

Mighty Japanese Bank

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What have happened to Japanese banks?

Are't they mighty Japanese bank?

No it was old story some decades ago.

So it should be stated as follows, Once upon a time there were mighty Japanese bank ——

Let me talk about Japanese bank, because I've worked at Daiwa Bank, one of big Japanese bank, in the past quarter century, covering 10 years in New York, 5 years in Tokyo, engaging in the trading in the market.

Remaining 10 years I was at domestic branch as a calling officer to corporate customer.

The 1980s —— Time For Take Off

What was the market situation in 1980's?

When I first came to the United State and in those days every big Japanese banks were trying to learn American banks, because they were a step ahead of the rest world.

I landed in Chicago to be a trainee at the First National Bank of Chicago. In those days so many trainee was in the United State, and First Chicago too attracted them from all over the world, including Germany, France, England, Eastern European countries, South American Countries and Korea and of course Japan.

The reason behind these movement are not only that American banks are a little bit ahead of rest of the world, especially in the market oriented products, such as money market deposit, but also there were more urgent needs for Japanese bank to catch up with American banks.

It's because their corporate customers, such as trading companies as Mitsubishi Corp or Mitsui & Co, and such manufacturers as Panasonic, Sharp, Toyota or Nissan went out to the world earlier than Japanese banks, and their products or services were so good and the world needed their products desperately.

Therefore Japanese corporation whose worldwide activities forced them to need more dollars and more advanced technology in financial area, especially more funding without currency risks.

First, their needs for dollars drove Japanese bank to be more international and more dollar chaser.

Secondly a commercial bank such Chase and an investment banker as Goldman Sachs developed financial products using financial technologies, especially financial mathematics, such as option and futures.

Those technique enable us to hedge out exposure of interest rate risks and currency risks.

Those are called "Derivative Products". And the driving power behind these "derivative" business expansion is the theory of "Black and Scholes Model"¹⁾

Almost all of option model are using this "Black & Scholes Model" theory, and based on this model, business world are pricing their position and P & L.

If this theory would become irrelevant, world business would become huge confusion and collapse, because gigantic position of all over the world are depending on this model.

- 1) Basic Black & Scholes option pricing model using statistical expectation based on normal distribution of return can be explained as follows,

$$C = S \cdot N(d1) - K e^{-rt} \cdot N(d2)$$

$$d1 = \{\ln(S/K) + rt\} / \sigma \sqrt{t} + 0.5\sigma \sqrt{t}$$

$$d2 = \{\ln(S/K) + rt\} / \sigma \sqrt{t} - 0.5\sigma \sqrt{t}$$

C=Call option price

S=Market price, say, in case of \$yen, spot price

N()=Cumulative normal distribution function

k=Strike price

e=Exponential (the constant value of 2.7182818)

r=Risk free interest rate (as a decimal)

t=Time to expiry (in years)

σ =Annualized standard deviation of return (volatility) as a decimal

See farther detail to J. C Hull, "Option, Future and other Derivatives" (1999), Prentice Hall Chapter 11, "The Black & Scholes Model".

Thus "Black & Scholes Model" became basic and standard formula for option model, and without this we could not see such a business expansion of derivative products.

New Financial Technology — Swap

It was in the middle of 1980's that this derivative business actually started as "Interest rate swap" which exchange fixed rate and floating rate for a long period and enabling institutional investor to avoid interest rate risk.

I myself started investing fixed rated securities, such as "Kingdom of Sweden, 8 %, 10 years note".

When I bought fixed rate note, I was betting that interest rate will be coming down.

And when we buy securities, we usually cover by getting short term money, say 3 month or 6 month money based on "Libor" base. (London Interbank Offering Rate, in short)

To cover assets we fund in the interbank market where bankers gives and take (offer and bid) money rated based on Libor.

When I bought \$10 million "Sweden's 10 years fixed rate note at par, I fund the note by getting 6 month's 10 million at, say 6 % based on 6 month Libor.

