The Latest Wave of Consolidation in Japan's Financial Sector

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On 8th August 1999 Dai-ichi Kangyo Bank, Fuji Bank and the Industrial Bank of Japan decided to form a comprehensive banking alliance. This was followed by announcements in October that Tokai Bank and Asahi Bank were to join together under a holding company structure, and that Sumitomo Bank and Sakura Bank had agreed on a comprehensive tie-up to pave the way to a possible full-scale merger. This report examines this new wave of restructuring sweeping the Japanese financial industry centering on its largest banking institutions.

1. Three Restructuring Models

1) Model 1: Dai-ichi Kangyo Bank, Fuji Bank, Industrial Bank of Japan - A holding company structure organized around specific banking functions

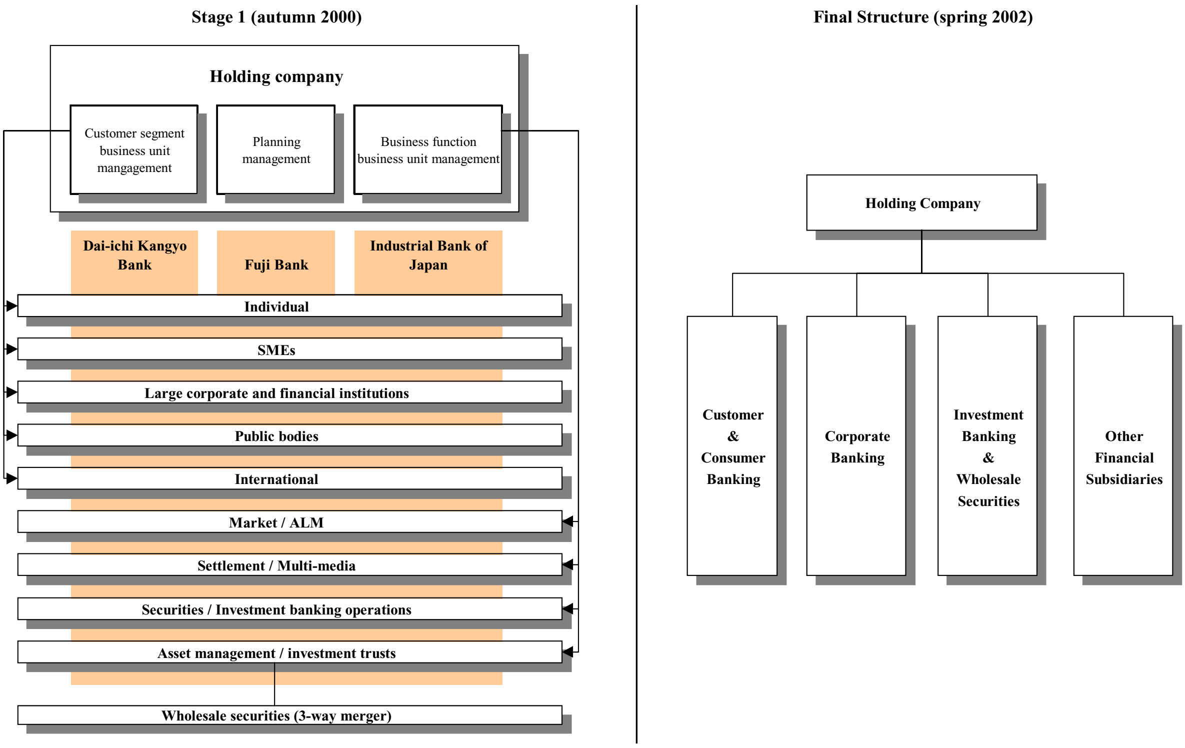
On the 20th August 1999 Dai-ichi Kangyo Bank, Fuji Bank and the Industrial Bank of Japan agreed to a 3-way alliance aimed at projecting them into the "top-tier" of global financial institutions, as a new and leading Japanese comprehensive financial services group. The agreement envisaged the following:

- Initial stage: A joint holding company will be set up in autumn 2000 of which the 3 banks would become subsidiaries. The whole business will then be reorganized in the form of horizontal business units working across the banks focusing on specific client segment / and or functions.
- Securities subsidiaries: The wholesale securities subsidiaries DKB Securities, Fuji Securities and IBJ Securities would be initially merged.
- Final structure (targeted for spring 2002): Utilizing the expected legislative and tax code changes for corporate splits in Japan, the existing operations of each bank will be completely reorganized according to customer segment and consolidated into legally separated subsidiaries under the holding company. The merged securities subsidiary will be converted into a direct subsidiary of the holding company, and will take over the investment banking operations held by the banking subsidiaries.

The final outcome would leave 3 separate business operations – retail, corporate, and investment banking – operating as separate banks under the holding company according to a business model based around banking function (Figure 1).

The banks also announced plans for restructuring their operations. These planned for reducing the number of branches by 150, downsizing the workforce by 6,000, and reducing operating expenses by ¥100 billion, to be achieved by 2005, 5 years after the holding company is set up (Figure 1). In addition, the new grouping would integrate business departments and IT systems as quickly as possible to reduce costs, while total annual investments of approximately ¥150 billion would be made in strategically important IT areas. According to the announcement, the implementation of these measures would enable the new group to achieve annual net operating profits of over ¥1 trillion (Figure 2).

