

**INVIGORATING REGIONAL FINANCIAL  
INSTITUTIONS IN JAPAN AND THE UNITED STATES**

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## ABBREVIATIONS

ABA	American Bankers Association
ACB	America's Community Bankers
BIS	Bank for International Settlements
BOJ	Bank of Japan
CEO	Chief executive officer
CRA	Community Reinvestment Act
DIC	Deposit Insurance Corporation of Japan
FSA	Financial Services Agency
FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Bank
GDP	Gross domestic product
ICBA	Independent Community Bankers of America
JBA	Japanese Bankers Association
LTCB	Long-Term Credit Bank
M&A	Mergers and acquisitions
MOF	Ministry of Finance
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision



## INTRODUCTION

The Japanese Ministry of Finance (MOF) and Financial Services Agency (FSA), among others, have described the administration of Japanese financial institutions as the “convoy system” (*goso-sendan hoshiki*), which means that the risk is spread evenly as all of the nation’s banks pursue similar actions.<sup>1</sup> This word has an ironical twist in that it somewhat describes the communist financial system. And, in fact, very few Japanese financial institutions<sup>2</sup> failed during the *goso-sendan hoshiki* period.<sup>3</sup>

Between 1995 and 2003, however, after the collapse of the bubble economy, 16 Japanese banks went bankrupt.<sup>4</sup> Ending the *goso-sendan hoshiki* period, the new banking system was created under central rule with the Basel Capital Accords of 1988 and 2004 established by the Bank for International Settlements (BIS). Thus, since the relief of Resona Bank in 2003, only a few Japanese banks have failed.

Mergers and acquisitions (M&A) in Japan, on the other hand, have been increasing since the end of the bubble economy in 1990. As a result, the number of banks has been declining quite rapidly. In particular, the number of Japan’s trust banks (*shinyo-kinko*) and trust unions (*shinyo-kumiai*)<sup>5</sup> has been decreasing dramatically. Some observers have said that this is the beginning of the second *goso-sendan hoshiki* period. From my experience, I can say that the

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<sup>1</sup>Originally, this term was used to describe a strategy for moving ships in times of war – i.e., a number vessels sailing together as a group. But it is now commonly applied in a derogatory manner to explain Japanese administration practices.

<sup>2</sup>In this report, “financial institutions” means banks (including long-term credit banks, trust and banking institutions), *shinyo-kinko* (trust banks), *shinyo-kumiai* (trust unions), and *nogyo-kyodo-kumiai* (agricultural cooperatives).

<sup>3</sup>It is widely said that this period was from the middle to the end of the 20<sup>th</sup> century. But there is no generally accepted definition.

<sup>4</sup>These data are based on records from the Japanese Bankers Association.

<sup>5</sup>It is very hard to translate these terms into English. But for the sake of simplicity, I would like to refer to them as trust banks and trust unions.

peak of the crisis of financial institutions in Japan occurred in 1998 and 1999.<sup>6</sup> This period was called a “financial crisis.” Since then, the Japanese banking system has been improving steadily. At the same time, the Japanese people and government have been hoping to establish a safe financial system, especially in the rural areas of the country. One typical method of accomplishing this is M&A. A number of financial institution managers, stockholders, and investors<sup>7</sup> hope to see their capital increase through M&A’s. At the same time, many Japanese people want their financial system to be safe above all else. I feel that one of the main businesses of the FSA is to conduct M&A’s in financial institutions under the guidance of the agency’s policy. This is very similar to the first *goso-sendan hoshiki* period.

As I see the situation of banking in the United States, the circumstances in the late 1980’s were very similar to those in Japan a decade later. Because of the decline in land prices, a great deal of credit turned out to be bad loans. This is the reason why the government should deregulate the rules related to the banking business. But more deregulation in the banking system has created more competition, not only in related fields, but in different ones as well. For example, big banks in the United States tried to take customers away from credit unions by making use of their large organizations and systems. On the other hand, the number of M&A’s increased after the late 1980’s.<sup>8</sup> This trend was also notable among the credit unions. Some American credit unions and small banks have their own unique strategies, and they have tried to survive without relying on M&A’s.

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<sup>6</sup>There were two big bank failures in Japan in 1998: the Long-Term Credit Bank of Japan (now Shinsei Bank) and the Bond Credit Bank of Japan (now Aozora Bank).

<sup>7</sup>In Japan, banks are corporations with stockholders. Trust banks and trust unions, on the other hand, are cooperatives with investors.

<sup>8</sup>In Massachusetts, for example, Fleet Bank was merged with Bank of America in 2004. It was said that Fleet was one of the best-managed banks in the United States.

Frankly speaking, it is very important to understand that customers and ordinary people in the United States are mostly concerned with how much money they can obtain. The number of financial institution bankruptcies and the effects on the financial system are not so important for the people and government in the United States. Their main focus is to what extent financial institutions can benefit their customers and how they contribute to society.

Japanese financial institutions, of course, also believe that these factors are valuable. But such institutions as well as government circles tend to think that the most important issues are “stability” and “sustainability.” The Japanese people believe that it is most important for financial institutions to maintain their organizations and styles. People in the United States, especially bankers and financial customers, on the other hand, tend to think that stability and sustainability of financial institutions are not so important. Stability of the financial system is, of course, one of the most important issues in any country. But people in the United States tend not to care very much about the situation of individual financial institutions. In my opinion, the reason why there is such a difference lies in each country’s history of indirect finance and their rate of savings.

In any case, as a result of financial crises in Japan and the United States, there is now a legacy of experience and systems to help deal with such disruptions. I think this is very valuable for individuals who work in the financial sector, as well as for ordinary people, because we know what should be done in such an event. This is particularly true for the Japanese people, because, prior to the financial crisis of the late 1990’s, they had no experience of bank failures and did not know what they should do in such a case. Unfortunately, however, the governments and people of the United States and Japan tend to believe that financial institutions should become larger and larger and that this is safe for their property and other assets. The theory is that small financial

institutions are always weak, and it is thought that the best way for them to survive is to expand through M&A's and other similar means.

