

**SHOULD JAPAN SHIFT TO THE
U.S.-STYLE FINANCIAL SYSTEM?**

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LIST OF ABBREVIATIONS

BOJ	Bank of Japan
FLR	Financial leverage ratio
GLB Act	Gramm-Leach-Bliley Act
IPO	Initial public offering
JPMC	JPMorgan Chase
M&A	Merger and acquisition
MUFG	Mitsubishi UFJ Financial Group
NPL	Non-performing loan
OHR	Overhead ratio
ROA	Return on (total) assets
ROE	Return on equity

INTRODUCTION

After the burst of the bubble economy, Japan's banking industry changed dramatically, experiencing financial crisis, integration, and deregulation. Starting in 2000, a wave of mergers and acquisitions (M&A's) swept over the banking industry in Japan. Since then, through M&A's, 16 major Japanese banks have been restructured into six financial groups. These Japanese bank mergers came about more as a result of crisis management than strategic business development. They peaked between 2000 and 2001, when the disposal of massive nonperforming loans (NPL's) was the most imminent threat to the deregulated and increasingly competitive Japanese banking industry.

U.S. banks, on the other hand, also went through a crisis and deregulation in the 1980's, similar to what had been experienced by Japanese banks in the 1990's. But the recovery of the U.S. banking industry was completely different from that in Japan, and it took relatively less time and public money to resolve the problem. It is often said that the Japanese banking industry lags far behind its U.S. counterpart, with more than a 10-year gap between them. This is because Japanese banks' financial services and profitability are poor compared to those in the United States. In the 1990's, Japanese weak banking industry and its financial system came to be viewed as the source of prolonged economic stagnation, as it ceased to function properly because of the NPL's that emerged following the burst of the bubble economy. For example, the difference in profitability between U.S. and Japanese banks is often cited when the financial system is discussed. And the low profitability of Japan's banking industry compared to that in the United States is viewed as a problem related to a weak financial system in Japan.

A comparative analysis between Japan and the United States is a fundamental of the above argument. The Japanese model is often compared to its U.S. counterpart in fields such as

business, corporate governance, and financial and labor markets. For instance, because the American economy swept the global economy in the 1990's, many advocated – from the standpoint of global capitalization – that Japan should adopt the U.S. model as the global standard.

Financial systems are generally classified into the following two groups: “bank-centered financial systems,” such as those in Japan and Germany, and “capital market-based financial systems” such as seen in the United States and England. Furthermore, there are many observers who have advocated that Japan should shift rapidly to capital market-based financial systems like the U.S. model as the global standard because the main bank system and cross-shareholdings are out of fashion, and the shift from a bank-centered financial system to a capital market-based financial system is necessary from the standpoint of global capitalization.

I cannot help feeling somewhat at odds with this way of thinking because the bank-centered financial system has played an important role and is tied in so closely with the unique culture and institutions of Japan. In this paper, then, I would like to explore whether such a shift would be appropriate and/or advisable.

This paper is organized as follows. Chapter 1 will briefly cover the characteristics of the bank-centered and capital market-based financial systems, in order to ascertain the basic differences between them, and then introduce the ideas of those who support the capital market-based financial system. In Chapter 2, I will describe the changing background of the Japanese banking industry and examine whether shock or change in the environment surrounding it did happen to support a shift of the financial system in Japan. Chapter 3 will undertake a comparative analysis of major banks in Japan, the United States, and Europe, since the differences of financial systems are likely to emerge as variations of profits or assets, which are

the output of bank behavior, and, additionally, because financial systems should be surveyed from the international point of view. Then I will give a short outline of the relation between bank profitability and the respective banking system. Chapter 4 will look to a possible shift of the financial market in Japan and the necessity, if any, for such a change.

CHAPTER 1

CHARACTERISTICS OF THE BANK-CENTERED AND CAPITAL MARKET-BASED FINANCIAL SYSTEMS

As noted above, financial systems are generally classified into the following two groups: bank-centered financial systems such as in Japan and Germany, and capital market-based financial systems such as in the United States and England. Kazuto Ikee, a professor of economics at Keio University, defined the former as a “relation-based financial system” and the latter as an “arm’s-length financial system” and made a theoretical comparison.¹

This chapter first compares the characteristics of the two financial systems and then introduces the ideas of those who support the capital market-based financial system.

Characteristics of the Bank-centered Financial System

A financial deal is an exchange between a lender’s current money and a borrower’s promise of returning it on specific conditions in the future. Thus, examining a borrower’s credit risk in advance and enforcing the promise to repay are very important for a lender. In the bank-centered financial system, the examining and enforcing are based on the relation between the borrower and the lender (generally a financial institution). Thus, the borrower’s credit risk information is acquired by the lender, which gleans and analyzes it. This involves a cost. At the same time, the borrower’s information is exclusive to the lender. Since the information acquired can lower the cost of information production with the passage of time by applying it to subsequent transactions, the relation between a borrower and a lender tends to be continuous.

¹Kazuto, Ikee, *Reckless Driving and Self-Protection of Relationship Capitalism [Kaihatsushugi no Boso to Hoshin]* (Tokyo: 2006).

Therefore, once a borrower and a lender have established ties, they tend to be motivated to maintain their relationship and to avoid defaulting on their agreements. As a result, the merits of maintaining the relationship influence the enforcement of the contract.

Characteristics of the Capital market-based Financial System

In the capital market-based financial system, the borrower's credit risk information consists of voluntarily disclosed financial data. In addition, many parties can participate in the market if there is no particular relation between the borrower and the lender, since the lender can acquire public information about the borrower's reliability and future. In the capital market-based financial system, financial deals are competitively based on the price, such as interest rates and stock prices. And enforcing the promise depends on the explicit contract and legislative measures. Thus the arm's-length financial system is not effective in situations in which investors' rights are weak.

Ikeo introduced the "law-and-finance"² approach, by which the capital market-based financial system has developed in countries such as the United States and England, based on common law and where investors' rights are strong and it has been underdeveloped in the countries such as Japan and Germany, based on civil law and where investors' rights are weak. Generally speaking, developing capital markets requires security of property rights, especially in financial deals, which are more secured by common law than civil law. And, as I will mention in Chapter 3, differences in bank profitability among countries may also reflect on the background of the legal regime because bank profitability is divided into these same two groups.

²Ikeo.

The Ideas of Supporters of the Capital Market-based Financial System

As mentioned above, one of the major fundamental differences between the two systems is the pricing function. The transparency is higher in the capital market-based financial system than in the bank-centered financial system, since conditions tend to be disclosed to the public. Thus, for a highly sophisticated and complicated economy such as Japan's, it is advocated that more efficient allocation of resources can be attained by an arm's-length financial system.

Based on his historical survey of the development of the Japanese financial system after World War II and the tasks it now faces, Ikeno insisted that Japan's financial system should be changed from a bank-centered to a capital market-based financial system. He came to this conclusion because he believed that the bank-centered financial system had completed its historic role and is no longer appropriate for Japanese economic development with its need for new innovation.

Ikeno's point of view is influenced by Raghuram Rajan and Luigi Zingales who wrote the 2003 book *Saving Capitalism from the Capitalists*, in which they criticize Japanese "relationship capitalism" based on financial deals and connections. In this work, they cite the example of Sumitomo Bank's rescue of Mazda – what we call the main bank system³ in Japan – as a case of failure of relationship capitalism.⁴

³Within the Japanese banking system, firms have tended to have a particularly tight bilateral relationship with a specific bank. These ties have developed through lending, personnel exchange, and cross-shareholding. This phenomenon is called a "main bank" relationship. It is summarized by Aoki and Patrick, in a major study of the topic, as "A more or less informal set of regular practices, institutional arrangements, and behavior that constitute a system of corporate finance and governance..." Takeshi Aoki and Hugh T. Patrick, *The Japanese Main Bank System* (Oxford: Oxford University Press, 1994).

