‘Scale’, ‘Scope’ & ‘Skill’
– The Conditions for Success in Japan’s Banking Mega-Mergers

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1. The trend toward ever bigger financial institutions

1) A sign of changing times – “bigger is better?”

Following the August 20th 1999 merger announcement of Fuji Bank, Dai-ichi Kangyo Bank and IBJ, on October 7th Tokai and Asahi banks announced they were to set up a joint holding company. One week later, on October 14th, Sumitomo Bank and Sakura Bank announced they had agreed on a comprehensive alliance that would pave the way to a full merger. Then again, 2 days later, Mitsui Fire & Marine, Nippon Fire and Marine and Koa Fire and Marine announced they were to merge operations. Three years after the Japanese government announced the “Big Bang” set of financial deregulation measures in November 1996, these financial sector “mega-mergers” look set to entirely change the financial landscape of Japan.

The most important development is the emphasis on business “size.” Though anyone can point out that bigger is not necessarily better, on further examination it seems that now the pure size of an enterprise is more important than it has ever been before. In our view, the two major factors that have brought this about are firstly the increasing selectivity among clients coupled with a concentration of business in a smaller number of financial companies, and secondly the increasing role of IT.

(1) Clients demanding higher standards and concentrating business in fewer hands

The first important development has been the way clients of financial institutions are now demanding higher standards, and are entrusting their business to a smaller number of institutions. To spell it out more clearly - the old “convoy system” where all financial institutions were protected by the government and offered customers exactly the same product has been replaced by one where institutions can innovate and compete on price and quality of service. Therefore, in this new market place, winners and losers can emerge. Customers obviously want to place their business with the winners. If, as before, clients did not care who handled their business, they might see their money disappear as one of the losers collapses. This shift in mindset is also to some extent behind the current unwinding of cross-shareholdings.

Some individual customers are also beginning to consider moving their accounts to safer institutions as the deposit insurance limit is about to be re-imposed. Moreover, with the changes now affecting the asset management industry such as a new emphasis on fiduciary

responsibility and the debate on “management structure”, pension funds are choosing their asset managers much more carefully than before, and in turn the asset managers are choosing their execution brokers more carefully. In addition to this increased selectivity, the clients of financial institutions are also completely reviewing their business relationships and concentrating their business in a fewer number of institutions. This is happening across all financial sectors – banks, securities houses and asset managers, and in order to be one of the chosen, it helps if the financial institution has size on its side. Companies are therefore merging in order to boost their chances of keeping or attracting business.

Individual investors’ motives for choosing to place their business with any bank or broker is also very much tied in with the institution’s size. As we can see in Table 1, there are 3 main reasons for choosing any particular firm. Firstly convenience – that there is a branch or ATM nearby. Secondly, that the company is financially sound, and thirdly that there is a nation-wide network of branches. These 3 reasons are far and away the most important for any individual customer. In other words, if a firm cannot fulfil these 3 conditions, its chances of attracting business are significantly lowered. Important to note here is that many individuals consider a nation-wide network of branches to be important – a convenient local service is no longer enough. This naturally makes size an important issue.

Table 1 Important criteria in choosing a financial institution for individual investors

Criterion	%
Convenience of having a branch or ATM nearby	73.8
Sound management / financial health	39.0
A nation-wide branch network	26.9
Enthusiastic sales-person	9.1
Provision of extensive financial advice	4.6
Financial products are more profitable	4.0
Wider range of financial products available	3.4
Influence of TV commercial, posters, branded goods etc.	1.0
Other	11.0

Note: Respondents could choose up to 3 criteria; figures show %-age of households choosing any particular criteria

Source: The Central Council for Savings Information, “Savings and Consumption Opinion Survey, 1998”

(2) The rise in importance of IT

The other factor underlying the growth in importance of “size” is the increasingly important role of IT in the provision of financial services, to the extent that it is redefining how these services are being performed. In terms of delivery, with Internet and call centre technologies, or in terms of marketing, driven by customer database analysis, now the level of service a financial institution can provide depends heavily on its IT resources.

In wholesale financial services, buy-side and sell-side institutions are now aiming to implement STP (Straight Through Processing) technologies in order to form a joint securities trading network and boost their operating efficiency. That the value of financial intermediary services now depend heavily on the level of STP that a financial firm has

achieved is testament to IT's central role in any financial institution. Though it has risen in importance recently as customers seek to minimize total trade execution cost, and with the recent heightened interest in best execution by pension funds, it is set to become much more important with the August 1999 announcement of the bond market issues subcommittee of the ruling LDP party urging reform of the settlement system to bring the settlement cycle down to T+1 sometime during fiscal 2002.

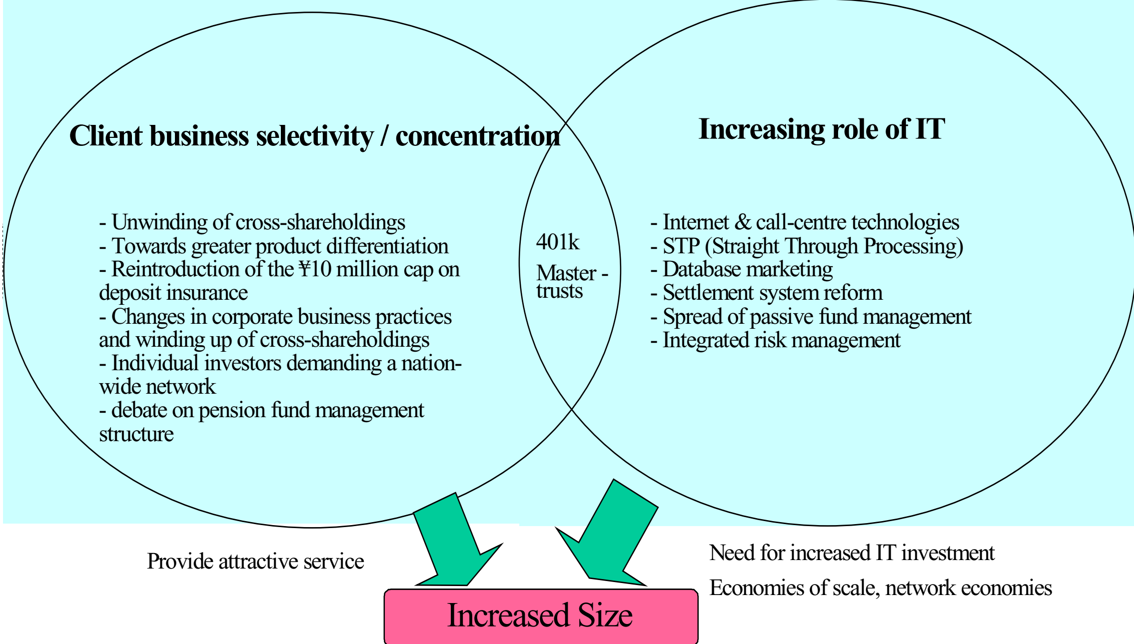
Japan should also see passive fund management and active quantitative fund management growing in importance, as happened in the U.S. Since these are only made possible by the ability to number crunch huge amounts of data, it is turning the industry into one driven by machine (computer) power, where a small number of large players are able to take a lion's share of the market.