But I am always somewhat skeptical of this view. In Japan, there have been no bankruptcies among the nation's trust banks.<sup>9</sup> On the other hand, many major banks have failed. This indicates that large organizations are not always superior to small ones. There are many ways to survive, and financial institutions are no exception to this rule.

In this report, I would like to talk about three interesting topics that I have found in my business experiences, mainly by comparing the differences between the United States and Japan. The first chapter will cover styles of inspection and supervision. In Chapter 2, I will explore business models. In the last chapter, relationship and community banking will be investigated. Then in the conclusion, I will discuss the prospects for financial institutions in the two countries and suggest some good ways to create a better future for many Japanese trust banks and trust unions, as well as for the governments of both the United States and Japan.

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<sup>9</sup>But there have been many cases in which they chose M&A in order to survive.

# CHAPTER 1

## STYLES OF INSPECTION AND SUPERVISION

### **Differences Between the United States and Japan**

Except for cultural variances, one of the most important differences in the style of supervision between the United States and Japan is the number of supervising organizations. There are multiple supervising bodies for every financial institution in the United States. In Japan, on the other hand, there is only one supervising agency, the FSA. Before June 22, 1998, the supervising organization in Japan was the MOF. There are other inspection organizations, such as the Bank of Japan (BOJ) and the Deposit Insurance Corporation of Japan (DIC), for financial institutions. But these two organizations do not have the right to supervise or give any guidance, only to inspect. Because the cost of inspections is paid from government budgets, there has been considerable criticism of this system. It is said that this is due to the waste of the money involved. I have also heard that many times officers at financial institutions have complained about this system as it requires them to prepare for numerous inspections.

Likewise, there is only one organization for Japanese banks, the JBA (Japanese Bankers Association). In the United States, on the other hand, there are three banker's associations at the national level: the American Bankers Association (ABA), the Independent Community Bankers of America (ICBA), and America's Community Bankers (ACB). There are also several bankers associations at the state level.<sup>10</sup>

Many people say that the U.S. system is not effective and that it would be better if the government and bankers associations rebuilt it. It is impossible, however, to decide which is

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<sup>10</sup>There are three bankers associations in the state of New York, for example. It is possible for one bank to belong to six such associations, and it is not rare for one bank to belong to four at once.

better, the Japanese approach or the American. If the Japanese government and the JBA try to change the system to more closely resemble that of the United States, the Japanese people will consider this a waste of the money. This is because they are accustomed to the system of one top organization and also because Japanese financial institutions do not pay for their inspections; only the government does. But in the United States, it is customary for financial institutions to pay for their inspections.

In this chapter, I would like to consider the advantages and disadvantages of the systems in both countries, as well as optimum methods of inspection and supervision.

### **Bank Licensing and Supervising Organizations**

The main reason why there are so many supervising organizations in the United States is because of the history of the country.<sup>11</sup> At the nationwide level, there are the Office of the Comptroller of the Currency (OCC), the Federal Reserve Bank (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA), all supervising and inspecting within their own jurisdictions. In addition to these organizations, each state supervises and inspects its own financial institutions.

There are advantages and disadvantages to this system. Its complexity has been criticized continuously over the years, and it has been reconfigured 25 times since the 1930's. On the other hand, many people believe that this system has some good points in spite of the inefficiencies involving the officers of the supervising bodies, the ABA, and the financial institutions.

First, each financial institution can get the best license for its particular line of business. For example, in half of the 50 states, a financial institution that wants to get a real estate broker's

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<sup>11</sup>The main factor here is the opposition between the Union and the Confederacy during the Civil War (1861-65).

license can get do so. Second, financial institutions can choose the organization by which they wish to be supervised. Because inspectors who belong to the OCC are not regarded as high-level officers, for instance, financial institutions can change their supervising and inspecting organization from the OCC to the state supervising and inspecting organization. For this reason, supervising and inspecting organizations must undertake “business activities” for financial institutions. If they obtain many financial institutions as their “customers,” they can get excellent evaluations from the market. As a result, they can charge higher fees for their services, and they will be attractive to a talented pool of potential employees.

In the case of Japan, there is only one organization. It is considered that one government entity for one industry is normal, and Japanese people tend to like the style of administrative guidance (*gyosei shido*) by the government because of the financial system stability it provides. On the other hand, the administrative guidance style has had repercussions, i.e., scandals involving the government and financial institutions. One typical incident was bribes for MOF inspectors. From the standpoint of a clear relationship between financial institutions and the Japanese government, the latter should investigate the U.S. system for its reference.

### **Typical Japanese Style of Administration – *Gyosei Shido***

What is the typical Japanese style of administrative guidance? As a member of the staff of the MOF, I was frequently asked by bankers what they should do for their survival, management, and strategy. This was a very strange situation because these questions are the most important issues for their creativity, leadership, and future. I did not know why they did not initially think about these questions on their own. But I think one of the major reasons for this is the influence of *gyosei shido*. Because of *gyosei shido*, many bankers, especially in small-scale institutions,

had not been in situations in which they needed to think and decide about important questions. My answer to the above type of questions is as follows:

“I can understand your situation, but I believe that you should first grasp the situation and then think about it on your own. The government has had to bear many responsibilities because we have always used *gyosei shido*. But fortunately or unfortunately, the situation is changing rapidly. If you hope to rely on *gyosei shido*, you should choose M&A’s in the future.”

### **Current Styles of Supervision and Inspection**

Nowadays, there are no big differences between the United States and Japan in the styles of supervision and inspection. In my experiences at the FSA and the MOF, however, I can say that the Japanese government’s style of financial supervision and inspection lags about five years behind that of the United States and Europe. But it is hard to say that the Japanese style is inferior because of this lag. Even though the recovery of the Japanese economy was slow as compared to that in other countries, especially the United States, if the Japanese government had tried to catch up, there might have been other problems because of the immaturity of the financial system.