⁴Rajan and Zingales concluded that Sumitomo bank's rescue of Mazda in the 1970's made no sense for Sumitomo's depositors and equity holders, because Mazda was finally bailed out by Ford two decades later.

In addition, Takeo Hoshi of the University of California and Anil Kashyap of the University of Chicago, both economists,⁵ who conducted historical research about the Japanese financial system, also predicted that the Japanese financial system would be capital market-based and characterized by shareholder-centered corporate governance. They argued as follows:

The securities market will become more important in Japan, and the shift from banking financing to capital market financing is already clearly observed for large firms, and it is highly likely that smaller firms will follow, although very small ones will remain bank dependent.... The diversified groups being formed around merged major banks undoubtedly will be big players in the Japanese financial sector. But using a financial holding company structure to compete in many areas by bringing together other incumbent players does not necessarily do much for the banks themselves. The banking business in the traditional sense will decline, becoming a smaller part of financial institutions.

Ikeo and Akiyoshi Horiuchi, a professor of economics at Chuo University, predict that the future of Japanese firms and the nation's economy may approach the Anglo-American model based on the capital market. They admit, however, that Anglo-American corporate governance is not perfect or the only model, considering that the importance of bank-centered cross-shareholding is declining.⁶

In sum, the viewpoints of economists who support a shift of the financial system are that efficient capital market financing surpasses inefficient indirect banking financing in Japan. In addition, they argue that the main bank system and cross-shareholdings, which have characterized the Japanese bank-centered financial system, will decrease in importance. They also insist that, in the bank-centered financial system, risk money is not allocated smoothly to new industries that contribute to innovation; this is because bank loans do not fit such risky

⁵Takeo Hoshi and Anil Kashyap *Corporate Financing and Governance in Japan* (Cambridge, MA: 2001).

⁶Financial Services Industry (2004).

enterprises. The number of initial public offerings (IPO's) in Japan, however, is much larger than in the United States, because IPO's are easier in Japan. So it seems not to be a problem of the Japanese financial system. Japan needs to establish a new capital market-based financial system and corporate governance for new economic development. Currently, these opinions seem mainstream in Japan.

Is it really true that great environmental changes did occur in Japan, necessitating a shift of the financial system? The next chapter will review and analyze major trends in the Japanese banking industry.

CHAPTER 2

CHANGING BACKGROUND OF THE JAPANESE BANKING INDUSTRY

It seems that there is a connection between environmental changes in the banking industry and the argument in which supporters of a capital market-based financial system insist that the bank-centered financial system is out of fashion. In this chapter, I will describe four major trends in the Japanese banking industry, examine their influences on the financial system, and consider whether environmental shocks or changes have occurred to support the shift of the Japanese financial system toward a capital market model.

Major recent trends in the Japanese banking industry are as follows: (1) recovery from the NPL problem; (2) innovation in information technology (IT); (3) deregulation; and (4) structural changes of financial behavior in corporations and households.

Recovery from the NPL problem

According to the Bank of Japan (BOJ),⁷ the nation's financial system overall has finally regained stability, and the quality of the banks' loan portfolios has improved substantially. The economy has been recovering for more than four and half years now, with strengthening in the performance of the corporate sector and a decline in the ratio of banks' NPL's to total credit exposure (Figure 1).⁸ Additionally, bank profits have increased significantly, mainly due to the decline in credit costs. In fiscal 2005, in fact, the profits of both major and regional banks

⁷Bank of Japan, "Financial System Report," July 2006.

⁸The ratio of NPLs to total exposure of the major banks (12 large nationwide commercial and trust banks) declined significantly to 2.9 percent at the end of fiscal 2004 from 8.7 percent at the end of fiscal 2001, more than achieving the target set by the government of halving the ratio as of the end fiscal 2001 within three years. This figure continued to decline, reaching 1.8 percent at the end of fiscal 2005. The ratio of NPLs at the regional banks (111 local commercial banks) declined to 4.6 percent at the end of fiscal 2005 from 8.1 percent at the end of fiscal 2001.

recorded all-time highs. Due to the recovery of the economy, bank lending has become more positive. At the same time, reflecting the change in supply and demand conditions, the total amount of bank loans outstanding, which had been declining for several years, began to increase (Figure 2).

The above developments intrinsically mean recovery of the risk-taking capabilities of Japanese banks. Thus, the pressure for Japanese banks to dispose of NPLs has been an obstacle to the functioning of the bank-centered financial system. In this regard, recovery from the NPL problem is not an environmental change that would force a shift of the financial system.

Innovation in Information Technology

The innovation in IT has changed financial services dramatically. Today, individual customers can easily take advantage of financial services such as remitting money and checking their accounts wherever and whenever they please via the Internet and their cell phones. In Japan, furthermore, cell phones are used for paying small amounts of money, for example, train tickets, inexpensive items from kiosks, and even karaoke sessions. IT has also made financial services more familiar to customers. Thus, customers can easily search, gather, and compare information about financial goods and services. IT has shifted Japanese banks' attitudes in favor of retail banking, which presents new business opportunities. As to this point, IT is playing a positive role in creating a bank-centered financial system.

On the other hand, Naohiko Baba, an economist, and Takamasa Hisada, chief manager, both at the Institute for Monetary and Economic Studies of the BOJ, point out that IT innovation works to reinforce the functioning of capital markets.⁹ They argue that the progress in IT has

⁹*Japan's Financial System: Its Perspective and the Authorities' Role in Redesigning and Administering the System* (2001).

made it much easier to process massive amounts of data efficiently and has facilitated more accurate quantification of the risk-return profile of financial products, which has expanded the scope of products traded on capital markets. On the other hand, such IT contributes to an efficient method of credit screening using statistical models based on probability theory and drawing on accumulated customer data in the bank loan business. Thus, innovations in IT have influenced the shift in the financial system both positively and negatively.

Deregulation

Hoshi and Kashyap argue that, when the “Japanese Big Bang”¹⁰ is completed, “Japanese financial markets will be at least as liberalized as the American markets and may be even less regulated.”¹¹ Japanese authorities have eased or almost abolished financial regulations, by which the businesses of banking, securities, and insurance had been separately governed.

The relaxation of the segregation rules that used to restrict financial services providers to offering only their specialized lines of business has opened the way for “one-stop-shopping,” by which a single institution can provide integrated financial services. This change is clearly for the better. Besides offering greater convenience to customers, it generates an incentive for financial institutions to benefit from the effects of synergy. Many Japanese banks are aiming to realize the benefits of synergy through mass sales of standardized products in the area of retail financial services. Furthermore, deregulation has also encouraged business alliances between and among

¹⁰The “Japanese Big Bang” was a reform of the Japanese financial market. The aim of this initiative was for Tokyo to become an international financial market such as New York and London. Japanese Prime Minister Ryutaro Hashimoto announced this program in the fall of 1996. The principals of the “Japanese Big Bang” are “free,” “fair,” and “global.”

¹¹Takeo Hoshi and Anil Kashyap, “The Japanese Banking Crisis: Where Did It Come From and How Will It End?”

banks, securities companies, and insurance firms, and the entry into consumer finance by banks through joint ventures or partnerships with consumer finance enterprises. Here, deregulation plays a positive role for a bank-centered financial system, which creates new business prospects for the banking industry in the same way as IT does.

Baba and Hisada, on the other hand, point out that deregulation has a negative impact on the bank-centered financial system, because the primary objectives of the Big Bang include strengthening the functioning of capital markets and activating of capital market transactions. They argue that IT innovation, globalization, and the relaxation and abolition of financial regulations are working together to increase the effectiveness of capital markets and lessen that of banks.

Corporate and household needs for financial services are becoming increasingly diversified and complex. Firms face globalization and the spread of strategic M&A activities, while households have to deal with the maturation of the economy and the aging society. Against this background, Japanese banks in recent years have attempted to expand their fee business in areas such as selling investment trusts, private pensions, and derivatives, and arranging the securitization of loan assets, with the aim of diversifying revenue sources by IT and deregulation. In light of the above, there is greater scope for Japanese banks to play a large intermediary role. Thus, innovations in IT and deregulation may not be environmental shocks or changes that would compel a shift of the Japanese financial system.

