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The Growing Presence of Japanese Banks in California

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Japanese-owned banking institutions have dramatically increased their share of the California banking market since the early 1980s. However, the author finds that, overall, the increase in foreign bank ownership in the State has been slight. Japanese bank expansion appears to have arisen primarily from the rapid increase in trade with Japan and Japanese direct foreign investment in California. While Japanese banks emphasize commercial lending and rely more heavily on purchased funding, they have a substantial, and growing, retail presence in the State.

Japanese banks have made significant inroads into the California banking market since the early 1980s. Over the period from 1982 through 1988, assets of Japanese-owned banking institutions in California increased nearly threefold. At the end of 1988, Japanese-owned banks held one-quarter of the banking assets and over 30 percent of all business loans in the State. This expansion has come about through acquisitions and new entry, as well as through rapid growth of existing institutions.

California is not the only market where Japanese banks have made inroads. World-wide, Japanese-owned banking institutions have grown over the last decade and now dominate the list of the world's largest banks. Their overseas branches alone nearly doubled their assets from 1982 to 1987, reaching almost $1.1 trillion by year-end 1987.[1]

In California, in particular, this growth has received considerable attention, raising concerns about its causes and the possibility that with continued growth, Japanese banks could come to dominate the California market. This paper first examines the strong growth and increasing market shares of two groups of Japanese-owned banking institutions: commercial banks chartered in California and the agencies and branches of Japanese banks that operate in California. (A description of the banking powers and services of these different types of banking institutions is provided in the BOX.) Section II then explores possible explanations for the rapid growth of Japanese-owned banking institutions in California, and Section III examines empirical evidence on growth patterns of banking institutions to assess the potential causes of rapid growth. In particular, empirical comparisons of the composition of bank portfolios and funding attempt to determine whether balance sheets of Japanese banks reflect the factors that may be causing rapid growth. Section IV provides some observations and conclusions about the Japanese banking presence in California. Specifically, growth is likely to continue, but at a slower pace, with more emphasis placed on the "retail banking" area.

I. Rapid Growth

The growth of Japanese banks, agencies, and branches in the mid-1980s in the U.S. has been rapid. In California, the traditional measures of market presence reflect that growth; assets, loans, and deposits all show dramatic increases. Between 1982 and 1988, the assets of Japanese-owned banking institutions in California nearly tripled, growing from $34.6 billion to $93.4 billion.[2] As shown in Chart 1A, Japanese-owned institutions' market share, which was 10.7 percent of the total assets of all banks, agencies, and branches in the State in 1982, rose to 25.2 percent by the end of 1988.

Using a narrower definition of the banking market, that is, commercial banks only (excluding agencies and branches), there still is a strong increase in the market share of Japanese-owned institutions. As Chart 1B shows, assets of Japanese-owned banks rose from 3.7 percent to 11.9 percent of the "bank only" market from 1982 to 1988.[3] The Japanese-owned commercial banks more than

Chart 1A

Share of Total Bank, Agency and Branch Assets for California

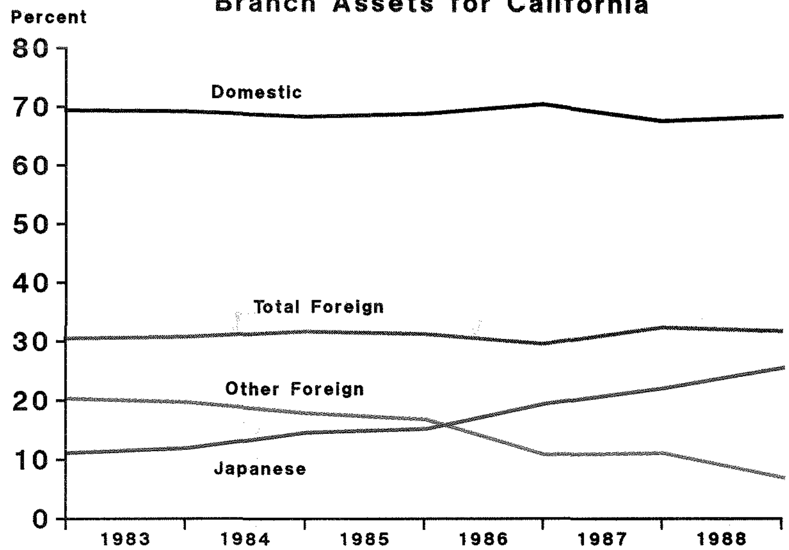
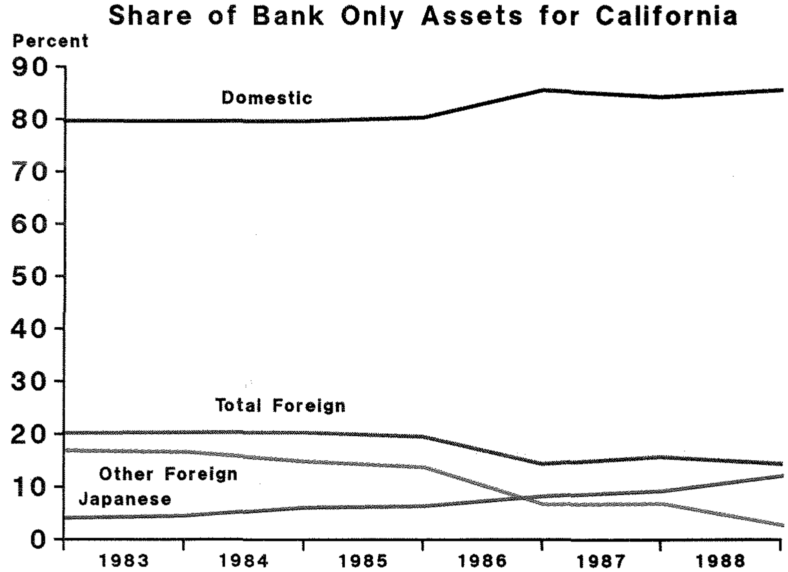


Chart 1B

Share of Bank Only Assets for California



tripled their assets during the period, reaching $35.3 billion by year-end 1988. Sixty percent of this increase resulted from acquisitions of three large foreign-owned banks by Japanese-owned banks.[4] However, Japanese-owned banks in general also grew at a faster pace than did other California banks.