Figure 1 Proposed structure of the DKB-Fuji-IBJ comprehensive alliance



Source: Company press releases

2) Model 2: Tokai Bank, Asahi Bank – regional and functional focus under a holding company structure

Tokai Bank and Asahi Bank announced on October 7th 1999 their agreement to set up a joint holding company in October 2000. The consolidation of the two banks would create a final entity with around ¥60 trillion in assets, pushing Sanwa bank into 4th place in terms of size in Japan (as at October 21st 1999).

Tokai and Asahi had already agreed in September 1998, at a time of growing unease regarding the health of Japan's financial institutions, to a 2-stage plan to implement a strategic alliance. Negotiations had therefore been ongoing for around a year before the October announcement. Originally the first stage called for: (1) an equity capital alliance and pooling of business resources; (2) plans for establishing a multi-regional bank; (3) the disposal of non-performing loans. The second stage, targeted for FY02 – FY03, called for: (1) the establishment of a multi-regional bank, and (2) further alliances with other strong regional banking institutions. The October announcement for the setting up of a holding company was in effect simply bringing forward the second stage of the original plan to October 2000.

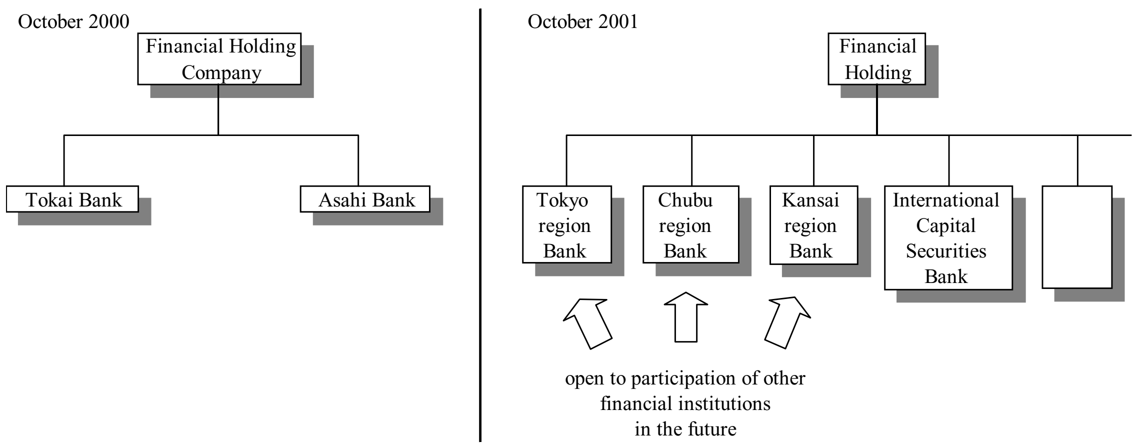
The plan targets October 2000 for the setting up of a holding company "Tokai-Asahi" via a stock transfer or swap, of which Tokai and Asahi Banks would become wholly-owned subsidiaries. The intended stock swap ratio is 1:1 (though the final allocation ratio is to be determined taking into consideration an assessment by independent third parties).

Further, assuming that a legal system is in place for splitting companies and a consolidation based tax system is implemented, by October 2001 the wholly owned subsidiaries are to be reorganized into 4 companies from the perspective of regional and functional focus, namely, 3 regional bank subsidiaries based on the 3 major economic regions of Japan, and 1 product subsidiary, within which structure the autonomy of each regional bank would be respected (Figure 2).

It also invited participation from a wide range of strong regional banks and financial institutions from other business sectors, with an aim to creating a new financial group based around cross-regional and cross-sector alliances targeting SMEs (small and medium-sized enterprises) and individuals.

While the holding company structure is also a feature of the previous DKB-Fuji-IBJ model, the setting up of 3 regional subsidiaries and 1 product subsidiary is what differentiates the Tokai-Asahi alliance. For them, to set up as a multi-regional bank and expand the alliance to encompass other strong regional banks is probably the only course of action left open if they want to survive, as many regional banks with no recourse to the public purse have already embarked on systems integration and broad-based alliances. In order for them to appeal to the powerful regional financial institutions with firmly rooted local business franchises there was also a pressing need to create an attractive business model into which they could fit in.

Figure 2 Proposed structure of the Tokai-Asahi alliance



Source: NRI, from company press releases

The banks also intend to speed up the pace of restructuring measures outlined in their respective "business revitalization" plans (Table 1). The number of branches to be cut has been raised by 87, and as a result of these measures plus expense cuts and cost-savings from integration of IT systems, they are targeting ¥450 billion in net operating profits in the year to March 2003 (a 35% increase over end March 1999) (Table 2).

3) Model 3: Sumitomo Bank & Sakura Bank – a full scale merger

On October 14th 1999 Sumitomo Bank and Sakura Bank announced a comprehensive business alliance premised on a full future integration of the two banks. In order to keep up with a rapidly changing financial environment and to maximize their business potential, they announced plans to: (1) form a capital alliance; (2) exchange personnel; (3) consolidate business units; (4) merge subsidiaries and affiliates; (5) integrate back office and computer systems; (6) unify HR and risk management policies and other infrastructure. These central elements of their plan for a comprehensive alliance were to be achieved in the following way:

- Capital alliance
  Within FY99 both banks are to engage in cross-holding of issued shares (details to be disclosed at a later date).
- Improve capabilities in providing products and services
  Cooperation between business units, with the following examples:

  1) Retail Banking
  - Joint efforts in developing internet banking and other such programs
  - Integration of ATM networks
  - Joint development of products targeting retail customers (investment trusts, consumer loans)