In the United States, the FRB’s supervision and inspection style was changed from the “check-list” method to the “risk-base” approach in 1995.<sup>12</sup> If a financial institution is in good shape, for example, its credit risk is the main item that is checked, rather than the market or operational risk. The cycle of the inspection for such a financial institution is once a year or so. On the other hand, if an institution is in bad shape, all of its risks are checked,<sup>13</sup> the cycle of

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<sup>12</sup>The former is based on inspection manuals, the latter on inspections for special risks, which are found by supervision.

<sup>13</sup>Six financial risks are checked: credit, operational, market, fluidity, law, and rumor.

inspection is less than six months, and the period of the inspection is longer than for its healthier counterparts.<sup>14</sup> This is very similar to the situation in Japan nowadays, but the Japanese system was begun in 1998 because of the financial crisis. I think that had it not been for this crisis, the MOF would not have changed its system.

Nowadays in both countries, the supervisory style has shifted to focus on “off-site monitoring.”<sup>15</sup> Changing the important point of supervision from the results of inspection to off-site monitoring indicates the following:

1. The economic situations in both countries have evolved from instability to stability.

The number of bankruptcies in both countries is tending to decline. It is not necessary to check the financial institutions in detail because their stocks have been improving and their capital has increased. This situation shows that the financial institutions have sufficient physical strength to survive after the period of recession. Thus, the supervising institutions in both countries should not check every detail when they undertake inspections.

2. The speed of economic change has become very rapid.

The cycle of the inspection for a financial institution is at least six months. But the cycle of economic changes has become more and more rapid. The data of off-site monitoring are less than one month old; thus, it is easy to check the situation of financial institutions very quickly.

### **Some Opinions About Different Systems**

There are some differing opinions about the publication of inspection results. Such results are treated as confidential basically because of the influence they would have on the markets. But

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<sup>14</sup>Usually, the inspection period is four to six weeks. But, when I was an inspector for big city banks in Japan in 1998, the period of inspection for the Long-Term Credit Bank (LTCB) was more than 10 weeks.

<sup>15</sup>Off-site monitoring means the analysis of various management data that are submitted from the financial institution and making inquiries among the institution’s customers.

this question has been debated by financial economists and public officers of financial entities. Recently, new research about this topic has indicated that there is a good deal of valuable information in the results of inspections of financial institutions.<sup>16</sup> But one FRB officer in Kansas said that there is a risk for the market in going public and changing the price of stocks, and it is impossible to determine the standing of a financial institution in this way because the method of inspection differs according to the institution.

It is hard to decide which opinion is better. Nonetheless, I think that it is important that the topic be discussed. In Japan, though, I did not get the impression that this subject was a very common topic. Still, some regional financial institutions that are in good shape would like to announce their results publicly because they want to be rated highly by the markets, stockholders, and customers.<sup>17</sup> Generally speaking, in nearly every country, companies tend to avoid public revelations of their inner workings. One of the major reasons for this is “information asymmetry.”<sup>18</sup> When one party has more or better information than another, there is a chance of obtaining some advantages by using this information.

In analyzing this debate, the influences on the markets and customers should be taken into consideration. If customers worry about their main financial institution’s sustainability, they might well withdraw their money. This could cause a run on the bank (*toritsuke-sawagi*). Nobody knows for sure whether or not there will be such an occurrence in the future in Japan.<sup>19</sup> The situation of financial institutions there is very different from that in the United States. Even

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<sup>16</sup>R. De Young et al, “The Information Advantage of Specialized Monitors: The Case of Bank Examiners.” *FRB Chicago Working Paper 1998*.

<sup>17</sup>Wakkanai Trust Bank, which is located in Hokkaido, for example, has a high rate of net worth, 55.37 percent (March 2006). This is the highest rate of net worth in Japan, and the bank always advertises this fact.

<sup>18</sup>This situation was first described by Kenneth J. Arrow in a seminal article on health care in 1963 entitled “Uncertainty and the Welfare Economics of Medical Care” in the *American Economic Review*.

<sup>19</sup>In 2003, there was an incident in which a woman e-mailed a friend that Saga Bank would go bankrupt on December 26. There was no evidence to support this rumor, but the e-mail caused many people to make a bank run.

if a disclosure is possible in the United States because the history of banks is based on the history of M&A's and bankruptcies, the situation in Japan is not the same.

## CHAPTER 2

### BUSINESS MODELS IN THE UNITED STATES AND JAPAN

#### Summary of My Impressions

Because of differences in history, systems, and situations, there are many types of financial institutions in the field of finance. My first strong impression of banks in the United States is that they have individual and independent management, strategies, and business models; this is very rare in Japan. Financial institutions in Japan differ only by scale; it is very rare for them to show originality by means of individual and independent management, strategies, and business models. This is because of the historical system in Japan. Starting in the Edo period, Japanese companies preferred to supply their capital by indirect finance. Then, in the Meiji era, some of the big companies that were built in the Edo period became the so-called *zaibatsu* and they created their own banks, which are the big banks today. From the standpoint of financial institutions in Japan, it has been impossible for them to distinguish themselves from one another by putting forth original ideas because they were hampered by many rules and the demands of their customers. But I believe that this situation will change in the future.

In this chapter, I would like to talk about some characteristics and future challenges of financial institutions in the United States and Japan.

#### Characteristics of Financial Institutions in the United States

The U.S. banking business model used to be described as “3-6-3,”<sup>20</sup> but this has largely disappeared after the revision of many rules in the 1980’s.<sup>21</sup> Nowadays, financial institutions,

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<sup>20</sup>This means that financial institutions pay their customers 3 percent interest on deposits and lend them money at 6 percent, and that their officers start to play golf at 3 p.m.

<sup>21</sup>Prior to this, there were many rules about the rate of deposits, setting of branches, and business fields.

especially big banks, must earn their money in other ways – trusting money or bond trading, for example. On the other hand, community financial institutions with ties in their small local areas can be profitable by doing business mainly in deposits and loans. But, if these financial institutions are explored closely, it can be seen that they have many kinds of business models and they can earn sufficient money.