Of the ten Japanese-owned commercial banks operating in the State at year-end 1988, eight were subsidiaries of Japanese banks. Two small banks are Japanese-owned, but are not owned by banks headquartered in Japan. The subsidiary banks account for virtually all of the assets of the Japanese-owned banks in the State. Four of these banks ranked among the top ten banks in the State at year-end 1988: Union Bank (fifth largest at $15.0 billion in assets), Bank of California (sixth largest, $6.9 billion), Sanwa Bank California (seventh largest, $6.4 billion), and Sumitomo Bank of California (ninth largest, $3.7 billion). Earlier in the year Tokai Bank of California ranked tenth.[5]

The twenty-two foreign agencies and six foreign branches of Japanese-owned banks more than doubled in size over the 1982 to 1988 period. Their combined assets reached $58.1 billion by year-end 1988. The agencies ($44.7 billion) and branches ($13.4 billion) provide an array of commercial, money market, and trade-related banking services, either directly or through international banking facilities that serve only foreign residents.[6]

Shifts in Market Shares

Although the increase in Japanese ownership of banks in the U.S. has raised concerns about "a wave" of Japanese financial services acquisitions,[7] expansion has not occurred at the expense of domestic banks' market share in California. Over the six years ending in 1988, the market share of all foreign banking institutions increased only modestly, from 30.8 percent to 31.7 percent.[8] As can be seen in Chart 1A, rather than gaining market share from domestic banks, Japanese banks essentially have replaced other foreign banks as the dominant foreign banking power in California.

In fact, using the narrow market definition, commercial banks only, foreign market share actually *declined* from 20.2 percent in 1982 to 14.9 percent in 1988. Most of this

Types of Foreign-Owned Banking Institutions

Commercial Bank
- Chartered in the U.S. as a bank.
- Owned by foreign individuals, firms or banks.
- Same capital and insurance requirements as a domestically-owned bank.
- Same regulations as other domestically-chartered banks.
- May offer full range of banking services.
- May provide both retail and wholesale banking services.

Subsidiary Bank
- Owned and operated as a U.S. subsidiary of a foreign commercial bank.
- Subsidiaries are chartered in the U.S. as a bank.
- Incorporated as a separate entity from the foreign parent.
- Same capital and insurance requirements as a domestically-owned bank.
- Same regulations as domestic banks.
- May offer full range of banking services.
- May provide both retail and wholesale banking services.
- May be funded by parent bank or affiliated institutions.

Agency of a foreign bank
- Offers only limited banking services.
- Cannot accept deposits, but may accept "credit balances."
- Concentrates on trade-financing and money-market services.
- May be funded with borrowings from parent or affiliates.

Branch of a foreign bank
- Has full banking powers.
- Can accept deposits.
- Provides many trade-financing and money-market services.
- May be funded with borrowings from parent or affiliates.

International Banking Facility (IBF):
- Not a separate entity, but a set of accounts on the books of the bank, agency, or branch.
- May accept deposits from and extend credit to foreign residents, parent, and other IBFs.
- Not subject to U.S. reserve requirements or interest rate ceilings.

decline resulted from the purchase of the British-owned Crocker Bank by Wells Fargo Bank in 1986.[9] This explains the sharp decline in "other-foreign bank" market share in Chart 1B. Thus, we have seen a shift, rather than an increase, in foreign ownership.

II. Reasons for Expansion

This section examines a number of factors that may have played a role in the growth of Japanese banking assets in California. For example, the growth in trade with Japan and the growth of Japan's current account surpluses are two factors that may have stimulated the growth of Japanese banking institutions in California. Liberalization of domestic capital markets in Japan is another factor that may have stimulated investment in the State. Finally, California's location, making it an important point of entry, as well as the State's perceived attractiveness as a growing banking market, are factors that may have helped to set the stage for the upsurge in investment in Japanese banking in California. These considerations are discussed below.

Banks Follow Trade

One reason for the growth in Japanese banking assets in California may be the growth of U.S. trade with Japan. Because of California's location on the Asia-Pacific Rim, the State has become an important locus of trade-related activity. With the increasing presence of Japanese-owned multinational firms engaging in trade-related activities in the State, there has been a commensurate increase in the need for trade-related financing, exchange, clearing, and other credit and banking services. Japanese-owned banking institutions may have a comparative advantage over the U.S. and other competitors in providing these services. If this is the case, it is logical that Japanese banking assets would increase in the current environment of growing trade with Japan.

A study of U.S. and Japanese banking by Henry Terrell (1979) provides a theoretical and empirical basis for suggesting that in the context of rapid growth in trade, Japanese banks do indeed enjoy comparative advantages in providing banking services in California.[10] In this analysis, Terrell adapts Caves' (1974) model of foreign investment to international banking. He notes that ". . . foreign investment is often associated with product differentiation, which may include possession of intangible assets such as a firm's knowledge about how to produce and distribute its product."[11] Terrell applies this concept to multinational banking, hypothesizing that in foreign markets, foreign banks can differentiate their products from those of domestic competitors by specializing in services to multinational firms from their home country. By specializing in such services, Terrell argues, Japanese banks' subsidiaries, agencies, and branches may enjoy a significant competitive advantage over their domestic competitors on account of their pre-existing business relationships with Japanese firms, as well as their superior knowledge of Japan's markets, customs, and operations.

Thus, Terrell suggests that "rapid growth of foreign branch and subsidiary activities by both Japanese [banks in America] and American banks [in Japan] indicates a customer preference for obtaining banking services [in a foreign country]—such as access to credit, deposit, and payment facilities—from the office of a bank with which they [already] are familiar [in their home country]. . ." He also asserts that "Customers much prefer this approach to the alternatives of either dealing with a local institution or, more expensively, dealing with a far-distant banking facility."[12]

These assertions provide a testable hypothesis; namely, that foreign banking activity is related to growth in trade with a given foreign country, as well as strong local economic conditions in the host country. Indeed, Terrell finds such a positive correlation in his empirical analysis.[13]

The strong relationship Terrell found in the 1970s between international trade and foreign banking activity appears to have been borne out in the 1980s. The surge in trade between Japan and California appears to have increased the demand for Japanese banking services in California and the U.S.[14] Chart 2A shows California's combined volume of imports from and exports to Japan from 1980 to 1987. The volume of trade increased by nearly 150 percent during this period.[15] Similarly, the assets of Japanese-owned banking institutions experienced a surge in growth over this period, as shown in Chart 2B. Moreover, just as Japan's trade with California came to take up a larger share of California's total trade volume (35 percent in 1987, versus 30 percent in 1982), Japanese banking assets in California also accounted for a larger share of foreign banking assets in California by the end of 1987. (See Charts 1A and 1B.)

