

DEREGULATION OF THE JAPANESE FINANCIAL MARKETS – OPPORTUNITIES
FOR THE EDINBURGH INVESTMENT COMMUNITY?

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ABSTRACT

The proposed deregulation of the Japanese financial markets, first announced in November 1996 is intended to make the financial system more competitive, and to make better use of the country's ¥1200 trillion of personal savings. The potential for new business is hard for foreign financial institutions to ignore. Many foreign institutions are therefore seeking to enhance their presence in the Japanese market prior to the reforms taking place. Edinburgh has a long and distinguished history as a fund management centre, but in recent years has increasingly seen its clients move their business to London, a trend that has led to it slipping down the European league table of top financial centres. Japan's "Big Bang" could be a timely opportunity for Edinburgh to seek to replace some of the funds lost to London through specific targeting of the Japanese market. This paper examines the reactions and opinions of Edinburgh's fund managers in relation to the Japanese government proposals. It concludes that entering into tie-ups with Japanese institutions, or acting as non-discretionary advisors to Japanese fund managers, are the preferred options for Edinburgh firms seeking to enter Japanese investment markets. A more pro-active and united approach by the Edinburgh financial community is required to ensure it reaps maximum benefit from the unique opportunities opening up in Japan.

1. THE EDINBURGH INVESTMENT COMMUNITY

1.0 History

Edinburgh developed as Scotland's premier financial centre during the nineteenth century, a time when Scottish industry was booming and the prospering middle classes of Glasgow, Dundee and Edinburgh had surplus funds to invest. Initial impetus for Edinburgh's development came from a rapidly expanding regional economy matched by an effective network of local connections and knowledge. The earlier establishment of the Bank of Scotland in 1695 and the Royal Bank of Scotland in 1727 in Edinburgh had provided a financial nucleus around which other financial institutions such as investment trusts and life offices were able to develop. Most of Edinburgh's life offices were founded in the first half of the nineteenth century, with investment trusts following slightly later, towards the end of the nineteenth and the beginning of the twentieth centuries. Scottish investment managers soon developed a reputation for innovation and the acceptance of unusual risk-taking; with local investment opportunities being limited, investors' money was placed overseas often only on the basis of knowledge of opportunities gained through emigration and travel. With most of the largest Scottish-based financial institutions establishing a presence in Edinburgh, and with many non-Scottish financial institutions setting up regional headquarters in the city, Edinburgh quickly developed as the undisputed centre of the Scottish financial community, and the UK's second financial centre after London.

1.1 Edinburgh's investing institutions

Edinburgh is the chosen location for the head office of two major Scottish clearing banks, home to five major life assurance companies, seven specialist investment managers and one independently owned investment trust company. It is also the first choice location for representative offices of many other UK and international banks. A list of Edinburgh's investment institutions (excluding banks) is attached as Appendix 1.

1.2 Life offices

The UK is one of the most 'life assured' markets in the world, with an average of three to four policies per household, a success due in part to successful packaging of life assurance products with mortgages and pensions, as well as the use of somewhat aggressive sales techniques. As such, the UK has a strong claim for market leadership in this area, with Edinburgh as one of its main centres.

Four of Edinburgh's five life assurance companies are mutuals, a fact which is often cited as being one of the chief reasons for their continued independence and presence in Scotland. Although mutual status provides immunity from hostile take-overs, the downside to this is that there can often be little incentive to take risks, having no shareholders or market price to maintain. The life offices have been criticised for being traditionally conservative towards developing innovative products or entering new overseas markets, often preferring a 'wait and see' approach. Such conservatism can of course be seen as a strength; reliability and a dedication to the interests of their policyholders rather than shareholders can also be seen as an asset and thus act as a useful marketing tool.

Funds managed by the life offices make up the largest component of funds under management in Scotland. The 1995 survey of funds under management in Scotland produced by Scottish Financial Enterprise (SFE) showed long-term life funds to make up 55% of the total, with a market value of £124bn. Although this has fallen from 59% in 1994, the sector is still a dominant force in the Scottish investment community, with 18% of all long-term life assurance business in the UK being handled by Scottish life companies. Scottish life offices also play a leading role in the pooled pension fund sector, offering unitised funds to companies not able to run their own segregated pension schemes. Scottish Widows and Scottish Equitable have two of the largest pooled pension funds in the UK, although poor returns have recently resulted in some business shifting to the big name fund management houses based in London, such as Mercury Asset Management and Schroders¹. A survey by Money Marketing and KPMG published in September 1996 found Scottish life firms to be performing consistently above average, with Standard Life, Scottish Equitable, Scottish

¹ "Pension Fund Investment Survey" Financial Times, May 9, 1997

Provident and the now defunct Scottish Amicable producing particularly favourable results for 10 year unit-linked single premium bonds, executive pensions and personal pensions².

Competition within the life assurance industry is becoming more intense; the deregulation of financial services in the UK has seen traditional barriers to entry removed with newcomers, particularly those offering direct telephone services, often able to offer cheaper alternatives to the services offered by established players. Industry practitioners acknowledge that the UK life assurance sector is saturated and that some consolidation is necessary for the long-term health of the Scottish sector. Life firms involved in recent take-overs include Scottish Mutual (by Abbey National in 1991), Scottish Equitable (by Aegon, the Dutch life group, in 1993) and Scottish Amicable (by the Prudential in 1997), and further take-overs are a possibility in the near future. According to the Economist, an “injection of outside expertise” is perhaps what the Scottish life offices need, since all those that have gone into new ownership have since prospered, suggesting that the mutual status of some of the remaining firms is disguising poor management³.

The key to future success in the sector undoubtedly lies in the ability of the life offices to market themselves effectively, and to concentrate on selling their expertise abroad. Faced with a declining market in the UK, a report by Hodgson Martin in 1996 recommended that Scottish life companies focus their efforts on penetrating markets in the European Union⁴. The report argues that Scottish firms with their long experience in equity investment have a considerable advantage over their European counterparts, who are more familiar with bonds, and that an improved performance with equities would increase demand for this type of investment. The rewards would be impressive according to the report; five percent of the newly deregulated German market would yield £1.4bn in new premiums, whilst five percent of the French market would provide £1.57bn (such rewards are of course dependent on changing the more conservative attitudes of continental European investors, many of whom are happier holding bonds – a not inconsiderable task).

² “*Scottish life firms shine in survey*” The Scotsman, September 28, 1996

³ “*Fresh air: Scottish finance*” The Economist, February 8, 1997

⁴ “*Life sector must look to Europe, says report*” The Scotsman, 27 January, 1996

1.3 Specialist fund managers

Edinburgh is home to nine specialist fund managers, five of them independently owned. Although the specialist fund management business has its origins in the investment trust industry of the nineteenth century, the sector has long since diversified from its roots, nowadays offering additional services such as unit trusts, pension fund management, private client and charity portfolio management and overseas fund management. Joint ventures with institutions overseas have provided a number of fund managers with additional business. Baillie Gifford and Ivory & Sime are two with well-established link-ups with Japan.

According to the SFE's latest survey, Scotland's specialist fund managers are responsible for funds with a market value of close to £41bn, giving them a market share of 24% of the total funds under management in Scotland. Pension fund management provides the lion's share of the business for many of the specialist houses, with personal pensions one of the fastest growing sectors; Scottish fund managers currently handle 24% of all personal pension business in the UK⁵. According to a recent Financial Times survey, Baillie Gifford currently ranks among the top 10 UK pension fund managers⁶. Continuing one of Scotland's traditional strengths, Edinburgh is home to one of the UK's largest self-managed investment trusts, the Scottish Investment Trust (total assets of over £1bn), and Baillie Gifford manages two of the largest investment trusts in the UK.