It can be said that, because of the number of financial institutions in the United States, the situation there is one of “over-banking” as compared to Japan. The average population per financial institution branch is about 3,300 in the United States versus 5,400 in Japan. From this standpoint, there is more over-banking in the United States.<sup>22</sup> But financial institutions in the United States, even small ones, can do very well. One of the main reasons for this is that many financial institutions build their own “market niche strategies” and “business models,” even if the scale is somewhat reduced.

## **Examples of Financial Institutions in the United States**

### ***Boston Private Bank & Trust Company***

Boston Private Bank & Trust Company is a private bank mainly for wealthy customers.<sup>23</sup> At the same time, they earned the top rank in an inspection under the Community Reinvestment Act (CRA) because of the good balance between affluent and not-so-affluent clients.

Their main businesses are as follows:

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<sup>22</sup>If Japanese post office branches, where many Japanese people engage in banking activities, are added, the Japanese figure declines to about 2,600. Post offices in Japan used to collect only deposits from customers, but this system was changed by former Prime Minister Junichiro Koizumi. This change means that post offices will become large banks rather than public offices.

<sup>23</sup>Boston Private Bank & Trust Company is not only for wealthy customers, but the majority of their clients are considered affluent.

1. Cash management – deposits, settlements, and so on
2. Housing loans
3. Business loans
4. Trust and financial planning

They call this business the “Financial Life Cycle.”<sup>24</sup> Their main business strategy is “High Price and High Value.” They do not need widespread and huge numbers of customers and business fields because of their concentrated strategy. This style of business minimizes their costs. From the standpoint of the customers, the distance between them and their bankers is quite short. Japanese trust banks and trust unions also have numerous wealthy customers. I believe this could be a survival hint for many small and medium-sized Japanese financial institutions in rural areas.

### ***Mission Federal Credit Union***

Mission Federal Credit Union is located in San Diego, CA. Their business strategy is to educate and advise their members so that they can make decisions wisely. Of course, not all of their 3 million customers need financial advice, but the mission and strategy of this institution are that their real customers are those who find their advice and services valuable.

One of the typical methods to show their strategy is the income and output management system. The credit union’s managers check customers according to six criteria<sup>25</sup> and give advice according to the individual situation. The advice, of course, is based on the managers’ findings

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<sup>24</sup>This term means starting relationships with customers through deposits, continuing the relationships with loans, and supplying capital trust services and financial planning.

<sup>25</sup>The criteria include the size of the deposit, duration of the business relationship with the credit union, and the situation of any loans to the customer.

after they look at these criteria, but, if the customer requests further advice, they can give it based on their financial knowledge and information.

It is still rare for Japanese financial institutions to act like financial schools and give advice to their customers. But the Japanese FSA and local government institutions have started financial classes for people who need such instruction. In the case of financial institutions, they can give more detailed advice to their customers because they have more financial information about them than any other institution. In this way, they can create strong relationships with their customers and thus distinguish themselves from other large banks.<sup>26</sup>

### **Characteristics of Financial Institutions in Japan**

In Japan, the main financial institutions for small and medium-sized companies, especially in rural areas, are trust banks and trust unions. The chief executive officers (CEO) of some of these institutions say that they have their own management philosophy and that their investors have supported them in it. On the other hand, I have heard negative opinions from executives of small and medium-sized companies, who say that regional financial institutions need to know their situations much more clearly. “They will loan us an umbrella when the weather is fine, but not when it rains.” This situation means that it is only the philosophy of the financial institution, not concrete plans or strategies for their customers, which are guiding them.

There are several reasons why such regional financial institutions cannot make any headway in Japan. Japan’s system is based on strong legal restrictions. The government tries to maintain its power over many industries,<sup>27</sup> and numerous organizations, in fact, do not want this situation to change.

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<sup>26</sup>It is very difficult for large banks to give advice to their customers because the number of customers is so huge.

<sup>27</sup>Many governments tend to act similarly all over the world. But it is interesting that, on the contrary, there

One of the main reasons why financial institutions in Japan do not want to explore new strategies and business models is the mindset of their main investors. As far as I know, the average main investors and managers in Japanese trust banks and trust unions are rather elderly. Older people tend to prefer stability over attempting something new and unproven.

There are several reasons why such investors and managers are older. They include:

1. Lack of fresh talent in the countryside because young people want to live in urban areas.
2. Lack of training opportunities for the next generation.
3. Lack of mobility among older people.
4. Complaints about personal matters, especially among young people who have high-level skills.

### ***Date Shinyo-Kinko (Japan)***

Date Shinyo-Kinko is located in the south of Sapporo in Hokkaido. Mt. Usu, a volcano in the area, had a major eruption in 2000. At that time, regional financial institutions had to lend a considerable amount of money to their customers at low interest. This weakened the local economy and the capital of Date Shinyo-Kinko.

Their strategy for recovery was to concentrate on housing loans for older people, especially those over 60.<sup>28</sup> Such people like to own their homes, and some wealthy individuals also want to have second homes in rural areas. Hokkaido is a dream place where many people want to live after retirement. Hokkaido is cold, but Date is located in the southern part and is relatively warmer than other areas of the island.

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are many different styles of corporate management.

<sup>28</sup>In Japan, 60 is the usual retirement age. Nowadays, though, many companies are extending this.

One of the most important points of this strategy is cooperation with local governments. In many cases, new projects cannot be undertaken very rapidly because of the many laws and permit requirements related to local governments in Japan. But, in this case, Date Shinyo-Kinko and Date City tried to work together for their mutual benefit. The bank could attract many customers by lending money, and the city could obtain increased resident tax revenues as a result of a larger population.

Another important point of this strategy is that the number of senior citizens in Japan is increasing very quickly. Such individuals need to borrow fairly large sums of money if they want to build a home for themselves and their families. This shows that it is effective to observe demographic flows in creating business opportunities and plans

### ***Engaru Shinyo-Kinko***

Engaru Shinyo-Kinko is located near the Sea of Okhotsk in northeastern Hokkaido. Engaru is not a very large city, and the population has been decreasing because people, especially the younger generation, cannot find jobs in the area. The main industry of the town, construction, is not doing particularly well because of the long-term recession. This is the main reason why the bank's loans have not been increasing for more than three decades.