Risk management is also rising rapidly in importance across the entire range of financial service sectors - banking, securities, insurance and fund management. This is exemplified by integrated risk management structures generally termed "Enterprise Risk Management", which have also been made possible by the advent of large amounts of computer power.

As the IT side of financial services becomes more important, so therefore does the amount a firm can invest in IT. Consequently, size also becomes a great deal more significant, as IT calls for a large amount of investment in fixed assets. Therefore economies of scale apply. Furthermore, recent IT technology is network-based, and the value of the network increases the more people are connected to it – i.e. "network externalities" apply. As a result, the larger the number of customers and greater the size of the business, the stronger you become.

Figure 1 shows the interplay between these two factors underlying the increase in size of financial institutions – greater client selectivity, concentration of business, and the greater dependence on IT. In addition Figure 1 also shows how the appearance of 401k style pensions and master trusts have also worked to reinforce both these trends.

Figure 1 The attraction of size for Japan's financial institutions



Source: NRI

2) The attraction of size for financial institutions

Above we examined the two factors working to increase the size of players in the financial sector in Japan, while in fact this is a global phenomenon. The attraction is often explained in the following way[1]:

- increased company size results in a lower expense ratio.
- increased capital results in greater competitiveness in capital intensive business areas, such as underwriting.
- a merger presents a company with the opportunity to rid itself of existing inefficiencies
- increased brand recognition
- greater market influence
- greater chance of being regarded as "too big to fail"

The economies of scale argument is often justified in this way, though there are few examples of quantitative analysis that clearly confirm its occurrence in the real world. The prevailing view however is that the increasing importance of business size will become clearer alongside further developments in IT and as markets expand (e.g. EU integration) and become more global. In fact, the economies of scale argument has been confirmed in the only recent real-life study, of the Bank of America merger in the early 1990s. This is commonly regarded as having been facilitated by developments in IT and by the deregulatory measures enacted regarding inter-state banking[2].

Alongside the economies of scale argument there is sometimes mention of "economies of scope." This is explained in the following way:

- Where products share the same fixed costs, increasing the number of products results in cost efficiencies.
- Cross-selling effects.
- Risk diversification through being engaged in several business areas.

However real-life examples showing the existence of economies of scope are also hard to find. The appearance of comprehensive financial services companies in the U.S. was a temporary 1980s phenomenon, with the cross-sector alliances between Sears and Dean Witter, GE and Kidder Peabody, and the securities business of Citibank not regarded generally as great successes.

The issue of business scope has recently threatened to become more significant however. Firstly, this is due to the hugely increased dependence on IT in the financial services. It has become easier to deliver a number of different products and services, or expand into other areas, based on a common IT infrastructure. This can be seen in the use of a common customer database in marketing across different product areas, important in terms of boosting

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1 J. Dermine "The Economics of Bank Mergers in the European Union, A Review of the Public Policy Issues," mimeo, May 1999.

2 A. Berger and L. Mester, "Inside the Black Box: What Explains Differences in the Inefficiencies of Financial Institutions?," Journal of Banking and Finance, 1997

a company's competitiveness. One point, where it differs from economies of scale, is the effect of an increase in brand recognition. Financial companies are no longer passive suppliers or drainers of liquidity, but are becoming more and more consumer-oriented where effective marketing and brand image are all-important. Network delivery of services is one core trend in finance, and the existence of a powerful brand image enables the selling of many other services over this common network. E*Trade is a classic example of this model - starting as an internet brokerage, it then went on to sell many other types of financial services via its internet site.

Another factor making scope economies more significant is changes in the nature of the financial market itself, and the breakdown of the traditional divide between banking and stock-broking. There are a growing number of business areas which straddle both broking and banking sectors, such as the securitization of bank loans. A company engaged in such activities is not just expanding into other business areas, but rather it is redefining the borders of financial business. The division of financial services into banking, securities and insurance sectors itself is a human construct, so as the environment changes, naturally certain players can form a business portfolio that extends across previously incompatible business sectors.

The important element here is how a company views the purpose of its products. In the case of retail financial product sales for instance, banking, securities and insurance products seem obviously to be complementary. However, as with the one-stop shopping idea that does not seem to have been a tear-away success in the U.S., while on the surface different products may seem to be fulfilling a similar function, this does not mean to say that strengths in one type of product will necessarily rub off on others. Financial companies need therefore to take a careful approach when it comes to evaluating product purposes as against their own strengths.

One-stop shopping, in the case of a convenience store having a range of products available in one location, obviously has its attractions. Such products generally require little or no explanation from the shop staff, however. In the case of financial services, this sales environment works as long as the products are standardized and consumers are comfortable with them. In which case there should be plenty of room to pursue economies of scope, crossing traditional business categories. Where a product requires specialist advice however the customer will need to go and see that specialist. They will not simply choose one provider because of convenience of location.

