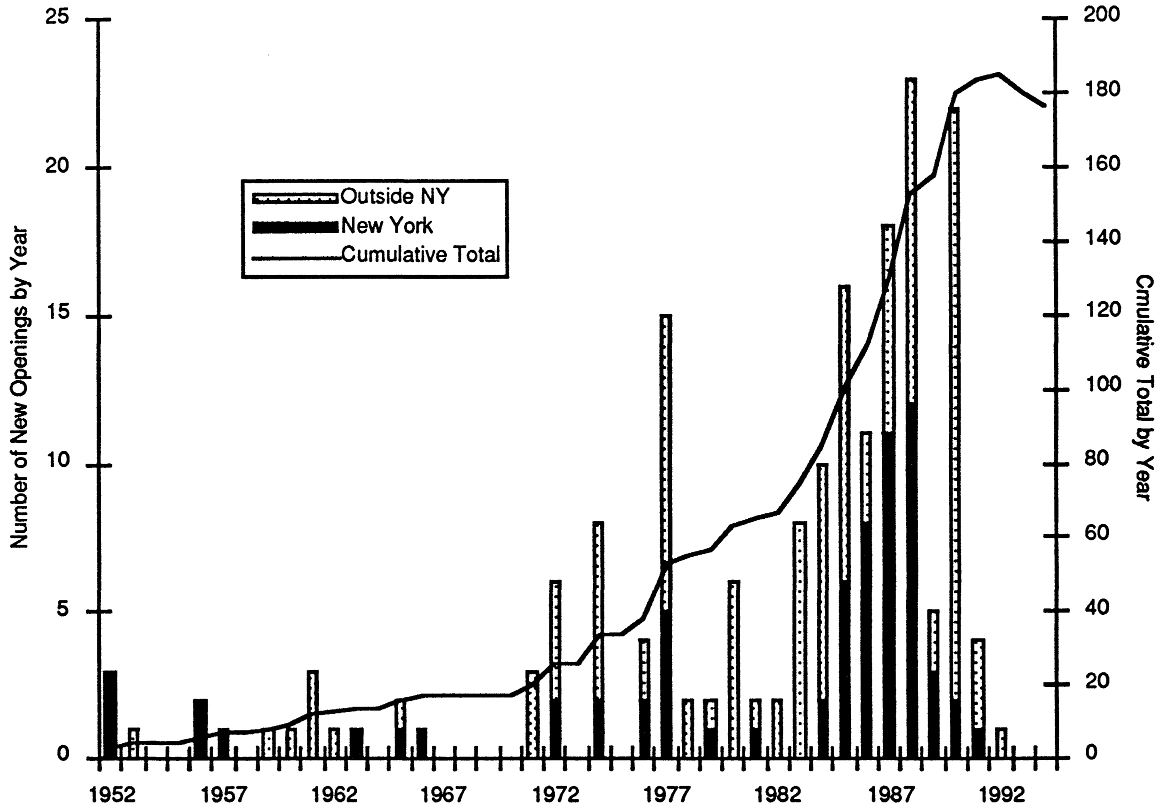
In the mid-1970s this first stage of international banking business was followed by a second phase marked by expanded lending and investment. Japan's three long-term credit banks also received MoF's permission to open branch offices in New York, (see Graph 2). Still, by 1976 there were only eighteen Japanese banks, mainly the larger city banks and long-term credit banks, with a total of 38 offices in the United States.

When Japan's eight trust banks finally entered the U.S. market in the late 1970s, they first opened offices to participate in New York's financial market, and their investments in U.S. securities began to soar. In 1980, the trust banks opened branch offices in Los Angeles to manage their burgeoning real estate trust activities (see Graph 3). Behind the sharp rise in Japanese investment in the U.S. was the fact that Japan had grown from being a net debtor into a net exporter of capital with investments in financial instruments and international lending. During this period, following the lead of the American banks, Japanese banks began to boost bank assets by making risky loans to Lesser Developed Countries (LDC), booking many of the loans through the New York branches of the Japanese banks. At the time these sovereign debt loans seemed secure, but later in the decade many were to go into default.

Phase III — Foreign Direct Investment and Services

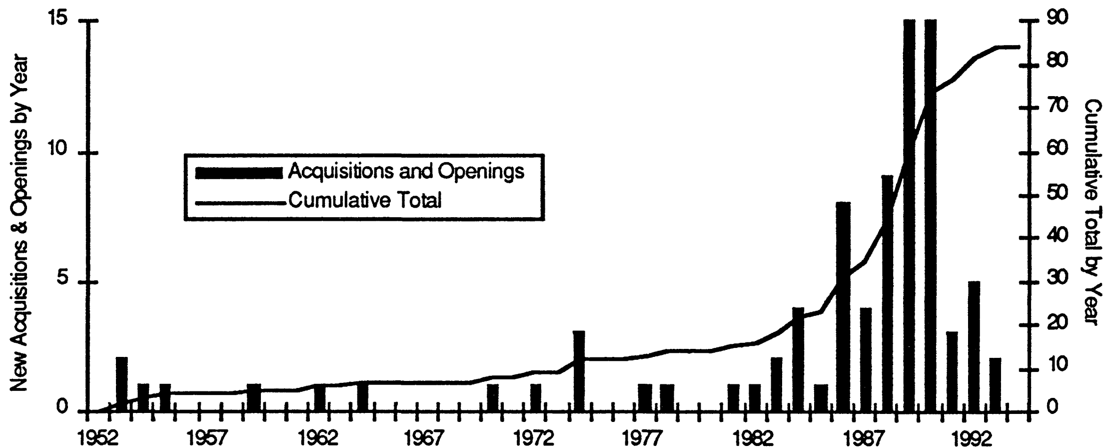
In the years following the 1985 Plaza Accord, the total number of city, long-term credit, regional, and 2nd-tier regional bank branches and representative offices in the United States nearly doubled, from 85 in 1984 to 180 by 1990, (see Graph 4). During this period many Japanese-owned banks in the U.S. were participating in the U.S. domestic market through large-scale commercial lending to industrial and real estate interests, and through their acquisition of U.S. retail banking networks and financial services firms as partly or wholly-owned bank subsidiaries

Graph 4: Yearly and Cumulative Openings of All Types* of Japanese Bank Branch and Representative Offices in the U.S., 1952-1994



* City banks, long-term credit banks, trust banks, regional banks, and 2nd-tier regional banks.

Graph 5: Acquisition and Opening of U.S. Financial Subsidiaries by Japanese Banks, 1953-1994



NOTE TO GRAPH 5: These companies may be wholly-owned, a majority-share-held subsidiary, or a company in which the bank holds a minority position but has determined that it plays a significant role.

SOURCE: Statistical data for graphs compiled by the author from *Kinyu Zaisei Jijo*

(see Graph 5). It was during this period that the internationalization of the Japanese banking industry really escalated and entered its third phase of direct investment and financial services, which is the primary focus of this study.

The sharp upward revaluation of the Japanese yen following the September 1985 Plaza Accord resulted in a massive flow of direct investment abroad from a wide spectrum of Japanese corporations. According to Japanese government statistics, between FY1988 and FY1989 alone, worldwide foreign direct investment by Japanese firms increased from $47.022 billion to $67.540 billion, more than a five-and-a- half-fold increase over the 1985 investment level of $12.217 billion [*MFR* June 1986; June 1990].

Responding both to the revaluation of the yen and the threat of trade sanctions against products manufactured in Japan, Japanese companies of all sizes and categories adopted strategies of aggressive overseas investment — most notably in the United States which received 41.1% of total Japanese foreign direct investment from 1951 to 1989 [*MFR* June 1990]. In the United States, new Japanese investment increased dramatically in the mid-1980s and peaked in fiscal year 1989 at $32.540 billion, with 2,668 new cases of investment reported [*MFR* June 1990].

Manufacturers led the charge overseas to reduce production costs, as the revaluation of the yen made Japanese export goods more expensive and forced a shift away from Japan-based production to production in countries which paid lower wages. However, the rise in the value of the yen also suddenly made Japanese companies across-the-board cash-rich, and all types of companies dived head-first into the speculative fever of M&A. Almost overnight, they acquired large stakes, if not outright takeovers, in U.S. companies, paying top dollar prices for the opportunity.