The British experience provides further support for the view that increased trade helped to stimulate the growth of Japanese banking assets in California. While commerce with Japan has soared, British trade with California has grown only slightly since 1982. (See Chart 2A.) By 1987, California's $3.1 billion total trade with Britain was dwarfed by the $41.1 billion trade with Japan. According to the "banks follow trade" hypothesis, the lackluster growth in British trade with California should have been associated with lackluster growth in British banking assets during this period. In fact, as discussed earlier, the British banks left the State. Thus, even though they held about 15 percent of California's commercial bank assets in 1982, without growing trade flows to sustain them, a number of years of subpar performances by their California banks induced most of the British banks to sell their California subsidiaries and invest elsewhere.

Direct Foreign Investment

Another factor that may have helped to stimulate the rapid growth in Japanese banking assets in recent years is the growth of Japan's external surpluses over most of this period. Japan's large trade surpluses have made funds available for direct foreign investment. Coupled with the 1980 amendments to the Foreign Exchange and Foreign Trade Control Law, which deregulated capital flows into and out of Japan, these trade surpluses have stimulated a dramatic increase in Japanese investment in the U.S. in general and California in particular.

Chart 2A
Total Volume of Imports and Exports For the State of California

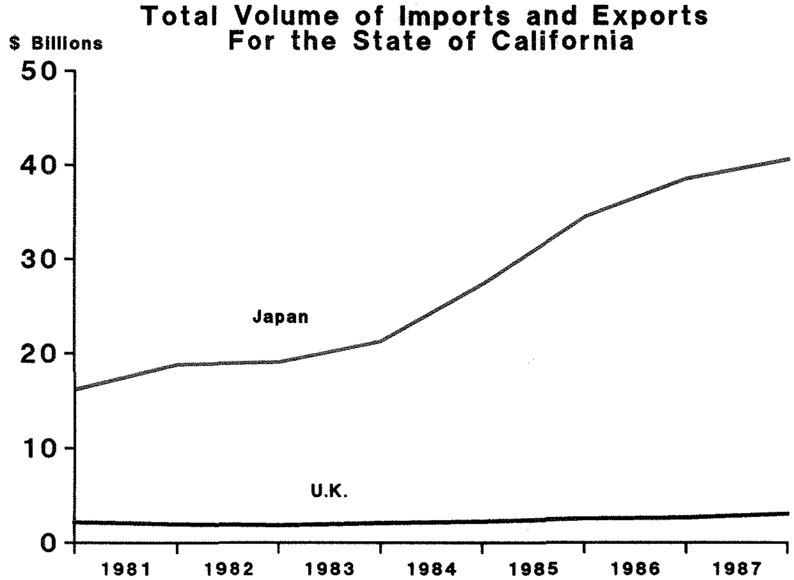
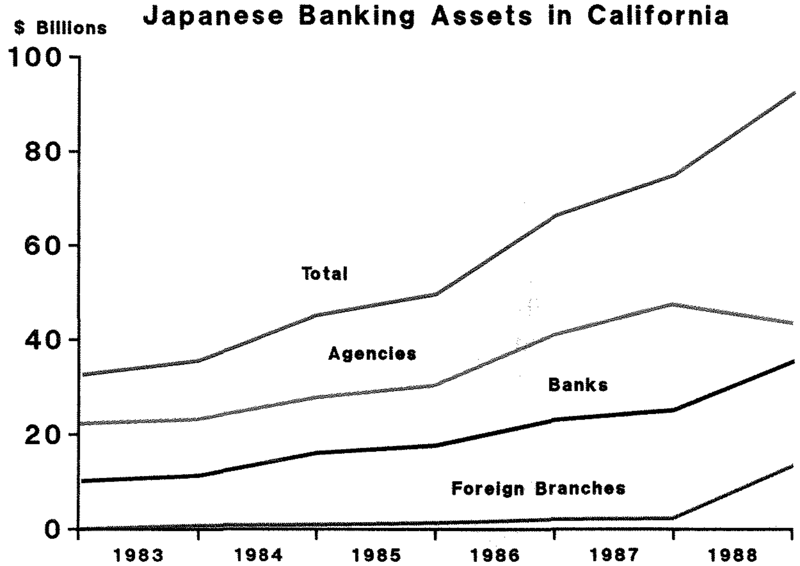


Chart 2B
Japanese Banking Assets in California



Over 700 Japanese firms have established manufacturing operations in the U.S.; about one-quarter of those are located in California.[16] The bulk of the Japanese investment through 1986 was in manufacturing, wholesale trade, and real estate. Finance accounted for under seven percent, according to U.S. Commerce Department data.

According to Commerce Department data, by 1986, Japan accounted for 14.2 percent of total direct foreign investment in California, up from 9.1 percent in 1982. In 1986, Japan was second only to Canada in terms of direct foreign investment in California, with $5.3 billion to Canada's $6.0 billion. However, for Japan, there was a 129.1 percent increase between 1982 and 1986 in the book value of plant, property, and equipment invested in California. Over the same period, Canada's increase was only 9.2 percent. The Japanese also surpassed Britain, which slipped to third, despite a 63.6 percent increase in direct foreign investment over the period.

This increase in direct investment probably has affected the growth of Japanese banks in California both directly and indirectly. The direct effects can be seen in the stepped-up pace of Japanese acquisitions of existing banks in California. Another potential channel for increased direct investment in California may have been increased funding from the parent banks in Japan. Such funds could have enabled Japanese banks in California to grow more rapidly than their competitors.

Increased direct investment also may have provided an indirect stimulus to Japanese banks in California through increased demand for banking services on the part of Japanese-owned commercial firms that have set up operations in California. As in the case of the "banks follow trade" argument, banks also may follow investment since Japanese investors probably prefer banking services provided by Japanese-owned banks with which they already have established business relationships in Japan.

Other Factors

The strength of the California economy is another factor that may have influenced Japanese bank expansion. In its own right, California is a large market. Its GDP ranks with the top eight countries in the world. Its large size, good location for international trade, and diversified base of production offer banks an attractive market. In recent years, the State's economy has outperformed the U.S. economy, with more rapid growth and greater resistance to downturns, potentially making California more attractive than other U.S. locations to foreign banks.