1.4 Recent developments

Over the past few years, Edinburgh's position as a major player in both the UK and European fund management business has come under increasing threat. For many years ranked number three in the European Union in terms of institutional equity under management, behind London and Paris, it has now slipped into fourth place with Frankfurt taking the third position. There has been a steady loss of business to London, drawn by the superior infrastructure and global status of the capital, and an increasing attitude in fund management circles that "big is beautiful". Fund managers to have seen funds dwindle this year include Ivory & Sime, who have lost BAA's £644m pension fund business, and Edinburgh Fund

⁵ Colin Hook, former CEO of Ivory & Sime, in a talk given to MBA students, Feb. 1997

⁶ "Pension fund investment survey" Financial Times, May 9, 1997

Managers, who have so far lost about £500m in funds as a result of a number of defectors, including the British Investment Trust. However, the most significant loss this year for the Scottish, rather than the Edinburgh, investment community occurred in Glasgow, with the announcement of the closure of Scottish Amicable Investment Managers (SAIM), Glasgow's largest fund manager, in July. The decision by the Prudential, who acquired Scottish Amicable in March, to move the £15bn portfolio to London highlights the increasing trend by organisations looking to compete in the global market place to concentrate their business in the UK capital.

The £3-£5bn of funds under management of many of the Edinburgh houses is simply not enough to win new business when competing on a global scale with large groups such as Fidelity and Mercury Asset Management. A minimum of £7.5bn of funds has been quoted as being the amount required to make a business competitive; Glasgow's Britannia Investment Managers recently announced plans to build funds under management from £5.1bn to £10bn over the next two years⁷. Aberdeen Asset Management's bold move to take over Prolific, the investment management arm of Edinburgh-based Scottish Provident, will almost quadruple its funds under management from £3bn to £11bn, and further echoes the sentiment that critical mass is essential for success in the fund management business today⁸. So far Edinburgh firms have avoided taking such a route, although the recent announcement by Ivory & Sime that it was looking for a partner to "grow assets under management" could be the first sign that Edinburgh firms are finally acknowledging the necessity of improving critical mass to survive.

The latest edition of the annual "International Target Cities Report" by Technimetrics, the New York-based consultants, which ranks the world's leading financial centres on the basis of institutional equity under management, puts Edinburgh in 6th place in Europe, and 4th in the EU (see Appendix 2). The £83bn of funds under management in 1996, down from £86bn in 1995 and a drop of 4%, compares unfavourably with Dublin's 45% rise from £10bn to £14.6bn, and Stockholm's 20% increase from £56bn to £67bn. In 13th place in Europe, Glasgow saw a small rise from £21bn to £22bn, but the report predicted that both Scottish

⁷ "Buoyant Britannia sizes up Murray Johnstone" Scotland on Sunday, July 13, 1997

⁸ "Quantum leap for AAM" The Scotsman, August 1, 1997

cities would experience a decline in business throughout 1997, mainly as a result of consolidation in the UK fund management industry.

Like other not-quite-leading financial centres, Edinburgh has been affected by the trend towards consolidation and globalisation of financial services, which favour the larger centres such as London, threatening Edinburgh's growth prospects and therefore its morale. However, additional criticisms that have been levelled at the Edinburgh investment community include an unwillingness or inability to cooperate with one another and a somewhat laissez-faire approach to new business opportunities. Draper et al (1988) observe that, although links between Scottish financial institutions are sometimes forged, and some pooling of information and informal cooperation may occur, intense inter-firm rivalry often dominates any attempt to create a regional identity; competition is the main force behind the creation of any links⁹. Certainly, joint marketing strategies and joint products remain relatively undeveloped; a possible missed opportunity to create a powerful niche market image to present to the world. More recently, it has been suggested that a more proactive stance is required, with a focus on what Scottish companies can do better than their City of London rivals¹⁰. Scottish investment houses need to decide whether to develop the niche market concept, focusing on a narrow product range and limited number of markets, or whether to forsake their independence and become part of a larger operation with global market coverage.

There is some good news however, for Scotland's investment community. A recent report by Combined Actuarial Performance Services (CAPS), a performance measurement company, found that Scottish fund managers have on the whole outperformed their City rivals over the first half of 1997¹¹. Nine out of eleven Scottish firms made the top quarter of the performance league tables for flagship managed funds, with Glasgow Investment Managers coming out as overall top performers over three and five years. Many of the leading London fund managers such as Mercury Asset Management, Morgan Grenfell, the Prudential and Gartmore failed even to meet the sector average. This latest report is obviously extremely

⁹ Draper, P. et al (1988) *"The Scottish Financial Sector"* Edinburgh University Press

¹⁰ "Survival of the biggest" *The Scotsman*, July 10, 1997

¹¹ "Bravehearts beat City at its own game" *Scotland on Sunday*; August 3, 1997

encouraging news for the Scottish investment sector, worried about losing funds to London and the increasing fears of being about to enter into a long, slow and irreversible decline.

Recently, there have been some encouraging signs of change in the industry. As the official umbrella group of the Scottish financial sector, SFE now seems to be adopting a more proactive stance towards its industry's wellbeing and is involved in organising events such as the forthcoming European Investment Conference¹². This is being held in Edinburgh reportedly with the specific intention of attracting more investment funds to Scotland, and may even develop into an annual event, which would enhance Edinburgh's profile in European financial circles. Edinburgh is certainly one of the most desirable cities in Europe in which to hold such functions, a fact that should not do its businesses any harm either.

1.5 Summary

Edinburgh's long history in fund management and its reputation for above-average performance should ensure its survival as a financial centre in one form or another. It is however currently going through a period of turbulence, and a strategy rethink is necessary to enable it to approach the millennium with confidence. A niche market strategy would seem to be the obvious choice to distinguish it from London, but the key requirement is that institutions begin to work together to present Edinburgh as a confident and powerful force in the fund management industry.

¹² "ScotAm aims for 100% growth target" Scotland on Sunday, Sept. 21, 1997

2. PERSONAL AND INSTITUTIONAL INVESTMENT IN JAPAN

2.0 Introduction

Japan is the world's largest centre for fund management by a considerable margin, with over \$4000 billion of assets under management according to the latest survey of non-US fund managers by Euromoney.¹³ Almost all funds are domestically managed with only a small proportion managed by investment houses overseas, particularly in the case of the life insurance companies. Personal savers are offered few alternatives for their money, with most opting for bank and postal savings accounts at very low rates of interest. Recently, the situation has begun to show signs of change; this chapter provides a brief overview of current developments that will put the significance of the Big Bang proposals into clearer perspective.

2.1 Pension fund management

Until recently, Japan's ¥240,000 billion pension fund sector has stayed largely immune to market forces. Corporate pension funds in Japan are traditionally handled either by life assurance companies, with the companies typically holding cross-shareholdings in one another, or by trust banks, usually the bank in that company's *keiretsu*, or corporate group. Until 1990, these were the only two types of financial institutions permitted to manage pension funds, and since economic growth and a rising stock market generated satisfactory returns there was little incentive to change this. However, pressure for reform of the pension fund management industry has been slowly building up over the past 7 years or so. Underfunding is one; employee pension funds were estimated to have a funding shortfall of ¥1.7 trillion in fiscal 1995¹⁴. Combining this with a rapidly ageing population, a steep drop in asset prices and a stagnant economy, has alerted the government to the fact that investment returns on pension funds need to rise dramatically to avoid a major shortfall of receipts. Increased competition in the fund management industry is essential to help achieve this.

¹³ "Clash of the Titans, once again" *Euromoney*, August 1997, p72-78

¹⁴ "Year of the Ox: 1997 Outlook" Matsui K., Suzuki S. *Goldman Sachs*, Jan. 14, 1997

In partial response to this recognised need for improved returns, and as something of a precursor to the full-blown deregulation proposals of 1997, investment advisory firms were given permission to enter the corporate pension scheme market in 1990. The superior performance of many of these firms has seen them gain business at the expense of the life assurance companies and trust banks. Between March and December 1996, the value of funds under management by investment advisory firms rose from Y6.8 trillion to nearly Y13 trillion, with foreign investment managers winning an increasing share: from Y707 billion to Y1.6 trillion over the same period and a market share of 12%¹⁵. Most of the new business is being taken up by the investment advisory firms of the big four brokerage houses, with Nomura Investment Management at the top of the list with more than Y2 trillion of funds under management. Schroders is the leading foreign investment firm with Y295 billion, followed by Deutsche Morgan Grenfell, Mercury Asset Management and Jardine Fleming, each with approximately Y200 billion as of December 1996.¹⁶

Nenpuku, the largest pension fund in the world with Y23 trillion (\$220 billion) in assets, is run by the Ministry of Health and Welfare with express instructions to generate higher returns through investments in riskier assets. In 1995 Nenpuku decided to adopt a new strategy for investment, basically rejecting safer fixed rate returns and opting for better-performing fund managers and higher risk assets. In 1996 it removed Y5 trillion from life assurance companies, following the announcement by life firms of a reduction in guaranteed annual yields from 4.5% to 2.5%. The funds were instead placed with trust banks and investment advisors; Nenpuku now uses 20 specialist investment advisors, many of them foreign¹⁷, and has acted as something of an industry leader to a more cautious private sector which has since been encouraged to follow their example.