  2) Corporate Banking
  - Mutual sharing of credit scoring data
  - Joint development of a corporate CMS (cash management service)
  - Development and promotion of loan products and solutions for SMEs

  3) International Banking
  - Joint development of a global CMS
  - Unified strategy for the Asian market
  - Joint pursuit of financing arrangement deals

  4) Investment Banking
  - Cooperation and consolidation of investment banking operations

Further, in order to enhance the effectiveness of their IT investments, they announced the intention to unify their management and operational infrastructures, and cooperate in: (1) research to enhance management systems through the adoption of quantifiable profitability targets and other measures based on cost-of-capital considerations; (2) research to enhance risk management and the integration of their credit risk databases; (3) research and development aimed at systems integration; (4) unification of self-assessment etc. standards; (5) unification of back office operations and development of a joint branch network strategy.

Additionally the following management targets were set as the responsibility of each bank to be achieved in time for the merger to go ahead in April 2002:

- Implementation of restructuring plans as detailed in the "Plan for the Strengthening of the Financial Base of the Bank" to be brought forward. These included the completion by March 2002, one year ahead of schedule, of a workforce reduction of 6,300 personnel, 151 domestic and 32 overseas branches (from those existing as at March 1998, Table 1).

- Resolution of problem assets: commitment to a final resolution of asset quality problems by March 2002, to bring associated credit costs within an annual ¥200 billion post-merger.
- Sales of cross-shareholdings

Both banks also agreed to additional restructuring measures to be implemented after the merger, which would reduce the total workforce by a further 3,000 personnel by consolidating overlapping branch offices and streamlining head office operations. As a result, the total workforce reduction to be achieved by March 2004 would be 9,300 (as against March 1998). The merger ratio is to be further discussed, and while it is to be based primarily on stock price it will be finally decided at the same time as the form of integration is determined.

Sumitomo Bank president Yoshifumi Nishikawa, in a press interview, gave his reasons for the decision to choose over a holding company structure saying that "…as our clients range from large corporations to small and medium-sized companies and individuals, it is very difficult to start drawing lines on how the company should be divided. Therefore we thought a single entity was the best option…Mergers have the disadvantage of making management decision-making slower, which is something we will have to fight to avoid. We will have to resolve the issues of problem assets before the merger takes place." This showed how he was keeping in check any expectations of achieving restructuring through the merger itself, and his strong belief that the merger would not be a success unless restructuring had first taken place. It also highlighted the differences between U.S. style corporate management and the way things have traditionally been done in Japan.

Table 1 Restructuring measures envisaged in Sumitomo and Sakura's "business revitalization" plans

	DKB	Fuji	IBJ	DKB-Fiji-IBJ	Sumitomo	Sakura	Sumitomo-Sakura	Tokai	Asahi	Tokai-Asahi	Sanwa	Daiwa
Target workforce size (2003/3) (units: people)	13,200	13,000	4,482	30,682	13,000	13,200	26,200	9,731	9,500	19,231	11,400	6,300
Reduction (against 98/3)	-3,765	-1,615	-489	-5,869	-2,111	-4,220	-6,331	-1,676	-3,188	-4,864	-2,295	-1,791
Reduction rate	-22.2%	-11.1%	-9.8%	-16.1%	-14.0%	-24.2%	-19.5%	-14.7%	-25.1%	-20.2%	-16.8%	-22.1%
Target expenses (2003/3) (units: ¥ billion)	339	334	142	815	320	367	686	212	248	460	325	155
Reduction in personnel expenses (03/3)	-316	-210	-63	-589	-132	-435	-567	-227	-127	-354	-258	-187
Reduction rate	-18.6%	-13.2%	-8.5%	-14.6%	-8.2%	-22.2%	-15.9%	-19.3%	-10.6%	-14.9%	-17.0%	-26.3%
Reduction in non-personnel expenses (against 98/3)	4.6	5.4	-5.3	4.7	-19.0	10.1	-8.9	1.2	14.2	15.4	20.5	-4.0
Reduction rate	2.3%	2.8%	-6.7%	1.0%	-9.9%	4.9%	-2.3%	1.0%	11.2%	6.4%	11.5%	-3.8%
Target no. of branches (2003/3) (units: branches)	290	262	24	576	265	319	584	208	328	536	310	150
Reduction in no. of domestic branches (against 98/3)	-50	-28	-4	-82	-40	-111	-151	-25	-25	-50	-49	-24
Reduction rate	-14.7%	-9.7%	-14.3%	-12.5%	-13.1%	-25.8%	-20.5%	-10.7%	-7.1%	-8.5%	-13.6%	-13.8%
Reduction in no. of overseas branches (against 98/3)	-9	-10	-8	-27	-22	-10	-32	-7	-7	-14	-6	-6
Reduction rate	-36.0%	-40.0%	-36.4%	-37.5%	-59.5%	-43.5%	-53.5%	-43.8%	-58.3%	-50.0%	-24.0%	-100.0%

Source: NRI, from business revitalization plans as announced by each bank

Table 2　Profit forecasts included in the business revitalization plans

DKB-Fuji-IBJ (Units:¥bn)