The survival strategy of Engaru Shinyo-Kinko was decided 30 or 40 years ago. The two main points are as follows:

1. Shinyo-Kinko's main branch and central headquarters will always be located in Engaru.
2. But most of their branches, which can increase the number and amount of loans, will be in Sapporo, Hokkaido's largest city.<sup>29</sup>

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<sup>29</sup>The population of Sapporo is more than 1 million people. This is more than 40 percent of the total population of Hokkaido.

This strategy is based on a distinction between deposits and loans. At the time this plan was originally created, there were numerous criticisms from the bank's members. This was because Shinyo-Kinko's original mission was to contribute to the local area, so it seemed to people in that area as if the bank were carrying their money away to the big city. But nowadays, the concentration of population in large Japanese cities has become much higher.

This is not a theory based on results, but a hint for the survival of small and medium-sized regional institutions in Japan. It is very important that the strategy and target be decided and acted upon as quickly as possible. This is one of the strongest advantages of small and medium-sized organizations; they can make decisions more quickly and flexibly than their larger counterparts.

### **Future Challenges in Both Countries**

It is said that the Japanese financial system always lags behind that in the United States by about 10 years.<sup>30</sup> In my opinion, American financial institutions feel they must produce many benefits for their investors, and that is why they always want to experiment with new business models. On the other hand, Japanese financial institutions have to maintain stability because of their investors' wishes, and benefits to investors are relatively less important than in the United States. I think that it is very difficult to change this situation, but developments are appearing on the financial scene at an ever-more-rapid pace.

When thinking about this issue, there are some points worth considering.

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<sup>30</sup>Some people say that it is now only about five years.

1. *It is better to strengthen advantages than to correct weaknesses.*

There is no one “one-size-fits-all” kind of situation in the field of business models. Each financial institution has some good points in its organization. Of course, attempting new strategies is one of the most important things, but there are many risks in business. Before undertaking a new strategy, an entity should re-consider its existing strengths.

2. *It is better to attempt new business models while maintaining the ground rules.*

Good financial institutions do not always have special strategies and business models. One of their common characteristics is the height of the margin rate. This does not mean that their personnel costs are lower than those of other financial institutions. In my experience, good financial institutions pay a lot of money for their employees; and, for their part, the employees bring great benefits to their organizations. Data show that good financial institutions have strong management and motivation. Maintaining the ground rules is possible only when an institution’s leaders and employees have good business morals.

3. *It is wise to think about the business model and the scale of economics.*

There have been many M&A’s both in Japan and the United States, but only a few new financial institutions have been created in Japan since World War II. The exception to this is the re-emergence of a financial institution after a bankruptcy. In Japan, the consensus is that small financial institutions have to reorganize through M&A’s because it is better for them to have more capital and not to go bankrupt. I think this is true if the strategies and business models of the financial institutions involved are the same.

Scale merit is one of the strongest advantages in any industry. On the other hand, the basic mission of small and medium-sized regional financial institutions in both countries is to

maximize benefits for their customers, employees, and investors. In the case of an M&A involving such financial institutions, these people tend to worry about their financial institution changing and feel unsure about continuing their relationship with it.

## CHAPTER 3

### RELATIONSHIP AND COMMUNITY BANKING

#### What Is the Meaning of “Relationship Banking”?

Many regional financial institutions in the United States and Japan say that they have already undertaken relationship and community banking and have had very good relationships with their investors and customers. I do not disagree entirely with these statements. It is true that they know their customers’ names, addresses, and financial balances quite well and they play a very important role in their communities. But I have heard that customers often complain about the attitude and judgment of financial institutions when it comes to loans.

From the standpoint of small and medium-sized enterprises, loans are the most important thing about “relationship banking,” especially working funds when their situation is not so good. When I was an MOF director in Hokkaido, I heard many opinions from many kinds of people. At that time, almost all of the managers and presidents of small and medium-sized enterprises who had borrowed money from financial institutions complained about the lender’s attitude towards collecting loans when they, the borrower, were in a bad business situation. They even called some regional financial institutions “wicked financial dealers (*akutoku kinyu gyosha*).” But this situation is not unique.<sup>31</sup> It is common for small and medium-sized enterprises to be more emotional than analytical.

In Japanese government, the meaning of “relationship banking” is as follows: to collect a large amount of information about the institution’s customers by maintaining good long-term relationships. On such a basis, then, financial institutions can develop their business models by

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<sup>31</sup>See, for example, Shakespeare’s *The Merchant of Venice*.

offering financial services to their customers based on the body of information they have collected.

From the point of view of the scientific economy, on the other hand, the meaning of “relationship banking” is as follows: loans that are based on the information that financial institutions have obtained through connections with their customers (including enterprises), owners, and communities.<sup>32</sup> This is the ordinary meaning in the United States.

The common terms to both definitions are “information” and “customers.” To collect information about customers is the basis of relationship banking. On the other hand, what is different between the two points of view is the use of the word “loans.” Loans do not appear to be so important in the FSA financial council’s report. On the other hand, some researchers in the United States have used the term “relationship lending” in book titles as an explanation of the financial system.<sup>33</sup>

### **What Is the Meaning of “Community Banking”?**

It is true that financial institutions acquire a great deal of information by maintaining good relationships with their customers, but it is doubtful that all of them develop their business models by creating the infrastructures necessary to become real community banks. One main reason for this is that financial institutions cannot acquire customer information with absolute accuracy. If such information were always perfectly clear, there would be no unexpected bankruptcies or bad loans. As a result, it is important for financial institutions to develop their

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<sup>32</sup>Allen N. Berger and Gregory F. Udell, “Small Business Credit Availability and Relationship Lending: The Importance of Bank Organizational Structure,” *Economic Journal* 2002

<sup>33</sup>For example, Allen N. Berger and Gregory F. Udell, “Relationship Lending and Lines of Credit in Small Firm Finance” University of Chicago Press *Journal of Business*. July 1995; Yener Altunbas, Blaise Gadanecz, and Alper Kara, “Syndicated Loans: A Hybrid of Relationship Lending and Publicly Traded Debt (Studies in Banking and International Finance)” *Palgrave Macmillan*, 2006.

judgment infrastructures to avoid these risks as well as they can. Unfortunately, I always feel that the judgment infrastructure of Japanese financial institutions is not sufficient to really help them improve their relationships with their customers. This is the main reason that some financial institutions do not make good use of their information and that there are many misunderstandings between them and their customers.