Structural Changes of Financial Behavior in Corporations and Households in Japan

For a long time, Japanese banks have played an important role as financial intermediaries between the nation's corporations and households. In this framework, Japanese banks have been

supplying money from the household sector, which has been in a surplus position, to the corporate sector, which has been in a short position. And, in postwar Japan, it was this money cycle, by which abundant funds from individuals were supplied to basic industries such as iron manufacturing, energy, and automobiles, that supported the economic recovery of the nation. Furthermore throughout the rapid-growth era, sufficient bank profits were ensured under the protective financial administration policies characteristic of the convoy system¹² (*goso sendan hoshiki*). This sufficient rent and stability of bank management contributed the bank-centered financial system.

The environment for corporations and households, however, is changing. The Japanese savings rate, once very high, is now gradually declining. According to statistics from the BOJ, while surplus money from the household sector has been decreasing since 1998, the corporate sector switched from a short position to a surplus position at around the same time (Figure 3).¹³ Thus, it has become difficult for banks to earn high profits from large corporate customers through transactions such as lending and underwriting of corporate bonds.

On the other hand, considerable capital is still concentrated in the banking sector. In fact, 52 percent of the total financial assets of individuals in the nation are invested in cash and deposits, with only 18 percent in securities. In the United States, on the other hand, the corresponding figures are 13 percent and 52 percent (Figure 4).¹⁴

¹²Hoshi and Kashyap wrote about this as follows: “The convoy system kept the laggards from falling behind and prevented the leaders from moving too far ahead. Under the system, even the most inefficient financial institutions were led to grow at the same speed, and protection was provided against failure.”

¹³One reason for this change in corporate behavior is said to be that corporations addressed three excesses after the collapse of the bubble economy, i.e., debt, employees, and facilities.

¹⁴BOJ (2006).

Thus, the supply of money in Japan is far greater than the demand. This “overbanking”¹⁵ situation has caused excessive competition among Japanese banks in financial markets, and the profitability of Japan’s loan market is quite low. According to a 2006 Standard & Poor’s survey,¹⁶ while the margins of American banks were more than 3.0 percent, the corresponding figure for Japanese mega-banks ranged from 1.35 percent to 1.97 percent (Figure 5). Competition among banks in the loan business intensified further in fiscal 2005.¹⁷ At the same time, interest margins on loans have diminished due to the downward trend in lending interest rates and the limited room to cut deposit interest rates further.

The above overbanking situation means that not only money, but also financial risk, is concentrated in the banking sector. Supporters of the capital market-based financial system regard this as a negative factor for the Japanese financial system. Thus, they insist on the necessity of a shift from savings to investments as well as from a bank-centered to a capital market-based financial system, and enhancing of the capital market infrastructure by the authorities.

This chapter has surveyed the relationship between four major changing situations in the banking industry and the shift of the financial system. The first three of the four changes have had both positive and negative influences on the shift of the financial system, while the fourth seems to have a stronger effect in favor of the arguments for a financial system shift than the other three. It is difficult, however, to assert that a shift of the financial system is inevitable only

¹⁵There are several definitions of this term. In the present context, “overbanking” does not mean that the number of Japanese banks is excessive compared with other countries, but rather that money is concentrated in the banking sector.

¹⁶*Insight into Credit Risk at Japan’s Financial Institutions* (Tokyo: Nihon no Kinyogyokai, 2006)..

¹⁷Among banks focusing their lending strategies on the expansion of loan portfolios, there was a tendency for the major banks to expand their loan business in rural areas, while the regional banks did so in urban areas.

from surveying the changing background of the banking industry. In any case, it is clear that the above developments have a connection with bank profitability and overbanking in Japan, and further arguments concerning them will be useful in thinking about the financial system.

The next chapter will undertake a comparative analysis of major banks in Japan, the United States, and Europe, since differences in financial systems are likely to emerge as variations of profits or assets, which are an output of bank behavior. Not only a comparison with the United States, but also from the international point of view, the next chapter discusses the necessity of a financial system shift in Japan.

CHAPTER 3
COMPARATIVE ANALYSIS OF MAJOR BANKS
IN JAPAN, THE UNITED STATES, AND EUROPE

As noted above, the low profitability of the Japanese banking industry has been seen as a weakness of the Japanese financial system. There is a great profitability gap between Japan and the United States; for this reason, it is said that Japanese banks could make improvements in this regard. Furthermore, since U.S. banks overcame their own financial crisis in the 1980's and recovered profitability by building an efficient capital market-centered financial system in the 1990's through IT, globalization, and deregulation, some observers believe that Japan should follow suit. In addition, it is obvious that indirect finance is not suitable for Japan any longer because the environment is changing dramatically.

Is such an argument appropriate when thinking about a shift of the financial system? Is the low profitability of the Japanese banking industry related to the bank-centered financial system? As noted in Chapter 2 with regard to environmental change surrounding the banking industry, further discussions concerning bank profitability from the international point of view are necessary as is a comparison between Japan and the United States. This chapter undertakes a comparative analysis of profitability and the structure of profits and businesses of major banks in Japan, the United States, and Europe. Recently, Shinkin Central Bank made a comparative analysis of 18 major banks (Table 1) in Japan, the United States, and Europe.¹⁸ Mainly through this international analysis, this chapter discusses the necessity of a possible shift in Japan's financial system.

¹⁸Shinkin Sentoraru Kinko. *Kinyu Chosa Joho 17-20 Nichibei-o no Shuyo Ginko no Shuekisei to Sono Hakei [Profitability and Its Background Among Major Banks in Japan, the United States, and Europe]* (2006).

Profitability

ROE (return on equity) is one of the most basic ratios to measure bank profitability, which means efficiency of capital. Thus, it is one of the most important ratios for shareholders. From the standpoint of the ROE, it seems that British and U.S. banks are the most profitable, followed by their French and Japanese counterparts, with German banks at the bottom. For example, the ROE's of U.S. and British banks are 20.0 percent or more, while those of Japanese and German banks ranged from 9.0 to 20.0 percent (Figure 6).

ROE is broken into the following three components:

- Return on total assets (ROA);
- Overhead ratio (OHR; cost ratio to net income); and
- Financial leverage ratio (FLR; inverse of capital adequacy ratio)

$ROE = ROA \times (1 - OHR) \times FLR$ Thus, a high ROA and FLR and a low OHR make for a high ROE. For example, increasing capital for a bank's stability of management or high rating makes a low FLR and a low ROE.

Next, we will investigate bank profitability using the above formula.

ROA

The ROA is the most basic financial ratio accounting for profitability, which means efficiency of assets. From the standpoint of the ROA, U.S. banks are the most profitable, followed by their European counterparts, with Japanese banks at the bottom. For example, the ROA's of U.S. banks are around 6.0 percent, while those of Japanese banks are from 1.0 to 2.0 percent.

The main factors in these differences seem to involve: competition, level of rates and fees in the domestic market, and regulations in each country. As argued in Chapter 2, the profitability of Japanese banks is low because lending money is very competitive from the standpoint of the supply of money.

The high profitability of U.S. banks is brought about by the margin between loans and deposits. Why is the margin so high in the United States as compared to other countries? There seem to be two main reasons for this. The first is the supply-demand situation in the lending market, and the second is the influence of deregulation.

Historically, there was considerable demand from large companies with high credit ratings in the U.S. lending market. But deregulation, mainly liberalization and securitization, changed this situation in the 1980's.

According to the Nomura Research Institute, in the first half of the 1970's, the margin in the United States was about 2.65 percent, and the ratio of the reserve for bad debts was about 0.2 percent. Along with deregulation of the financial markets, the margin increased along with the credit cost, since deregulation encouraged large companies to leave lending to the securities market, and the former became competitive. In the late 1980's, the margin rose to about 3.4 percent, and the ratio of the reserve for bad debts was about 0.9 percent. Thus, U.S. banks rushed into the high-risk/high-return market, such as big loans to commercial buildings and developing countries (Figure 7).