		99/3	00/3E	01/3E	02/3E	03/3E	% chg on 99/3
Gross operating profits		1,789.4	1,648.3	1,745.5	1,840.8	1,904.4	6.4%
	Interest income	1,339.3	1,268.6	1,358.0	1,432.2	1,473.0	10.0%
	Fees & commissions	182.2	179.3	195.6	223.8	246.0	35.0%
	Other	222.9	181.9	170.5	160.2	157.8	-29.2%
Net operating profits before additions to general reserves		879.3	742.3	869.4	975.9	1,042.3	18.5%
Recurring profits		-1,545.3	305.7	421.9	670.8	804.5	—
Net profits		-964.8	181.8	246.1	406.9	468.3	—

Tokai-Asahi (Units:¥bn)

		99/3	00/3E	01/3E	02/3E	03/3E	% chg on 99/3
Gross operating profits		825.0	802.5	829.9	859.9	895.0	8.5%
	Interest income	665.6	684.4	712.9	748.2	780.8	17.3%
	Fees & commissions	71.7	70.3	69.3	69.8	69.8	-2.6%
	Other	73.7	29.0	24.9	17.7	18.2	-75.3%
Net operating profits before additions to general reserves		332.9	303.5	341.5	372.5	409.5	23.0%
Recurring profits		-746.7	119.5	127.5	238.5	275.5	—
Net profits		-405.7	71.1	75.8	141.6	163.7	—

Sumitomo-Sakura (Units:¥bn)

		99/3	00/3E	01/3E	02/3E	03/3E	% chg on 99/3
Gross operating profits		1,449.5	1,388.6	1,420.2	1,454.7	1,490.1	2.8%
	Interest income	1,174.6	1,195.2	1,212.1	1,235.0	1,260.0	7.3%
	Fees & commissions	114.7	135.3	143.1	151.5	159.2	38.8%
	Other	112.8	25.6	31.9	34.7	36.9	-67.3%
Net operating profits before additions to general reserves		670.5	619.5	693.0	736.1	763.2	13.8%
Recurring profits		-1,495.2	293.3	393.0	460.1	487.2	—
Net profits		-749.4	150.7	210.9	262.6	264.9	—

Source:　NRI, from the business revitalization plans as announced by each bank

2.　Japan's Rapidly Changing Market Structure

1) Position in the global financial league

If things go to plan, the 3-way alliance of DKB, Fuji and IBJ will create a group with total assets worth around ¥153 trillion (on a consolidated basis), while the Sumitomo - Sakura merger will create an entity with ¥99 trillion worth in assets, vaulting these organizations into the world No. 1 and 2 positions ahead of Deutsche Bank (Table 3). In terms of market capitalization and capital they will also rank in the top 5.

Table 3 Size ranking of the top 5 world banks

(Units:¥bn)

	Level1	Level2	Level3	Level4	Level5	Reference
Total assets	DKB-Fuji-IBJ	Sumitomo-Sakura	Deutsche+BT	Citigroup	UBS	BNP+Paribas
Amount	152,867	98,740	96,969	80,605	76,379	76,194
Gross operating profits	Citigroup	BankAmerica	HSBC	DKB-Fuji-IBJ	Deutsche+BT	Sumitomo-Sakura
Amount	4,891	3,798	2,418	2,351	2,249	1,450
Net operating profits	BankAmerica	Citigroup	HSBC	DKB-Fuji-IBJ	Chase Manhattan	Tokyo-Mitsubishi
Amount	1,539	1,449	1,091	986	877	559
Shareholders' profits	DKB-Fuji-IBJ	BankAmerica	Citigroup	Sumitomo-Sakura	HSBC	Chase Manhattan
Amount	6,140	5,538	5,054	4,070	3,303	2,874
Market capitalization	Citigroup	DKB-Fuji-IBJ	HSBC	BankAmerica	Sumitomo-Sakura	Tokyo-Mitsubishi
Amount	17,756	15,047	11,185	10,735	10,674	87,492

Note: DKB-Fuji-IBJ figures are consolidated basis, and include Yasuda Trust; Exchange rates as at end 99/3 used

Source: NRI, from company supplied information and "The Banker"

2) Positioning in the Japanese market

In terms of size of domestic operations, the DKB-Fuji-IBJ grouping and Sumitomo - Sakura alliance will have by far the lion's share of the market:- as at March 1999 out of a total ¥272 trillion in loan assets (total of DKB-Fuji-IBJ, Sumitomo - Sakura, Bank of Tokyo - Mitsubishi, Tokai-Asahi and Daiwa), DKB-Fuji-IBJ (31.6%) and Sumitomo - Sakura (24.3%) combined accounted for over 50% of the total. Also out of a total of ¥42.3 trillion in housing loans, the main retail financial market in Japan, Sumitomo - Sakura accounted for 27.1% and DKB-Fuji-IBJ 25.3%. In loans to SMEs, which will probably become the most important market for banks in Japan, out of a total market size of ¥153.2 trillion, again DKB-Fuji-IBJ (with 28.6%) and Sumitomo - Sakura (with 26.5%) together will have an overwhelming market presence and be in a position to set price benchmarks (Figure 3). In terms of large corporate customers, while there are 722 large companies who have either DKB, Fuji or IBJ as their main bank (against the 466 of Sumitomo - Sakura), in the SME market Sumitomo - Sakura is stronger with 40,400 customers (against the 33,000 of DKB-Fuji-IBJ). Further DKB-Fuji-IBJ have 31.0%, Sumitomo - Sakura 25.7% and Tokai-Asahi 13.3% of the total ¥63.7 trillion in lending by all city banks plus IBJ to the 3 main industrial sectors (construction, real-estate and financial).