A significant influence on investment decisions, and hence profitability, is the so-called 5-3-3-2 rule. This stipulates that all fund managers are required to hold 50% of their portfolio in bonds and cash, and no more than 30% in foreign securities, 30% in domestic equities and 20% in property. This is scheduled to be removed for investment advisors and trust banks in 1997 (although not for other fund managers), which will further enhance their attractiveness

¹⁵ "Japanese Finance" The Economist, June 28, 1997, p13

¹⁶ "Pension Fund Investment Survey" Financial Times, May 9, 1997, p6

¹⁷ "Japanese Finance" The Economist, June 28, 1997, p12

as fund managers when compared with the life companies. The 5-3-3-2 rule will eventually be abolished completely. However, its relevance for so-called employee pension funds (EPFs), which made up 70% of total corporate pension assets in March 1996, is greatly reduced even now¹⁸. Company pension managers of EPFs are currently allowed to place half their money with investment advisors, and in two years may put all of it with these firms¹⁹.

The introduction of market-value accounting for corporate pension funds from April 1997, which will appear in accounts for fiscal year end 1998, is providing a further incentive for firms to transfer their pension portfolios away from the life companies to investment advisors. The old book-value accounting system valued assets at the price at which they were bought rather than at their current value. The fall in the stock market in the early 1990s, and its subsequent failure to recover, has provided little incentive for pension funds to sell their investments and transfer funds to better performing investment vehicles. With the requirement to price investments at their true value, however, pension funds will be more inclined to sell the poor performers and invest their money where they expect better returns. The reasons for holding a company's shares will no longer be linked to the *keiretsu*, or to an archaic accounting system, but to internationally recognised concepts of risk and return.

The pension fund market is becoming more performance oriented, which is good news for foreign investment managers whose performance records tend to be far superior to those of the Japanese. As foreign firms become a more established part of the Japanese investment scene, and gain a reputation for offering better returns than their Japanese competitors, more business is likely to flow their way.

2.2 Life assurance firms

The life insurance business in Japan is on a scale unmatched elsewhere in the world: its premiums make up 40% of the global market, and between them the eight largest life firms have assets of Y145 trillion (\$1.3 trillion)²⁰. Life companies have two main lines of business: corporate pension schemes, which make up two-thirds of liabilities, and individual life

¹⁸ "Deregulation: breaking the 10,000 commandments" Matsui K., Suzuki, H., Goldman Sachs, Feb. 24, 1997

¹⁹ "Pensioned off: fund management in Japan" The Economist, Feb. 10, 1996

²⁰ "Insurer performance mixed in deregulation" The Nikkei Weekly, June 16, 1997

policies, which make up the other third. Both typically offer fixed returns, although these can be altered annually in the case of the corporate schemes; last year saw a reduction in rates from 4.5% to 2.5%. Individual life schemes tend to carry guaranteed returns for a period of ten years, and stiff penalties are imposed for withdrawing funds prior to maturity.

Despite their size, the life firms have not fared well in the 1990s. During the late 1980s, investors were offered guaranteed rates of return on life policies above those available from yen bonds. Relying on capital gains from heavy investment in equity and property, the gamble backfired with the collapse of both markets in the early 1990s. Life companies have been forced to make up the difference between the actual and guaranteed rates of return, often through sales of their better-performing stocks; hardly shrewd investment management. As a result stockholdings by life assurance companies declined for the fifth year in a row to 10.9% at the end of fiscal year 1996 (from a peak of 13.5% in 1985)²¹.

The situation for the life firms has recently gone from bad to worse. In 1995, Japanese life insurers reportedly managed about one-quarter of the financial assets of individuals²². That proportion has fallen this year with the collapse in April of Nissan Mutual, the country's 16th largest life assurance company, triggering a wave of policy cancellations by nervous investors, regardless of the penalties incurred. This was the first failure by a life assurer since 1945, but in June the US credit rating agency, Standard & Poor's (S&P), warned that further failures in the sector are likely. Five major life companies have had "B" ratings assigned to them or reaffirmed by S&P, signifying that they are not financially secure enough to meet policyholders' needs. Stronger companies still appear to be doing well, however; Nippon Life, Japan's (and the world's) largest life assurer, has been given a rating of A++, and Yasuda Mutual and Daido Life have each been awarded A+.²³ Certainly, prior to the collapse of Nissan Mutual, it was assumed that no life company would be allowed to fail; now the concern is that others will almost certainly follow. With pension fund managers demanding better returns from their investments, many are no longer opting to place as much with the traditional life companies of their *keiretsu*, preferring to use independent investment advisors.

²¹ "Foreigners own record 9.8% of listed companies' shares" The Nikkei Weekly, July 14, 1997

²² "Unsure insurers: Japan's cautious life insurers" The Economist, April 8, 1995

²³ "S&P warns that more life assurers will fail" Financial Times, June 24, 1997

The life industry reportedly lost about Y7,000bn of funds in fiscal 1996 due to such changes,²⁴ with premiums down 5.4% - the largest annual drop of the postwar era²⁵.

Information about the life sector is scarce; S&P warn that their information has come from public records rather than internal data. Nevertheless, it does appear that the gap is widening between the stronger and weaker firms in the sector, and that more failures in the industry will occur before very long.

2.3 Private investors

Japan's private investors are faced with limited choices over where to deposit their savings, estimated at Y1200 trillion (\$10.5 trillion). At present, the most attractive options for most are either bank deposit accounts or post office savings accounts; a strategy of low risk, low return investment, but preferable to the often high risk and low returns available from equities. The post office is the nation's largest financial institution, and since postal savings accounts are guaranteed by the government, they do not have to make a profit and can therefore offer more attractive savings rates than the banks. Their popularity should come as no surprise: deposits at the post office now account for a third of all private savings, up from about a fifth in 1991. A staggering 92.5% of Japan's GDP is in deposits (compared to 34% in the US).²⁶ However with the average return on a bank deposit account in May of this year standing at 0.34%, domestic savers are not well-served by the present financial system.

It is the uncomplaining private investor who has meekly provided the banks with cheap capital that has enabled them to lend on a reckless scale at minimal spreads with little heed to counterparty risk. As a result, the banking sector is suffering from chronic over-capacity with portfolios of bad debts that are taking up disproportionate amounts of senior management time to sort out. This trend of lending at minuscule spreads is likely to continue as long as Japanese savers keep their money in bank deposits, particularly as the majority of bank shareholders typically belong to the same *keiretsu* and are therefore beneficiaries of cheap funding.

²⁴ "Japan's life insurers struggle for credibility" Financial Times, April 1997

²⁵ "Insurer performance mixed in deregulation" The Nikkei Weekly, June 16, 1997

²⁶ "Japanese Finance" The Economist, June 28, 1997, p7

Alternative savings vehicles for the private investor are few: until 1990, unit trusts were only permitted to be sold over the counter by domestic securities houses. A handful of foreign firms are now able to offer them, as can a few banks and insurance houses, but distribution is still controlled by the securities houses, with the “big four” - Nomura, Daiwa, Nikko and Yamaichi - handling three-quarters of it. Recent scandals involving compensation payments by the “big four” to favoured institutional investors at the expense of smaller private investors has contributed to the decline in popularity of unit trusts among individual investors; personal savings in unit trusts peaked in 1989 at 6.5%, but are now down to just 3%.²⁷ This is in part due to the long bear market in Japanese equities, but is also a result of the “churning” that securities firms encourage their clients to do, switching between stocks and charging brokerage fees for doing so, thereby reducing overall returns for investors. The value of unit trusts over 10 years to December 1996 grew by just 13% in Japan compared to 260% in Britain and 480% in the US.