Thus, if California's attractiveness as a market in its own right were a factor stimulating the growth of Japanese banking in the State, one would expect to see Japanese-owned banks and agencies and branches growing more rapidly in California than in the U.S. generally or in the New York and Chicago banking markets. Despite the obvious Japanese interest in California, a comparison of growth rates for Japanese-owned banking institutions from 1982 to 1988 indicates that Japanese-owned institutions in the U.S. generally, and in New York and Illinois particularly, grew at slightly *faster* rates than did Japanese-owned banks in California.[17]

Likewise, if California were particularly attractive as a banking market in its own right, one might expect foreign banks in general to grow rapidly in California. However, this pattern is not observed. As discussed above, Japanese-owned banking institutions have grown much more rapidly than other foreign institutions. Charts 1A and 1B illustrate the impact that differential growth rates have had on market share. While the Japanese-owned banks have been growing rapidly, other foreign-owned banks have been leaving the market. In several cases, the Japanese have acquired foreign-owned banks. The pattern also extends to the agencies and branches, where the Japanese institutions have grown much more rapidly than the non-Japanese institutions. Given these observations, the attractiveness of the California market relative to other U.S. markets does not appear to have been a major factor in the rapid growth of Japanese-owned banks.

Diversification of geographic risks and access to U.S. markets also may have been a stimulus for the growth of Japanese banks in California. Specifically, entry into the California market would provide access to the U.S. money markets and diversify an international institution's funding base by allowing it to raise funds in the large U.S. financial markets. Similarly, operations in California provide access to major corporate borrowers in the U.S. and an opportunity to diversify lending risks across countries. However, this may not be a particularly strong argument, since diversification may be attained without access to California, or even the U.S., for that matter.

One final explanation that has been offered for the rapid growth of Japanese banks has to do with potential competitive advantages. Some argue, for example, that Japanese-owned banks have access to funding and/or capital from their parent banks, which, because of their size and strong credit ratings, can borrow at lower costs than can the subsidiary (or than domestic banks).[18] This advantage, moreover, may be reinforced by the availability of funds associated with Japan's large external surpluses. Thus, borrowing from an overseas parent could provide a funding advantage for Japanese-owned subsidiary banks, agencies, and branches. However, the parent must be willing to forsake alternative open market returns on the funds in favor of subsidizing the operations of its California affiliates.

In any event, Japanese banks are unlikely to have any significant funding advantages over their domestic rivals in *domestic* funding markets. It seems clear that within California, Japanese banks price their retail deposits competitively to survive in the retail market. And in the wholesale markets, Japanese banks offer competitive rates on large CDs, federal funds, and eurodollars.

In sum, there are a number of factors that potentially have stimulated the growth of Japanese banks in California. Based on the evidence considered in this section, it appears that the growth in U.S. trade with Japan, the increase in Japanese direct investment in the U.S., and possibly, competitive advantages associated with using Japanese parents as a funding source have been the major reasons for the growth of Japanese banks in California and in the U.S. In the next section, I compare the portfolios of Japanese-owned banks with those of domestically-owned banks in California to determine whether investment and/or funding patterns reflect these influences.

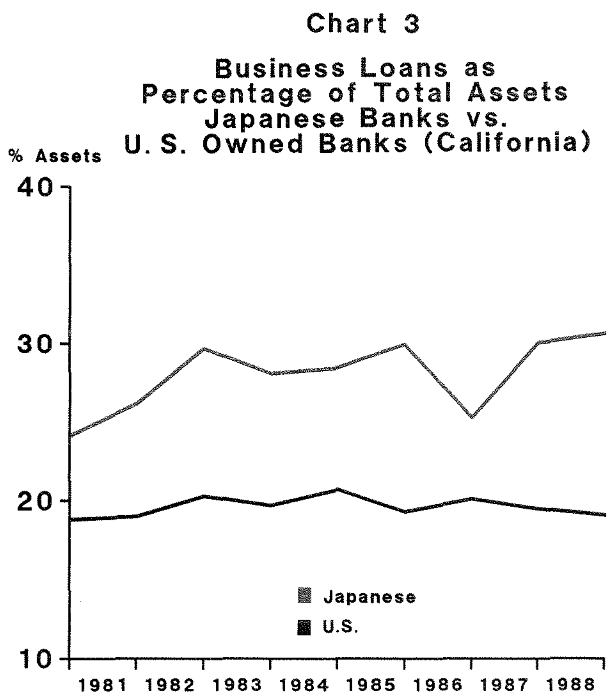
III. A Comparison of Portfolios and Cost Structures

As discussed above, the dramatic increase in trade with Japan and the growth in Japan's trade surpluses likely have been key reasons for the increase in the Japanese banking presence in California. Trade financing is an area where Japanese banks may have a competitive edge in light of this growth in trade and trade surpluses. Therefore, one might expect to find that Japanese banks have a larger market share and extend more of this type of credit as a proportion of assets than do domestic banks. Since trade financing should appear on commercial banks' balance sheets as business lending, commercial and industrial loans, commercial letters of credit, and standby letters of credit (SLCs) provide useful measures of market presence.[19]

Data on outstanding balances of commercial and industrial loans and letters of credit show that Japanese-owned banking institutions in California have, in fact, gained a large share of these major commercial lending markets. In business lending, Japanese-owned banking institutions held 30.1 percent of the California market at year-end 1988. Their share of commercial letters of credit was even higher, nearly 32 percent. They controlled a 44 percent share of the rapidly growing SLC market, which is dominated by foreign banks with strong credit ratings.[20] Clearly, then, Japanese banks in California have a strong position in the markets for commercial lending and letters of credit. This is consistent with the view that the growth in Japanese-owned banks is associated with their trade orientation.

Aggregate Portfolio Measures

Other indications of Japanese banks' trade orientation potentially may arise in comparisons of Japanese- and domestically-owned banks' portfolios; that is, if the growth in Japanese-owned banks largely is the result of increased trade, one might expect to see differences between the composition of the portfolios of Japanese-owned and domestically-owned banks in California. Specifically, Japanese-owned banks probably extend proportionately more business-oriented credit, including commercial real estate loans, and proportionately less consumer-oriented credit, including residential mortgage loans, than do domestically-owned banks. Likewise, if direct investment is a factor in Japanese-owned banks' growth, there could be differences in the composition of Japanese-owned and domestically-owned banks' liabilities. Specifically, Japanese-owned banks may rely proportionately more on borrowings from their parents and proportionately less on retail-oriented deposits than do domestically-owned banks.