In short, the factor accounting for the high margin of U.S. banks reflects high-risk loans. This was also a basic factor in the U.S. financial crisis in the 1980's. Thus, during the 1990's, U.S. banks made efforts to improve the margin by "low-cost funding," lending to individuals and

small companies, and pricing influenced credit costs. These efforts enabled U.S. banks to be healthy and stable and improved the margin further.

Overhead Ratio (Cost Ratio to Net Income)

This figure means efficiency of management. Among major banks, as a whole, U.S. and British banks are more efficient than German banks. Currently, Japanese banks are not particularly inefficient. In the 1990's, however, there was a nearly 20 percent gap between the United States and Japan.¹⁹ Japanese banks undertook restructurings, using such measures as cutting salaries and recruitment of new employees and holding back on opening new branches. In addition, IT cuts costs, so that now there seems to be no significant variances between the different countries. The lack of efficiency of German banks is reflected in personnel costs.

Financial Leverage Ratio (Inverse of Capital Adequacy Ratio)

This figure means efficiency of capital. A high FLR indicates that efficiency of capital is high, in other words, profits are earned by small capital (large debt). From the standpoint of the FLR, U.S. banks are the lowest, followed by their European counterparts, with Japanese banks at the bottom. For example, the FLR's of U.S. banks are around 10 times, while those of Japanese banks are from 20 times to 30 times.

As noted above, the high ROEs of major U.S. and British banks are brought about by high ROAs and low OHRs. On the other hand, the low ROEs of major German, French, and Japanese banks are caused by low ROAs and high OHRs.

¹⁹In 2000, the OHR of U.S. banks was about 45 percent, while that of Japanese banks was about 65 percent. Fujiwara, *Nichibei Ginkogyo no Koritsuseikakusa to Sono Yoin* (2002).

Profit Structure

The source of gross operating profits of each bank is mainly the retail business and investment banking, but the ratio is totally different by bank. In the United States, major banks, except for JPMorgan Chase (JPMC), earned more than half of their profits from the retail business. And in Europe, major banks, except for Deutsche Bank, earned more than 40 percent of their profits from retail (Figure 8).

In Japan, statistics are compiled differently from those in the United States and Europe, so it is impossible to make a comparative analysis using the same standard. Nonetheless, major Japanese banks' ratios of retail business seem very low from the international point of view; Mitsubishi UFJ Financial Group (MUFG), for example, earned only 26.4 percent from the retail business in fiscal 2005.

Diversification of Business

The expansion of banks' fee business is leading to a diversification of their sources of profit and effective utilization of their managerial resources.

The proportion of fee income to banks' total income is high in French and German banks, from 60 to 70 percent, as compared to U.S. and British banks. This is because historically France and Germany have had a universal banking system, which enables banks to earn fee income from securities and insurance, while the banking and securities sectors were separated in the United States and Britain.

The proportion of fee income to banks' total income is still smaller in Japan than in other countries. The gap in the ratio of fee incomes to gross profits, however, has narrowed in recent

years. Looking at the components of Japanese banks' fee income, the sale of investment trusts²⁰ and private pension policies, and loan-related fee business, such as syndicating loans and liquidizing loan assets, are notable. In U.S. banks, fee income related to deposits such as maintenance fees, is relatively high, which is not the usual situation in Japan.

International Business

There is also no geographic difference between major banks. This is mainly because the scale of international business depends on each bank's policy. Historically, for example, Citigroup has developed international business and has focused on consumer finance worldwide,²¹ while the Bank of America is concentrating on the domestic market, so its international revenue is quite low.

Each bank's lending share in the domestic market in the United States, Britain, and Japan, except for Citigroup and the Royal Bank of Scotland, is more than 80 percent. At the same time, the lending share of German banks in the domestic market is less than 60 percent, since the economy is slack and the domestic lending market is very competitive because of the huge number of banks.

Below, I would like to give a brief historical overview of each country's banking system, because bank profitability has a great relationship between each country's financial regulations and institutions.

²⁰Investment trusts sold over bank counters now account for about half of the total sales of investment trusts.

²¹Citigroup earned more than half of its profits from the international market; its market share in Asia is the highest except for North America.

The U.S. Banking System

Historically, regulations on interstate banking were strong in the United States because of its strong decentralization, as the Glass-Steagall Act of 1933 banned any sort of participation by banks and securities companies in each other's sector. The relaxation and elimination of regulations on interstate banking and the introduction of the holding company system, however, have encouraged consolidation of the financial industry. The regulations on interstate banking were gradually relaxed at the state level beginning in the 1980's and eliminated with amendments to federal laws in 1994.²² This deregulation spurred consolidation among banks and encouraged mergers between banks. In 1999, the Gramm-Leach-Bliley Act (GLB Act) was passed, allowing banks, securities companies, and insurance firms to participate in each other's sectors.

Meanwhile, the U.S. banking industry experienced a financial crisis in the 1980's, and major banks improved their profitability mainly by strengthening retail banking and business efficiency with IT. Major banks' customer bases are in large states such as New York and California, and they do not do business all over the country. In the United States, there are many small banks, so competitiveness in the domestic market is not so severe as in Japan and Europe.

The European Banking System

In Europe, the Second Banking Directive of 1989 extended Germany's universal banking system, by which banks themselves also provide securities services, to the EU. Ever since the late 1980's, banking and insurance have been in the process of integration throughout Europe. Behind the integration of banks and insurance companies in Europe is the fact that the

²²The Reagle-Neal Interstate Banking and Branch Efficiency Act of 1994.

profitability of traditional banking services is declining, and banks are seeking to strengthen their private banking services, which they provide to wealthy individuals, by expanding their business strategies.

This system reflects the high ratio of non-interest income in French and German banks. In Britain, oligopoly in the domestic financial market made the profitability of major banks high,²³ while in Germany, the competitive domestic market and existence of public financial institutions had a bad effect on profitability. In Germany, besides the slack economy, banks are struggling with the NPL problem, which was caused by excess debt after East and West Germany united.

The Japanese Banking System

Japan first allowed banks and securities companies to enter into each other's sectors by establishing sector-specific subsidiaries in 1993 and then gradually relaxed and eliminated restrictions on the scope of business open to these subsidiaries. It has also phased in competition between banks and insurance companies on one hand and securities companies and insurance companies on the other. The "Big Bang" accelerated the relaxation; in 1998, Japan lifted the ban on holding companies, allowing them to be established.

As can be seen from the above, there are some similarities and differences among banks. Fundamental profitability in the banking industry reflecting the difference of financial markets, however, is one of the major factors. Japanese banks cut their OHR and diversified their business, especially fee income, through restructuring, as major U.S. and European banks did. The fundamental factor in their low ROA, however, is not easy to change after the zero-interest rate

²³Among five major countries, Britain has the smallest number of banks: the United States, 8,932; Germany, 2,225; Japan 1,515; France, 939; Britain, 426.

policy of the BOJ was stopped in 2006, and Japanese banks are struggling to add margins to lending.

As discussed above, the basic difference of profitability among major banks seems to be characterized not by each bank's business model, but by productive machinery in each country. While there are small geographic differences between major banks concerned with profit structure, diversification of business, and international business, there are apparently geographic differences in bank profitability. That is to say, the profit model of U.S. and British banks is produced by high ROA's and low FLR's, while that of Japanese and German banks is produced by the inverse phenomenon. This difference is accordance with the different financial systems in these countries. Furthermore, the profit model is influenced by each country's financial institutions and historical backgrounds. Thus, the gap of bank profitability is a result of differences among countries, which contribute to and reflect different social values. If a gap of bank profitability between countries is reasonable, it may be that the effectiveness of any shift of the financial system cannot be predicted or judged by bank profitability and efficiency. Should these differences of financial markets or systems be accepted as given or should attempts be made to bring them into convergence? In the next chapter, I want to think about this issue.