Fearful of losing their best clients to foreign banks, Japanese banks of all types and sizes followed their clients abroad, expanding their own overseas operations to keep up with their clients' activities. As one Japanese banker explained:

> One reason why the banks moved quickly to internationalize was because their customers went international. Customers like Toyota started to build plants overseas. Of course at first their business was principally import-export transactions, and the Bank of Tokyo did a good job in serving those needs. However, the more internationalized the Japanese economy became, the more international networks the banks needed to serve their customers [author's interview].

Japanese banks were also affected by the same speculative psychology that had gripped Japanese industry to seize opportunities in foreign investment. A Japanese bank officer explained the expansion strategy of the Japanese banks at the time:

> The banks wanted to strengthen their profit base. At first they thought they could earn money rather easily in the U.S. market because they knew that it would be easier to enter and make profits than in the European market. In Europe the relationship between clients and their banks is much more closed while relationships in the U.S. market are open.
>
> At the time Japanese banks had very good credit ratings, and by providing that kind of credit to the states and municipalities they could do a very good business. I think they assumed it would be a very good opportunity for them to penetrate the U.S. market, especially because at that time the Japanese yen was very strong. Many U.S. banks wanted to sell their assets. They were selling at a very reasonable price to Japanese banks and companies [author's interview].

Between 1976 and 1994 the number of Japanese bank offices in the U.S. tripled, with a four-fold increase in the number of their branches (see Graph 4) and a seven-fold increase in the acquisition and establishment of financial subsidiaries (see Graph 5). The expansion of Japanese banking and financial services usually took the form of either branches and representative offices of the banks or subsidiaries.

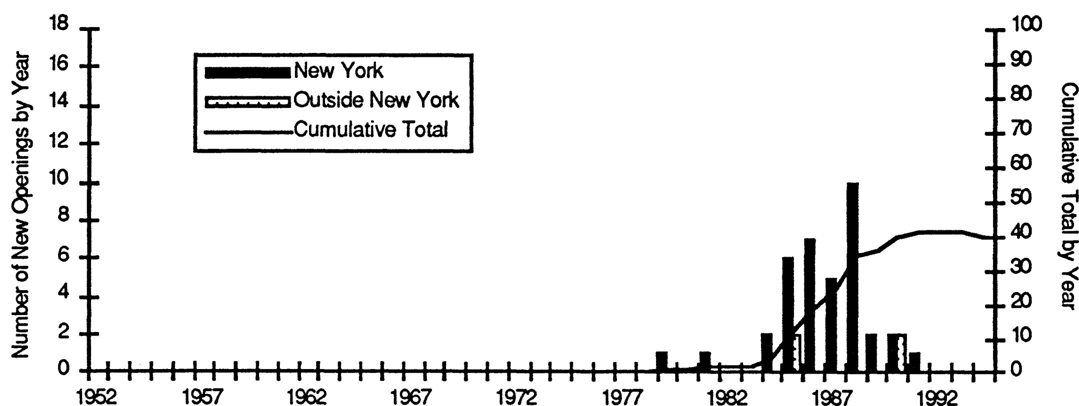
Branch offices differ from representative offices in that branches can offer a full-range of banking services, while the representative offices are restricted in the scope of their transactions. They cannot accept domestic deposits but must limit their activities to trade financing and money-market services. Subsidiaries, on the other hand, are U.S. corporations, many having been acquired through M&A. They have become important vehicles for Japanese bank expansion into the U.S. financial services sector, taking such diverse forms as: retail banking networks, investment banks, securities firms, primary dealerships in U.S. Treasuries, commodity brokers, leasing operations, factoring companies, and all sorts of financial boutiques.

To gain a foothold in the U.S. market, Japanese banks relied most heavily on their capital advantage, particularly in lending. Indeed, the deep pockets of Japanese banks were sought out by U.S. federal and local governments as well as businesses. During the 1980s Japanese banks increased their share from 6.5% of lending to U.S. corporations, municipal, state, and individuals in 1985 to 11.8% in 1990 [Zimmerman, 1993]. In California, Japanese bank-owned subsidiaries

of the Bank of Tokyo, Sanwa, Mitsubishi, and Sumitomo banks held 24% of all outstanding loans in 1988 [*JFMR* Nov. 14, 1988]. Their loan assets doubled when the Bank of Tokyo and Sanwa Bank purchased two U.K.-owned retail banking networks, Standard Chartered's Union Bank, and Lloyds California, respectively, in order to gain experience in U.S. financial services and to broaden their customer bases [*JFMR*, Nov. 14, 1988].

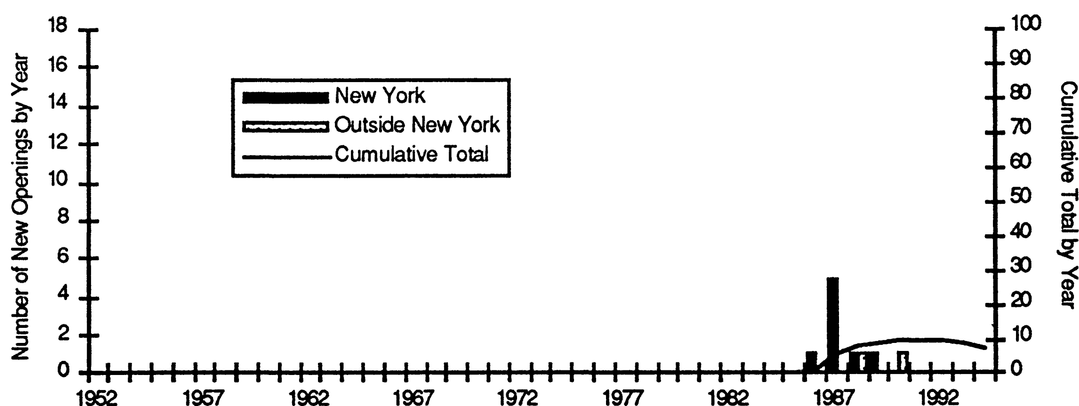
By the mid- to late-1980s the Japanese city bank branches had mushroomed throughout the U.S., overshadowing their presence in New York and a few West Coast cities (see Graph 1). These overseas moves were not confined only to major commercial banks, that is, the city banks. Even Japan's regional and second-tier regional banks (formerly *sogo* — mutual banks) were impelled to open overseas representative and branch offices so as not to lose their internationalizing corporate clients either to Japanese city banks or local banks overseas. Among the regional banks, the number of New York offices more than tripled between 1986 and 1990, from the 11 representative offices and 3 branches which existed in 1986 (none of them second-tier regionals) to 21 branches plus 23 representative offices in 1990 (including 3 branches and 6 representative of the second-tier regionals) (see Graphs 6 and 7). Similarly, in Hong Kong the number of representative and branch offices rose from 11 to 37, and in London from 15 to 19 during the same period [*Kinyu Zaisei Jijo*, August 9, 1993].

Graph 6: Regional Banks — Yearly and Cumulative Openings of U.S. Branches and Representative Offices, 1979-1994



SOURCE: Statistical data for graphs compiled by the author from *Kinyu Zaisei Jijo*

Graph 7: Second-Tier Regional Banks — Yearly and Cumulative Openings of U.S. Branches and Representative Offices, 1986-1994



SOURCE: Statistical data for graphs compiled by the author from *Kinyu Zaisei Jijo*

It is important to differentiate between the regional and city banks when considering the international development of Japanese banking, not just because of the vast differences in size between regional and city banks, but also because of the limited capabilities and quite different strategies the regional banks were forced to pursue. Most of the regional banks lacked significant levels of transaction business with their clients which would have warranted their opening a New York office in the first place, and the regional banks had little choice but to engage in high-risk debt in order to amortize the expense of opening and maintaining these offices.

The timing of the arrival of many of the regional banks in New York coincided with the sub-syndication of LDC loans by the larger Japanese city banks to their newly arrived country cousins, in the process ensnaring the regional banks in the ensuing LDC loan debacle. One banker described the situation of the regional banks in this way:

> For many of the second-tier regional banks which had only opened representative offices there was little they could do in transaction business except wait for a phone call from the large city banks, the long-term credit banks, or the Bank of Tokyo, inviting their participation in a syndicated loan. The higher rated regionals were more careful, but the lower rated banks adopted more aggressive, high-risk strategies in order to secure profits [author's interviews].