What is happening in the Japanese financial industry is not a simple hankering for size as a good in itself, but is also often aimed at bringing together different product areas and services. Bank mergers combining trust bank, securities, insurance and other services are not simply a way to increase the size of the business, but are also aiming at pushing economies of scope to their limit.

2. New Methods Of Cultivating Human Expertise Are Required

1) The Human Face of Banking vs. Technology

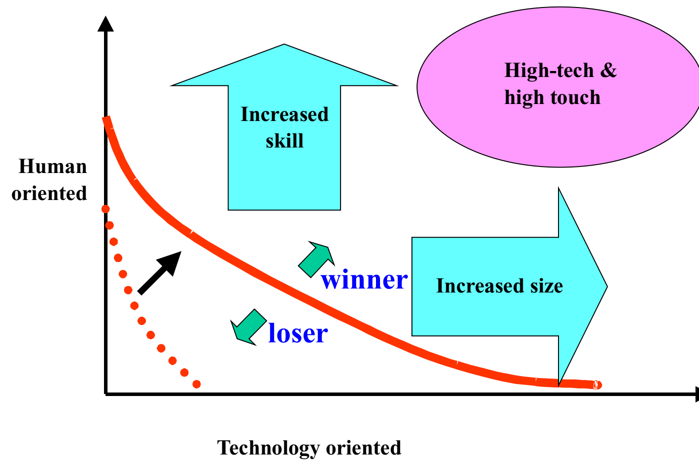
In the preceding section we explained how the size of a firm has now become a decisive factor in financial services, and emphasized the potential growing importance of business scope. Naturally however, while these economies of scale and scope may exist in theory, whether they can actually be realized is down to the company itself. Previous bank mergers have thrown up all sorts of problems, and the question facing the current merger hopefuls is whether they can learn from others' experiences.

The challenge facing Japan's banks is not simply to successfully complete their merger or business alliances, however. In the face of financial deregulation and the non-performing loans problem, they have to fundamentally change the way they are run. The decision to merge or otherwise integrate operations indicates that the banks are prepared to take radical steps to change, but there is no automatic guarantee that these will lead to the required management reforms. These companies need to adapt to a changed environment. Quite apart from the effects of increased size, the question of how to manage the human "skill" (expertise) resources of the company is of major importance.

Figure 2 shows a simplified representation of the inter-relationship between "scale" (size of business) and "skill." Broadly separating the business of a financial institution into technology oriented business and human oriented business, as explained before, where business is more technology oriented, size becomes an important factor. On the other hand, "skill" becomes more important where the business is human oriented. A certain level of skill and size is required for a financial company to be a market winner, and since these two elements have both grown in importance this is represented by the winner-loser border line in Figure 2 shifting to the right. A financial institution which is underdeveloped both in terms of technological and human expertise will find it difficult to survive. However since technology will become more important in the future, the winner-loser line in Figure 2 leans more heavily to the right to indicate the greater business size or scale required.

The rise of internet banking and on-line brokers heralds an age where financial companies can be based purely around the strength of their technology. There are also niche players however that rely purely on their human expertise. Nevertheless, for a company to succeed as a provider of comprehensive financial services it would have to be located to the upper right of Figure 2 – i.e. to be both "high-tech" and "high-touch".

Figure 2 The relationship between Skill and Size



Source: NRI

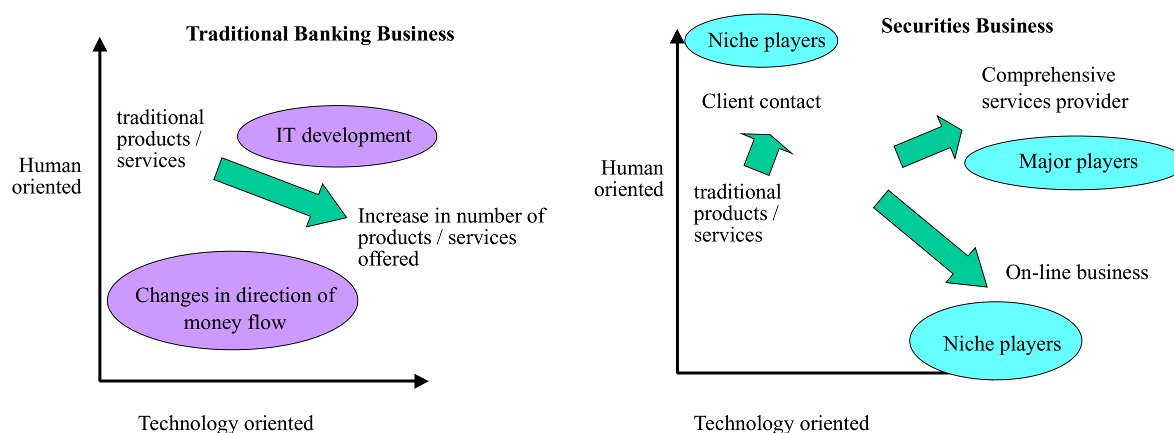
2) The different reform vectors in banking and securities sectors

(1) Technology's rising importance in the banking sector

This relationship between business scale and scope is different for each industry type. While all facets of banking business relied originally entirely on the exercise of human expertise, now technology is fast replacing the human role in all these areas. Retail banking transactions are a perfect example. Automation of the credit scoring process for obtaining bank loans is becoming one of the most important technology applications.

As money flows shift from being bank-centric to a greater reliance on securities markets, banks are diverting human resources away from traditional banking to the securities side of their operations in order to achieve efficiencies, while traditional banking business is becoming more and more automated. Securities related services are also moving away from being the traditional sales only approach to one where the provider takes on more of an advisory role. On-line brokers on the other hand are a contrasting example of a trend towards complete reliance on technology. Major financial institutions will therefore have to achieve high levels of competence in both human expertise and technology if they want to be successful. While reform is now an imperative in both banking and securities businesses, Japan's banks and securities houses must make use of technology to reduce their reliance on human resources in traditional banking in particular so that these same resources can be freed up and employed more usefully elsewhere.