CHAPTER 4

THE SHIFT OF THE FINANCIAL SYSTEM IN JAPAN

As noted in Chapter 3, it seems that bank profitability in the capital market-based financial system is high, while that in the bank-centered financial system is low. But the banking industry and profit structure of major banks differ by country because each country has its own financial institutions and historical backgrounds. In other words, the financial system seems to have a strong connection with nationality and culture. In Japan, then, what sort of financial system is suitable from the standpoints of these factors? And what sort of institutions should be considered when the financial system is discussed? This chapter concludes the arguments about the shift of the financial system in Japan, introducing the ideas of supporters of a bank-centered financial system and considering the above arguments.

The Ideas of Supporters of a Bank-centered Financial System

Economic analyst James Abegglen has a different perspective regarding the recently changing Japanese financial system. He argues that:

Cross-shareholdings between banks and clients, now very much diminished, are likely to be renewed to some degree. Indirect financing through bank borrowing is likely to increase again with renewed capital expenditure. The institution of the main bank will have a lessened role, but the main bank in a more limited role is to continue. Corporations in 21st-century Japan will not be funded and governed by the securities market as in Britain and the United States. The emerging Japanese pattern is a complex one, with a great deal of change, but largely within the broad and familiar patterns of the past.²⁴

²⁴James Abegglen, *21st-Century Japanese Management: New Systems, Lasting Values* (Basingstoke: U.K.; New York: Palgrave Macmillan, 2006).

He supports this view with survey data on the role of cross-shareholdings.²⁵

Abegglen also opposes adopting the Anglo-American model in Japan because of two major problems. The first is that there is considerable evidence that the U.S. system of corporate governance, so highly praised, has, in fact, been a great failure.²⁶ The second is that companies in Europe and Japan, with different histories, cultures, traditions legal systems, and institutional frameworks, must develop their own systems of governance.

Furthermore, Masahiko Aoki, professor of economics at Stanford University, supports Abegglen's view on the second problem, noting that national systems of economic governance incorporate complementary labor, financial, and political systems. Thus, the Japanese financial system, with patient capital channeled to firms by banks, for example, complements the Japanese labor system, with long-term employment stability and strong labor-management collaboration at the firm level. Japanese enterprises can uphold their employment guarantee to workers in a downturn because they are not subject to shareholder pressure for short-term returns. This means that the evolution of the Japanese labor relations system is shaped not only by the existing institutions of the labor market, but by the distinctive institutions of the financial market as well.

Although there are numerous arguments, suggestions, and analyses regarding whether or not Japan should follow the U.S. model, the answer would not be a simple "yes" or "no." And it is necessary not only to compare each financial system simply and independently, but also to

²⁵Firms were asked to specify the single most important benefit of cross-shareholding. The results of this 1993 survey show that three kinds of benefits, namely "preventing hostile takeover" (36.2 percent), "providing the stability of the firm's transactional relationships" (27.0 percent), and "long-term stability of share price" (22.8 percent), stand out as the most important functions of cross-shareholding.

²⁶He pointed out that: "It is impossible to escape the conclusion that the U.S. system of corporate governance has failed in a great many cases and from basic weakness. The concept an outside board has in practice meant a top management with nearly total powers, as outside, presumably independent, board members are too often cronies of top management. The concept that shareholders' interest is best served by basing management compensation on share price has in practice brought about major share price distortions that damage the company in both the short and long term by providing top management very great incentives to distort results and inflate share prices. Greed has consequences."

compare each country's unified arrangement composed of several systems such as financial, corporate governance, and labor. Furthermore, capital market-based financial systems and bank-centered financial systems are not simply conflicting concepts; they can be harmonized for economic development in Japan.

But even if the Japanese financial arrangement, which has been based on a bank-centered financial set-up, should go to a new financial system harmonizing with the capital market-based financial system, its core is bank-centered and its pivot is relationship banking. From this standpoint, the idea that a shift of the financial system is irreversible in Japan is not acceptable, because this sort of discussion should not be started from a system's point of view to be adapted to its members, but vice versa. Thus, we should not start by considering the system to be adopted, but with the behavior patterns of its members. Which do we think about first – the structure or the taste of the resident – when we design a house? Focusing on the subjects and their behaviors in the system is important when we think about changing the system.

Next, I want to support the above from two points of view. The first is that Japanese people tend to seek for long-term relationships and the overall benefit of society. The second is that there is a limit to any shift from savings to investments.

Long-term Relationships and the Overall Benefit of Society

Trust or the relationship is the most fundamental concept in financial services because financial services are intangible and complicated for customers. Banks are in an advantageous position, from which it is easy to exploit customers. Thus, building trust between customers and banks is more important than in other industries. Generally, the relationship is weak in the capital market, because loss and gain are figured out instantly by the price, and the price is the most

important signal there. Abegglen believes that the reason why U.S. corporate governance does not fit Japan is that U.S. companies are clearly based on economics, while their Japanese counterparts are communities. He cites the following from Arie de Geus, author of *The Living Company*,²⁷ who worked for the Royal Dutch/Shell Group for 38 years from 1951 to 1989 and was head of an Advisory Group to the World Bank from 1990 to 1993.

There are, in fact two different types of commercial companies in existence today, distinguished by their primary reason for being in business. The first type is run for a purely “economic” purpose. This sort of “economic company” is managed primarily for profit. The economic company is not a work community. It is a corporate machine. Its sole purpose is the production of wealth for a small inner group of managers and investors. It feels no responsibility to the membership as a whole.

The second type of company, by contrast, is organized around the purpose of perpetuating itself as an ongoing community. Return on investment remains important. But managers regard the optimization of capital as a complement to the optimization of people. The company itself is primarily a community.

Thus, the relationship or trust is more essential than the price in Japanese society. Abegglen also cites Michel Albert, author of *Capitalism vs. Capitalism*, as follows: “Capitalism has two faces, two personalities. The neo-American model is based on individual success and short-term financial gain; the Rhine model, of German pedigree but with strong Japanese connections, emphasizes collective consensus and long-term concerns.”²⁸

The Japanese institution of gifts to shareholders is a good example of the above.²⁹ From a corporate finance theory view, such a custom is not rational because the payout policy to

²⁷Arie de Geus, *The Living Company* (Boston: Harvard Business School Press, 1997).

²⁸Michel Albert, *Capitalism vs. Capitalism* (New York: Four Walls Eight Windows, 1993).

²⁹Such gifts included services and products (excluding dividends). Airline companies, for example, gave discount coupons, food companies gave their products. In Japan, more than 700 listed companies had adopted this practice as of 2002.

shareholders should be dividends or repurchases. This notion of gifts, however, has penetrated Japanese society because shareholders are willing to build relationships with the company.

It is clear that the main bank system and cross-shareholdings are less common than they used to be. But they will not completely disappear as long as trust between customers and banks exists. Hostile takeovers are considered to be among the measures of self-purification in the capital market-based financial system. But they are not appropriate for Japanese society. And considering the recent threat to Japanese companies involving hostile takeovers by huge American investment funds, which are seeking for short-term shareholders' profits, there is a possibility that many companies will renegotiate the role of the main bank system and cross-shareholdings.

Thus, as long as customers regard long-term relations with banks as important, it seems that the shift from a bank-centered financial system to a capital market-based financial system will not occur easily.

Limit to Shifts from Savings to Investments

As mentioned in Chapter 2, most of the total financial assets of individuals in Japan are invested in safer assets, such as cash and deposits, than in the United States. To achieve a capital market-based financial system, a shift from savings to investments is inevitable, and the Japanese government is encouraging such a change through its policies. Recently, this trend has been gradually taking hold through deregulations.³⁰ It seems impossible, however, that risk assets will become as dominant as in the United States; this is because Japanese people have already have

³⁰Sales of investment trusts by banks that were deregulated in 1998 are growing rapidly. Such products sold over bank counters now account for about half of total sales.

invested in fairly risky assets, such as stock, and the situation is quite different from that in the United States.