A comparison of total funding as evidenced in deposits (plus bank debentures) and Certificates of Deposit, shows that DKB-Fuji-IBJ (with 32.0%) and Sumitomo - Sakura (with 22.2%) together have over 50% of the total ¥297 trillion of city banks plus IBJ (Table 4), while DKB-Fuji-IBJ alone have 17.0% of the total (¥559 trillion) of all Japanese banks. However, in terms of their retail network, Sumitomo - Sakura would have a total of 808 branches and other outlets (plus a total of 7,963 ATMs and CDs), against the 714 of DKB-Fuji-IBJ.

Through their alliance with Daiwa Securities, Sumitomo - Sakura will be in a position to strengthen their retail and wholesale securities business. DKB-Fuji-IBJ on the other hand will be able to call on their strong relationships with industry to command a large share of the corporate bond underwriting and bond trading markets, and by boosting the equities side of their operations they will be able to compete on an equal footing with Sumitomo - Sakura (Table 4).

The DKB-Fuji-IBJ grouping would also account for a large 33.0% share of the international lending business of Japanese city banks. However this is not a very profitable market, as evidenced by the fact that most Japanese banks are basically reducing their activities in this area, which means the difference between DKB-Fuji-IBJ and other Japanese banks is not really that significant. In evaluating the strength of their international business it would instead be better to focus on banks' links with Japanese corporates having a strong overseas presence, the quantity of sovereign business they attract, their level of access to the international capital markets and their investment banking strategy.

In asset management (investment trusts, investment advice and trust business), looked on as having the greatest market growth potential, DKB-Fuji-IBJ and Sumitomo - Sakura would occupy the No. 1 & 2 positions in Japan. DKB-Fuji-IBJ for example would have top share in both pension related assets under management and securities, cash bond and real estate trusts. On the other hand Sumitomo - Sakura would be top in investment trust sales (a cumulative total of ¥469.5 billion as at September 1999, since the ban on bank sales of investment trusts was lifted in December 1998) and be No. 1 in the number of designated pension accounts.

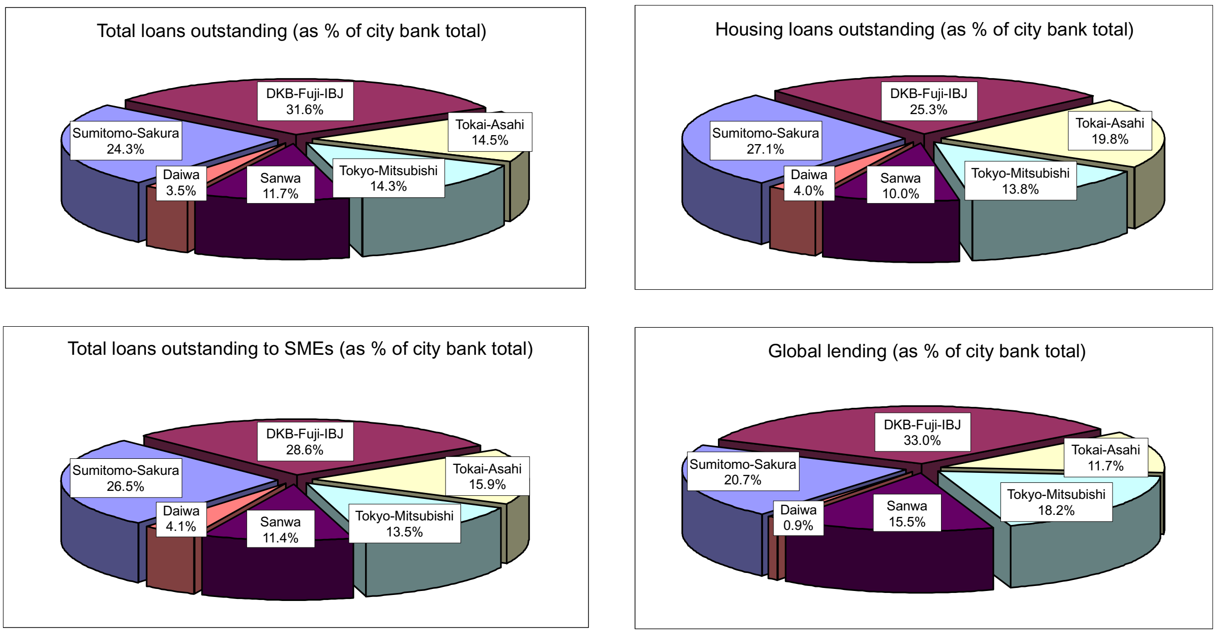
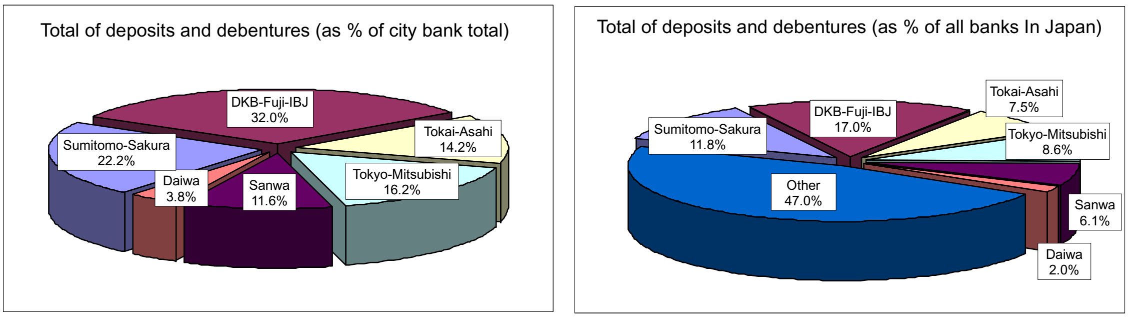