Figure 3 Comparison of reform vectors in banking and securities sectors



Source: NRI

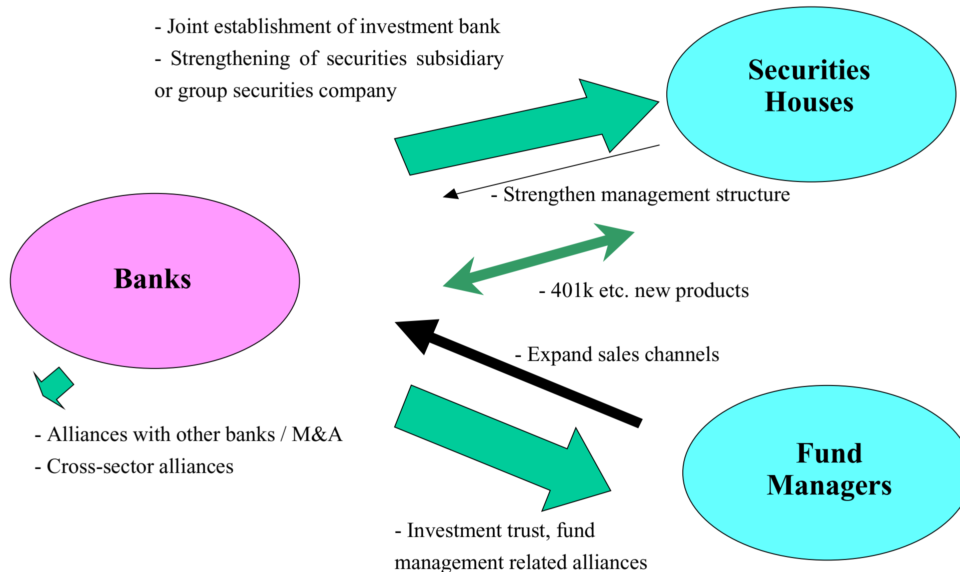
(2) Banks are and will continue to be the main instigators of financial sector reform

The recent financial sector alliances have highlighted the different ways in which business reform is related to technology and human resources. Money is flowing out of the banks and into the securities markets, while those areas of operations that remain the domain of traditional banks are becoming more technology oriented. It is therefore the traditional banks that have the greatest need to implement business reforms.

In response, banks are now both trying to recapture the business they have seen escape to the securities markets, while at the same time investing in better IT systems. The need for banks to acquire securities market expertise is leading them into alliances with securities houses and fund management firms. They are also tempted to merge with other banks in order to pursue economies of scale. Securities houses on the other hand have not been so eager to jump into bed with the banks - unless the bank is bailing them out, or they are trying to cover some area of weakness. Bank bail-outs of securities houses are likely to become less necessary as the economy and securities markets pick up however, and therefore banks are likely to continue to be the main instigators of financial sector reform.

Of course it is not just banks who are facing this demand for new skills - the same can be said for all financial sector companies. The balance between human expertise and technology is also shifting - Figure 5 shows how traditional financial institutions will have to raise their human expertise and technology levels in order to succeed as a new type of financial services provider, whether in alliance with other firms or going it alone. It is not just banks, but all financial sector companies, traditional securities brokers, asset management firms and insurers included, who will need to face this huge change in the role of human resources and technology. Companies will then have to choose how this restructuring will be achieved - via the "new Japan-style management model" (as touted by Toyota chairman H. Okuda and Fujitsu's president N. Akikusa) avoiding workforce reductions, or along European / U.S. lines involving drastic cuts.

Figure 4 Restructuring and the relationships between financial sector firms

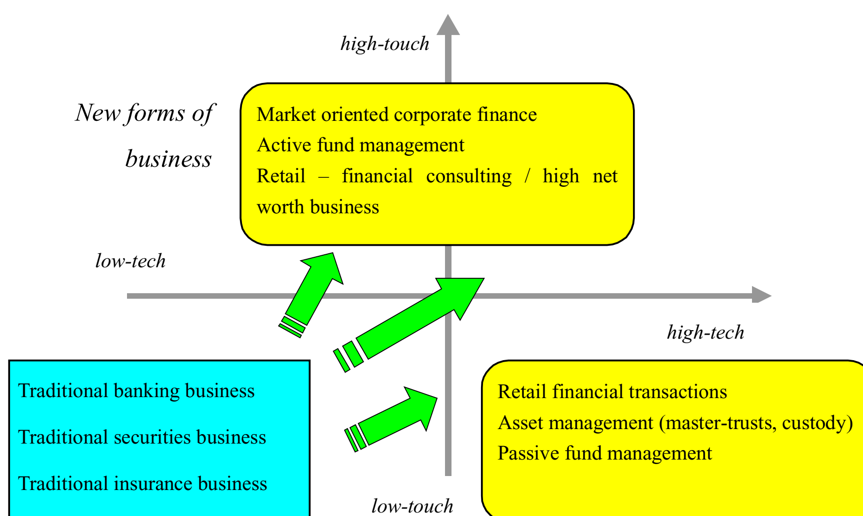


Source: NRI

The main instigators of this new phase of financial restructuring, the banks, have all already announced plans to cut their workforces and seem at last to be breaking free from traditional Japanese management practices. However, needless to say, the crux will be in the details of their plans for reform, whether in terms of their development of human-based expertise, or in an emphasis on IT systems in a pursuit of scale economies.

The following section will concentrate on what reforms, in our view, are required in the banking sector.

Figure 5 Development of new financial products and services



Source: NRI

3. Structural problems afflicting the Japanese financial system and banking institutions

In order to consider the question of reform, first we should identify the problems with the current system. While there are many theories put forward as to where the problems lie with Japan's banking sector, the debate generally centres around 3 major issues: “overbanking”, low profit margins, and a weak capital base.