According to Katsumi Matsuura,³¹ a professor of social science at Hiroshima University, the ratio of stockholding households in Japan is not much smaller than in Europe and the United States, but the ratio of stock among total financial assets is considerably lower. Furthermore, in the United States, the ratio of the wealthy in the stock market is extremely high, while that of the middle class is quite low. The opposite, however, is true in Japan. For example, the weight of stock possession by the top 5 percent of individuals of net assets in the United States is 79.1 percent; in Japan, on the other hand, the corresponding figure is 48.7 percent. And the weight by the bottom 50.0 percent in the United States is 0.6 percent; in Japan, the corresponding figure is 8.96 percent. He concludes that the stock markets in Japan and the United States are quite different and that the extent of individual stock ownership in Japan is much broader.³²

Japan is facing a rapidly aging society, and most of the nation's savings are held by the elderly. In addition, considering that the weight of real estate is quite high in total assets in Japan, it seems dangerous to encourage older people to invest too much in risky assets. Maintaining a large amount of money in savings reflects not only the risk-averse nature of the Japanese people, but is also influenced by the above-noted demographics. And remember "Wide Fever" in 1990. At that time, the Japanese stock market price was relatively good. Nevertheless, it had already peaked out in December 1989, but many Japanese were making a beeline to deposit high-yield savings named "Wide."³³ It was big news at that time. Now, the interest rate is very low. If

³¹Katsumi Matsuura. *Why Is the Share of Stock Investment Low in Japan?* (2006).

³²Matsuura points out the necessity of increasing dividends in order to accelerate the shift from savings to investments in Japan.

³³"Wide" is a nickname for financial products for individuals that former long-term credit banks could deal with. In 1990, the duration was five years and the compound interest was fixed at 9.606.

interest rates rise to a relatively high level, can we still expect a further shift from savings to investments in Japan? Under these circumstances, then, is it right to encourage a shift from savings to investments strongly and blindly? At least Japanese authorities should create investment policies toward individuals that take the nation's demographics into consideration.

The capital market-based financial system emphasizes short-term efficiency, while the bank-centered financial system focuses on stability. In the former, standardized large-lot financial transactions, such as the trading of corporate bonds, are suitable; the household sector, however, is more directly exposed to market price fluctuations. Meanwhile, handling flexible or small-lot financial transactions is better in bank-centered financial systems. And corporate governance is imposed by market mechanisms, such as takeovers, in the capital market-based financial system, and by bank monitoring in the bank-centered financial system. When market prices fluctuate excessively due to exogenous shocks, households and companies are directly affected by price fluctuations in the capital market-based financial system. On the other hand, when such temporary shocks occur in the bank-centered financial system, banks absorb the shocks in the first place before partly passing them on to households and companies. Therefore, the effects of these shocks are relatively small. In other words, the bank-centered financial system is based on stable, long-term relations among households, companies, and banks, and this enables them to mutually achieve maximum long-term benefits. In contrast, in the capital market-based financial system, each market participant strives to maximize his own short-term benefits. From these arguments, then, which system is suitable for Japan?

The above also applies to the management of an individual bank itself. Joseph DiVanna,³⁴ the Managing Director of Maris Strategies Limited, a financial services, global business, and innovation think-tank providing research and advisory services, has said that:

Years of cost cutting, mergers and other internally focused activities targeted to increase shareholder value have acted to commoditize banking products to the point where there is little perceived differentiation between financial providers with local, regional, national markets.... Unfortunately, a large number of customers have now become shoppers and view banking services as single commoditized products, rather than a mechanism to facilitate a total relationship of services. The new challenge for retail banks is to educate customers on the advantage of maintaining a total relationship understanding of how the bank serves to meet the client's individual financial needs, incorporating cultural, social, lifestyle and life events into a cohesive structure that results in overall wealth generation.

This statement has very important implications for Japanese banks. Bank business has two main streams. One is commoditized products and services, such as electronic money, that customers are unconscious of just like social infrastructure. The other is high value-added products and services that customers need to tailor to their own needs, such as private banking. Each bank has plenty of customers as debtors and creditors, as well as many shareholders, and satisfies their needs. An excessive focus on shareholder value threatens the bank's *raison d'être* itself.

Stakeholders are numerous and complicated, especially in the banking industry. As I noted in Chapters 2 and 3, ROA's are very low in Japan. This situation may mean that Japanese banks are offering high interest rates and low fees to depositors and low interest rates to borrowers. Thus, the Japanese financial system is useful for many customers; nevertheless, many customers do not realize this. If Japanese banks start to lower interest rates and raise fees for

³⁴*The Future of Retail Banking* (2004).

depositors, and to raise interest rates for borrowers to maximize their margin, in other words, short-term benefits, Japanese banks may fulfill the profits of shareholders, but harm relations and lose trust with their customers. In the long run, which is better for the management of an individual bank itself? In this sense, corporate management of banks should achieve long-term balanced profits of all stakeholders, including employees, to satisfy the above two main streams of bank business.

CONCLUSION

In this paper, in looking at the reasons why the core of the Japanese financial system is bank-centered, the pivot is relationship banking. Capital market-based financial systems and bank-centered financial systems are not simply conflicting concepts; they can be harmonized for economic development in Japan. The idea that a shift of the financial system is irreversible and inevitable in Japan, however, is not acceptable for the following reasons. First, no environmental change has occurred to force the shift, and great reform is not necessary in the Japanese financial system. Second, low profitability in the banking industry would not be a reason for the shift. Third, the current bank-centered financial system is suitable for Japanese society and institutions. Again, the major reasons for this are:

1. A capital market-based financial system, in which each market participant strives to maximize his own short-term benefits, does not fit Japanese institutions. The bank-centered financial system is connected with Japanese society, which regards long-term relations and management, such as corporate governance and the labor system, as important. Financial services depend greatly upon relations between customers and financial institutions.
2. Although some shift from savings to investments is probably necessary, a dramatic shift would be difficult because a good deal of money remains in the banking sector in Japan. And this should be considered a prerequisite condition when thinking about the financial system.

Even if the change and development of finance were streaming in one direction, the future of banking will not converge on a simple pattern. I believe that the relationship between customers and banks will not change even if the financial system does, and relationship banking

will never disappear so long as trust between customers and banks exists. Furthermore, this relationship is also very important for the stability of the financial market, which is not produced exclusively by a capital market-based financial system.

This does not mean, however, that Japanese banks should not change at all. Indeed, it goes without saying that they must do so for the sake of the future, even if the core of the Japanese financial system is the bank-centered financial system. As noted above, overbanking in Japan, in other words, a situation in which the financial risk is concentrated in the banking sector, may threaten the Japanese financial system. Thus, Japanese banks must maintain sound financial conditions for the stability of the nation.