At the time, the leading Japanese city banks were already taking part in a feverish M&A lending frenzy characteristic of the late 1980s. Some, such as Sumitomo, after earning their syndication fees, completely unloaded their entire share of syndicated LBO debt onto the regionals

which had little ability or opportunity to discern the risks. Sumitomo was later rebuked by the Ministry of Finance and required to retain at least a 25% portion of the debt. The regionals and second-tier regionals were also warned by the MoF and the Bank of Japan about the dangers of their sub-participation in LBO lending [*JFMR* Dec. 12, 1988]. However, even now some of the regionals still continue to participate in the sub-syndication's of the larger Japanese banks. Although the majority of the regional banks have upgraded their New York offices to branches, others were forced to close, and some 13 are still only representative offices unable to engage in transaction business.

Many regional banks opened representative offices for the sole purpose of enhancing their status. Some used their foreign offices as a recruitment device to win new Japanese college graduates as employees. Like the MBA programs abroad offered as an inducement by the larger banks, the opportunity of an overseas assignment was and is used to entice new Japanese recruits to join a firm. Today many regional and 2nd-tier regional banks limit themselves to entertaining visiting company presidents from their home regions or arranging an economic briefing for the visiting executive, a courtesy usually supplied by the Bank of Tokyo to the regional banks.

For the most part, however, these New York offices serve as "guest houses," typically making arrangements for such things as theater tickets, shopping and sightseeing expeditions for visiting company officials and their wives. For example, a bank based in northern Honshu, which had no local clients doing business in New York, placed an advertisement in the *Nikkei Kinyu* newspaper inviting visitors to New York to stop in at their new office located conveniently to Fifth Avenue shopping. These seemingly "non-business" functions were seen by the banks as important to building and nurturing client and potential client relationships.

The Role of the Ministry of Finance

One key factor which made ambitious overseas expansion possible in the late 1980s was the informal but important backing of banking activity abroad by the Japanese government. Since World War II the government had prevented individual bank failure by restricting entry into the banking business, dictating interest rates, and tightly controlling central bank credit, all with the cooperation of the banking community. This protective policy was designed to assist the weakest banks but also enabled the bigger banks to achieve super-profits. Historic deference to and reliance

upon governmental authority continues today as an institutional component of the Japanese banking industry. For the weaker regional banks then and now it implies an orchestrated regimen of care and control by which the government and the banking industry attune their actions and goals in exchange for the MoF's continued protection.

The swift move of banks overseas in the 1980s occurred with little advance planning but with the approval, if not the blessing, of the Ministry of Finance which strictly limits the allocation of branch offices to each bank, both domestic and foreign. The result created the appearance of the concerted movement of Japanese banks into overseas markets. This phenomenon of concerted action, quite common in the Japanese banking industry, is popularly called the "*yokonarabi* system" in which all banks move together at the same time, whether venturing into new markets or offering new financial products or services.[1]

The following is a description of the bank-government relationship given by an officer at one of Japan's long-term credit banks:

> I think that Japanese banks are very different from Japanese manufacturers because the banks are protected by the government. Manufacturers are not protected by the government, and they went into the global market in the '60s and accumulated experience. Japanese banks are protected by the MoF. We do not have much flexibility in managing our banks because we have to negotiate with the MoF on almost everything. For example, in the 1960s, 1970s, and most of the 1980s, it was very difficult for us to open a new branch, we were severely restricted. The management of banks is rather weak compared to other Japanese companies, and so they tend towards a kind of bandwagon behavior.... [The MoF] wants everybody to do the same thing at the same time. So one bank cannot be more innovative than another bank [author's interview].

Once the green light was given by the government, little further thought was paid by bank management to the consequences of their overseas expansion. Bank executives assumed that the government not only backed the move but, in the event of difficulties or crisis, would take over responsibility for working out a solution as they would in Japan. A senior official of MoF's "rival," the Ministry of International Trade and Industry (MITI), commented that the difficulties

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[1] This term, which in current popular usage means "everyone doing the same thing at the same time," actually dates back to the the feudal Edo period when each daimyo "looked to see what the other was doing," since none would dare to do anything out of turn as this might incur the shogun's wrath. One banker suggested that within this context the MoF is considered by the banks as the present-day shogun.

experienced by banks in adapting to foreign competition were a result of "looking too much to government" for guidance, protection, and insulation from their mistakes and misfortunes.

A case in point is the Ministry of Finance's management of the non-performing loan crisis of Japanese banks. By its actions, if not always by its words, the MoF has indicated its intention to save even small banks from failure because to do otherwise would place the creditability of the whole financial system in jeopardy. This system contrasts sharply with that in place in the United States where the management of bank failure has been based mainly on deposit insurance to maintain public confidence and where bail-outs are reserved for the largest banks whose failure would have serious adverse effects on economic conditions or financial stability.

However, even the Japanese government could not protect the banks from the profound changes which their own internationalization brought about in the international banking industry. Foreign banks retaliated against the Japanese banking invasion of their markets by calling for uniform standards in the international banking industry. An internationally negotiated agreement under the aegis of the Bank for International Settlement (BIS), the so-called Basel Accords, subsequently implemented balance sheet requirements, primarily engineered by the British delegates, which required Japanese banks to maintain a minimum capital adequacy ratio of 8%, with a minimum of 4% in so-called Tier 1 equity capital by the end of FY1992. Until the imposition of BIS requirements, the capital adequacy ratio of Japanese banks 1st Tier capital averaged 2.5 to 3.5% compared to the 6% average of their U.S. and U.K. competitors [*JFMR*, Oct. 5, 1987; Dec. 28, 1987].

The Bursting of the Bubble

During the late 1980's "bubble economy" of ever-rising stock prices, it seemed an easy matter for the banks to raise additional capital for the new BIS requirements simply by issuing new stock to an insatiable equity market. In 1988-89 new equity offerings on the Tokyo Stock Exchange totaled a record ¥8.5 trillion; one-third was raised by banks to meet interim BIS equity capital requirements.

However, the collapse of share prices on the Japanese exchanges in 1990 brought disaster to the banks in its wake, particularly in regard to the BIS requirements. First, the value of the

banks' 2nd Tier capital — their so-called "hidden assets" of corporate share holdings — was slashed by 60%. In addition, banks could no longer easily raise capital through new equity offerings in the market to meet their Tier 1 requirements. Quality of assets rather than size of assets became the banks' new standard and ROE (Return on Equity) became the new watchword in the post-BIS era. As a result, profitability emerged as a critical issue for Japanese banks. Although the new BIS requirements reduced the potential risk of bank failure, they also reined in Japanese predatory loan pricing, since low-performing assets adversely affect capital adequacy ratios. Burdened with pre-existing low-performing assets, the banks were forced to revise their domestic and overseas strategies.

The comparative strength of Japanese banks, based principally on the perception of superior-sized assets, eroded with the collapse of the domestic real estate market. Alarmed by the U.S. savings and loan debacle, at the end of 1989 the Bank of Japan and the Ministry of Finance increased their scrutiny of similar lending activities by Japanese financial institutions to Japan's domestic real estate market and began to rein in the banks through "window guidance" — unwritten directives to the banks by BoJ and MoF administrators on credit policy [*JFMR*, Oct. 9, 1989].

In this drastically changed environment the Japanese banks lost their competitive advantage. Although they could still maintain close personal ties to their Japanese clients, their competitive edge with non-Japanese clients was almost instantly lost during 1990-91 with the deterioration of the value of domestic real estate loan portfolios, the chief underlying collateral of most Japanese bank assets during the 1980s. Instead of a relationship approach with their non-Japanese clients, the banks had attempted to compete head-to-head with American banks by pursuing a low-price, low-profit strategy to attract clients. However, the same strategy that had enabled Japanese banks to quickly penetrate the U.S. corporate loan market led just as quickly to the loss of these new clients when the banks could no longer continue below market-rate lending. Japanese banks became victims of their own loan underbidding tactics when declining profit margins forced them to retreat.