Individual share ownership has also declined in popularity. Reaching a peak in 1949 at 70% of the total, it now stands at around 25%. This fall is largely due to the minuscule size of the dividend payment; the average is now 0.8%. Investors therefore have to rely on capital gains to make their investment worthwhile – a somewhat scant hope in the weak stock market climate of the 1990s. Institutional shareholders now make up the majority of shareholders in Japan.

Life insurance used to be viewed as a riskless investment by private investors, offering a guaranteed fixed rate of interest to policyholders. With the guaranteed rate reduced last year to 2.75%, and the precarious nature of many of the life insurance companies’ books, this type of investment looks anything but riskless at the moment. Furthermore, individuals are heavily penalised for cancelling policies prior to maturity. However, following the collapse in April of Nissan Mutual, a loss of confidence in the sector has led to individual investors cancelling policies, with life assurance companies losing a record \$28.4bn of business in May.²⁸ Records from the Life Insurance Industry of Japan showed that cancellations by individuals had risen in May by 20% year-on-year, and that new business had fallen by 10%.

²⁷ “*Japanese Finance*” The Economist, June 28, 1997, p8

²⁸ “*Japan: record fall in life sector*” Financial Times, Aug. 6, 1997

Individuals are clearly now actively moving money out of the sector and seeking other, more attractive, investment vehicles for their savings.

2.4 Summary

It is clear that Japanese investors are increasingly seeking more competitive returns for their money; pension fund trustees are moving funds to independent investment advisors, and private investors are no longer content to hold on to risky life insurance policies until maturity. This is bad news for the life assurance firms, but good news for independent advisors and providers of new financial products, many of whom are foreign investment institutions. Over-capacity, minuscule returns on capital employed, and continuing problems with bad loans continue to plague the banking sector, a situation that is likely to continue for as long as savers continue to keep such a large proportion of their money in bank deposits. Improving the profitability of the banking sector is crucial if Japan is to obtain better returns on its assets, and if Tokyo is to take its place alongside New York and London once more as a leading global financial centre.

3. THE JAPANESE “BIG BANG”

3.0 Introduction

The proposed deregulation of the Tokyo financial markets (the so-called “Big Bang”) was first unveiled in November 1996 by Prime Minister Hashimoto, with reforms to be introduced over a period of five years to 2001. The Prime Minister stated that the primary motivators for introducing such reforms were threefold: Tokyo’s declining position as a key player in the world financial markets; disastrous lending decisions by Japanese financial institutions during the late 1980s; and the problem of a rapidly ageing population needing to maximise returns from a huge savings pool in order to support itself.

Not all the committees charged with formulating the proposals published their reports at the same time, reducing the impression of creating a unified reform package. However, the reforms have collectively become known as Japan’s “Big Bang”, and for the purposes of this report will be considered as comprising one package. The Committee on Foreign Exchange and Other Transactions was the first to publish in January 1997, with the key amendment to the Foreign Exchange and Foreign Trade Control Law which was passed by the Diet in May. Three other Ministry of Finance advisory boards – the Financial System Reform Council, the Securities and Exchange Council, and the Insurance Council - published their recommendations on June 13, 1997, far earlier than had originally been expected and an encouraging sign to a somewhat sceptical international community that the commitment to reform of the financial markets was genuine.

The documents, published in both Japanese and English, contain detailed proposals of the principal reform measures and a time schedule for implementation. The proposals also contain sections on reform of related infrastructure such as legal and accounting systems, and financial stability and soundness. These are substantial documents heavy on detail - an encouraging sign of a clear determination by the government to oversee a complete overhaul of the financial system²⁹.

3.1 Principal Reform Measures

²⁹ “Japan: weighty blueprint for Big Bang” Financial Times, June 16, 1997

The report has been constructed on the basis of three main principles: freedom, fairness and globalization. The reforms have been constructed with at least one of the following four perspectives in mind: expanding choices for investors and borrowers; improving the quality of services offered by intermediaries; expanding the range of products traded and offered; and establishing a framework of rules for fair and transparent transactions.

The recommendations contain 35 major reform items, most of which are to be implemented by April 1998 (ie. fiscal year end April 1999). Those measures considered to be of greatest significance to foreign participants are detailed below.

- **Liberalisation of cross-border capital transactions**

By far the most important measure from a foreign perspective is the reform of the Foreign Exchange and Foreign Trade Control Law, which has already passed through the Diet and will come into effect from 1 April 1998. This will expand choices for domestic investors, allowing them to borrow and invest abroad without first having to obtain permission from the Ministry of Finance (at present, both institutional and individual investors must seek Ministry approval to place more than Y2m abroad, and domestic investors may not hold overseas yen accounts).

The liberalisation of foreign currency transactions will make it much easier for Japanese investors to buy foreign assets. Products that are relatively undeveloped in Japan, or that offer higher returns than domestic equivalents, are likely to prove popular. Two obvious examples are unit trusts, currently only sold privately through securities houses, and foreign pension plans, which tend to offer superior returns to Japanese ones.³⁰ This has already started happening to a certain extent; over the past 3 years, Japanese individual investors have invested more than Y10 trillion in foreign securities as far as the current restrictions allow.

³⁰ "Forex move by Tokyo lights fuse" Financial Times, Feb. 24, 1997

- **Freedom for banks to sell investment trusts and insurance**

At present investment trusts (unit trusts in the UK) are only permitted to be sold by securities houses. The investment trust business is under developed and suffers from a poor image, not helped by the continued weakness of the Nikkei and the recent scandals involving the major securities houses. The entry of Japanese city banks and foreign investment houses into the market should lead to greater product choice and performance and thus improve the reputation of the investment trust business for the individual investor.

- **Deregulation of commissions on share trading**

This measure is essential alongside the liberalisation of the foreign exchange markets, since if securities commissions were not also liberalised, business would move offshore to where fees are lower. The measure is expected to lead to intense competition in the sector, which already suffers from over-capacity, with many of the smaller brokerage houses expected to fold. Foreign institutions are in a good position to benefit at the expense of the scandal-ridden domestic securities houses.

- **Removal of barriers to entry between banks, trust banks and securities houses**

This will allow financial institutions free entry into each other's businesses, for example through banks offering investment trusts and securities houses offering deposit accounts. This will promote free market competition in many areas of financial services, allowing "one stop financial shopping" and improving customer choice and service.

There are a number of significant omissions in the final proposals. Reform proposals on the postal savings system, the insurance industry and the taxation system are still vague, although a review on the taxation system for the financial industry, including the securities transaction tax, is expected in the autumn. More worryingly for foreign institutions, there are no specific references to issues of market access even though one of the government's stated aims is to encourage greater competition within the financial services sector.

3.2 Industry consensus on the likely implications of the "Big Bang"

In a forum sponsored by The Nikkei Weekly, industry experts predicted that the reforms would lead to Japan's savers to invest in new products³¹. However, there was concern that foreign investors had perhaps developed "potentially excessive expectations" in relation to the opportunities available from Big Bang. The main function of the reforms was to "get rid of excess capacity", which would in turn lead to increased efficiency, more competition and improved choice for investors. Speakers at the forum disagreed over whether the reforms would necessarily lead to more business for foreign institutions, however. One speaker doubted that Japanese consumers would feel comfortable shifting assets to foreign institutions even if they did offer a wider range of services than domestic ones.

A commentary by **Merrill Lynch**³² considers the most significant reform to be that allowing banks to sell unit trusts. A substantial amount of savings is predicted to shift from bank deposits to unit trusts over the medium term, with banks accordingly having to reduce their assets, probably through the securitisation of loans. Bank consolidation is also expected as deposits decrease, with the stronger banks buying up the weaker ones, possibly as affiliates under the new holding company structures. To remain competitive in the deregulated market, banks are predicted to acquire expertise through affiliations (either through domestic or foreign partnerships) rather than expanding existing structures or creating subsidiaries, both of which would be more expensive.