Figure 3 Relative shares of loans outstanding

Source: NRI, from company supplied materials

Figure 4 Relative shares in deposit funds



Source: NRI, from company supplied material and annual reports

Table 4 Relative market share of largest securities houses and financial groups

	Total assets	Net assets	Assets under management	Share of TSE Equities trading volume	Share of equities trading	Share of bond trading	Share of straight corporate bond trading
NOMURA SECURITIES	12,055.9	1,384.9	49,490.3	9.2%	11.486%	7.487%	24.2%
DKB-Fuji-IBJ Total	10,762.8	384.2	16,103.7	5.7%	8.555%	10.938%	21.2%
DKB-Fuji-IBJ	8,369.2	116.3	2,038.2		—	6.503%	
DKB Securities	2,011.3	43.6	—		—	2.328%	6.0%
Fuji Securities	3,083.5	—	—		—	1.776%	5.2%
IBJ Securities	3,274.4	72.7	2,038.2		—	2.399%	10.0%
Kankaku / Taito / New Japan / Wako	2,393.6	267.9	14,065.5		8.555%	4.435%	
Kankaku Securities	528.8	65.2	3,960.8		1.357%	1.225%	
Taito Securities	36.5	12.3	251.2		0.285%	0.010%	
New Japan Securities	791.4	111.6	5,904.3		3.809%	1.201%	
Wako Securities	1,036.9	8.8	3,949.2		3.104%	1.999%	
SUMITOMO-SAKURA-DAIWA Total	7,126.6	759.2	32,757.2		13.292%	8.848%	22.9%
Daiwa Securities group	4,671.3	669.1	31,159.4	9.0%	12.111%	7.589%	14.0%
Sakura-Sumitomo Capital	1,918.6	41.3	—		—	4.495%	8.9%
Sakura Securities	1,860.5	—	—		—	1.521%	5.5%
Sumitomo Capital	58.1	41.3	—		—	2.974%	3.4%
Yamatane/Shinyei-Ishino/Meiko National	276.3	48.8	1,597.8		1.181%	0.777%	
Yamatane Securities	83.3	18.0	654.8		0.407%	0.274%	
Shinyei-Ishino Securities	80.9	8.3	306.0		0.288%	0.003%	
Meiko National Securities	112.1	22.5	637.0		0.486%	0.018%	
Sumitomo Trust Securities	260.4	—	—		—	0.482%	
NIKKO SECURITIES	3,811.5	521.3	30,399.9	4.8%	6.528%	3.602%	12.4%
KOKUSAI SECURITIES	2,255.1	251.8	7,654.2	1.7%	2.976%	1.579%	
MITSUBISHI GROUP Total	9,714.6	172.8	667.6		0.599%	2.199%	5.5%
Tokyo Mitsubishi Securities	3,274.3	160.1	—		—	1.769%	5.5%
Tokyo Mitsubishi Parsonal Securities	75.5	12.7	667.6		0.599%	0.020%	
Mitsubishi Trust Securities	298.2	—	—		—	0.410%	
SANWA Total	2,850.7	166.2	4,582.2		2.496%	2.566%	2.9%
Sanwa Securities	2,251.6	49.7	—		—	0.775%	2.9%
Universal / Taiheiyo / Dai-ichi / Towa	599.1	116.5	4,582.2		2.496%	1.791%	
Universal Securities	244.1	47.5	2,053.1	0.9%	0.761%	1.289%	
Taiheiyo Securities	84.5	24.0	740.7		0.377%	0.074%	
Dai-ichi Securities	128.5	13.9	1,022.7		0.804%	0.109%	
Towa Securities	142.0	31.1	765.7		0.554%	0.319%	
TOKAI-ASAHI Total	1,186.0	47.2	1,363.1		1.326%	1.980%	
Tokai International Securities	997.8	—	—		—	1.957%	
Tokai Maruman Securities	188.2	47.2	1,363.1	1.2%	1.326%	0.023%	

Source: NRI, from company supplied material and *Nikkei Kinyu Nenpo*

3. Impact of the appearance of large financial groups, and issues raised

1) Impact

The alliances between DKB-Fuji-IBJ, Sumitomo - Sakura plus Tokai and Asahi will, in our view, also force a restructuring among Japan's regional banks, life and non-life insurers, securities houses and industry at large (Figure 5). The DKB-Fuji-IBJ and Sumitomo - Sakura alliances are also widely reckoned to be the shot in the arm that Japanese industry desperately needs.

The immediate effects will be felt by regional financial institutions. Though the DKB-Fuji-IBJ combination would already have a strong regional network, the Tokai-Asahi group plans to bring other regional banks on board. There are also planned changes in the business environment - the injection of public funds into regional institutions slated for March 2000 and the re-introduction of the cap on deposit insurance. This makes it far more likely that we will see regional banks integrating with each other and forming blocks of companies bound together by cross-shareholdings, and / or of a wholesale vertical restructuring of the industry as the larger banks try to acquire the retail networks of the powerful regional institutions. Added to this is the possible collapse of weaker financial institutions.