As the weight of non-performing real estate loans and high risk LBOs quickly deteriorated the quality of bank assets, Japanese banks, struggling against mounting losses, began to falter

heavily until the industry was finally forced into retrenchment from its short-lived world dominance. More than timing, it was a serious lack of technical expertise and knowledge that underlay the missteps of judgment of the banking industry. Japanese banks were not yet sufficiently skilled in providing their new overseas clients with the range of sophisticated financial services offered by their Western banking competitors. Furthermore, they had not developed any intangible resources — durable, untradeable or specialized to sustain their competitive advantage. [Williams, 1992].

III. ANALYSIS: TRANSIENT ADVANTAGES AND STRATEGIC FAILURES OF JAPANESE BANKS IN THE U.S.

Theoretical Framework

We frame our analysis of the strategic advantages and disadvantages of Japanese banks in the United States in resource-based terms [e.g. Penrose, 1963; Wernerfelt, 1984; Collis, 1991; Barney, 1986]. The resource-based view of the firm looks at idiosyncratic factor endowments of firms to explain differences in competitiveness. A key tenet of the resource-based approach is that competitive advantages derive through resource accumulation and deployment. Over time, firms accumulate unique combinations of resources and abilities which result in "distinctive competences" [Selznick, 1957]. These distinctive competences are valuable resources that the firm possesses, and the most critical of these assets are usually intangible or tacit [Prahalad and Hamel, 1990; Itami, 1987; Nelson and Winter, 1982; Teece, Pisano and Shuen, 1991]. These resources are seen as relatively immobile and differential mechanisms for resource combination and utilization. They result in heterogeneity among firms and, when they are not easily imitated or substitutable, can account for advantages over competing firms (this argument is consistent with Bartlett and Ghoshal's [1988] notion of "administrative heritage").

Merely possessing the necessary competences to survive does not yield competitive advantage. The competences must be both distinctive and be valued by customers (market worth). In the absence of customer demand for products created by the firm's competences, these competences, however distinctive, will not lead to rents [McGrath, MacMillan & Venkataraman, 1994].

Even competitive advantage translates to rents only when a firm can earn abnormal profits for its offerings, and when other firms cannot duplicate the product characteristics that allow these abnormal profits [McGrath et al, 1994]. This occurs when the firm is able to operate with superior efficiency relative to competitors, thus creating a pricing advantage, or when a product offers so much customer value that it commands prices for its offerings which far exceed the industry costs of creating those offerings [von Hippel, 1988; McGrath et al., 1994].

In order to benefit from its competences, a firm must offer a customer either *distinctive efficiency advantage* or *distinctive value advantage* [McGrath et al., 1994]. While distinctive efficiency advantage has been emphasized by authors using the resource-based theory of the firm as a source of competitive advantage [e.g. Petaraf, 1993], firms can also obtain rents from distinctive value advantage [McGrath et al., 1994]. Distinctive value advantage occurs when the benefit a firm is able to offer a customer exceeds the customers' cost of obtaining that benefit. If no other firm can match the benefits of the firm's offering, the firm can expect to command premium prices for the offerings. To the extent this premium price exceeds the costs to the firm required to create the benefits, the firm can earn rent [Teece, Pisano and Schuen, 1991].

The resource-based theory of the firm is consistent with theories in international business concerning the decision of firms to invest overseas. For example, the market imperfections approach states that, assuming the firm has a global horizon, its foreign investment decision is explained as a move to take advantage of certain capabilities not shared by local competitors. The foreign firm which enters a country for the first time faces a number of disadvantages not incurred by local firms which have intimate knowledge of the economic, social, legal and governmental environment [Buckley and Casson, 1976; Caves, 1982; Dunning, 1977]. It also faces exchange rate risks, risks of communication errors and misunderstandings from cross-cultural operations, and additional costs of operating from afar. To operate successfully, therefore, the foreign firm must have compensating advantages that are transferable overseas and that more than offset the home court advantages of the local firms. In resource-based theory terms, the foreign bank with global horizons must possess resources or competences which are unique from those held by their competitors and which are valued by the local market in order to overcome the liabilities inherent in operating outside of their home country.

Long-Term Client Relationships, an "Invisible Asset"

Japanese banks originally attempted to utilize resources which were already at their disposal to tap new international markets. At first, Japanese banks went overseas in order to follow their clients. They relied on the long-term relationships that had been previously established between their parent companies and the parent companies of other Japanese firms which were now doing business abroad. These banks had staffs of Japanese nationals in their overseas branches who could communicate with the top-level Japanese managers of their client firms in their native language. Such intangible resources or "invisible assets" [Itami 1987] proved to be extremely important in doing business with Japanese clients overseas since long-term relationships and smooth communication with business associates are highly valued and critical to conducting business. For this group of Japanese clients, Japanese banks had greater value competence [McGrath, MacMillan & Venkataraman, 1994] than their American rivals and were thus able to garner abnormal rents from this segment of the market.

Cost of Capital as a Competitive Advantage

Another advantage all Japanese banks had when entering the international market was their cost of capital. Japanese banks had access to cheaper capital due to their superior (albeit undeserved in retrospect) Aa or better credit ratings. Overawing Western financial markets with the sheer size of their assets, the banks easily convinced money market creditors to overlook the rather speculative quality of the underlying collateral. During the 1980s Japanese banks were thus able to raise long-term capital in the Eurodollar and other overseas financial markets more cheaply than British and U.S. banks. Japanese banks were also able to tap low-cost funds in Japan where the differential between the high propensity to save and low interest rates provided banks with access to cheap capital.

Access to cheaper capital allowed Japanese banks to employ predatory rate-cutting tactics, undercutting their Anglo and American rivals to secure a greater market share in local lending business. As one banker recalled:

> We were trying to get more market share in the U.S. and the U.K.; we weren't interested in ROE [Return on Equity] or profitability. Until the BIS [Bank for

> International Settlements] requirements we didn't pay attention to ratios or loan spread. As long as our funding costs were lower, we could permanently maintain these low margins [author's interview].

These two advantages together made Japanese banks' rapid foray into the American banking market highly impressive. For example, by the end of 1991 foreign-owned banks in general accounted for 45% of business lending to U.S. firms, a sharp upward expansion that quadrupled lending from $85 billion (a 19% share) in 1983 to $346 billion. Of that, Japanese-owned banks held a nearly 60% share of commercial, industrial, and real estate lending markets at their peak in 1990 [Nolle 1994]. For loans made only by their on-shore U.S. branches and agencies,[2] the Japanese banks accounted for some 80% of the foreign bank lending to the U.S. market [Terrell, 1993]. Even today, several years after their retreat, Japanese banks still hold some 40% of the combined onshore and off-shore loans by foreign-owned banks to the U.S. market [Nolle 1994].

In fact the banks were even more highly leveraged than industry in Japan. There they enjoyed a greater than 2:1 advantage in a country which already had among the lowest costing equity capital in the world. These low equity costs enabled Japanese banks to capture a huge share of the international market, in part because only a 0.1% interest loan spread gave them a 0.4 to 0.6% advantage in loan pricing over rival U.S., German, U.K., Canadian, and Swiss banks [Zimmer & McCauley, 1991:49-50]. In addition, they were backed by strong government support, operating under a TSTF regime — that no Japanese bank is Too Small [to be allowed] To Fail. This safety net encouraged Japanese banks to be indifferent to their razor-thin loan margins and to the risky quality of the underlying assets [Zimmer & McCauley, 1991]. Once Japanese banks lost their Aa credit ratings and the equity market in Japan collapsed, government support and access to Japanese customers alone were not enough to cover the costs of their pursuing an internationalization strategy.