If financial institutions want to build up real community banking with customers and other people who live in their business area, they must be honest. To be honest is not generally difficult, but it is not so easy in the field of finance. In any case, real community banks must contribute to their business areas and customers. This is very difficult for large banks such as the Bank of America, City Bank, Mitsubishi-Tokyo UFJ Bank, and Mizuho-Bank, for example. Thus, it is only regional financial institutions that become real community banks by using the advantages of their business style.

In this chapter, I would like to compare the differences between and advantages of both countries with regard to relationship and community banking.

### **Differences Between the United States and Japan**

When the officers of financial institutions and the FSA talk about relationship banking in Japan, they often speak of the need for loans that do not depend on mortgages. They are very sensitive about loans that do depend on mortgages. This is because they had such a bad experience with the decline in land prices after the bubble economy. In the United States, on the other hand, when many community bankers and FRB officers talk about relationship banking, their main point of view is that the banking business is based on long-term relationships with their customers. It is rare for them to talk about mortgages.

One of the major explanations for this is the difference of the cycle of the economies in the two countries. In the United States, the bottom of the economy was in 1994, and the top was in 2000. In Japan, on the other hand, the top of the economy was in 1988, and the bottom was in 2003. This is the main reason why they have different views of mortgages. Except for this, there is not so much difference in the thinking about this point; of course, mortgages are important in both countries. As to the classification of loan technology for small and medium-sized enterprises, there are two types of loans. One is the “relationship type”; the other is the “transactional type.”<sup>34</sup> For example, in the case of a home mortgage, face-to-face decisions and constant checking is “relationship banking.” On the other hand, the way of collecting home mortgages by using the Internet and selling them in the market as soon as possible could be called “transactional banking.”

It is rare to see transactional-type loan technology in small Japanese financial institutions. One of the main reasons for this is that Japanese people, especially in rural areas, tend to worry about transactional-type arrangements.<sup>35</sup> Another reason is that such institutions are short of people who are talented in this field, and they have no experience in making judgments about customer quality. But they are located in – and very intimately involved with – their communities. This is a great advantage in creating good relationships with their customers.

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<sup>34</sup>“Transactional type” means the deal, sell-and-buy typically.

<sup>35</sup>In the theory of comparative international culture, it is said to be difficult for Japanese people to cope with unresolved situations, while American people find this relatively easy (Hofstede [1997]).

## **Suggestions for Japanese Regional Finance from U.S. Experiences**

The economic situation in the rural United States is similar to that in Japan. Some experiences in the United States offer the following suggestions for Japanese regional financial institutions:

1. It is important to weigh soft information. Soft information means determining the character of the CEO and predicting the customer's future using certain systems.
2. M&A's by big banks offer a chance to obtain new customers because some people do not like large financial institutions.
3. It is not good to change loan officers too frequently.
4. Cost-cutting efforts should be constant.
5. Regional financial institutions should make full use of cooperation with other organizations, such as central financial institutions, governments, and universities. It is impossible to succeed alone.

Needless to say, not all the U.S. methods are better than their Japanese counterparts, and the converse is also true. These suggestions are not only for Japanese regional financial institutions, but for some American financial institutions as well. From the point of view of the relationship, some Japanese banks are better than those in any other country. Below, I would like to explore typical good and bad points of both countries.

## **Relationship and Community Banking**

It is very hard to judge one point as good or bad because there can be weaknesses in good points and strengths in bad ones. For example, small and medium-sized financial institutions in Japan tend to undertake affective loans. It is true that this has resulted in bad loans. Also it is quite common in Japan for the CEO of a trust bank or trust union to be the chairman of the chamber of

commerce and industry as well, especially in rural areas. This situation is not particularly favorable from the point of view of finance because the money lender is also the borrower. If the lender is also the borrower, the lender will lend over the limit of repayment of the borrower. It is a strange situation, though these cases exist not only in Japan but in other countries as well.

Finance and industry have had a particularly strong relationship in Japan from the Edo period or earlier. In addition to this, Japanese society has had strong relationships by forming financial cliques, especially in rural areas. This social system was the one of the most important factors in the strong economic recovery after World War II.

In the case of the United States, the financial system is really capitalist and democratic. The strategies of the financial institutions in the United States are basically hit and run. Once they decide that the customer's situation is bad, they just try to collect or sell their loans as soon as possible. The customers do not think that the financial institutions' attitudes are cool or inhuman. But nowadays, people in the United States are so diverse that some complain about the service of U.S. banks. Bankers in the United States do not mean any harm. But it is necessary for survival that financial institutions should hear the needs of everyone, whether they are socioeconomically strong or weak.

Real relationship and community banking involves addressing customer needs. At the same time, each bank has its own strategies for its customers and uses them to survive. Japanese regional financial institutions, in particular, should watch how U.S. financial institutions survive and search for good examples for their future business.