Comparisons of ratios of various categories of loans to total assets and ratios of various types of liabilities to total assets are made. Percentages for aggregate data on all Japanese-owned banks are compared with percentages for aggregate data on all domestic banks. These percentages are tracked over time, and presented in Charts 3 through 7. The aggregate data provide a measure of portfolio differences between the bank groups, as well as a measure of portfolio trends over time for each group. (However, these are relative portfolio measures, scaled by assets; they obscure differences in the actual growth rates of the asset and deposit categories across bank groups. For example, even though small time and savings deposits at Japanese-owned banks have grown more rapidly than at domestic banks, Chart 7 shows that the even more rapid expansion of Japanese bank assets has reduced the relative reliance on small time and savings deposits as a funding source for the Japanese banks.)

Aggregate data indicate that Japanese banks *do* have a much higher proportion of commercial loans than domestic banks have. While Japanese-owned banks held nearly 30 percent of their assets in business loans in 1988, domestic banks held only 19.5 percent. Chart 3 indicates that the difference between the two groups grew over the period when trade with Japan was soaring. It also is interesting to note that there are no Japanese-owned savings and loan associations or savings banks in California at present. While this may be due in part to regulatory restrictions, it also provides support for the argument that Japanese banks follow trade and thus are trade/business-oriented. Thrift institutions in California traditionally have not engaged in business finance and instead concentrate primarily on household finance, an area in which Japanese banks do not have a comparative advantage, according to the "banks follow trade" argument.

Chart 4

Real Estate Loans as Percentage of Total Assets Japanese Banks vs. U.S. Owned Banks (California)

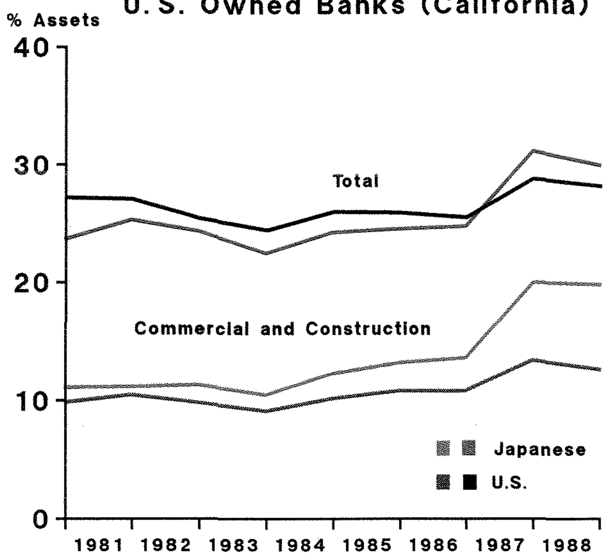
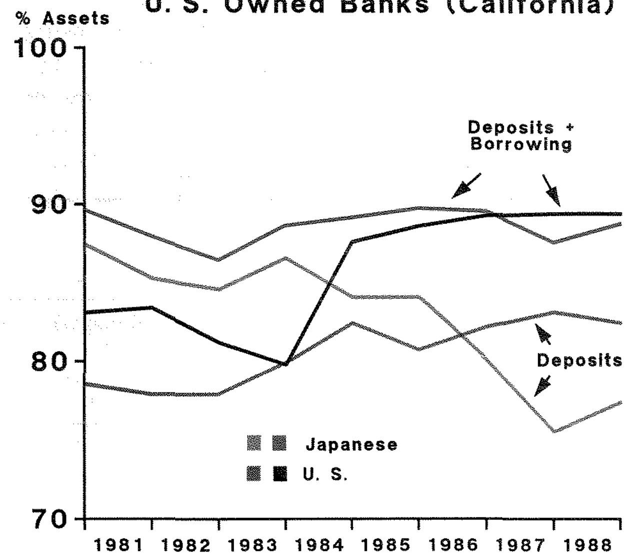


Chart 5

Funding as Percentage of Total Assets Japanese Banks vs. U. S. Owned Banks (California)



In the aggregate, we also find that Japanese-owned banks have a higher proportion of commercial real estate loans than domestic banks have. At year-end 1988, Japanese banks had 10.4 percent of their assets in commercial real estate loans, versus only 6.7 percent for domestic banks.

It is also interesting to note that while Japanese banks have a higher proportion of business and commercial real estate lending, there appear to be no significant differences in their relative proportions of total real estate lending (as shown in Chart 4), single family real estate lending, or consumer loans. Rather, as shown in Table 1, they have a higher proportion of loans to assets, which is offset by a smaller proportion of federal funds and repurchase agreement lending, securities holdings, and other assets, which mostly includes cash and balances due from other banks.

Deposit and liability data also tend to support the view that Japanese banks are more wholesale-business oriented than are their domestic counterparts. As can be seen in Chart 5, in the aggregate, Japanese-owned banks primarily are funded by domestic deposits, like their domestic bank competitors. However, from Chart 6, it is clear that

Japanese-owned banks in California rely more heavily on jumbo CDs ($100,000 and over) than do domestic banks. Moreover, Chart 6 shows that other borrowings, which may include federal funds, repurchase agreements, and eurodollar borrowing, as well as borrowing from parent banks, have been a more important source of funds for Japanese-owned banks than for their domestic counterparts. Nonetheless, at present, as a percent of assets, funding from parent banking organizations is not a particularly large funding source for Japanese subsidiary banks in California. According to recent bank holding company data, only about five percent of assets were funded this way, and only one of the eight subsidiaries had a significantly greater amount of borrowing from its parent.[21] One reason is that most of the subsidiary banks view such borrowing as a backup, rather than a primary, source of funds. Finally, Chart 7 indicates that retail time and savings deposits account for just over one-third of Japanese-owned bank funding, versus closer to fifty percent for domestic banks.

Thus, there are significant funding differences between Japanese-owned banks and domestic banks. Japanese-owned banks rely more on wholesale deposits and borrowings and less on retail deposits, consistent with the view that they are more trade- and business-oriented.

Taken together, then, the aggregate data on lending and funding patterns roughly are consistent with the trade patterns, lending support to the view that increased trade and increased direct investment have been important stimuli to the growth of Japanese-owned banks in California.