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[2] Unlike other foreign-owned banks which book some 72% of their U.S. commercial and industrial loans off-shore through their Cayman Island and other off-shore facilities, Japanese banks until 1990 had booked only some 5% of their C & I loans out of a 25% total of their off-shore bookings through their 16 Cayman Island branches.[Zimmer and McCauley, 1991, McCauley and Seth, 1992] More recently however, lending has increased to 54.1% by Japanese banks' Cayman branches to U.S. businesses, and there is also a significant amount of deposits in the Caymans from nonbank U.S. residents, 33.5% compared to 31.6% from U.S. on-shore branch deposits. [Terrell, 1993]

Although the changes in the external economic environment can help explain the failure of Japanese banks in the United States to achieve long-term competitive advantage, all competitive advantages have a limited life [see e.g., D'Aveni, 1994]. Because of the dynamic nature of competition, the value of the firm's resources vary over time and organizations must continually discover new competitive advantage through the acquisition of new resources or through a reconfiguration of existing resources [McGrath, MacMillan & Venkataraman, 1994]. Resources are not valuable in and of themselves, but because they allow firms to perform activities that create advantages in particular markets. As Porter notes, "Resources are only meaningful in the context of performing certain activities to achieve certain competitive advantages. The competitive value of resources can be enhanced or eliminated by changes in technology, competitive behavior, or buyer needs, which an inward focus on resources will overlook" [Porter, 1991: 108]. This indicates that the processes used to develop new sources of advantage are as, if not more, important to the long-run competitive vitality of a firm than the content of any given advantage [McGrath, MacMillan & Venkataraman, 1994]. It is these processes to which we now turn.

When Japanese banks first entered the U.S. market it was their ability to produce at a lower average cost and to sell at a price fractionally below the industry equilibrium price that enabled them to attract new customers (distinctive efficiency advantage). Once this price advantage eroded, however, they lost their new customers. Japanese banks had competed with American banks solely on the basis of price (the cost of capital) and won a substantial share of the market. However, they failed to provide other distinctive sources of value to their customers which would sustain their relationship once their price advantage disappeared.

For example, in a 1988 survey by Greenwich Associates of U.S. corporate clients using foreign banks, Japanese banks were rated highly only for their competitive loan pricing policy when compared to German, U.K., Canadian, and Swiss banks. In all other services Japanese banks fell far short of the average, usually placing dead last to other foreign-owned banks in such services as: international capabilities, ability to propose innovative international banking alternatives, integration of merchant and commercial banking services, reliable source of credit, caliber of banking officers, capital markets and corporate finance capabilities, knowledge of

innovative domestic banking alternatives, historical relationship, and cash management [McCauley and Seth, 1982:56].

The failure of Japanese banks to understand, develop, and offer these value-added services to their American clients doomed the possibility of any relationship beyond transactions involving cut-rate loan pricing. Once their original source of competitive advantage had been lost, Japanese banks failed to develop and mobilize new competences. This raises the question of how this occurred. Using a recently developed framework in strategy [McGrath, MacMillan & Venkataraman, 1994], we next turn to our analysis of this question.

Strategic Failure to Develop New Competences

In order for a firm to reach its objectives or goals, the organization must first understand which combination of resources, assembled in which sequences, and applied to which situations, will lead to the desired result [McGrath, MacMillan & Venkataraman, 1994]. In addition, even if this understanding exists, the organization must be able to communicate and apply this understanding within the organizational context (defined as "deftness" by McGrath, MacMillan & Venkataraman [1994]). This is a second necessary antecedent for the development of competence. In the case of Japanese banks in the United States, we can see that most Japanese banks failed on one or both accounts. Despite expectations to the contrary, the American operations of Japanese banks were both unable to duplicate their parent companies' existing competences in the new environmental context or to develop new competences aimed at an American client base with greater perceived value than products offered by their competitors. While they did maintain their advantages vis-à-vis their American competitors in providing value for their Japanese clients in the U.S., the volume of profits generated by these clients was insufficient to sustain losses during the ensuing risky period of rampant speculative lending to the U.S. market.

One could argue that the failure to develop new competences was, in part, a result of the lack of international experience and knowledge about the U.S. market. The American financial market is sufficiently different from the Japanese for this to have been a major liability. However, Japanese banks had access to knowledge and expertise within their organization. What transpired, was a failure to institutionalize this knowledge or transfer it within the organization in order to

develop it into more than a transitory resource. Japanese banks also failed to link their unique resources to different types of strategies over time or to learn within their new environment how to survive [Williams, 1992].

Lack of Long-term Planning and Knowledge of Local Market Conditions

The lack of long-term strategic planning was one factor that rapidly undermined the clear competitive advantage Japanese banks enjoyed when they first stepped onto the international stage. Although some Japanese manufacturing firms have long had a reputation for careful analysis and detailed advance planning prior to any attempts at penetrating overseas markets, most Japanese financial institutions have shown little such foresight or regard for developing a coherent, long-term strategy when expanding overseas. In an environment like international banking, where advantages erode rapidly, trying to sustain an existing advantage rather than pressing forward with new ones can be fatal [D'Aveni, 1994: 8].

The easiest course was to purchase companies. Banks began to acquire stakes in U.S. financial companies without careful analysis of local conditions and requirements. With the expectation that business abroad was not appreciably different from business at home even the most sophisticated banks plunged near-blindly into the U.S. market. Two notable examples were the California branches of the Bank of Tokyo and Mitsubishi Bank. According to one respondent:

> During the 1980s the Japanese banks were very profitable due to the low interest rates. We had a lot of money, the price of the banks in the U.S. seemed very cheap, so we thought why not buy one? We believe that in Japan there are some economies of scale in the banking industry. Japanese city [commercial] banks always think about acquiring other banks. They thought that somehow the same thing would work in the overseas market. Plus the city banks wanted to introduce in Japan some retail business techniques from the United States.
>
> But I think they have learned that the U.S. market is very different from the Japanese market. The deeper they penetrated into the U.S. market, the more they understood that it is neither easy nor cheap to do business in the United States. For example, they did not know that the Community Reinvestment Act is a burden. This Act requires banks to reinvest money into the community. Before acquiring the U.S. banks they didn't know that. Now Mitsubishi Bank is suffering because of its ownership of the Bank of California, and the Bank of Tokyo is suffering from its ownership if the Union Bank even though the Union Bank is in far better shape than the Bank of California [author's interviews].

Led by the large Japanese city banks, the regional banks proceeded to participate in syndicated loans to major property developers such as Olympia & York, the aircraft leasing operations of the Guiness Peat Aviation Group, and to Robert Campeau's Federated Department Stores empire. No longer content to be merely institutional investors in U.S. Treasuries, they became direct investors in a wide range of acquisitions of over-priced financial companies and real estate in an overheated market.

The banks served as intermediaries for their Japanese corporate clients' real estate investments and corporate buyouts. Japanese banks became a mainstay in lending during the speculative real estate booms of the late 1980s for which they were significantly responsible. [*JFMR* Nov. 7, 1988; Feb. 20, 1989]. The consequences of some of these rash moves continue to plague Japanese investors today. One respondent stated:

> Mitsubishi Estates bought Rockefeller Center, but they are now having problems, and Mitsubishi Bank and other banks have recommended that it sell. Dai-Ichi Real Estate is now in particular difficulty with the Tiffany building. The Kumagai Group, the construction company, is also in trouble. Mitsui Trust Bank, the main bank of Dai-Ichi Real Estate, has recommended to Dai-Ichi Real Estate to sell as soon as possible, but it will have trouble with the current exchange rate. If it sells now it will have a foreign exchange loss. At the time of purchase the exchange rate was about 150 yen to the dollar and now it's only two-thirds of that [author's interviews].

For the 32 Japanese bank branches and representative offices in California, real estate lending accounted for some one-third of their $59 billion loan portfolio at the end of 1992. Using their access to mid-sized U.S. firms, real estate loans by Japanese bank-owned subsidiaries in California accounted for another $18 billion, the subsidiaries' loans quadrupling between 1985 to 1991, twice the rate of domestically-owned U.S. institutions during the same period. By the end of 1992 the problem real estate loans of the California branches and representative offices grew from 2.3% in 1991 to 9.4%, and for New York branches, problem real estate loans reached 15.5% of their loan portfolios [Zimmerman, 1993].