Figure 1

NPL Ratios (major banks)

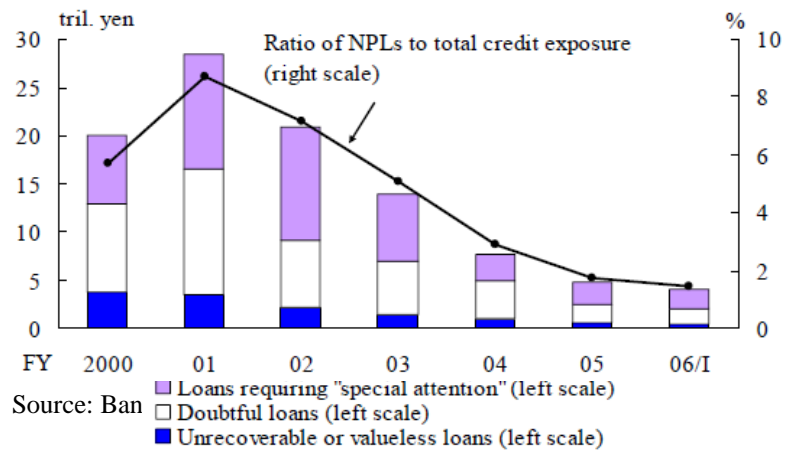
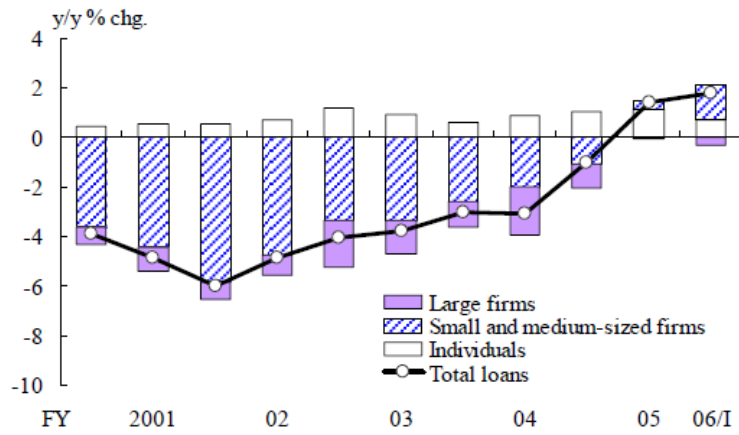
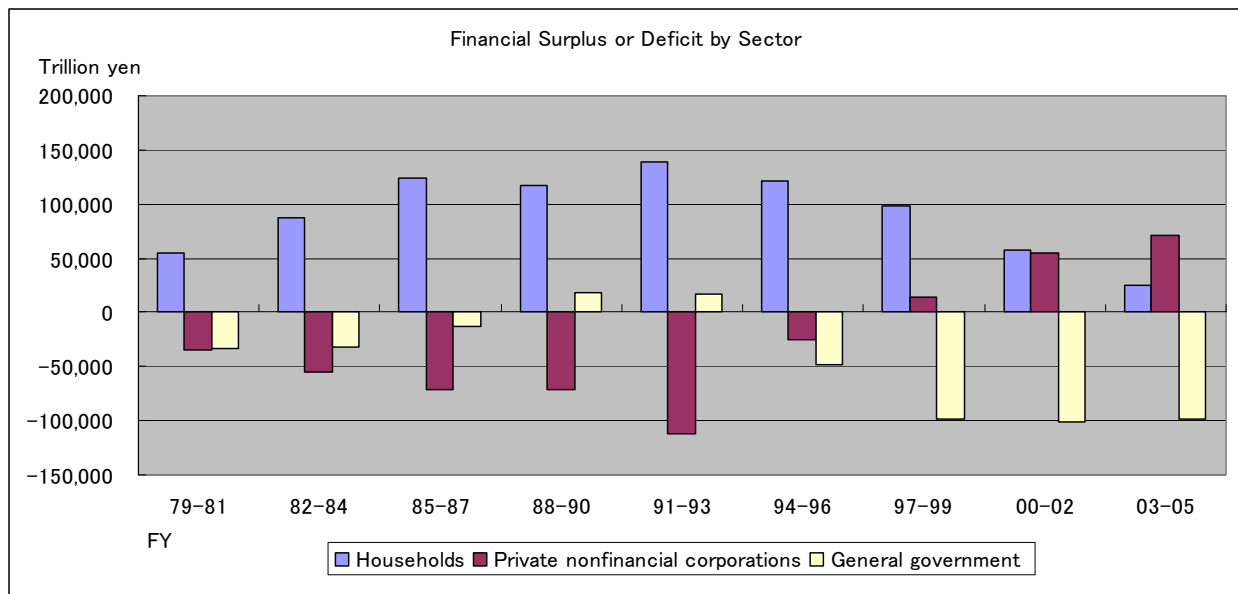


Figure 2
Outstandings of Bank Loans (Major Banks)



Source: Bank of Japan

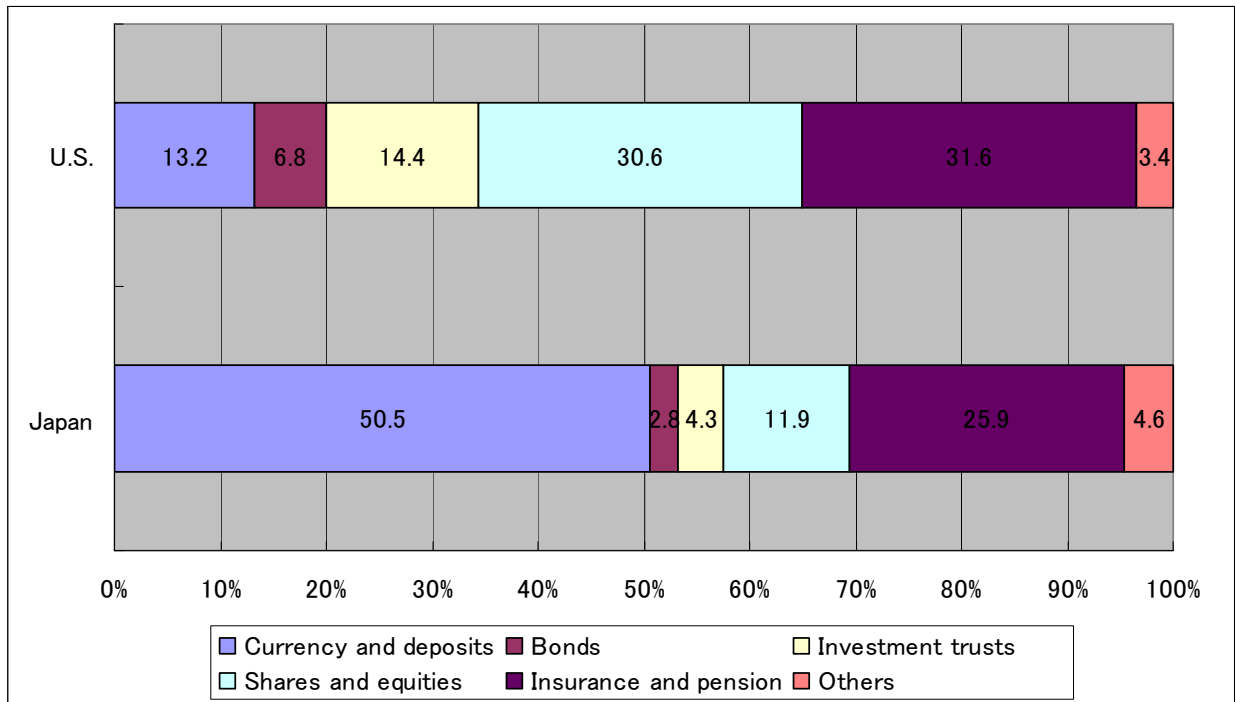
Figure 3
Financial Surplus and Deficit by Sector in Japan