A report by **Schroders**³³ argues that domestic financial institutions in Japan will need to undertake a complete review of their operations and produce clear strategies for survival in the newly competitive environment. A small number of winners will be outnumbered by a much larger number of losers unable to adapt to the new rules. Schroders predicts there will be tie-ups between stronger and weaker institutions in an attempt to hasten the elimination of bad debts (for example Long-Term Credit Bank of Japan and Swiss Bank Corporation). The Ministry of Finance is expected to encourage more mergers between the 20 major banks in order to improve competitiveness with foreign banks. Long-term credit banks and trust banks are expected to be most damaged by the reforms. The trust business is predicted to have the

³¹ "Opportunity, efficiency seen in 'Big Bang'" The Nikkei Weekly, June 23, 1997, p12

³² "Japanese Financial Industry" Yamada Y., Merrill Lynch, June 17, 1997

³³ "Choosing winners ahead of the 'Big Bang'" Seiji Otsuka, Schroders, July 18, 1997

greatest potential for expansion following the reforms; competitive pressures from new entrants (both domestic and foreign) will force the seven existing trust banks to improve performance and acquire greater expertise in order to survive. The alternatives are either a tie-up with a domestic or a foreign institution, or becoming a subsidiary of a larger institution.

Goldman Sachs³⁴ predicts that the Big Bang may lead to far less change in profitability than the market believes, and that competition will decrease potential returns on all existing businesses. The report argues that there is an urgent need to break the dependency of the Japanese financial system on deposits, and the monopoly of the banks. The profit potential is massive, but Big Bang is led by the city banks, which are at the root of the problem. The report predicts a surge in demand for specialist financial services, pointing out that city banks tend to think in terms of mass markets, and that their standards of customer service tend to suffer as a result.

In a later paper, **Goldman Sachs**³⁵ argues that the best case scenario would be for city banks to create large trust, brokerage and fund management companies and use these to cannibalise their own balance sheets. Banks should securitise off between 47-65% of their assets, freeing up Y6.4 and Y8.8 trillion worth of capital. However, it is believed that city banks may be aiming to enter new businesses without such radical restructuring, in a typically relentless pursuit of market share. Goldman Sachs warns of a risk that profitability across all areas will decline as banks enter new businesses in which they have no competitive advantage. Huge amounts of money will be wasted, weaker players forced out and chaos will reign before the system is able to become lean and efficient.

Salomon Brothers³⁶ argues that the reports by the five commissions in June 1997 also revealed weaker points in the reform process, eg. the avoidance of discussions of areas under the jurisdiction of other commissions, and the fact that the recommendations of commissions are not binding. Other problems include an inadequate treatment of tax issues, and the insistence by the insurance industry of protecting vested interests. Although new committees

³⁴ “*Big Bang will never yield global comparability in profitability*” Atkinson D., Richards D., Townshend D., **Goldman Sachs**, Jan. 9, 1997

³⁵ “*Big Bang II – what would it take to meet global standards?*” Atkinson, D., Richards D., Japan Research, **Goldman Sachs**, Feb. 17, 1997

³⁶ “*Phoenix in Ink: origins and prospects for the Big Bang debate*” Feldman R., **Salomon Brothers**, Aug. 15, 1997

for continuing the reform process have been formed, Salomon Brothers argues that the key factors for success are unity and coordination, or vested interests will continue to prevail and the deregulation programme may even become derailed.

It might be worth remembering that this is not Japan's first experience of market reform. The so-called Yen-Dollar Agreement in 1984 was a result of pressure from the US on the Japanese government to internationalise the yen. Although it took the authorities a long time to decide to sanction the reforms, once they had made up their minds to do so they moved with extraordinary speed. An aggrieved senior banker at the time observed that, "before consensus is achieved nothing seems to move. Once achieved, no one wants to hear from the objectors".³⁷ This time the government has moved faster than many expected, even without outside pressures. It would appear that the government is serious about implementing the reforms as quickly as possible now the decision to deregulate the markets has been taken. To procrastinate now would certainly lose them much-needed credibility on international markets, which they cannot afford to do.

3.3 Competitive Matrix: Japanese financial services

A competitive matrix of Japanese financial services is attached as Appendix 3. This summarises the main areas of business, the potential for market expansion and the degree of competition in each, and highlights the opportunities for foreign institutions. The quadrant with the most significance for foreign institutions is that showing weak domestic competition and high growth potential. These are the areas offering foreign institutions the greatest chances of success, with real opportunities to attract large sections of the market at favourable profit margins. Financial services in this category include investment trusts, corporate pension funds, asset-backed securities and securities derivatives. The other quadrant of lesser (but still significant) interest to foreign institutions is that showing high growth potential but also strong domestic competition. Competition in these areas is likely to be cut-throat and will inevitably mean reduced profit margins. Financial services in this category include foreign exchange services, stock-broking and advisory services for non-bank corporate bond issues. The potential business opportunities for foreign institutions are numerous, but for maximum chances of success concentration on those areas where they enjoy a competitive

advantage over the domestic providers would be advisable at first, where they can most effectively establish feelings of trust and a reputation for quality service among their customers. Once that reputation is established, competition with domestic institutions in other areas of financial services may become easier.

3.4 Foreign Institutions and Big Bang

The constant stream of announcements concerning tie-ups between Japanese and foreign financial institutions following the publication of the proposals in June should have come as no surprise to industry observers. One of the main problems for foreign firms wishing to enter the Japanese market is the lack of access to distribution networks. The other main deterrent is of course cost. One way of reducing both these problems is through a link up with a Japanese institution; many foreign institutions are opting to do just this. The alliances announced so far vary in degrees of formality and commitment, with the parties typically agreeing to exchange expertise in areas such as securitisation and asset management in return for access to the established customer bases of the domestic institutions. Some of the alliances are the result of long-standing business relationships, others seem to be rather more spontaneous. The major alliances agreed so far between Japanese and foreign firms since the first announcement of Big Bang in November 1996 are listed in Appendix 4, along with other activities undertaken by foreign firms in anticipation of the newly liberated markets.

Most of the new alliances appear to err on the side of caution: agreements to delegate a portion of funds under management to the foreign firm; to come to the assistance of a debt-laden Japanese firm; or to employ the foreign firm in an advisory role are more common than are full-blown partnership agreements. Only SBC and LTCB, both strong operations in their own right, have truly embraced the notion of a merged operation and seem comfortable with the consequences of this.

³⁷ Hamilton A. (1986) *"The Financial Revolution"* p174 Viking

3.5 Summary

The stated aims of Japan's Big Bang are to increase the efficiency of the financial markets, improving returns on assets (particularly the country's huge pool of private savings) in order that Japan's ageing society will continue to be able to support itself into the next century. The government is keen to improve competitiveness and in this regard the prospects for foreign institutions seeking to enter or expand in the Japanese market look promising. In particular, foreign expertise in unit trust and pension fund management should provide foreign institutions with a competitive advantage over the domestic institutions. Whether or not this is enough to permit entry into a notoriously protected market is another matter. A lot will also depend on the success of the domestic institutions, particularly city banks who will also be diversifying into new areas of financial services.

4. BIG BANG AND THE EDINBURGH INVESTMENT COMMUNITY

4.0 Introduction

The timing could perhaps not be better. The prospect of Y1200 in personal savings flowing out of Japan, some of it finding its way to Edinburgh's fund managers just when they need it most. Desperate for new business following further outflows of business to London and still smarting from the indignity of having slipped down the European rankings of institutional equity holdings, the Edinburgh investment community could do with a boost to its confidence. What better way than to attract some of those Japanese savings, and a pension fund or two?

In an attempt to gauge the mood of the City's fund managers, in-depth interviews were conducted with a number of investment houses in Edinburgh over the summer of 1997. With the Japanese government proposals having been published two months previously, and industry discussions on the Big Bang having gone on for most of the year, most interviewees were both familiar with the subject and more than happy to take part in the survey, viewing it as being both a topical and timely exercise.