There have also been rumours of other alliances that cut across the old *zaibatsu* industrial group boundaries. On 16th October 1999 there were reports of an agreement between Mitsui Marine & Fire (Mitsui group), Nippon Fire & Marine and Koa Fire & Marine (Sanwa group) to create a joint holding company by March 2001, with a strong chance of Sumitomo Marine & Fire (Sumitomo) joining at a later date. That the non-life insurance industry is also mulling such restructuring quite independently of the Sumitomo - Sakura alliance indicates how far the future financial landscape may change.

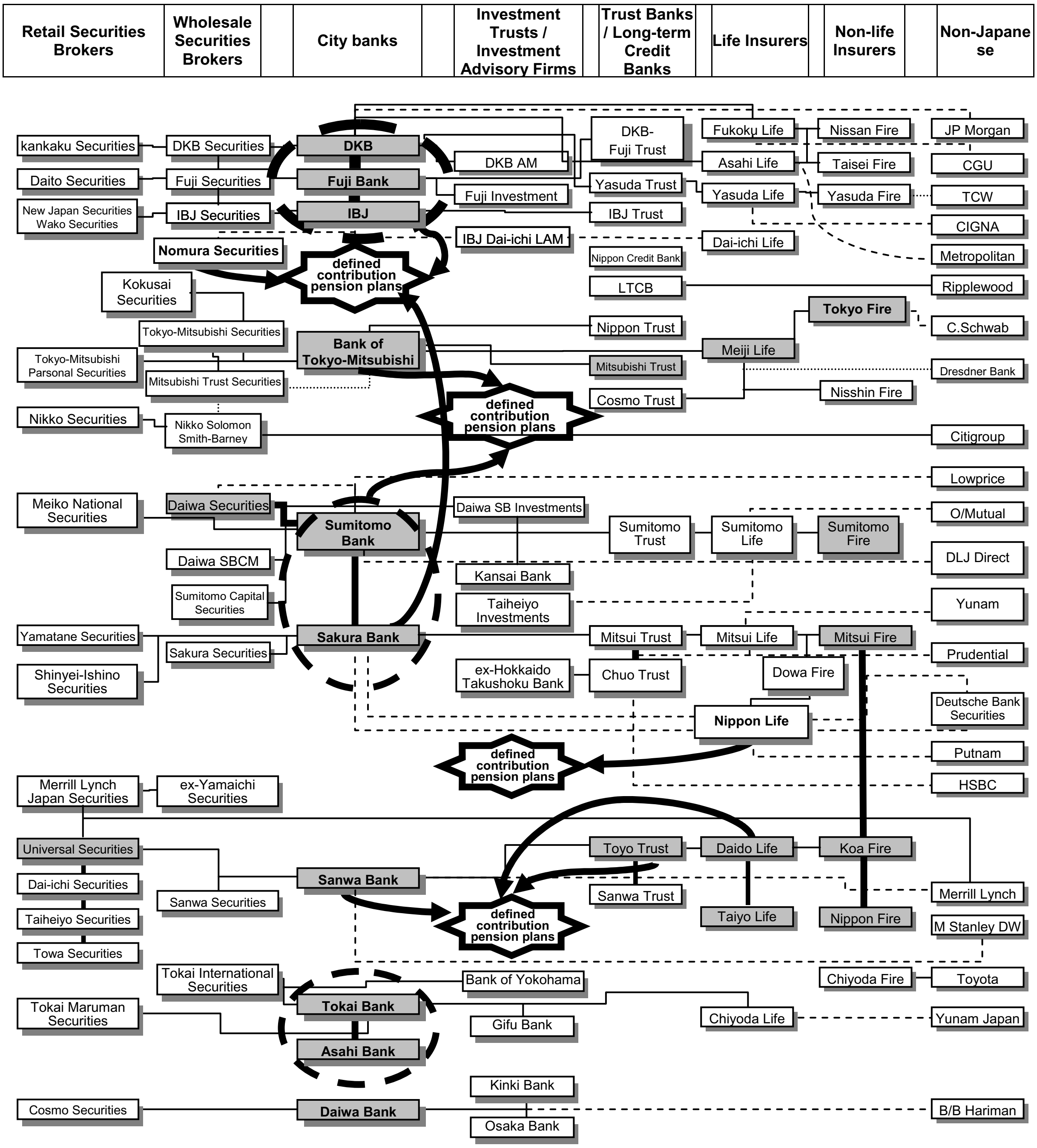
Industry commentators also expect this planned restructuring in the banking sector and among the life insurance subsidiaries of non-life insurers to accelerate restructuring within the life insurance sector as well. Certainly there are strong links between the life insurers and the major banks - the life insurers are major shareholders in the banks, and are major funders in terms of subordinated loans, while the banks supply a lot of funding to the life insurers. We can certainly see how the loyalties of the insurers will be challenged by this realignment in the banking sector. It is not a good time for cross-sector alliances however for either camp, as the life insurance companies are faced with mounting "negative spread" problems (asset returns under-performing guaranteed rates of returns on policies), while also facing the question of demututalization. Nor are the parties concerned particularly looking at other sectors. In our view, the focus of activity for the foreseeable future will be on internal restructuring within the life-insurance sector once demutualization has paved the way.