And I was betting that interest rate will be coming down, say bell weather bond (At that time bell weather bond was 30 year US Treasury note and market people were watching this bond's movement closely, because it fluctuate according to every economic and political news most sensitively) rate will be coming down from 7.50% to 6.50%, targetting a year later to fix the profitable 1 % spread during the remaining 9 years period.

Those days it was difficult to get fixed rate long term money, so people are normally funding their assets by getting short term money, say 3 month or 6 month money.

If we could get 9 years fixed rate money easily, we would cover the fixed rate assets without any problem.

But actually it is very difficult to get a long term fixed rated money, because there is very thin market for those money.

The only thing you could do is to issue fiexed rate note, but usually we would

Table 1 Value Of Outstanding Swap (\$billion of principal)

	Total Interest Rate Swap	Total Currency Swap
1987	682	182
1988	1,010	316
1989	1,539	434
1990	2,311	577
1991	3,065	807
1992	3,850	860
1993	6,177	899
1994	8,815	974
1995	12,810	1,197
1996	19,170	1,559
1997	22,115	1,584
1998	36,262	2,253
1999	43,936	2,444
2000	47,993	2,605
2001	57,219	4,302

*Reference from ISDA and Bank for International Settlement.

not cover invested securities by issuing note.

Once market moved as I expected, that is interest rate was coming down by 1 %, and I want to fix the profit which 1 % spread remaining 9 years, I started to use "Interest rate Swap".

In any market there are so many kind of participants and in this interest rate market, there are those who need fixed rate long term money and on the other hand there are those who need floating rate money.

And between those demand and supply, people will agree to exchange interest rate, say I agree to pay 7 % fixed rate and receive 6 month libor money for 9 years and my counterpart, say Chase will pay 6 month floating rate and receiving 7 % fixed rate. Maybe Chase has a customer who want his money to invest at 7 % remaining 9 year, because he think interest rate has been peaked out.

And this so called "Interest rate Swap" together with currency swap has brought the expansion of "derivative business" and later advanced to the stage of the very complicated hi-tech financial products such as "exotic derivative". (See table 1 above) Those derivative products were started by american banks and Japanese banks quickly learn and absorbed everything those days.

The 1990s — Rising Sun and Dream House on the Sand?

At around the ending 1990, while Japanese banks were absorbing everything

Table 2 Japanese foreign investment (\$million)

1980	4,693
1981	8,931
1982	7,703
1983	8,145
1984	10,155
1985	12,217
1986	22,320
1987	33,364
1988	47,022
1989	67,540
1990	56,911
1991	41,584
1992	34,138

from American banks, Japanese corporation also were charging to America, buying everything they want. It was amazing that Japanese started buying such as big Manhattan building, the famous golf course in Pebble Beach, ranches in California and even Goldman Sachs sold a large piece of its equity to Sumitomo bank.

(see table 2 for Japanese foreign investment.)

Were they successful? Not really.

Almost every Japanese investments in America were failure except Sumitomo Bank's one which turned out to be purely investment in a part of the Goldman Sachs' share and no involvement of the management, such as voting right, but it was the reason that investment bore good results.

Maybe something was wrong with Japanese involvement in management of American corporation in the United State.

Then what went wrong with them?

They brought Japanese way to judge their business investment in America.

In case of buying a building, interesting thing is that Japanese did not follow the American way to buy American real estate, but they brought in Japanese way, that is they decided on the price of real estate from the reference to a recent major deal nearby the place. While American way, maybe which is global standard, was that price was calculated according to the return from the real estate, which use the discounted cash flow analysis.

Accordingly Japanese businessman thought the American building and golf course are cheap compared from the similar Japanese case.

You maybe heard about "Bubble Economy" which Japan experienced in the ending of 1980'.

It was so crazy that such real estate's price was inflated to double to three times in just a couple years. (see fig. 1 for Japanese real estate movement.)