Source: Bank of Japan

Figure 4

Financial Assets Held by Households in the United States and Japan



Source: Bank of Japan

Figure 5

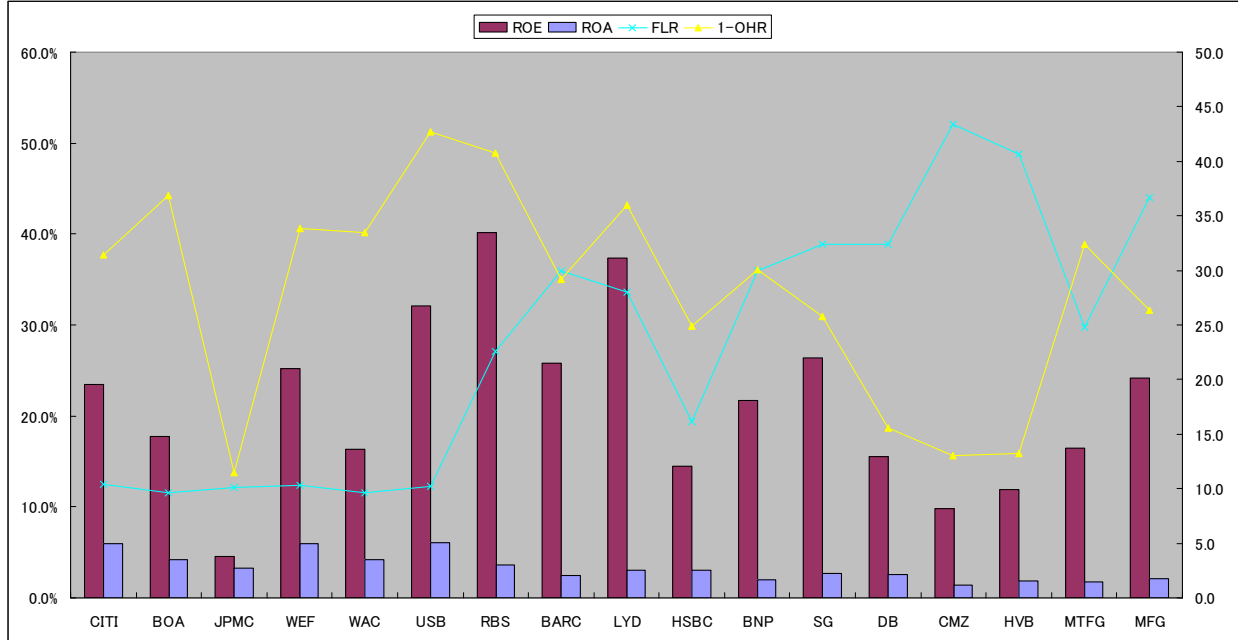
Margin (Loan Interest Rates – Deposit Interest Rates)

Bank of America	Citigroup	JPMorgan Chase	Bank of Tokyo-Mitsubishi	Sumitomo-Mitsui Financialgroup	Mizuho	UFJ	Risona
2004	2003	2002	2004/first half	2004/first half	2004/first half	2004/first half	2004/first half
4.74	6.76	3.88	1.35	1.77	1.37	1.64	1.97

Source: Standard & Poors

Figure 6

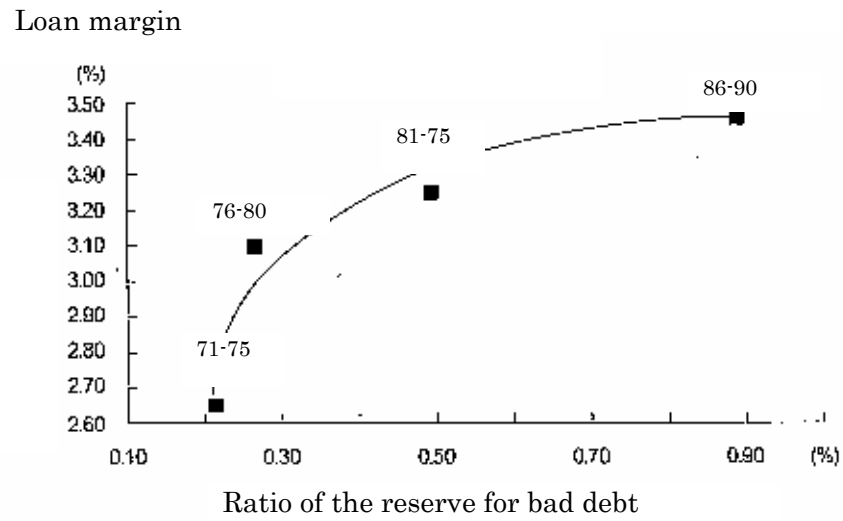
Ratio of Profitability of Major Banks in the United States, Europe and Japan



Source: Shinkin-chukin Sogo Kenkyusho

Figure 7

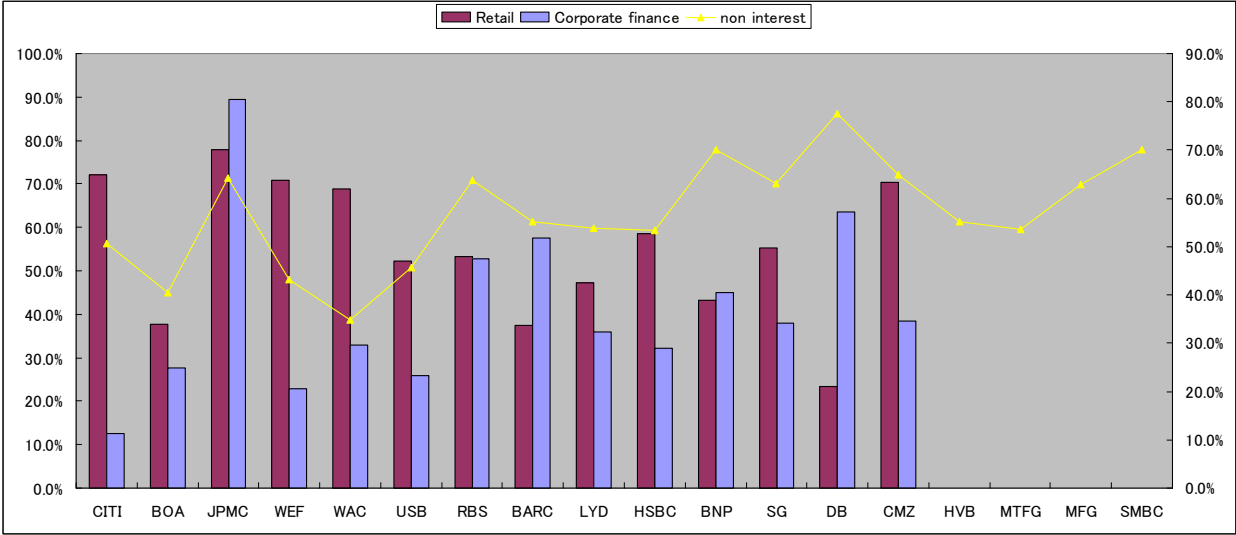
Increasing Risk of Bank Loans in the United States



Source: Nomura Research Institute

Figure 8

Profit Structure and Non-interest Ratio of Major Banks in the United States, Europe, and Japan



Source: Shinkin-Chukin Sogo Kenkyusho

Table
Eighteen Major Banks in the United States, Europe, and Japan

		gross income	before tax net income	net income	assets	capital
U.S. (2004/12)		m illion \$				
Citigroup	CTI	56,291	21,256	14,885	944,070	90,463
Bank of America	BOA	44,082	19,521	14,796	1,063,744	110,069
JPMorgan Chase	JPMC	34,640	4,790	3,363	1,060,931	104,978
Wells Fargo	WEF	23,429	9,529	6,054	389,878	37,770
Wachovia	WAC	19,205	7,715	5,412	451,936	47,071
US Bancorp	USB	12,093	6,196	4,087	197,851	19,280
Europe		m illion pond				
Britain		m illion pond				
The Royal Bank of Scotland	RBS	21,243	10,397	4,762	583,467	25,904
Barclays	BARC	12,852	4,502	3,314	522,089	17,417
Lloyds TSB	LYD	8,649	3,732	2,489	279,843	9,977
HSBC	HSBC	8,686	2,592	1,826	289,975	17,961
France		m illion euro				
BNP Paribas	BNP	18,145	6,553	4,668	905,936	30,194
Société Générale	SG	15,875	4,908	3,465	601,089	18,576
Germany		m illion euro				
Deutsche Bank	DB	21,546	4,029	2,472	840,068	25,904
Commerzbank	CMZ	6,151	960	475	424,879	9,801
Bayerische Hypo- und Vereinsbank	HVB	8,593	1,367	-2,278	467,408	11,485
Japan		m illion yen				
Mitsubishi Tokyo Financial Group	M TFG	1,856,980	721,389	408,318	108,422,100	4,373,097
Mizuho Financial Group	M FG	2,977,670	943,059	627,383	143,076,236	3,905,726
Sumitomo-Mitsui Financial Group	SMBC	2,950,586	-108,535	-234,201	99,731,858	2,775,728

Source: Shinkin-Chukin Sogo Kenkyusho

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