A total of five fund managers and three life assurance firms took part in the survey. All of these firms are Edinburgh-based, although some also have offices elsewhere in the UK and abroad. The survey specifically concentrated on Edinburgh firms although it is acknowledged that the inclusion of other leading Scottish investment houses would also have been useful.

4.1 Objectives

The main purpose of the interviews was to discover the extent to which the deregulation of the Japanese financial markets was being followed by the Edinburgh investment houses, and whether or not Big Bang was expected to bring new business to the city. Obtaining a picture of how Edinburgh firms saw themselves and viewed Edinburgh's future as a financial centre was a further objective.

4.2 Methodology

Interviews were conducted on a one-to-one basis at the respondents' places of work, with the exception of one interviewee, with whom the interview was conducted by telephone. The interviews were structured around a questionnaire containing a mixture of both open-ended and closed questions, with question extensions added from the "extra questions" sheet when considered appropriate. Respondents were encouraged to expand on issues as they wished. All respondents were assured of confidentiality and their comments therefore remain anonymous. As most of the questions are open-ended and qualitative in nature, and the number of interviewees relatively small, a subjective analysis is considered to be the most appropriate treatment of the results.

4.3 Interview content

Respondents were first asked about the nature of any business with Japan, and the responsibilities of the firm's Japanese department. They were then asked about their familiarity with the deregulation proposals, and which aspects were of greatest interest or significance to them. Opinions were sought on recent moves by foreign firms to seek tie-ups in Japan, and the possibilities of the respondents' organisations seeking similar arrangements with Japanese firms. The problems involved with doing business with Japanese clients were also touched upon. Interviewees were then asked about relations within the Edinburgh financial community, what they saw to be Edinburgh's strengths and weaknesses as a fund management centre, and the perceived strength of the Scottish and Edinburgh names as marketing tools to Japanese clients.

4.4 Results

On the question of current business with Japan, almost all of the investment houses reported they had a small number of Japanese clients on their books, many of them being through UK subsidiaries of Japanese firms, but for no firm was it a main part of their business. Lack of marketing budgets was cited as a problem for many, preventing any active marketing of Japanese clients. All firms have dedicated Japanese departments, with most primarily involved with investment management rather than marketing or research. A minority have

fluent Japanese speakers working for them. A number of firms maintain a physical presence in Tokyo, mostly through joint ventures with Japanese firms. However, prohibitive costs and insufficient business make independent operations unviable for Edinburgh institutions, although one firm maintains a small representative office in Tokyo.

All firms reported they had been following the Big Bang proposals closely this year, receiving information variously from meetings with Japanese institutions, stockbroker reports, the financial press and wire news services. Similarly, all were able to recall details of the main proposals without much prompting. The proposals of greatest interest to most are the liberalisation of stockbroking commission rates, the revision of the foreign exchange law and removal of barriers between the different areas of financial services.

Opinions on the commitment of the Japanese government to the Big Bang varied quite considerably. A number of respondents were very enthusiastic, seeing the proposals as credible and reporting that their contacts in Japan were viewing the reforms very seriously indeed. One respondent cautioned against taking these proposals at face value, however; the original proposals have been considerably watered-down with various interest groups having had their say, and he felt that whether or not the various promises will be delivered upon should be viewed with a certain degree of scepticism.

Firms were divided over whether they thought Big Bang would open up new sources of business for them. Most felt that the reforms would benefit them over the longer term, but that they would see little short to medium term effect. Two institutions were quite adamant that Big Bang would have no impact on business whatsoever, with the costs of setting up in Japan being a major deterrent. From a fund management perspective, it was generally felt that it would be difficult to tap the newly liberated market without a local office presence. Opinions varied on prospects for foreign fund managers; one respondent stated that it would be difficult to compete with Japanese fund managers, predicting that increased competition between Japanese fund managers for business as a result of Big Bang would lead to better performances by domestic institutions rather than an increase in business for overseas institutions (an observation that the Ministry of Finance would certainly be encouraged to hear). However another argued that there was “no way” the Japanese had the necessary expertise to survive in an open market and that more and more pension fund mandates would

be going to foreign firms. Securities houses such as Goldman Sachs and Merrill Lynch are already viewed in a more favourable light than are Nomura or Nikko and this trend is set to continue. On the potentially lucrative areas of personal pensions and personal savings, one respondent claimed that it was far too early to know what will happen with either, the market being tough to enter and with Japanese clients seen as being “untrustworthy” and prone to “fads and fashion”.

The cost and difficulties of developing marketing and servicing programmes for Japanese clients were also cited as reasons for not entering the market in a hurry. Fears were expressed that Japanese clients may require expensive custom-made products, and may have high expectations over a too-short time scale – most investments require a longer-term commitment to yield satisfactory results, which is something Japanese investors may not be willing to agree to.

It was observed that many Japanese clients are already familiar with western investment practices, and that many potential clients would not therefore pose problems for foreign institutions; it is below this top tier that client sophistication levels may drop dramatically, and where servicing difficulties may be encountered. A number of respondents reported that Japanese pension fund clients typically demand a huge amount of information from their investment advisors, with reports and meetings expected on an almost daily basis and fund managers asked to justify every decision they make down to the finest detail. The intensive level of service expected by Japanese clients means that an office presence in Japan is essential. The Japanese are also perceived as being hard negotiators over such issues as terms and charges, further reducing their potential attractiveness as clients.

One respondent spoke of the conservative nature of Japanese savers, who were unlikely to want to take the risk of moving their money offshore despite the potential for higher returns (particularly if, as expected, Japanese interest rates rise in the near future, providing a further incentive for savers to keep their money at home). The example of continental Europe was cited, where British fund managers have had little success with their equity-led investments; for the most part Europeans are more comfortable with the lower yielding but also lower risk bonds, and have seen little reason to switch away from their conservative home-based investment houses.

When questioned about the recent tie-ups between foreign and Japanese financial institutions in the wake of the announcement of Big Bang, many responded with the opinion that it was expensive and therefore not something that should be rushed into. One investment house with an established link to a Japanese institution observed that it had taken them a long time to build up trust and that a partnership and was not something that could be hurried in Japan. Generally, tie-ups were perceived as being more a strategy for the larger institutions, for those with an established presence in Japan. Nevertheless it was generally viewed as a “good thing”, with both sides having something to gain: Japanese firms acquiring know-how and a capital boost, foreign firms gaining access to a notoriously opaque market. One respondent said that the scarcity of larger deals of the type announced between Long Term Credit Bank and Swiss Bank was ominous and suggested that foreign banks, flush with capital and looking to invest in Japan, were not liking what they saw. Transparency is still a problem for many financial institutions in Japan and many foreign institutions may still feel that the risks are not worth taking. Despite this, the respondent was optimistic that more significant tie-ups would be announced before the end of the year.

Asked about possibilities of tie-ups between Japanese and Edinburgh institutions, more than one respondent claimed that most tie-ups of any significance had already taken place by larger US or European institutions and that they held little interest or relevance for the Edinburgh investment community, which was perceived as being too small for such endeavours. Others were more positive about the opportunities for Edinburgh, particularly (but not exclusively) the larger institutions. A number of the larger institutions appear to be investigating the possibility of tie-ups with Japanese institutions. One smaller firm acknowledged that, while being too small to lead the charge, it would nevertheless be keen to follow and support its larger compatriots in any push into the Japanese market. Another admitted that it may be interested in a tie-up with a Japanese fund manager, but only if the arrangement was “easy to consummate”. At least one investment house is applying for a license to act as a non-discretionary advisor in Japan. (Firms offering investment advisory services in Japan require a license from the Ministry of Finance, of which there are two types: non-discretionary and discretionary. Non-discretionary licenses do not permit advisors to execute transactions on the basis of any advice given, and firms can be based outside Japan. Discretionary advisors must have an office in Japan and may execute transactions on the basis of advice providing

they are also in possession of an investment trust license). The general feeling among interviewees seems to be that deep pockets are required for investment in Japan and that firms should not expect to reap much reward from any such investment for at least the first five years.