Later year when I was visiting my corporate customer in Japan, they told me that during "bubble days" in around 1990, everybody, especially brokerage firm told

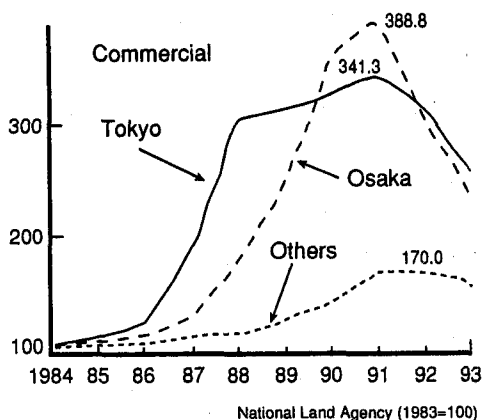


Fig. 1 Japanese real estate price movement

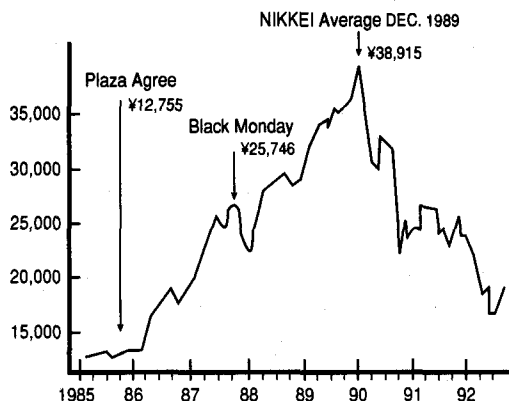


Fig. 2 Japanese stock market trends

them that it was silly not to jump in the stock market and miss profit chance. But in fact almost all of them ended failure, and lost their money. (see fig. 2 for Japanese stock market trend)

I saw so many corporate customer could not resist the persistent persuasion from various sales people to start to trade stocks and make money, but they could not see any good day and suffered so much instead.

Let's go back in New York in 1990, and the reason why Japanes started to invest in America was that they are just trying to bring japanes bubbled inflation into America unintentionally.

Anyway around the year 1990 was good old days for Japanese.

As I was working at Daiwa Bank, New York branch, it was surprise that everybody was talking about Japan, such as, how its economic system work, in another words, mystical and traditional social custom and corporate culture such "life long employment system", "cross-holding share" between banks and its corporate customer, as "bottom up decision making" system.

All those praises for Japanese system was the other side of coin which was American troubled system at that time.

It was no surprise that it was elevated to the stage that such book as "Japan as number one"²⁾ or "House of Nomura"³⁾ were published.

2) E.F. Vogel, "Japan As Number One", Lessons for America (1990) Harvard University Press.

3) Al Alletzhauer, "The House Of Nomura", (1990), Bloomsbury.

It was climaxed around the beginning of 1990, when every American banks except Morgan Guaranty were rumoured about their bankruptcy.

Those days I myself was in charge of chief dealer of the bank, and was very cautious about to place money to the American banks in the interbank market and told young dealer to refrain from lending money to them.

Those days were good old proud days and even Daiwa Bank had AA rating and was attracting Fortune 500 big American corporate customer's deposit and we are using those money to cover our loan or lent money to European banks and Japanese bank. and making money.

I myself felt that almost all American banks were collapsing just like "The world was falling apart."

Ironically same thing has been happening to Japanese banks recently, maybe much more worse situation compared to American banks in those days.

Then once again, why Japanese acted such same manner to buy almost everything in America.

There was a pattern in their manner.

As I mentioned before, there were so called "Bubble" in the stock and real estate market and every price, even golf course membership price was climbing up.

A friend of mine was boasting that he bought a golf course membership at yen 20 million and the price shot up to yen 23 million, but unfortunately he bought it by borrowed money, and 10 years later its price was down less than yen 2 million.

Sorry pal, but this is really cruel "fact of life".

Then based on those "bubbled" economy, Japanese corporation had a huge "hidden profit" or inflated assets according to the bubbled market price.

Among their portfolio, those stocks, which was another Japanese mystical custom, which was once praised, was intended originally to cross-hold between banks and its corporate customer.

And their cost was so cheap, because they bought it long time ago, and therefore market value was so immense.

And thinking about these "bubble" driven assets, Japanese felt and believed that they became "No 1". To make it worth, everybody was praising Japan that way.