## Comparison Between Financial Institutions in Japan and the United States

	Strengths	Weaknesses
Japan	<ul style="list-style-type: none"> <li>• Japanese society has created strong relationships by forming financial cliques (especially in rural areas).</li> <li>• Finance and industry have strong relationships.</li> </ul>	<ul style="list-style-type: none"> <li>• Small and medium-sized financial institutions tend to undertake affective loans, which can result in bad loans.</li> <li>• Large financial institutions cannot ascertain their customers' situations.</li> </ul>
The United States	<ul style="list-style-type: none"> <li>• There is a high level of economic efficiency.</li> <li>• Hit-and-run strategies are common.</li> <li>• Each financial institution's roles are separated.</li> </ul>	<ul style="list-style-type: none"> <li>• Financial institutions tend to treat the relationships with their customers coolly (especially in large banks).</li> <li>• There is a lack of service spirit.</li> </ul>

## CONCLUSION

There are many differences between financial institutions in the United States and Japan. This is the important point in thinking about the future of financial institutions in the two countries. There are many differences in their culture, history, system of government, national character, and, thus, in their attitudes toward finance. But I think this situation is changing.<sup>36</sup> Of course, there are many factors that will be similar and different, but one of the most important things is what each nation and system can learn from one other.

The United States is proud of its large gross domestic product (GDP) and its position as a leader of the worldwide economy. Japan's situation is very similar on this point because its GDP is the second in the world, and its economy has grown rapidly after World War II. Recently, it has been said that Japanese government and industry tend to be subordinate to the U.S. system. In the field of finance, the U.S. financial system is very thorough about market economy, but it is a fact that there are many types of regional financial institutions, and they can survive only by using their own strategies and business models.

### **The Basic Financial Structure in the United States and Japan**

As we explore the financial structure in the United States and Japan, we have seen that the U.S. government has pressed its ways gradually on other countries, as can be seen with the Iraq War. Some people call this U.S. attitude the "Single Principle."<sup>37</sup> We can observe the same tendency with regard to the Kyoto Protocol, the International Criminal Court, the International

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<sup>36</sup>For example, it is said that Japanese people like to save money by for a rainy day. But recently, the Japanese savings rate has been decreasing because of the economic recession. By 2004, the figure had declined to 2.8 percent from around 18 percent in 1981.

<sup>37</sup>Hayasaka Takashi "The World Anti-American Joke Collection" *Chuo Koron Shinsha, January 2005*.

Conference on AIDS and other world conferences. And the Japanese government's directions about new financial strategies are always influenced by those of the United States.

I am not a cultural anthropologist, but I can see the Japanese tendency to want stability, the non-liquidity of real estate in Japan, and the uniqueness of small and medium-sized enterprises. It is very hard to make Japan and the United States identical because of the differences of culture and history. The above-mentioned "They will loan us an umbrella when the weather is fine, but not when it rains" is one of the typical examples. In the United States, of course, there are financial institutions that do not loan to customers when the customer's situation is extremely bad. But sometimes it is considered that such an activity is very reasonable for financial institutions all over the world.

Actually, the Japanese government tends to value "the global standard," which originated from the U.S. government and financial institutions. I think that there is a mismatch in the Japanese people's demands, the financial institutions' stance, and the Japanese government's point of view.

I believe that there are several important things that financial institutions and governments must do. I know that it is very difficult to argue about what is important for the general public, and, furthermore, this is not a field for a financial researcher. I just want to write about what is basic for regional financial institutions and governments in order to invigorate regional financial institutions in Japan and the United States.

### **The Things That Financial Institutions Must Do**

In my opinion, there are several measures that financial institutions should adopt in order to survive in the United States and Japan. They need to:

1. Refine their style.

2. Concentrate on special niche fields.
3. Maintain their old style and philosophy, and then try to continue to offer their financial services to economically disadvantaged customers.
4. Strengthen and expand their basic style by becoming corporations.
5. Eliminate M&A's and bankruptcies.

One thing that financial institutions must not forget is their original ideology. Regional financial institutions stand for low-income groups and the economically disadvantaged.

In Japan, many regional financial institutions had to deal with bad loans after the bubble economy. Sometimes, this was the reason why financial institutions forgot about basic services for their customers and became dependent on real estate for security. I think that they should reconsider who their customers are and concentrate on their main fields, from which they can get the best profits.

### **The Things That Governments Must Do**

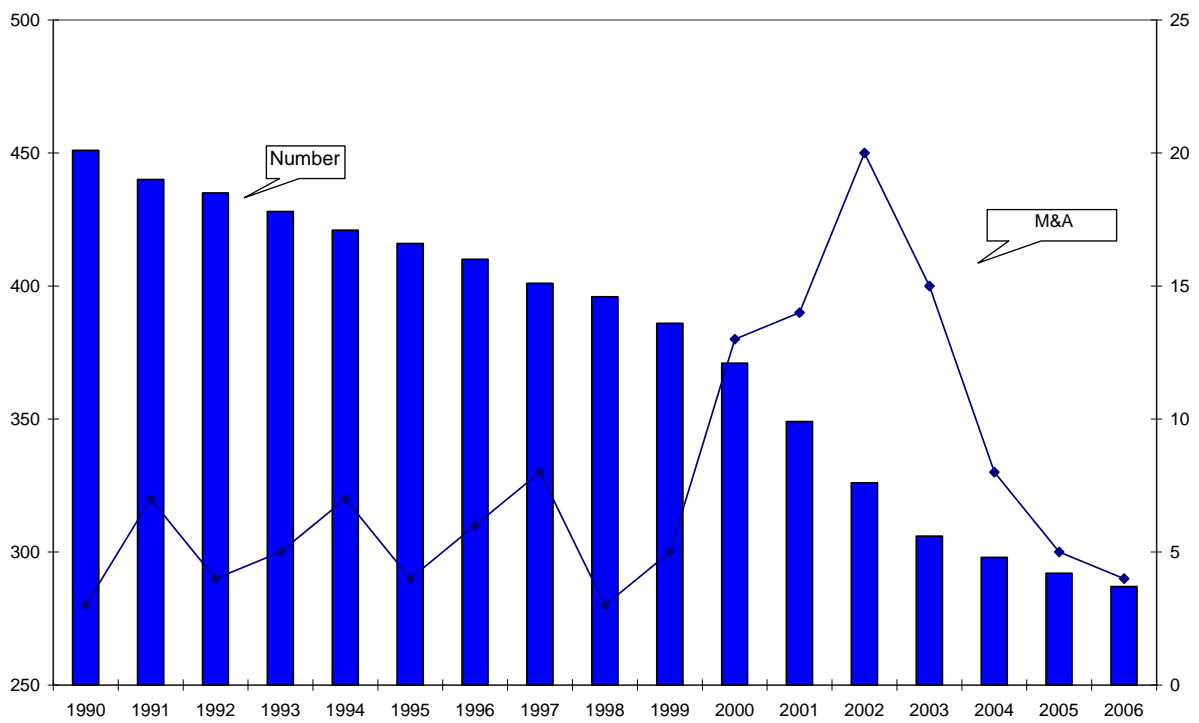
In both the United States and Japan, the governments have always tried to maintain stability within the financial system for the benefit of the nation and its people. Of course, there are many differences between the two countries, but I think that there is not so much difference in their basic stances. In thinking about the theme, “the things that governments must do” for their countries, there is one important fact that should not be forgotten. That is, there is no one correct answer for every problem or one way for every regional financial institution.