Integration of Global Operations — Lack of Shared Objectives

When Japanese banks set up overseas branches in their major markets of New York, London, and Hong Kong, they typically held the naive belief that the purchase of overseas assets

would automatically result in the diffusion of knowledge and information back to the parent. Japan has historically relied upon its ability to use foreign culture and expertise for its own ends to recast its own industries and institutions. This time, however, bankers were thwarted in their objectives to acquire badly-needed Western information and skills. Although some banks did gain a measure of expertise, they found a lack of comparability between Western financial markets and the regulated Japanese market.[3] According to one respondent:

> [Japanese banks sought to obtain] expertise from advanced markets, such as the U.S. and the Euromarket. They believed that expertise in securitization, trading, and some other specializations could be acquired by buying into international networks. For example, [Japanese] banks had not been allowed to underwrite securities in the domestic market, but in the Euromarket we could get that experience. The same was true for M&A or project finance. They thought that the transformation [of the Japanese financial markets] would proceed more rapidly, but the liberalization policy has not moved along fast enough [author's interview].

First, Japanese banks encountered problems with management as well as employees in their acquisition of American firms. The banks, in acquiring stakes in local firms, were attempting to purchase outside expertise but often found that their objectives were incompatible with those of their American partners. An officer of one Japanese bank recounted the case of conflicting objectives with local management when the Industrial Bank of Japan acquired a U.S. investment banking firm:

> The Industrial Bank of Japan acquired Schroeder Bank in New York and they wanted to do a kind of trust business in that market, plus a kind of underwriting business through a subsidiary of Schroeder Bank, but I heard Schroeder Bank declined to do that kind of business with IBJ. So IBJ has concluded that they might have to establish another securities subsidiary. I think they declined to do underwriting of corporate bonds, or that kind of thing because they thought that it was not profitable, but IBJ insisted on doing that new kind of business. IBJ was not successful in pressuring them to what they wanted to do. There was no harmonization [author's interview].

IBJ's initial intent in acquiring Schroeder was to gain access to the middle market, the investment firm's forte. When it sought to bring about changes, it found itself with a recalcitrant management. Managers at IBJ found they could not bring the same pressures to bear upon its

[3] Long-term credit banks and trust banks have recently been allowed to establish domestic subsidiaries for underwriting securities.

American subsidiary that it could have upon a Japanese affiliate. Although their acquisition had been an outright purchase, contrary to their initial expectations, financial ownership did not successfully translate into management control. Pre-existing management had written itself a number of "golden parachute" contracts and IBJ learned a costly lesson in U.S. management contracting customs when it sought to replace these managers.

The IBJ case was by no means an isolated one, a lack of shared objectives is highlighted by the following account:

> The typical example is Nippon Life Insurance. They bought a 13% stake in Shearson Lehman. From the outset it was quite clear that Shearson wanted a huge amount of capital and Nippon Life wanted to get some special techniques, certain skills from Shearson... Shearson just wanted Nippon Life's funds so they could dip their oars into the battle for LBO's. They needed bridge financing, they needed capital, free capital. It was provided by Nippon Life.
>
> At first, once Shearson got the money, they forgot about transferring skills to Nippon Life Insurance. Shearson Lehman was supposed to receive a team of experienced people from Nippon Life Insurance. However, even if they could train such a team, the markets are quite different. The U.S. is an open market, but here [in Japan] it's not so open. The cultures are quite different.
>
> Nippon Life Insurance is now sending over quite a lot people. But do you think that only two years of experience at Shearson can help Nippon Life Insurance introduce innovative financing in the Japanese market? Perhaps, if Nippon Life Insurance wanted to operate efficiently outside Japan, in the U.K., or New York, or wherever. With such a huge amount of assets, Nippon Life wanted to be international, not only in size but in skill. But that is impossible [author's interviews].

Lack of Organizational Learning

It has become commonplace in modern management studies, particularly those studying the Japanese firm, to emphasize the importance of human capital resources. In fact, many writers assert that it is their human resource management competences which give Japanese firms a competitive advantage over their Western rivals [e.g., Kenney and Florida 1993; Koike 1984; Ouchi, 1981; Shimada and MacDuffie, 1987; Wright and Pauli, 1987]. Paradoxically, however, Japanese banks have paid little attention to the development and retention of the knowledge resources of their employees which is critical to corporate success.

Even the best advance planning alone does not suffice to account for the complexities and intricacies of conducting business in a foreign country but is merely the first step, the preparation

to venturing overseas. The inevitable knowledge gap, presenting a weakness vis-à-vis local competitors at first, is overcome through a process of continual assimilation and information acquisition — organizational learning.

One notable exception was the joint venture between Dai-Ichi Kangyo and CIT. Dai-Ichi Kangyo Bank purchased of a 60% stake in CIT from Manufacturers Hanover and the venture not only provided a good return on equity but was also successful in transferring knowledge from the joint venture operation back to the parent company. The source of this success was a fundamentally different approach to the joint venture. Top officers assigned by DKB took a less aggressive role in exercising managerial prerogatives and used their position to write detailed reports to DKB's Tokyo headquarters on CIT's management techniques and practices. They did not attempt to impose their own objectives or agenda upon CIT management [author's interviews].

Lack of Integration of Local Employees

The effective use of all resources, including human resources, is critical to sustaining global economic success [e.g. Bartlett and Ghoshal, 1988]. In the case of Japanese banks, local human resources were one means by which first-hand information about the local business, economic, political and socio-cultural environments in the United States could have been mined. Although they often hired knowledgeable and talented local staff who had access to knowledge of the American market which was very valuable to their new Japanese bosses, Japanese financial institutions failed to capitalize on the local employee knowledge and talent within their organizations. In addition to often having conflicting objectives with their local partners, the banks typically maintained a Japanese hierarchy and did not admit locals into top positions despite their superior experience.

A former officer of a Top Six bank commented upon the view of management towards locals this way:

> Of course, they hire locals. They cannot be a local company without hiring local people. But it is typical of a Japanese institution that the head is Japanese and the second in authority is Japanese, although he might also be a local. The third position from the top will likely be occupied by locals as division heads, particularly in areas like aircraft financing, or something like that [author's interviews].

Japanese employees were transferred to the United States to fill key positions and to learn about the U.S. financial market. Despite a recognition by their Japanese employers that they could gain much expertise that would otherwise be unavailable from local workers, the absence of established mechanisms for information exchange often kept local employees, however necessary, as outsiders, non-core employees with little incentive to do more than "their job" for their Japanese bosses:

> An effective method to transfer knowledge is to hire specialists in the local market, New York, London, or Chicago. The people from those head offices are supposed to acquire expertise and bring it back... However, there is no established tutorial mechanism, just individuals working together. If the Japanese dispatched to local markets is not smart enough, he will probably get nothing out of it. He will just sit beside the specialist all day long, that's all. But if the person is smart, and if he can give something to the local employee, there will be some exchange of information. So the exchange depends more upon the nature, or potential, of the two individuals [author's interviews].

Keeping American employees outside of a Japanese-only core, Japanese banks created barriers to organizational learning and the development of new competences, undermining their own long-term success.

In addition to the staffing policies, the Japanese banks continued to reward local employees based on results, for performing their jobs, not for transferring information to the parent company employees. One such story described by a bank officer was his bank's acquisition of a securities company based in the U.S., a profitable financial boutique doing arbitrage trading:

> Superficially, it was a success because the company is profitable and highly regarded in the U.S. market, but the truth is our real goal was to learn advanced financial techniques from the U.S. company to introduce to our own securities division. That turned out to be very difficult to do because the employment system is very different.
>
> The major purpose of the employees in our new company is to earn money for themselves; each trader wants to earn money for their own accounts. Even though we spent a lot of money to acquire the company, we actually couldn't get any cash flow from the operation. We sent people from Japan to learn from the traders working at the company, but the traders didn't have time to train these younger Japanese to do arbitrage, how to manage risk, and they were not given incentives to do that kind of technology transfer. I think unless they are given an incentive they are unwilling to lose opportunities to make money in their trading [author's interview].

This illustrates an interesting divergence of assumptions between the Japanese collectivist ethos known as *wa* — harmony — and the more self-interested mode of management common in the West. The arbitrage traders, for example, saw no direct reward to themselves in transferring their skills to Japanese trainees; rather, their rewards were based directly on their trading performance. In addition to preventing most cross-fertilization of ideas between Americans and Japanese, this system drove the ablest of the local employees out of their firms and directly into the arms of their fiercest competitors.