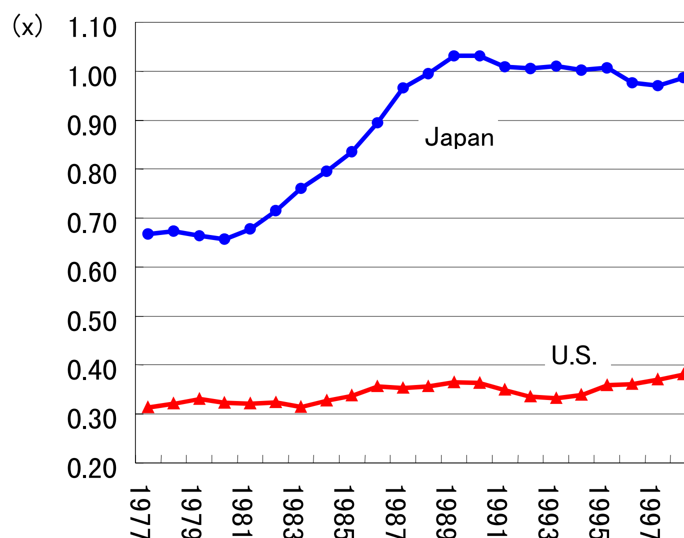
1) Overbanking

The problem of "overbanking," a disproportionate reliance on bank originated credit, has been pointed out by many observers as the trouble at the heart of the Japanese banking system. Figure 6 compares the total loan balance of the U.S. and Japan against their respective GDP. That Japan's banks lent as much as ¥200 trillion to the 3 main sectors of non-banks, construction and real estate companies at the time of the bubble economy in the early 1980s, is often criticised as being the cause of the subsequent non-performing loans crisis.

There is a widely held belief that in order to solve this problem of overbanking, Japan needs to reduce the number of its banking institutions. According to Takeo Hoshi and A. Kashyap (1999)[3], the banking sector needs to be cut by some 30% - 40%, or some 70 banks in total. However, in order for Japan to build a healthy capital market, we also need to concentrate on questions of "quality" rather than quantity, namely the roles played by Japan’s different banking institutions, and to understand why this situation arose. Unless the lessons of the past are fully digested it is not possible to chart the way forward to a properly functioning banking system, nor is it possible to determine the new business model required. This new business model has to take the place of the now defunct "convoy" system, whereby the government shepherded the stronger and weaker banks alike and kept them all afloat in return for accepting a large amount of bureaucratic interference. The former banking model brought about a serious neglect of risk management, as the banking system itself took on a huge amount of credit risk backed by the large unrealized gains held in the stock market and in real-estate during the asset price bubble.

3 Takeo Hoshi, Anil Kashyap, "The Japanese Banking Crisis: Where did it come from and How will it end?" (July 1999, NBER)

Figure 6　U.S. / Japan bank lending as a proportion of GDP



Source:　NRI, based on the Bank of Japan financial statistics monthly report

2) Low profit margins

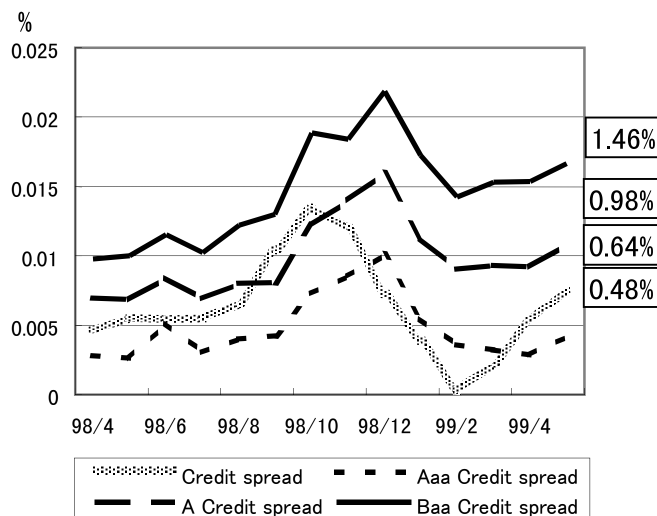
The old convoy system hurt the banking sector because the resulting excessive competition distorted the price setting mechanism - the interest charged by banks for credit.　Credit risk was not properly reflected in the interest rates banks charged, and low margin lending became the norm.　This practice has to be rooted out if Japan is to stand any chance at creating a new business model for its banking sector.

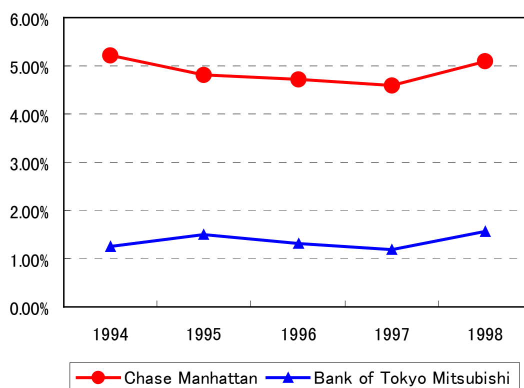
Figure 7[4] shows the credit spread on bank lending in Japan (calculated as the difference between the interest rate on new loans and the 10-year JGB yield).　When seen against the spread on rated (Moody's) corporate bonds (the difference between the yield on corporate bonds of a given credit rating and a 10-year JGB), the current bank credit spread equates to a bond midway between an Aaa-rated and an A-rated issuer.　Considering that Japanese banks' lending portolios are mostly made up of loans to un-rated or Baa class borrowers, an average credit spread of 0.64% is absurdly low.　In this way the overcrowded banking market and ensuing excessive competition has brought about a pricing structure that bears little relation to credit risk, and thus normalized a pattern of low returns on loan assets (Figure 7 - right hand graph).

The pressing need to increase profitability will force Japanese banks to base loan interest rates on an assessment of borrower risk.　The credit spreads shown in the left-hand graph of Figure 7 will need to diversify in accordance with credit risk, and at the same time the overall rate level will have to rise.