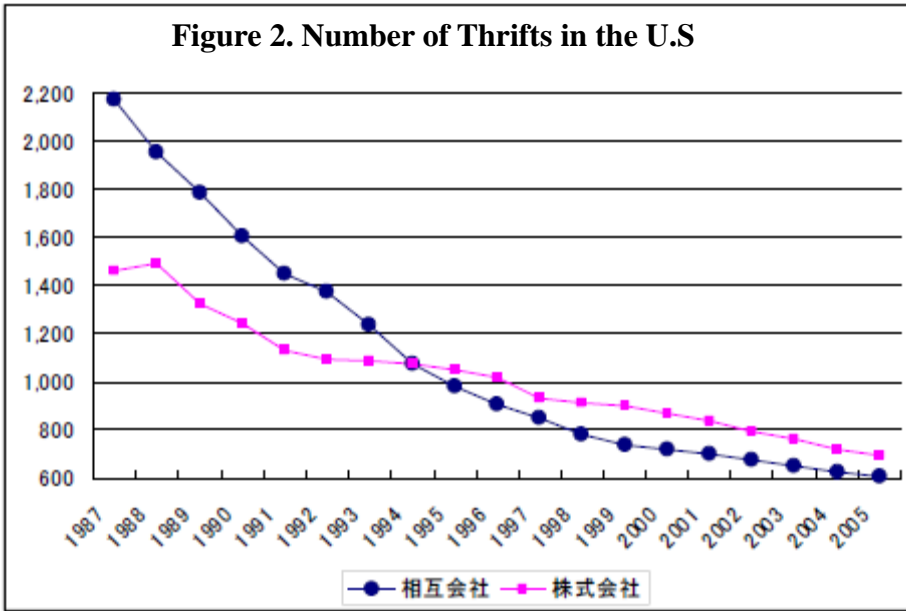
In my opinion, there are several points that governments should consider for the future of their regional financial institutions. They should:

1. Save low-income people and small and medium-sized companies from problems that arise from income differences by making full use of the system of regional financial institutions.
2. Take advantage of tax and financial inspections.
3. Emphasize cooperation among financial institutions, universities, and the government.
4. Do their utmost to maintain sound financial and economic markets.

Capitalism encourages competition. It is important for the market principle to work very well, but this is not the same thing as maximum benefits for the people. Assuring a healthy balance between these two factors is one of the most important functions of government.

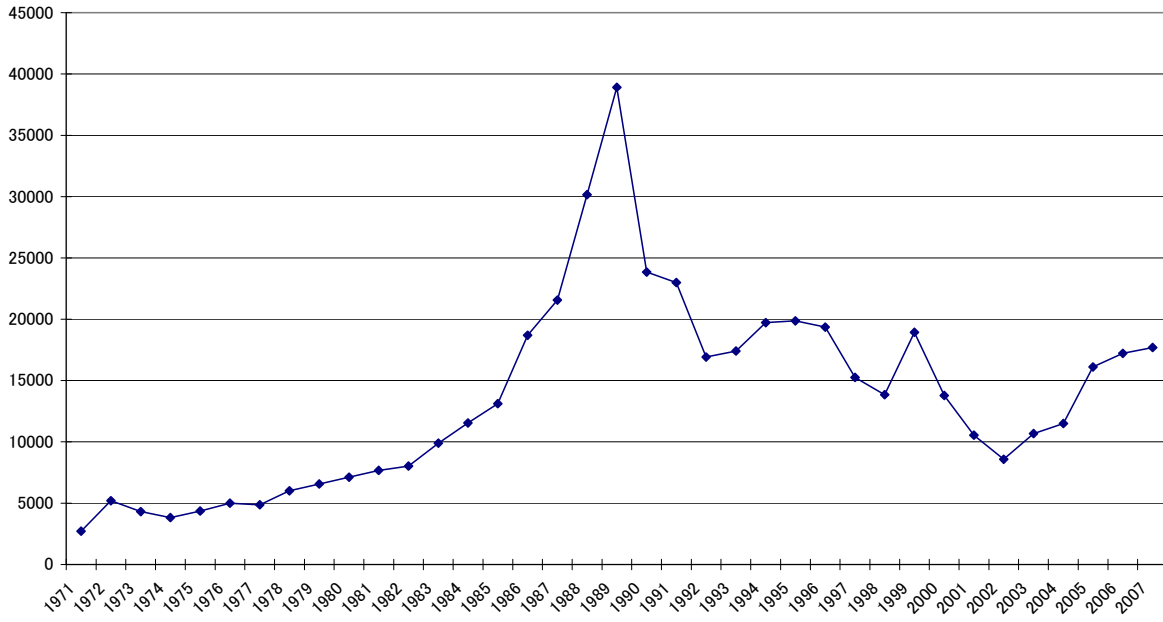
Figure 1. Japan's Trust Banks' (Shinyo-Kinko) Number and M&A





Data based on the FDIC.

Figure 3. Nikkei Stock Average (1971-2007)



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