But Japanese is basically shy people and those shy people tend to feel like they are great like they are told, when they are complimented.

After Mid 1990s — Turbulence and Trap into Depressed Economy Without Any Exit

Then what happened to American banks since then? They came back beautifully and became "No 1".

Basically American economy suffered real estate bubble at the end of 1980's, and almost all American banks were rumored bankruptsy.

But United State government took strong and decisive action to bail out american banks, injecting billions money in the market assisted by godlike Fed's Greenspan's monetary policy.⁴⁾

On the other hand Japanese banks suffered and underwent long, long tunnel and yet could not find its exit.

Then why are there big difference between American and Japanese banks's recovery? The key to the answer to this question lie in the difference of their business culture.

In Japan every corporation wants to know how their peer group are doing and want to be same at least.

For instance in the banking industries, when A bank want to sell a new product, they want to know whether other peer bank to do the same thing or not.

They does not want to be ahead of peer group.

Maybe we better call it Japanese "uniformization". They feel uneasy if not next neighbor do the same thing as he does.

On the other hand American banks want to know, before it sell a new product, whether other banks do the same product or not.

And they want to step ahead of other peer group to make more money.

Maybe we can understand the reason behind this corporate culture by refering to its history.

As you know, Japanese amazing economic expansion in a short period came from its government guldled well controlled economic policy.

In case of banking industries Japanese bank got to follow the order from the MOF (Ministry of Finance) and from the past experience, they became accustomed

4) Bob Woodward, "Maestro, Greenspan's Fed and the American Boom" (2001) Touchstone Books.

not to do a new business without other banks following, because those performance to be independent was not acceptable to MOF.

Another similar strange Japanese corporate business custom are that they want to shut the bad thing, or hide a rotten assets, hoping the price would come back in a long time. Japanese proverb say, "Put on the lid to the bad smelly thing".

While Japanese economy was peaking out around beginning of 1990, "bubble" economy was too shrinking.

Maybe the last blow was the decision by Bank of Japan's interest rate hike to fight the inflation. And I am not sure which is which, but as stock market was falling, real state's price too started to stumble, and corporate customer who had bought real estate through finance by bank, putting it as collateral, were in huge trouble.

Duaring "bubble" time so many corporation, such real estate as construction company and trading company, bought a lot of land and build apartment house or golf course, using them as security for borrowing money from bank.

Their purpose for those investment were more to take profit from farther inflated price rather than its designated line of business.

Japanese banks at that time wanted to expand its assets and as far as the loan was secured by the real estate, they made a loan to those whoever build anything whether its planned business were reasonably feasible or not. Same thing happened in stock market, especeally while corporate customer expanded, they needed capital and asked their friendly bank to cross holding their stock each other as an stable management side share holder.

Once Japanese economy started to stumble, especially stock market in addition to real estate price fall to half, Japanese banks started to demand additional securities as collateral.⁵⁾

Corporate customer started to run short of money, because when they bought real estate, they did, hoping the real estate price will shot up and they thought they would make money, not from the project cash flow. And to make it worth it, Japan got to follow the so called "global standard" which was actually pressed by Amer-

5) About japanese economy see "Japan's New Economy", continuity and change in the Twenty First Century, B. Blomstrom, B. Gangues, S. La Croix, London Univ Press.

ican government, and started "mark to market" their assets.

When Japanese bank were catching up American counterpart in mid 1980's, they were expanding "off balance" business on assets side such as "back up line", "commitment line" to their corporate customer to get a fee during just "committed" period. And in case customer actually want to draw down to get cash, they will pay some spread over base rate.

In those commitment line and liquidity backup facility business, Japanese banks caught up American banks, while American counterpart's condition started deteriorating due to real estate problem to the end of 1980'.

Thus Japanese bank expanded these "off balance" business and took the business from American bank, because of their rating superiority, at that time major Japanese bank received at least "AA", and got business from American big company and municipal corporation by "cut throat" price, such as 1/8% fee and 1/4% spread for actual cash drawdown.