Failure to Effectively Use Internationally-Trained Japanese Staff

One technique utilized by a number of Japanese firms to enhance the transfer of knowledge and information is to enroll their Japanese employees in overseas MBA programs. The MBA degree in itself has not been particularly valued in Japan, but two years in the United States is thought to provide valuable sources of information about the local market, language skills, and provide a bridge for the parent company to learn about local conditions. Unfortunately, this potential for effectively integrating new information into the organization has been overshadowed by its use as an incentive program to reward the best and the brightest among their younger employees.

For example, a senior official of a Top Six bank reported that out of an annual class of 300 employees, some ten to twenty individuals would be selected to study abroad in an overseas MBA program after seven or eight years' experience:

> We have 20 or more students overseas. About fifteen are in the United States and the others are in the United Kingdom, France, and Germany. Seventy or eighty percent of these MBA students will continue their careers working at an overseas branch or subsidiary [author's interviews].

The reason for this selection process has as much to do with creating personal incentives as it does with any technological gain, as was reported by several participants:

> For one, the bank wants to acquire the technology of the foreign countries. However, I think the main reason is to hire better people by saying that our bank sends two people to a foreign university [author's interviews].

Another participant added:

> The program is a natural investment in human resources. The person who is sent overseas to study is supposed to be loyal to the company... So what is the purpose of sending them? Incentive to the other employees, I think, is the first priority. And then, just getting acquainted with a lot of people outside of Japan is the second one. A reward and also a draw for newcomers. Every newcomer thinks that he can be the next one [author's interviews].

MBA students are also expected to develop international contacts that will be useful for the bank in later years. The Japanese corporate tradition that "who you know is more important than what you know" places high value on the ability to socialize in later life with fellow alumni of a prestigious university. The expectation that your Tokyo University classmate will rise to high ranks within the government and business is perceived as an asset to you and the firm. The transference of this expectation to the U.S. educational system may be somewhat naive in view of a highly fluid and more diverse U.S. labor market where such elite alumni fortunes are far from guaranteed.

Used effectively, the MBA program has the potential both to reward employees and to bring new capabilities into the Japanese parent company. However, many past participants reported that whatever knowledge they gained was not utilized — most Japanese companies with MBA education programs do not have any special plans for their employees once they return home.

Some Japanese banks have taken a highly expensive but ultimately more cost-effective route to develop high-level international corporate contacts through the enrollment of select mid-career officers in highly prestigious programs, such as the ten-week Harvard Business School Advanced Management Program, which offers regularly scheduled alumni gatherings. The hefty price tag of $30,000, with the tuition underwritten by the executive's firm, all but guarantees high-level contacts for years to come.

Domestic/International Dual Track System Prevented the Transfer of Information

In placing predominant value on the creation of personal and institutional relationships and a far lesser value on innovative practices, there has been virtually no expectation or opportunity that Japanese employees stationed in the U.S. will have a chance to share their newly-gained expertise

once they return home. Although the overseas experience does slowly add to the sophistication of the leaders and soon-to-be leaders of the banking industry, the lack of established mechanisms for the transference of learning acquired abroad is responsible for the slow response by Japanese banks to technological changes in the international marketplace.

One conspicuous example of the failure of Japanese banks to initiate modern banking practices emerged in 1993 when the latest buzzword in Tokyo financial circles became "ALM," Asset/Liability Management. The issues raised by ALM had not even been acknowledged in previous years by Japanese banks even though ALM deals with the key problem area facing banks world-wide, the management of the bank's own loan and securities portfolios. Despite the efforts of the Big Six accounting firms and Japanese bank service organizations, such as the Institute of Financial Affairs, which had sent missions in the mid-1980s to the U.S. to study and educate the banking industry, questions on bank portfolio management had drawn little recognition or response from bankers until 1993.

The sophisticated hedging techniques and trading programs known collectively as ALM have long been extensively developed and used by Western banking institutions in their efforts to vitiate interest rate risk. ALM principles have been taught in finance courses in U.S. MBA programs for many years. When asked why such knowledge had not been transferred earlier and instituted by Japanese banks, an officer explained:

> Japanese banks have sent their employees to U.S. universities and business schools but only now are they beginning to reach top management. Twenty years ago they were only officers or some rank like that. Top management did not understand such techniques or practices, so it was difficult to persuade them to implement such new systems in their banks [author's interviews].

In their highly regulated and protected market, senior management of Japanese banks previously had little incentive and understanding of the need to introduce new financial techniques. Even the Industrial Bank of Japan, the leading Japanese bank to implement an ALM program, had not established a risk management unit in their Treasury Department until 1991. It was the success of Tokyo's foreign-owned banks in selling financial derivatives to Japanese corporations that forced Japanese banks to consider the merits of selling these new financial products. Bankers found themselves neither able to explain the uses of these new products to their clients nor having senior managers who understood their usefulness. As one banker stated; "...all of a sudden ALM became

a magic word for getting clients" but even then it was not considered for the bank's own risk management requirements. Only now has the impetus of the next phase of BIS quality-of-asset requirements (which evaluates market risk regulation) forced the top management of Japanese banks to address their own needs for ALM programs.

The absence of ALM techniques, or other standard features of Western financial management taught in every university business curriculum, points to systemic defects that prevent the integration of skills and learning between domestic and international workers. Although the international track is often seen by younger officers as an exciting experience, it is also understood that in their tradition-bound institutions it is a cul-de-sac and not a likely career track to a top management position. Ultimately, because of the segmented domestic and international dual track employment system, as well as the job rotation system which moves people out of their area of expertise, the transference of learning has been inhibited rather than facilitated.

IV. PERFORMANCE OF JAPANESE BANKS IN THE U.S.

The failure to develop and mobilize new competences had a clear and dramatic impact on the performance of Japanese banks in the United States. For example, a recent study published by the U.S. Office of the Comptroller of the Currency [Nolle 1994] examines the profitability, efficiency, and credit quality of Japanese banks as compared to U.S. banks with similar loan portfolios over the ten-year period 1983-1992. The study reveals that Japanese banks and other foreign-owned banks were particularly inefficient, and, despite their lower cost of capital advantage, they had much poorer Return on Assets and Return on Equity ratios throughout the ten year period, with the exception of 1987, than did the U.S. banks. Not only did Japanese banks surge into troubled markets from which U.S. banks were already retreating, the study concludes that among the factors which doomed the Japanese banks' were a critical failure to achieve cost efficiencies, and the lack of adequate standards in evaluating client creditworthiness coupled to their cut-rate lending policy. [Nolle 1994].

Although U.S. banks were burdened with a higher cost of capital, they were ultimately more successful because they were accustomed to wringing out profits in competitive markets through better production economies, and better risk management and assessment. Japanese banks

presumed they could operate with the same lack of concern, with low-risk and low value-added products they had long been accustomed to in their highly protected market in Japan [Zimmer and McCauley 1991]. Because Japanese banks were under-capitalized until the imposition of the BIS standards, Japanese banks were more highly leveraged and thus more at risk. The failure of Japanese banks to adapt, adopt and learn these efficiencies in international markets not only hampered them in the U.S. but also in their domestic operations in Japan where such knowledge would have soon been useful in facing similar environmental challenges.

Some might argue that in some cases the investments in U.S. financial institutions by Japanese banks can be considered profitable from the aspect of return on equity, especially when compared to the Japanese banks' particularly poor returns in Japan on their own shares. However, when the U.S. stock market has been at an all-time high, the Japanese stock market has been in a slump, and Japan's economy in a profound recession in recent years, it is only within this context that some U.S. investments of Japanese banks can be considered profitable.

Japanese banks consider the maintenance of close relationships with their clients as the core aspect of their domestic strategy and have endeavored to maintain such relationships with their clients who have gone overseas. In this respect, their "internationalization" strategy has merely been an extension of their domestic practices and the carrying on of the traditional niche role of foreign-owned banks throughout the world. Japanese banks had little trouble moving overseas to serve their internationalizing clients as though they were all still doing business in Japan. The real difficulty was to make the transition to truly global banks. Of that, one banker caustically commented:

> The most absurd factor [in the downfall of the banks was that] Japanese bank management may have had some illusions that they could compete neck-to-neck with the first-class international financial institutions, just like the Japanese manufacturing sector does [author's interview].