4　Figures used are for 10-year JGB and rated corporate bonds.　Since the current average loan period is 3 - 4 years we had some reservations on their application as an indicator of 10-year rates. However, with an average statistical debt repayment capacity of over 10 years, it is normal practice for most Japanese corporates to roll-over such loans, so we believe these figures give as good an indication as can be found.

Figure 7　Japan / U.S. credit spreads on bank loans and total return (as a proportion of total assets)





Source:　NRI, based on the Bank of Japan financial statistics monthly report

3) Weak capital base

A further structural problem lies in the capital under-funding of Japan's banking institutions. The left-hand graph of Figure 8 shows that Japan's main 17 banks have concentrated on disposing of their non-performing loans, while the right-hand graph shows how unrealized gains on securities holdings have started to rise, while the proportion of capital provided by public funds in the form of government purchases of preferred stock has increased. As a result, now fully 67% (average of all city banks plus the Industrial Bank of Japan) of their core Tier 1 capital is in the form of preferred stock (close to a form of debt), and deferred taxes (which is a form of advance receipt of profits)[5].

However pressure from the capital markets, in the form of provision of shareholder value, is now growing, and boosting ROE is becoming the highest management priority. Further,

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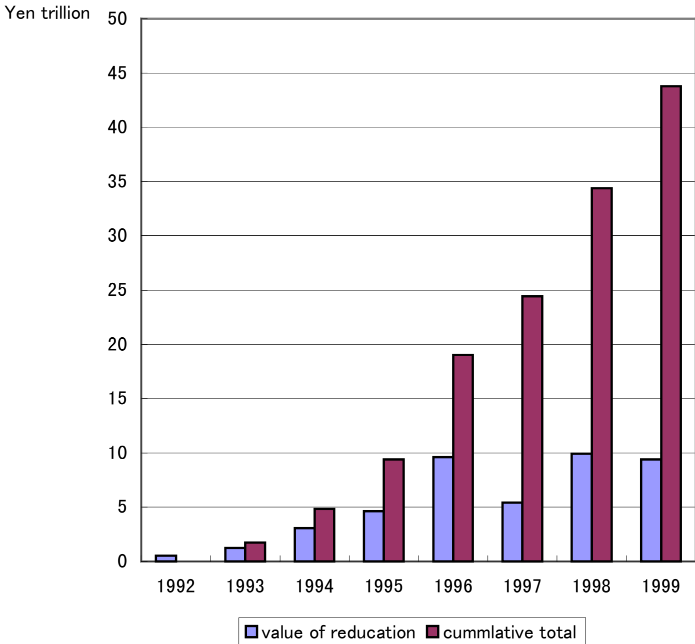
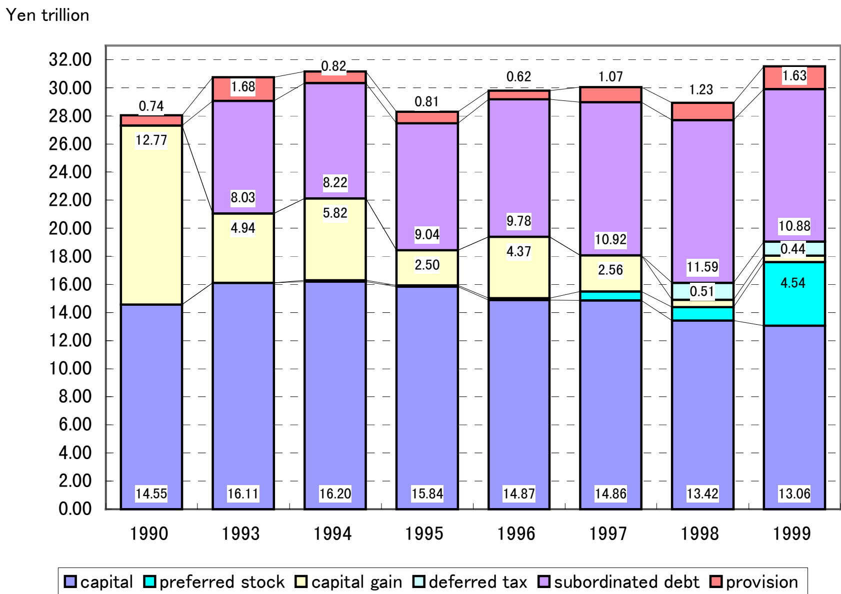
5　S&P "Japan's Banking Industry," 1999

the issue of capital management is also becoming an urgent international concern, as evidenced by the BIS' call for public comment regarding a revision to their regulations on capital adequacy[6].

Figure 8 Disposal of non-performing assets at Japan's 17 major banks (per financial year and cumulative total), and changes in the composition of capital





Source: NRI,from bank annual reports and the Japanese Federation of Bankers Associations "Analysis of Japanese financial statements"

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6 S. Iimura, "Moves to Revise the BIS Capital Adequacy Ratio Regulations," in the Capital Markets Quarterly, summer 1999

4) Risk, Returns and Capital

In short, we could say that the traditional Japanese banking model neglected both risk - return analysis, capital management, and a loan pricing mechanism. A new business model for Japan's banks needs to be based on the strong inter-connection between risk, return and capital - it must have risk management at its very core.

4. Towards the development of a new business model

1) A paradigm shift

The current American banking revival, occurring against the backdrop of an expanding market economy and the revolution in IT technology of the 1980s to '90s, has resulted in a move away from the traditional banking model to one of indirect financing via the capital markets as U.S. banks have proceeded to specialize in their own areas of banking expertise. Recent regroupings in the financial sector are evidence of a new stage where U.S. banks are globally "rebundling" their specialized financial services as a consequence of their focused business strategies. Their continued growth and acquisition of ever greater financial expertise has given birth to financial conglomerates and comprehensive financial services providers boasting highly competitive business portfolios (Figure 9). Japanese banks however are facing this shift to a financial system based on indirect financing via the capital markets, increased specialization and sector-wide consolidation all at once. This paradigm shift is represented in Table 2.