Comparisons of Individual Bank Portfolios

However, these results could arise from individual banks' portfolio decisions, and could be unrelated to the

Table 1

Loans and Investments as a Percentage of Assets

(California Banks, Fourth Quarter Averages, 1987)

Dependent Variable: As a percent of assets	Parameter Estimates: Intercept	Assets	Japanese-owned Dummy	Other-foreign Dummy	Number of branches	Observations	Adjusted R^2	F Value	Prob.>F
Total Securities	12.570***	−0.599	−4.163	0.280	0.029	435	−0.0039	0.577	0.6793
Federal Funds Sold and Repurchase Agreements	7.512***	0.310	−4.678*	−1.333	−0.023	435	0.0017	1.187	0.3160
Total Loans+	62.604***	0.521	14.420***	2.279	−0.020	435	0.0194	3.148	0.0144
Total Real Estate+	26.841***	−0.175	2.613	2.262	−0.014	435	−0.0057	0.379	0.8236
Single Family Real Estate	9.275***	−0.489	−1.711	0.189	0.039	435	0.0007	1.079	0.3666
Commercial Real Estate	7.719***	−0.129	6.775***	1.609	−0.010	435	0.0166	2.839	0.0241
Business Loans	21.768***	1.086	10.183***	1.083	−0.069	435	0.0160	2.768	0.0271
Consumer Loans	12.024***	−0.153	−3.159	−3.053	0.033	435	−0.0020	0.783	0.5365
Other Assets	17.313***	−0.232	−5.579*	−1.226	0.013	435	−0.0001	0.987	0.4145

* *Significant at 10% level.*
** *Significant at 5% level.*
*** *Significant at 1% level.*
\+ *Includes components not shown separately.*

individual banks' ownership status. Thus, it is important to determine whether the difference is significant at the individual bank level after controlling for other factors that might influence portfolio composition. Analysis of the individual bank data also may be necessary because the sample of Japanese-owned banks is small, and the larger institutions might skew the aggregate numbers.

Therefore, cross-sectional OLSQ regressions on individual bank data are employed to identify statistically significant portfolio differences between Japanese-owned banks and other banks. Financial statement data are available from the December 1987 Call Reports for all commercial banks in the state.[22] A description of the regression model is presented in the Appendix, and the results of the regressions are presented in Tables 1 and 2.

At the individual bank level, the regression results are consistent with the aggregate portfolio data. Controlling for size and branch differences, Japanese banks have 10.2 percent more business loans on average than domestic banks have. Moreover, that difference is statistically significant at the one-percent level, as shown in Table 1.

Similarly, the cross-sectional regressions indicate that commercial real estate lending at Japanese-owned banks accounts for nearly seven percent more of the asset portfolio than at domestic banks, and that the difference is statistically significant at the one-percent level. As shown in Table 1, these findings are consistent with the view that increases in trade and Japanese direct foreign investment in California played a part in the expansion of Japanese bank activity in the State.

Table 2

Liabilities and Net Worth as a Percentage of Assets

(California Banks, Fourth Quarter Averages, 1987)

	Parameter Estimates								
Dependent Variable: As a percent of assets	Intercept	Assets	Japanese-owned Dummy	Other-foreign Dummy	Number of branches	Observations	Adjusted R^2	F Value	Prob.>F
Total Deposits & Borrowings	88.802***	−0.551	−0.887	−3.089	0.034	435	−0.0026	0.713	0.5832
Borrowings	1.112***	1.281***	7.351***	1.356	−0.067	435	0.0706	9.258	0.0001
Deposits	87.691***	−1.831**	−8.238**	−4.445*	0.101*	435	0.0201	3.232	0.0125
Transaction +	32.578***	−0.900	−7.559**	−6.779***	0.054	435	0.0285	4.187	0.0025
Now	9.782***	−0.788**	−3.808**	−2.485**	0.045	435	0.0242	3.701	0.0056
Small Time	39.954***	−1.887**	−12.895***	−6.57***	0.112	435	0.0544	7.251	0.0001
Savings	7.785***	−1.228***	−2.188	−1.578	0.078	435	0.0222	3.467	0.0084
MMDAs	18.853***	0.566	−5.710**	−3.986***	−0.037	435	0.0230	3.558	0.0072
Certificates	13.316***	−1.224**	−4.998*	−1.011	0.071**	435	0.0098	2.072	0.0835
Large Time	15.159***	0.956	12.216***	8.908***	−0.066*	435	0.0830	10.843	0.0001
Equity Capital	9.497***	0.226	−2.231	1.223	−0.021	435	−0.0033	0.639	0.6351

* *Significant at 10% level.*
** *Significant at 5% level.*
*** *Significant at 1% level.*
\+ *Includes components not shown separately.*

Finally, at the individual bank level, differences in funding patterns are statistically significant, and in some cases these differences are also quite sizeable. For example, as shown in Table 2, on average, Japanese-owned banks were 12.2 percent more dependent on large CDs and 7.4 percent more dependent on other borrowing for funding than were domestic banks.

Chart 6

Purchased Funds as Percentage of Total Assets Japanese Banks vs. U. S. Owned Banks (California)

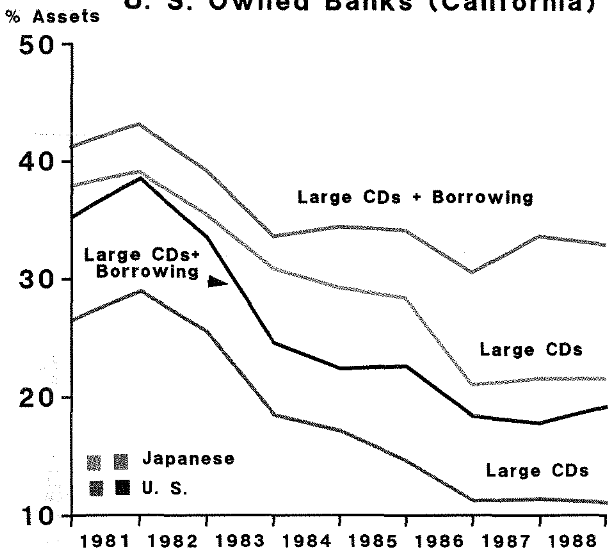
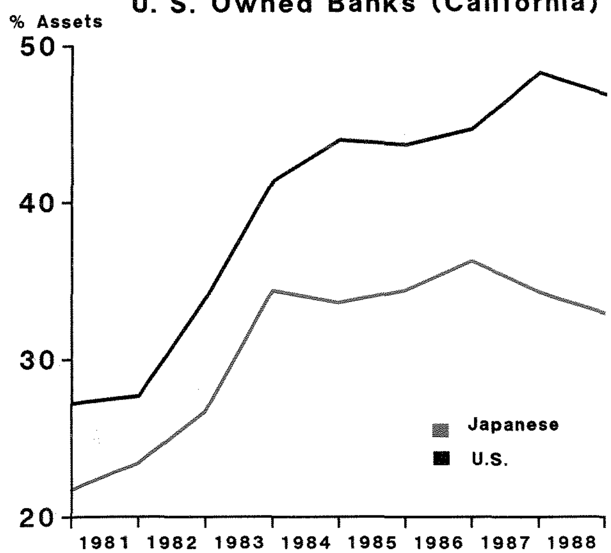