Interviewees were then questioned about the current state of relations between members of the Edinburgh financial community. There was general consensus that Edinburgh firms cooperate with one another “when necessary”, but that basically firms are in competition with one another and are therefore not generally predisposed to share information or work together. The increasing loss of business to London over the past few years may have prompted this change of attitude. Two respondents reported that about eight years ago the Edinburgh financial community used to have a cosy, cartel-like atmosphere, comfortable and with no poaching of staff, which has ultimately seen it lose out to a more competitive and aggressive London. As a result the community has become quite defensive and inward-looking. Concern was expressed about the implications of further decline, with even the stronger institutions admitting that they would have problems attracting quality staff should the community shrink much further. One respondent said that a fundamental problem that needs to be tackled is London’s perception of Scotland’s fund management industry, and that Scottish firms needed to work together to remove this perception. Another firm displayed a rather more defeatist attitude, saying that it was difficult to compete with London at the moment, with the perception that ‘big is best’ in the fund management industry putting Edinburgh at a crucial disadvantage that it could do little about. A critical mass of between £7.5bn to £10bn was viewed as essential to survive, but even this size was seen as being attractive to predators. More mergers were predicted, with the only survivors among the smaller institutions being those that adopted clear niche marketing strategies.

Respondents agreed that the Scotland/Edinburgh name was a powerful one to use when marketing to overseas clients, helped by the image of the ‘canny Scot’, and a tendency towards prudence. Kilts, whisky and golf courses are internationally recognised symbols of Scotland and are often used in marketing campaigns to distinguish firms from rivals from elsewhere. It was agreed that in theory Edinburgh should appeal to Japanese clients, helped by the Scottish reputation for having a “safe pair of hands” with the emphasis on team work rather than on having “star traders” of the Barings or Morgan Grenfell variety. Its good long-

term performances and the prominent position of many of its investment institutions in performance league tables will all go down well with the Japanese, who are obsessed by ranking lists. Edinburgh also has an impressive record of investing in Japanese stocks compared to London, which should also increase its potential appeal. Edinburgh is also seen as having an advantage over London in its continuity of personnel, which would be important in Japan where long-term relationships are paramount.

4.5 Summary

Overall, there seems to be a consensus that Big Bang will have an impact on business in Edinburgh, but probably not over the short to medium term. Japanese clients are seen as expensive and difficult to deal with and the Japanese market as tough to enter. Edinburgh's fund managers appear on the whole to be slightly downbeat about potential business opportunities to be unleashed by Japanese deregulation. Some cynicism exists about whether the Japanese legislature will actually deliver what they have promised, and whether the Japanese financial system will really change to become an industry that is market-led and competitive on the world stage. The potential opportunities for foreign firms in Japan are acknowledged, but much of the Edinburgh financial community seems content to sit back and wait. There is however a general concern about the future of Edinburgh as a financial centre, with all respondents agreeing that a strong and confident Edinburgh provides a boost to business, however independent they feel their success to be of any underlying Edinburgh influence.

5. RECOMMENDATIONS AND CONCLUSIONS

5.0 Introduction

The deregulation of the Japanese markets undoubtedly offers a unique opportunity for foreign firms to gain access to a notoriously protected market. Edinburgh's fund managers are following the developments in Tokyo with interest, and are watching as foreign institutions announce a variety of joint ventures and tie-ups with Japanese financial firms. The fit between Japan and Edinburgh is far from obvious however and there are no irrefutable reasons why Edinburgh should enjoy a greater success in the Japanese market than its rivals. Some of the Edinburgh firms who took part in the survey are investigating the possibility of tie-ups with Japanese institutions, or are at least considering extensions to their business. But the majority of those interviewed are not. It is beyond the scope of this report to recommend a full-scale action plan for Edinburgh's financial community to ensure it takes maximum advantage of the potential business on offer in Japan. A number of key observations may be made however on the basis of the findings of the preceding chapter.

5.1 Observations

Although it is clear that the Edinburgh financial community is following the developments in Japan, and are well-informed about the details of the proposals, there is a tendency to 'wait and see' before committing resources to the Japanese market. This attitude is not universal, and applies mainly to the smaller investment houses that argue quite understandably that they lack the necessary resources to take a gamble on Japan, a market with a reputation for being expensive as well as difficult. There is a feeling that marketing investment products in Japan requires deep pockets and needs to be part of a long-term strategy.

The caution expressed by many of the respondents is certainly reasonable under the circumstances, but it may also be a symptom of a deeper malaise and an underlying lack of self-confidence in relation to its larger competitors in London. The Edinburgh financial community needs to establish a clear identity for itself to ensure its status as a leading European investment centre into the next century. The most obvious choice, particularly for

the smaller institutions, is as a niche market player offering specialist investment services with an emphasis on quality. Providing specialist services to Japanese clients could be an example of this. Despite the positive imagery and commonality of approach towards investment decisions (prudence, teamwork, etc) between Japan and Edinburgh, there is nothing that decrees that the Edinburgh investment houses have a prior claim on business in Japan. Success will depend on taking a pro-active marketing stance and understanding the needs of their potential customers. It will depend on identifying and developing synergies between the two investment cultures and marketing these appropriately.

The competitive matrix of Japanese financial services introduced in Chapter 3 offers encouraging news for the Edinburgh investment community. At least two of the most promising areas of opportunity, investment trusts (unit trusts) and corporate pension fund management, fall within Edinburgh's core areas of expertise. Private pensions and specialist private banking services are other areas where Edinburgh firms may enjoy some competitive advantage over other providers once they have established a reputation among Japanese investors for quality performance in the investment trust and pension fund management businesses.

It is well known that success in the Japanese market requires long-term commitment, a dedication to quality and a strong brand image³⁸. There is no reason why Edinburgh cannot offer all three of these attributes, but it is the first that demands that it act now. To wait until other firms have enjoyed success will be to have waited too long. Setting up in the Japanese market is expensive and reputations are key to attracting new business; for this reason a tie-up with a Japanese institution is the most desirable method of entry, providing a ready-made customer base and distribution network. For most Edinburgh firms however, obtaining a non-discretionary license is the more attractive option in terms of cost and simplicity of operations. This would enable them to offer investment advice to Japanese clients such as pension funds and from this to build up a reputation as a quality investment institution. Only once reputations are established and contacts made may it be worthwhile for the smaller firms to seek a more hands-on role in Japanese fund management. For most, however, acting in an advisory capacity may well be enough. Most Edinburgh firms have neither the manpower nor

³⁸ March, R.M. (1990) *The Honourable Customer: marketing and selling to the Japanese in the 1990s*, Longman Professional

the budgets to set up a presence in Japan. Their strength is in their integrated operations at home and as such would be better off improving communication links with the Japanese market and developing tailor-made products and services, rather than spending vast amounts of money setting up an office presence in Tokyo. The cost of air tickets to Tokyo twice a month pales in comparison to the costs (never mind the logistics) involved in setting up an office presence in one of the most expensive cities in the world.

Edinburgh's larger investment institutions are moving ahead with a variety of plans to tap the Japanese market, but the smaller ones are not, hampered by their size and a lack of capital to make the investment worthwhile. Yet it is in the interests of all Edinburgh's investment community that the smaller players also thrive. Strength in depth is essential if Edinburgh is to maintain a separate identity as a financial centre, and to develop as a community rather than as a collection of disparate organisations competing with one another. It is not suggested the larger organisations go to the extent of subsidising the rest, but cooperation and a sharing of information would go a long way to reducing the gap between those whose market position is assured and those who are in increasing danger from predators. This is a time of change in the UK; the new government has introduced a more cooperative style of leadership and the adversarial climate of before is looking increasingly outdated. This might therefore be a timely opportunity for Scottish Financial Enterprise to consider a radical change of role, positioning itself as a forum for discussion and for encouraging active cooperation and collaboration between its members.