That such unrealistic aspirations were going to be dashed could soon be foretold by the downwardly changing economic picture that followed Japanese bank expansion. Ultimately, declining profit margins forced retrenchment on U.S. lending by Japanese banks. The mistakes of overconfidence made by Japanese banks were repeatedly exposed once the banks were stripped of their super-bankroll.

A number of Japanese banks have been forced to retreat from their global foray into the United States — some by withdrawing entirely and others by withdrawing all but a token presence. Faced by unprecedented losses incurred from real estate loans in Japan and continuing low returns from their U.S. operations, eight Japanese banks closed their branches between 1992-1994, two city bank branches in Dallas, another in Minneapolis, one regional, three 2nd-tier regional bank offices, as well as a trust bank branch in New York.

V. SUMMARY AND IMPLICATIONS

In the struggle to become global organizations, Japanese banks are not the only financial institutions to come to grief upon the shoals of the U.S. market.[4] What is perhaps most notable for strategic management analysis, however, in Japan's case is, first, that the banks failed to develop new competences once their advantages of cheap capital were lost, and second, that they failed to capitalize on the significant human resources of knowledge, expertise and customer contacts held by their American employees.

In general, given the globalization of the industry, multinational corporations face three imperatives to succeed: respond to local market conditions, integrate global operations, and integrate worldwide learning [Bartlett and Ghoshal, 1989]. In order to prosper, or even just to survive, Japanese banks must change fundamental aspects of their management and organization. If not limited to overseas operations, global learning can have a positive impact upon the development of domestic operations of Japan's financial institutions. As Japan's home market becomes more liberalized and its financial markets begin to resemble international markets more closely, many of the lessons learned abroad can be adapted to domestic operations by Japan's financial institutions.

Global learning should be made part of organizational strategy. Since time eventually renders nearly all competitive advantages obsolete [Williams, 1992], organizational learning is critical to sustaining success over the long-term. In order to succeed in the global marketplace, worldwide learning must be made an integral and conscious part of an organization's strategy

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[4] When U.K. banks beat a retreat from the U.S. market in the 1980s, many of their assets were acquired by Japanese banks: The Bank of Tokyo acquired Union Bank of California from Standard Charter Bank, Sanwa bought Lloyds of California, and Daiwa Bank bought Lloyds U.S retail banking networks.

[Bartlett and Ghoshal, 1990; Levinthal and March, 1993; Marquardt and Reynolds, 1994; Simon, 1993; Senge, 1990].

Corporate policies that proved successful in past decades are not necessarily appropriate for the conditions of the 1990s. Both the competitive conditions and the competences of organizations evolve and change over time. While access to cheap capital was a key advantage for Japanese banks in their initial foray into international banking, that advantage no longer exists today. In fact, Moody's has been systematically downgrading the ratings for Japanese banks based upon exposure to a collapsed domestic real estate market and lending to an over-leveraged M&A market and real estate market by their branches and subsidiaries in the U.S.

Their initial success in attracting American customers away from well-established competitors was due primarily to a short-lived advantage in the cost of capital. Once this advantage was lost, Japanese banks failed to develop the competences that would be critical to competitiveness. Relying chiefly on their tangible assets, Japanese banks failed to develop or deploy the intangible assets which were important to customers and offered by their competitors. This is ironic given the prevailing stereotypes held by many popular and academic writers that the source of Japanese firms' competitiveness is primarily in their "humanware" rather than their "hardware" [Shimada and MacDuffie, 1987]. In writing specifically about how American firms can compete with the formidable onslaught of Japanese banks, Wright and Pauli [1987] state that "One of the main strengths of our Japanese competitors is their low labor turnover and the extremely strong loyalty of their employees... There is ... a great deal we can learn in terms of recruiting, training, job security, and employee participation that could help Western companies improve their long-term productivity" [p.109]. It was this very prescription that Japanese banks failed to use with their U.S. employees and is suggestive of the entrenched tunnel vision that has kept their banks single-mindedly focused on winning friends and influencing clients solely through the power of their pocketbooks.

Conclusion

In today's global economic environment, with its intense international competition, environmental turbulence, and the total restructuring of many basic industries, the key to success is

the management of change instead of the management of growth [Garland et al., 1990: 41]. For the reasons outlined in this paper, in spite of the fact that Japanese banks enjoyed protection by the Japanese government, had access to lower cost of capital, and possessed formidable tangible assets, they were unable to leverage or mobilize these resources internationally and translate them into sources of competitive advantage. To be successful in a world that requires firms to innovate and change, a firm must have a coherent strategy that enables it to decide what new ventures to go into and what to stay out of. In addition, it needs a structure that guides and supports the building and sustaining of the core capabilities needed to carry out that strategy effectively [Nelson, 1991: 69].

Our analysis has shown that Japanese banks had neither a coherent strategy nor a structure that enabled them to build or sustain the core capabilities necessary to remain competitive in the global banking environment. To compete globally in the 1990s and beyond, Japanese banks must bring to the table both their tried-and-true competences as well as a new set of competences to use against their American and European rivals. Most likely these are soft skills, for example, the management of human resources. Japanese banks can build on their ongoing competence in dealing with Japanese multinational firms, which are continuing to internationalize. At the same time, however, they must strengthen their relationships and integrate non-Japanese experienced professionals into their operations. The ability to manage this kind of strategic collaboration is an example of the kind of skills which Japanese banks must master in order to succeed globally. As in all firms [McGrath and MacMillan Venkataraman 1994], the processes used by Japanese banks to develop new sources of advantage are as important, if not more so, to the long-run competitive success of a firm than the content of any given advantage.

APPENDIX: Research Methodology

62 Respondents; 186.5 interview hours; 109 meetings;

Average length of interview: 1 hr. 43 min.

Levels of Respondents, number and percent by category:

(I) 7 — 11.3%; (II) 19 —30.6%; (III) 27 — 43.6%; (IV) 9 — 14.5%

I — Senior Management: Director (*Torishimari-yaku*) and above, incl. former directors, O.B.s

II — Middle Management: General Manager of Branch or Department, Deputy Gen. Manager (*Shiten-cho, Bu-cho, Ji-cho*)

III — Junior Management: Manager of Division, Section Chief (*Ka-cho, Chosai-yaku, Shunin*)

IV — Associates — lower ranking officers

Respondent Table

Bank	# Respondents	Rank of Respondents	# Interviews	Total Hours
Top Six City Banks				
Bank #1	6	1-II, 3-III, 2-IV	10	18h25m
Bank #2	5	1-I; 2-II; 2-III	7	11h45m
Bank #3	1	1-III	4	7hrs.
Bank #4	6	2-I; 1-II; 1-III; 2-IV	9	19 hrs
Bank #5	2	1-III; 1-IV	2	2h45m
Bank #6	1	1-III	3	4hrs.
Other City Banks				
Bank #7	5	2-I; 2-II; 1-IV	1	17h5m
Long-Term Credit Banks				
Bank #8	8	2-II; 5-III; 1-IV	11	16h5m
Bank #9	3	1-II; 2-III	9	13h15m
Regional Banks				
Bank #10	1	1-II	1	45min.
Bank #11	2	1-II; 1-IV	2	1h45m
Bank #12	1	1-III	1	1hr.

continued:

Bank	# Respondents	Rank of Respondents	# Interviews	Total Hours
Trust Banks				
Bank #13	1	1-III	4	5h15m
Bank #14	1	1-III	1	1h45m
Other Banks				
Bank #15	5	3-II; 2-III	16	22h45m
Foreign Owned Bank				
Bank #16	2	1-II; 1-IV	5	8h35m
Overseas Bank of Securities Firm				
Bank #17	1	1-III	1	1hr.
Relevant Government Ministries Regulatory Agencies and Institutions				
Ministry #1	1	1-III	2	1h30m
Ministry #2	1	1-II	1	1hr.
Banking Associations and Institutions				
Institution #1	2	1-II; 1-III	3	5hrs.
Institution #2	1	1-I	1	1h30m
Institution #3	3	3-III	7	13h30m
Institution #4	1	1-II	1	1h30m
Consulting Firms to Financial Services Industry				
Firm #1	1	1-I	6	9hrs.
Firm #2	1	1-II	1	1h30m

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