Table 2 Paradigm Shift

	Previous business model	Current problems	New business model
● Main Bank System	Client growth = bank growth	Risk of over-exposure to a single borrower	Diversified risk,
● Cross-shareholding	Strong inter-business relationships,unrealized gains on equity holdings	Risk of price fluctuation, decline in profitability	Strategic unwinding of cross-shareholding and emphasis on profitability
● Lending business Wholesale Medium Retail	Unprofitable, but strengthens relationship Very profitable but demanding on resources Very profitable but demanding on resources	Devoting same amount of resources to all 3 areas, so potential profits are not realized. No reason to focus on any one area	Developments in IT and risk management allow to specialize in certain areas, to cultivate human expertise while also pursuing business size
● Collateral basis	Unrealized profits, enables increase in business volume	Poor assessment of creditworthiness risk of fall in collateral value	Emphasis on cashflow and non-recourse lending
● Customer base / returns	Non-strategic, volume hungry business expansion, stability in income	Cannot determine where most profitable business lies	Segmentation and business focus become key issues
● Attitude to risk	Risk averse	Difficult to change attitude	Ensure profits in accordance with risk taken
● Organization / Decision-making	Share risk of any decision among group	Slow, unclear where responsibility lies	Emphasis on speed and transparency
● Branch network	Low-cost customer recruitment	Customer recruitment and branch operation now high-cost	Costs falling as sales / service distribution channels diversify (telephone, PC etc.)
● Culture	Attitude that persistence and hard work will be able to conquer anything	Young people no longer receptive to traditional Japanese notions of self sacrifice	Objectivity, quantitative and risk-return based analysis

Source: NRI

2) Changing business processes

Now at last Japanese banks are taking their first tentative steps towards implementing a new business model. According to one major bank, under the previous regime there was no clear insight into which area of lending was the most profitable - the wholesale market (loans to companies with over ¥10 billion in turnover), the medium-size market (turnover of ¥5 - ¥10 billion), or small businesses (under ¥5 billion). The reason was, as an examination of the cost structure of their lending business shows, that there was in inverse relationship between the commitment of human resources and returns on lending. Though they were spending fully half of their time on the business of arranging loans to small businesses, the returns on this business were extremely low as a proportion of total returns, certainly bearing no relation to the actual time invested. Previously Japan's banks were happy to jump at business in an ad-hoc fashion that they, without any proper analysis, thought to be profitable, and then to expand the volume of this business as much as possible.

Now, in order to rectify the high cost structure of this business model, they intend to set up a new credit approval process through the use of a "credit scoring model" that automates the process of approving loans. This will reduce the time required for loan approval from the previous 1 week to between 1 to 3 days, thereby achieving the important twin goals of cutting costs and increasing the level of service provided to its customers. This credit checking process, by being objective and consistent, will result in reduced risks and allow the bank to realize those profits on small business lending that have previously eluded them, while simultaneously freeing up human resources that can be more profitably devoted to lending to medium-size companies.

Thus Japan's banks are at last waking up to the urgent need to develop a more focused business strategy based on objective credit risk management, and making full use of their IT resources. In the retail sector they are also planning to expand the range of financial products offered beyond simple bank deposit accounts to investment trusts, equity investment and insurance products (from 2001), in an effort to create a one-stop shopping type environment. PC-based internet banking[7] services will take over basic services such as making transfers and balance enquiries, while administrative services such as ATM maintenance will be outsourced. Advances in IT are revolutionising the way retail banking services are delivered and their cost structure.

IT is the one essential element in any new business model. DKB-Fuji-IBJ is planning on an annual ¥150 billion investment in IT to totally revamp its own business processes, which will be spent on improving its risk management procedures, building client databases, developing new sales and delivery channels and the development of CMS technology.

Despite these welcome developments, critics point out the business portfolios of Japan's banks are not undergoing similar drastic changes because the banks themselves have not traversed the same dynamic process of product specialization that occurred in the U.S. While changes to business processes can bring about a certain amount of cost reduction under current business structures, it will not go far. In order for Japan's banks to bring about the much greater cost reductions that are required of them, they have to radically restructure their business portfolios. The key to the success of the DKB-Fuji-IBJ alliance hangs on the speed

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7 S. Iimura, “Focus on Internet Banking Strategies,” Capital Markets Quarterly, autumn 1999

with which they can integrate their current dissimilar business structures and services, which is bound to demand a great deal of resources.

3) Restructuring around a focused business portfolio

One criticism often leveled against the restructuring moves being taken in Japan's financial sector is the seeming reliance on natural attrition. The Japanese banks themselves do not deny that their restructuring plans amount to little more than this. Downsizing itself, however, through workforce and branch network reductions, is not effective if it does not simultaneously challenge the old business structures where banks continue to offer the whole range of services without being particularly expert in any of them. Downsizing and restructuring will only be effective if it is accompanied by a focused business strategy. Any new business model for Japan's banks must be based around a more focused business portfolio accompanied by LBO / MBO / EBO or other financial restructuring.[8]

If the success of the DKB-Fuji-IBJ alliance hinges on building a competitive business portfolio as mentioned before, then first there needs to be wholesale organizational restructuring and the development of a focused business strategy. This equally applies to all other future attempts at restructuring in the financial sector.

A report by the BIS (Figure 10) points out that between the late 1980s to early 1990s, despite an average decline in net revenues at Japan's banks, they actually increased the size of their branch networks and workforce. That a decline in profitability was not automatically accompanied by downsizing was due to the peculiarity of the Japanese traditional employment system and its emphasis on long-term employment.[9] That this may have lengthened and worsened the financial crisis in Japan is a stark reminder of the disadvantages of the traditional Japanese business model which neglected corporate governance[10] and was therefore unable to react quickly to changing circumstances. In order for restructuring to have any real meaning in terms of creating a new business model, rather than simply downsizing, Japan's banks will have to restructure both at an organizational and business level in accordance with a focused business strategy, with the final aim of building competitive business portfolios.