5.2 Conclusions

It is felt that the Edinburgh financial community would gain considerable benefit from working together to present a united front to potential Japanese clients. For the Japanese, London and New York may be as far as the collective consciousness goes in terms of awareness of centres of world-class financial expertise, and Edinburgh badly needs to raise its profile in order to compete with other second-tier centres such as Frankfurt and Paris. Names such as Standard Life and Scottish Widows are well known on the international stage in their own right, but they are less well known for their connections with the Edinburgh investment community. That Edinburgh has an investment community of significant size and reputation needs to be emphasised to the Japanese in the strongest possible terms. The costs involved

in entering the Japanese market means that the disadvantages of sharing information and marketing programmes are far outweighed by the advantages to be gained from presenting the Japanese market with the powerful image of a united investment community high on quality and prudence and strong on client service.

In addition, Edinburgh investment houses should not be afraid to use the strong marketing images presented by traditional Scottish symbols such as tartan, whisky, bagpipes and shortbread, as well as its many famous golf courses, in their quest for new business. Few countries boast as many images with as many positive connotations for the Japanese as Scotland. Put a Japanese banker on a golf course and give him some whisky and he won't complain. There is no perfect fit between the two cultures, but there are enough similarities to recommend that the Edinburgh financial community works together on a pro-active marketing campaign to target potential Japanese clients.

Edinburgh needs to raise awareness levels in Japan if it is to break the current monopoly that London and New York currently enjoy in the area of foreign investment services. In terms of expertise, Edinburgh can and should hold its own with the world giants, but without sufficient trumpeting of this fact, its talents risk remaining hidden to all but the most discerning of clients. The deregulation of the Japanese financial market offers the Edinburgh financial community a timely opportunity to boost its image both at home and overseas, and to restore some of its lost self-confidence. It would be a pity to let that opportunity slip.

EPILOGUE

Interestingly, as this report was going to press, an article in Scotland on Sunday appeared containing a blue print for Scottish Financial Services³⁹. Its recommendations are similar to many of those made here; the creation of more innovative products; more aggressive marketing; more focus on specific areas of expertise; improvements in branding, particularly overseas; examination of methods of new distribution channels; and confident self-promotion (“blow your own trumpet”). This provides yet another sign that Edinburgh’s rejuvenation as a financial centre may not be too far away. Media concern does not automatically lead to the creation of problem-solving initiatives, but it may help to focus debate on key issues and from this to a consensus on a real-life blue print for action. It is hoped that this dissertation has in some way helped to do the same.

³⁹ *“Time to shake up financial boards”* Scotland on Sunday, Sept. 21, 1997

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APPENDIX 1

Edinburgh's Leading Investment Institutions (excluding banks)

Name of institution	Funds under management	Investment trusts	Pension funds	Unit trusts	Private clients	Other
Fund Managers						
Baillie Gifford	£13bn	x	x	x		5 th largest manager of investment trusts in UK. Institutional clients only.
Edinburgh Fund Managers plc	£6.7bn	x	x	x		£4bn in investment trusts. UK's 3 rd largest investment trust manager
Hodgson Martin		x	x	x	x	Niche market specialist
Ivory & Sime plc	£3.2bn	x			x	
Martin Currie	£6bn	x	x	x	x	
Newton Investment M'ment Ltd.	£10bn		x	x	x	33% owned by RBS. 7 other offices
Stewart Ivory	£2.6bn	x	x	x	x	
Templeton Investment M'ment	£3bn ⁴⁰	x		x		European HQ in Edinburgh. Group HQ in California; offices in 23 countries.
Insurance						
Royal Scottish Assurance	£0.6bn			x		Joint venture with RBS
Scottish Equitable plc	£13bn		x	x		Sales chiefly through IFAs. Part of AEGON Group
Scottish Life	£5.2bn		x	x	x	Sales through IFAs
Scottish Provident	£7.9bn ⁴¹	x		x		
Scottish Widows	£23bn		x	x	x	Sales through IFAs. 5 th largest pension provider in UK.
Standard Life	£55bn		x	x		Largest mutual life assurance company in Europe.
Investment Trusts						
Scottish Investment Trust	£1bn	x				

Source: Scottish Financial Enterprise Directory 1997/98

(NB This list is restricted to SFE members with head offices in Edinburgh)

⁴⁰ Total for all European offices (Edinburgh, Luxembourg, Frankfurt, Paris and Milan)

⁴¹ Investment management arm Prolific to be sold to Aberdeen Asset Management

APPENDIX 2

Institutional Equity Management Centres - Europe

Rank	Target City/Country	1996 Total (\$ billions)	1995 Total (\$ billions)
1	London	\$1,218.7	\$1,016.5
2	Zurich	423.0	411.0
3	Paris	289.3	261.1
4	Geneva	271.9	264.0
5	Frankfurt	169.8	157.2
6	Edinburgh	132.5	137.8
7	Stockholm	106.6	89.0
8	Basel	66.8	64.5
9	Milan	65.4	47.5
10	Brussels	63.3	58.5
11	Amsterdam	54.2	50.1
12	Dusseldorf	48.8	44.8
13	Glasgow	35.4	33.4
14	Munich	28.6	27.4
15	Rotterdam	24.0	23.0
16	Dublin	23.3	16.0
17	The Hague	20.9	21.1
18	Copenhagen	18.1	17.0
19	Utrecht	17.6	17.5
20	Stuttgart	16.5	15.1

Source: Technimetrics Inc. (1997) "International Target Cities Report"; Knight-Ridder

(Rankings based on total equity assets under management held on December 31, 1996)

APPENDIX 3

Competitive matrix - Japanese financial services

DOMESTIC COMPETITION	STRONG	Retail banking Off-exchange trading for listed securities Unlisted securities trading Short-term money market Short-term yen interest rate futures	Foreign exchange services Stock-broking services Non-life insurance (+ve discrimination for foreign firms) Issuance of corporate bonds and commercial paper by non-banks Private banking
	WEAK	Life insurance market	Investment trusts (unit trusts) Corporate pension funds Asset-backed securities OTC securities and commodities derivatives Personal pensions
		LOW	HIGH
		GROWTH POTENTIAL	

Adapted from Pawley P., Winstone D. and Bentley P. (1991) *UK Financial Institutions and Markets*, Macmillan, London p283

APPENDIX 4

Foreign tie-ups announced since November 1996

Date of first announcement	Institution	Details
April 11	Bankers Trust/Nippon Credit Bank	BT to offer expertise in asset securitisation, NCB to provide distribution network for BT products. BT to service NCB's overseas customers.
June 6	Putnam Investments/Nippon Life	Putnam to manage Y80bn pension fund assets, and to develop products for Nippon Life's institutional clients.
June 18	Barclays/Hokkaido Takushoku Bank	Barclays to provide expertise in asset securitisation, Takugin to provide customer base. Reports of difficulties with agreement however.
July 4	GE Capital/Sakura Finance	GE Capital to sell credit cards/consumer finance products via Sakura's distribution network.
July 9	Gartmore Investment Japan/Sumitomo Trust & Banking	Gartmore to provide advisory service to Sumitomo on European markets.
July 15	Swiss Bank Corp./Long-Term Credit Bank of Japan	Joint investment banking, asset management and private banking operation in Japan. SBC Warburg and securities affiliate of LTCB to merge to form investment banking unit. SBC provides expertise in fund management, corporate finance and equities; LTCB provides prestigious corporate customer base.
Sept 19	Commerzbank/?	Reports of tie-up with unnamed Japanese institution to market international asset management products in Japan.

Other activities by foreign institutions in Japan in response to Big Bang:

Institution	Details
Fidelity	Telephone stock-broking service — first of its kind by a foreign institution in Japan
Lehman Brothers	Expansion of derivatives and securitisation operations in Tokyo
Barclays	Expansion of derivatives, equities and bond-trading operations in Tokyo. Also have joint venture with Nikko Securities for pension fund advisory service
Commerzbank	Increasing employees at asset management subsidiary in Tokyo
Pictet Japan	Obtained license to enter mutual fund business
Franklin Templeton Group	Announced intentions to start selling mutual funds in Japan
Smith Barney	Joint venture with Nikko Securities, setting up an investment advisory firm