Chart 7

Consumer Time & Savings as Percentage of Total Assets Japanese Banks vs. U. S. Owned Banks (California)



Cost Structures

This greater reliance on borrowed funds potentially confers a cost advantage to Japanese-owned banks to the extent that they can borrow more cheaply than can domestically-owned banks, either because their parents in Japan are subsidizing them or because their affiliation with their highly-rated parents enables them to borrow directly at a lower cost. In the aggregate, the small proportion of parent funding probably dilutes any potential advantage significantly. Still, these portfolio measures do not rule out the possibility that a "small" advantage might exist.

We cannot rule out the possibility of a funding advantage from the portfolio data. However, if parent banks were willing to "subsidize" their California subsidiary banks,

Table 3
Cost of Funds Estimates for 1988

Dependent Variable:	Cost of Interest-Bearing Funds	
Independent Variable	**Parameter Estimate**	**Standard Error**
Intercept	0.06170***	0.00076
Assets (millions of $)	−0.00487	0.00310
Japanese-owned	−0.00314	0.00453
Other foreign-owned	0.00548*	0.00293
1 Year Growth Rate	0.00002	0.00002
Number of Branches	0.00006	0.00010
Equity Capital (mil. $)	0.06743*	0.03563
Number of Observations	360	
Adjusted R-squared	0.0113	
F Value	1.687	
Probability>F	0.1231	
Dependent Variable:	**Cost of Other Borrowing**	
Independent Variable	**Parameter Estimate**	**Standard Error**
Intercept	0.08011***	0.00996
Assets (millions of $)	−0.01417	0.01474
Japanese-owned	0.01225	0.03229
Other foreign-owned	−0.00013	0.02250
1 Year Growth Rate	−0.00010	0.00056
Number of Branches	0.00035	0.00049
Equity Capital (mil. $)	0.17513	0.17103
Number of Observations	69	
Adjusted R-squared	−0.0593	
F Value	0.356	
Probability>F	0.9035	

*** *Significant at the 1 percent level.*
* *Significant at the 10 percent level.*

we would expect Japanese-owned banks to have a lower cost of funds than their competitors.

Thus, it is useful to compare Japanese-owned and domestically-owned banks' average cost of funds for two categories of liabilities. The overall average costs of interest-bearing funds and of other borrowings were estimated using cross-sectional OLSQ regressions for 1988 to control for other factors that might influence banks' cost of funds, such as size, number of branches, equity capital, and growth over the past year. The results, presented in Table 3, show no significant difference between Japanese-owned banks and domestic banks in either the overall cost of interest-bearing funds or the cost of other borrowings (which includes the subsidiary banks' borrowing from parents). These results tend to refute the argument that Japanese banks have a funding advantage over domestic banks as a result of their ability to rely on low cost funding from their parents.

Related to potential funding advantages, it could be argued that Japanese banks have advantages arising from differential capital standards between Japan and the U.S. However, recent agreements on international capital standards for banks should eliminate or reduce any potential differences across countries.[23]

IV. How Will Japanese-Owned Banks Fare in the Future?

If the Japanese banks have an obvious competitive advantage in California, it is in the area of providing trade-related and commercial banking services. In this market they can provide services that are tailored to the needs of Japanese multinational business firms in California. Japanese banks' knowledge of Japan's markets, customs, and operations likely is superior to that of their other California competitors.

Using this advantage, the assets of Japanese-owned banks, agencies, and branches have grown from under 11 percent of the California total in 1982 to over one-quarter of the state's banking assets and over thirty percent of commercial loans at year-end 1988.

Japanese-owned banks especially have grown rapidly during this period. Acquisitions of other foreign banks accounted for a large part of that growth. Prospects for future acquisitions may be reduced somewhat by the limited number of "independent" medium-sized banks in the State as well as the opening of banking in California to institutions headquartered anywhere in the country. Japanese-owned commercial banks thus may find more competition for acquisitions after 1991. Thus, they also may find it difficult to continue increasing their market share at the rapid pace of the last six years.

A slowdown in trade with Japan or direct Japanese investment also could reduce the demand for the services of Japanese-owned banking institutions and limit their growth. And they will always be limited by the reality that trade-related lending is only a small portion of the State's total banking business.

Over time, a move in the retail direction could minimize these limitations. It also would tend to minimize portfolio differences with domestic banks, if other factors remained constant. However, unlike financing trade and the activities of foreign firms, there is no compelling evidence that Japanese commercial banks have an advantage in providing retail banking services in California.

Nonetheless, Japanese banks in California, as distinct from the agencies and branches, have demonstrated an interest in the "traditional retail banking field." A recent *American Banker* review of Japanese banking in the State suggests that the Japanese banks in California have broadened their customer bases over time, expanding their provision of banking services to include a wider segment of the market than just trade or the Japanese community.[24] Moreover, the article suggests that many Japanese banks are planning to extend their retail and middle market commercial lending business.

Japanese-owned commercial banks already have a significant investment in the "bricks and mortar" necessary for a retail banking presence in the State. Over the last five years, the number of branches has grown, although not as fast as assets. Japanese-owned banks had 424 branches in December 1988, up from 247 in 1982. Their expanded branch network gives them a "delivery system" for retail deposit services as well as for real estate lending, consumer finance, middle market commercial lending, and even agricultural lending.

This progression from trade finance to provision of banking services for the domestic market *per se* is not unusual. Terrell noted such a trend in his 1979 article, finding that it is consistent with Caves' theoretical framework concerning foreign investment.

Thus, to remain competitive in the State in the future, Japanese banks increasingly will need to compete directly with the large domestic banks. And their future, like that of their competitors, will be greatly influenced by the State's economic conditions and international economic developments.