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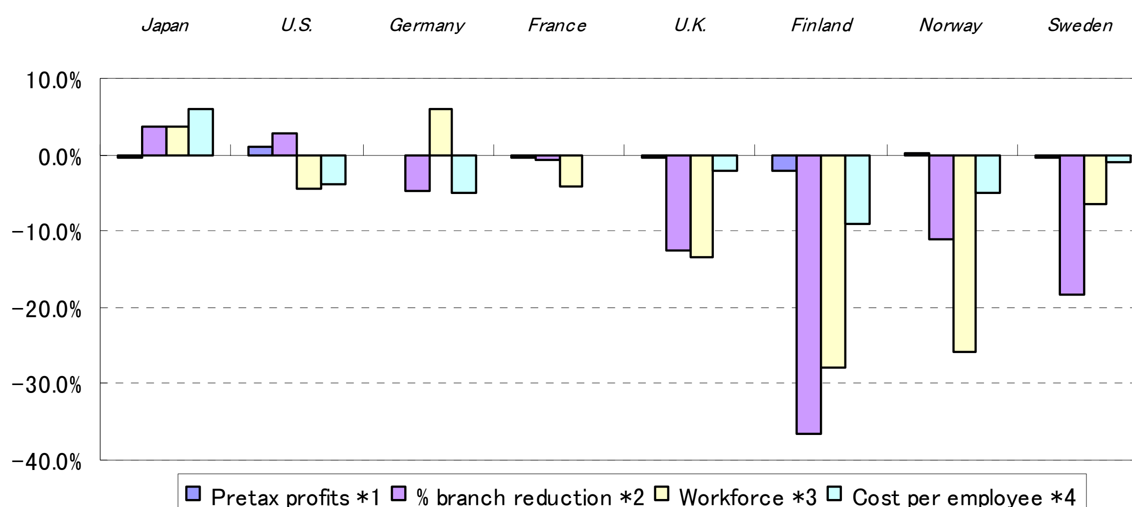
8 N. Suzuki, in the Nihon Keizai Shimbun, 30th August 1999, where he introduces the joint research of Bowman economists critical of the process of downsizing and its high regard as a method of improving profitability and efficiency.

9 A. Horiuchi, M.Hanazaki in "Economy Management Research," Vol.19-1, Development Bank of Japan Capital Investment Research Institute, argues that downsizing and restructuring in the financial industry is less advanced than that of the manufacturing industry.

10 The Basle Committee on Banking Regulation and Supervisory Practices, in a report entitled "Enhancing Corporate Governance in Banking Organizations," emphasized the role of corporate governance in the practice of sound bank management.

Figure 10 World-wide comparison of restructuring measures (late 1990s – early 1990s)



Note *1 Difference between 1986-88 and 1992-94 average values
*2 Overall % growth / reduction in branches 1990-95
*3 Change in total workforce 1990-94
*4 As proportion of total income (difference between 1986-88 average and 1992-94 average)
Source: NRI, from the BIS 66th annual report

5. Japan's Banks and the Economy

The banking sector mergers and alliances announced over the past year have clearly shown themselves to be either attempts at rescuing ailing affiliated institutions or at expanding business activities in the wake of financial sector deregulation, and not forward-looking attempts at restructuring. The DKB-Fuji-IBJ alliance at last seems to herald recognition of the need to construct a new business model based on a revitalization of their financial services through a thorough revamp of their operations. This is just the beginning however, and still far from the level reached in Europe and the U.S. where restructuring at already highly competitive banks has resulted in cross-border mergers acquisitions and the creation of international financial conglomerates. While there is still the possibility that Japanese banks may be absorbed into a global conglomerate, it is unlikely that they will be the leading force behind their formation.

Certainly with the Mitsubishi 4 company grouping, the alliance between the Sumitomo & Daiwa securities groups and the Sanwa 6-company alliance there is a growing trend toward formation of joint holding companies. Generally, not all financial institutions are strong in every field. Rather what is important for the Japanese economy as a whole is that each bank pursues competitive advantage through development of a focused business strategy. As a result, the structure of the whole financial system should change, with top tier banks becoming "international money-centre banks," while middle to lower tier banks and regional banks act mainly as domestic commercial banks specializing in a particular region or product area. These money-centre banks in particular need to have much better access to capital markets than they have at present. If not, then this will obstruct the healthy flow of capital abroad, and Japan's overall economic efficiency will not improve.

The DKB-Fuji-IBJ grouping and other top tier city banks that are likely candidates as money-centre banks should take the lead in this specialization process, trimming their assets via securitization and liquidity enhancement to shift these assets down to the middle and lower banking tiers. If the internationally active money-centre banks are to be more involved in the international capital markets they need to take on “arranger” roles such as lead managing syndicated loans, rather than increasing assets.[11]

The middle and lower tier banks meanwhile need to specialize in domestic commercial banking, and act as “institutional investors” by purchasing securities originating in loans made by the money-centre banks. In this way they can help to clear up the domestic loan situation. Of course they do not have to be limited to the middle to lower tier and regional banking roles – they may also opt for becoming national first tier banks by expansion (merger / acquisition), or via a comprehensive internet banking strategy.

The more specialized banking system structure that will result out of this new age of competition should pay off in terms of providing better risk management and better direct access to the financial markets. A determined shift to a more focused business strategy should thereby create a system with more highly differentiated banking services. With economic recovery underway it is easy to forget the crisis of only a few months ago. However, unless Japanese banks can focus on their own areas of banking specialization, creating their own business franchise and business model, they will not turn out as winners from financial sector deregulation.

The financial restructuring set to succeed this recent wave of bank mega-mergers, reflecting as it will the focused strategies of the individual institutions involved is a vital issue as regards the effective financing of the Japanese economy in the 21st century.

11 c.f. S. Iimura, “Liquidity Enhancement and Securitization of Loan Assets and Disposition of Bad Loans,” Capital Research Journal, Spring 1999, for a detailed examination of this subject.