While Japanese banks were seeking "assets" expansion, neglecting its quality, resulting very poor return on assets (ROA).

That was the point American and European authorities were serious about "8 % capital ratio" as a "global standard".

That was believed to target to calm down Japanese heated "size" business with "Harakiri" margin.

So historically 8 % capital ratio was imposed to limit Japanese bank's "chief" business, then came "mark to market" regulation, which hit already damaged Japanese banks hard.

When "mark to market" idea started, Japanese bank's cross held stocks had a huge depressed overvalued portfolio.

While Japanese economy was tumbling on the hill, American counterpart quickly recovered and came back to on "right course".⁶⁾

Then why, while it took just a couple years for American counterpart to come back, it has been taking more than decade for Japanese to recover from depressed economy?

According to a statistics the cause of American trouble was the same as Japa-

6) A. S. Blinder, J. Yellen "Fabulous Decade", (1998), Brookings Institution.

nese one, that is, real estate “bubble” collapse. Its price was just 25% down, while Japanese one came off as much as 85%.

Those magnitude was one big reason, but its main reason was Japanese business custom which were forcing Japan to suffer in just like poverty of “vicious circle”.

While I was living in New York for ten years, what I was most impressed was that american society is most free one and private sector can do anything they want under some rule

Within that rule they do compete each other, not cooperate like Japanese way. But they are always checked, when people do too far extreme.

We call it “Check and Balance” system, which enable them to be back on “right course”, when people went too far right or left.

I myself experienced this “cleansing system”, when I went through the disastrous incident of Daiwa Bank’s kicked out from US business in 1996. It was painful and hard job to close down the business of more than forty years history in New York.

And american and Japanese employee worked energetically to clean successfully without complaining much.

I learned so many thing from American authorities, such as Fed people, FDIC people and my American boss during that retreat. But most of all this “check and balance” taught me that when you don’t follow the rule and went too far, American government authority give you strong order or message and in some cases worst would happen.

Dooms Day — Any Hope?

Then how long will it take for Japanese economy to come back to normal? Well, it depends on how each private sector would do on their own and their way.

But as I mentioned before, Japanese people are mostly shy, and when they are praised, they do OK but when they are not in good condition and lost their confidence, they just get lost and don’t act rightly without guidance.

So after Japanese “irrational exuberant fiesta” Japanese economy was doomed by BIS 8% capital ratio requirement, and stock and real estate market collapsed, with another so called “global standard”, “mark to market” reguration, Japan was

knocked down and became worse and worse.⁷⁾

Maybe they were just following American standard without considering whether it is good for Japanese economy and harming its original good old business culture.

Recently Japan decided to start "Yen 10 million deposit guaranteed by government" from "full guaranty", we call it "payoff" in 2003, which was persuaded by American as one of "open market policy" or "transparency".

But is this really necessary, while Japanese economy especially banks are suffering?

Look at Argentina economy. Is it nice idea to follow IMF, which meant American led economic revival method? In another word "Globalization" is almighty?

Maybe you should know how Malaysian president Mahtir did well handle his economy, especially defended its currency from speculator, imposing his own rule to the international business people against western countries intention, which include Japan.

Each country has its own culture and has own economic condition, and they should have their own way to handle their business without intervention from outside, if it is not against general worldwide recognized rule.

We should consider one more time.

Have we been doing right thing in the past "lost decade"?

And find the clue and use it as a guidance for the future quick recovery.

While I was reviewing this report, the world economy has changed dramatically.

After September 11's Al Qaeda's attack to New York's World Trade center, It looked like American economy recovered from its impacts completely, people's "buying chance's" idea forced its Dow index to recover from 8,000s to 10,600s. But what happened later was not so easy one, Dow started tumbling to 7,100s, because of Enron's and Worldcom's trouble.

And some people say that American economy is experiencing "double dip", but worst scenario, one of my friend told me the other day that it would follow the Japanese case and right now, seems like just Japanese's 1994.

I hope American economy would come back after big correction by "Check and balance" which I explained before.

7) C. A. E. Goodhart, "Financial Regulation, Why, How and Where Now" Bank of England