California, and the U.S. generally, are obviously important markets to Japanese banks. It should be noted that the opportunity to increase their size and market share has come about as the result of acquisitions of other foreign-owned banks disillusioned with their retail banking experience in the Golden State. Despite the "warning" provided by the departing British, the Japanese banks have made a sizable long-term commitment to the California banking market, and they are likely to be an important factor in its future. Moreover, to the extent that trade and direct investment remain at high levels, the Japanese banks will have a base for operations that the British apparently lacked.

Appendix

The dependent variables in Tables 1 and 2 are the individual asset or liability categories as a percentage of assets. The regressions are estimated across banks, controlling for ownership by using dummy variables for Japanese ownership and for other foreign ownership. Two other control variables and an error term also are included in the model. The model appears robust, in that similar results are generated by adding a control variable for bank growth over the prior year and by dropping the size and branch control variables altogether.

Asset size is included as a control variable because banks in the State range from very large multinationals to very small local banks, and size may affect their asset and liability composition. For example, only large banks are likely to be able to borrow directly in the money markets or to be involved in major corporate financing. Furthermore, differences in the size mix also may be important across ownership groups, especially since the Japanese subsidiary banks are relatively large compared to most domestic banks.

The number of branches for each bank is also included as a control variable because of possible portfolio differences arising from branch structure. California is a statewide branching state, and the State's 442 banks operate around 5,000 offices. These branch networks generate retail deposits and retail lending opportunities and considerable overhead expenses. Different branching patterns between the ownership groups could account for some of the variation between groups, especially in terms of access to retail deposits and retail lending.

NOTES

1. Principal Accounts of Overseas Branches of Japanese Banks, at year-end, 1981 through 1987. *Japan Financial Statistics,* Federation of Bankers Associations of Japan, 1989, page 26.

2. Includes total foreign and domestic assets of Japanese-owned banks, subsidiary banks, agencies, and branches (including Edge Act Corporations). Year-end 1988 data from the December 31, 1988, Call Report.

3. Year-end 1988 Call Report data for California banks.

4. Japanese banks have made a significant financial commitment to penetrating the California market. Together, Bank of Tokyo, Mitsubishi, and Sanwa have invested upwards of $1.3 billion in California acquisitions. California First (owned by Bank of Tokyo) paid $750 million to acquire Union Bank in October 1988. Sanwa Bank of California paid $263 million to acquire Lloyds Bank California in 1986. Mitsubishi paid $242.5 million to acquire BanCal Tri-State Corp. in 1984. *American Banker,* 6-20-84, 1-20-87, and 7-20-88.

5. As of 12-31-88, Mitsui Manufacturers Bank ranked twelfth in the State with $1.6 billion in assets and Tokai Bank of California, with $939 million in assets, ranked twentieth. Tokai had ranked tenth through much of 1988. Two other banks are subsidiaries of Japanese banks, Dai-Ichi Kangyo Bank, $353 million in assets at year-end 1988, and Kyowa Bank of California, $114 million in assets. American Pacific State Bank, $165 million in assets, and Los Angeles National Bank, $60 million in assets, are also Japanese-owned, but are not owned by banks.

6. International Banking Facility (IBF) assets, which are limited to transactions with foreign residents, account for nearly half of the total foreign agency and branch assets nationally. See *Federal Reserve Bulletin,* Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks, June 30, 1988, page A78.

7. For example, see Richard W. Wright and Gunter A. Pauli's *The Second Wave: Japan's Global Assault on Financial services,* St. Martin's Press, New York, 1987, page 1.

8. See footnote 2 for the market definition.

9. The market share of the non-Japanese foreign-owned banking institutions fell from 20.1 percent in 1982 to 6.5 percent at year-end 1988, primarily as a result of the British retreat from California. British banks controlled about 15 percent of the assets of banking institutions in the State at the beginning of the period.

10. Terrell's (1979) study analyzes international banking on a bilateral basis. He examines the growth of foreign branch and subsidiary activities of both Japanese and American banks in the context of foreign investment. Data for these countries lend themselves to comparisons of banking and trade in local markets because most of the banking activities of these two countries are primarily either for the local market or are trade related.

11. Terrell's interpretation of Caves' basic assumption.

12. See Terrell, (1979), page 18.

13. See Terrell, (1979), page 26.

14. This process, in fact, closely parallels the expansion of U.S. banks overseas a generation earlier, when U.S. multinational firms were experiencing rapid overseas growth. See Terrell (1979).

15. Source: Commerce Department. *Foreign Trade Statistics Report: Waterborne Trade,* year-end totals. Imports: Report SM305, Exports: Report SM705.

16. From "Japan's Expanding U.S. Manufacturing Presence: 1987 Update," *JEI Report,* Japan Economic Institute, December 16, 1988, page 3.

17. Total assets of Japanese-owned banks, agencies and branches in the U.S. increased by 216.0 percent over the period from 1982 to 1988. The increase in New York was 226.3 percent. In California, the increase was only 170.1 percent.

18. Testimony presented at a Special Joint Hearing on Foreign Investment in California: Banking and Real Estate, California Legislature, January 25, 1989.

19. SLCs are essentially financial guarantees sold by large, creditworthy banks. Commercial and industrial loans provide a potentially cleaner measure of market share than assets because interbank transactions may bias assets upwards and inflate market shares.

20. For example, of the ten largest SLC-issuing Japanese-owned agencies in California in May 1988, eight held Moody's best rating, Aaa, for long-term and senior debt. The two remaining Japanese-owned agencies had third highest ratings of Aa2. In contrast, of the top four domestic banks in the State in May 1988, none had the highest rating. One had the next highest, Aa1, two had the third highest, Aa2, and the fourth had a rating of Baa2. *Moody's Credit Opinions,* Moody's Investors Service, New York, May 1988.

21. Source: Federal Reserve Bank of San Francisco, BHC Reports, December 31, 1987. Y-8 Report.

22. 1987 data were used because the late-1988 acquisition of Union Bank (British-owned) by Japanese-owned California First Bank may have distorted the "Japanese" bank portfolio. Union Bank's assets were equal to nearly one quarter of all Japanese bank assets at the time the merger took place, and to the extent that Union's portfolio was determined by the former British owners, portfolio measures would tend to reflect British ownership rather than Japanese ownership.

23. Also, all banks chartered in the U.S., including foreign subsidiary banks, are subject to U.S. capital standards.

24. *American Banker,* "Japanese Banks Tackle California Middle Market," September 10, 1987, and "Bank of Tokyo Targets California's Middle Market," February 19, 1988.

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