We should also be sceptical of the view that there will be any drastic short-term shake-up in the corporate lending market. Of course the banks may shift some funds around in order to reduce over-exposure to any single borrower. Also we see the new banking groups taking a stronger line on repayment from less profitable companies and perhaps raising their lending rates. However companies are moving away from a previous over-reliance on bank funding, and the main bank system itself is now dying out. In such circumstances if restructuring occurs it will naturally reinforce this shift away from reliance on a single main bank with its narrow range of funding options.

Banking restructuring should rather give companies the opportunity to review their relationships with their banks, while the banks themselves must all look to developing their own fields of specialization. In terms of the direction of "Big Bang" financial reforms, a greater number of funding channels and new types of financial markets and institutions offering new functions are prerequisites if Japan is to build a financial structure fit for the 21st century.

Whatever happens, the current feeding frenzy of alliances brought on by the DKB-Fuji-IBJ announcement may still have given rise to some tie-ups that are not followed through. In determining the financial map of the future there are plenty of other factors to consider - alliances between institutions to provide 401k type pension plans and other cross-sector alliances, or the pull of old *zaibatsu* group loyalties may well affect the outcome.

Figure 5 Japan's Changing Financial Map



2) Issues

These 3 cases of large-scale restructuring in the financial sector are generally welcomed as harbingers of a new age of financial competitiveness. There are still many issues to consider, however.

Firstly, the extent to which this will lead to improvements in profitability. Obviously if integration is going to create a stronger institution, then these banks will have to cut back on the wasteful elements of their operations. In the year to March 1999 the combined core operating ROE for the DKB-Fuji-IBJ group was 10.76%, around 1/2 of Bank of Tokyo-Mitsubishi's 20.06%, while their expense ratio of 50.86%, and Sumitomo - Sakura's 53.74%, is poor compared to the 44.07% of Bank of Tokyo-Mitsubishi and the 44.76% of Sanwa Bank (Table 5). If they plan to raise their gross operating margin by only 6.4% over March 1999 by March 2003 (Table 2), while equaling Tokyo-Mitsubishi in terms of core operating ROE, then they will have to raise their lending rates and drastically cut expenses.

As it stands now, Sumitomo will see its own indicators heading downward once it joins up with the less efficient Sakura, so the financial health of the joint bank will initially depend greatly on how far Sakura can pursue its own internal restructuring beforehand. While Sumitomo may be looking hungrily at Sakura's client list and is prepared to provide Sakura with the capital in return, if Sumitomo aims to retain current levels of profitability it will have to demand a faster pace of restructuring at Sakura.

There will also have to be reform of their entrenched high cost structures. Tokai-Asahi has an expense ratio of 59.65%, for example (Table 5). These high cost structures have been brought about by running the whole range of wholesale to retail business in the same way. Tokai-Asahi needs to commit itself to a large IT investment, and totally reengineer its business processes in order to achieve an efficient retail operation.

Secondly, will the new groups be able to make large reductions in their asset portfolios, including non-performing loans? If the current low-margin structure is not going to be ditched anytime soon, then the large asset portfolio is more of a disadvantage. As the banks find capital increasingly scarce, they will continue to be burdened by the cost of holding these non-performing loans as long as they have not been totally removed from the balance sheet. Disposal of these non-performing loans is of course important, but the banks may also have to clear performing loans off the balance sheet by e.g. securitization, as a way to avoid over-exposure to a single company, and as risk-weighted capital allocation becomes a more vital concern. In order to do this they will have to obtain better access to the capital markets.

The third question is whether they will be able to build a competitive business portfolio. Whether restructuring under a holding company structure or internal company restructuring, the potential synergistic effects will be wasted if the new group is structured according to the traditional Japanese method of equal apportionment of roles and functions regardless of ability. To build a unified business structure by a reshuffle of business units or internal company systems before the autumn 2000 set up of the holding company is the main stepping stone to a successful integration of DKB, Fuji and IBJ. There would be no meaning to the alliance if its purpose was just to keep their heads afloat - in order for it to have any significance there has to be restructuring and IT investment in order to focus on core competencies.

Fourth is the question of risk management. Without an objective and broad-based risk management structure supporting a risk-return attitude to the use of capital, the new groups will not be able to effectively allocate capital or build competitive business portfolios. The ultimate aim of management is the efficient use of capital, for which they will need a precise analysis of the risks involved. The new groups will have to unify their decision-making structures, channel their capital resources into strategic areas, and invest in IT systems that enable a higher level of risk management.

Finally, there is the question of the early return of public funds. The injection of public funds the banks received in March 1999 alone raised total outstanding preference shares of the DKB-Fuji-IBJ group to ¥1.85 trillion, and of Sumitomo - Sakura to ¥1.30 trillion. Including the tax benefits that are essentially an advance receipt of profits, this resulted in 58.7% of Tier 1 capital for all the major banks being in the form of "quasi-debt capital" (Table 5). However the leading international banks have well over 8% in Tier 1 capital, and the credit rating agencies at present seem to focus entirely on this measurement as an indicator of financial health. The real test of the strength of the new Japanese banking groups will be how early they can achieve their stated intention of returning these public funds.

While the above represents the financial issues the new groups are facing, there are also strategic issues to consider. In Tokai-Asahi's case, while they are openly inviting the participation of other regional institutions, the question is how far other potential candidates will be participating in the planning stage itself. The DKB-Fuji-IBJ group has a wide network of regional bank affiliations, and the regional banks are pushing ahead with mutual integration plans themselves. Against this background, how far can Tokai-Asahi tailor their plans to attract the participation of the other regional banks? DKB-Fuji-IBJ and Sumitomo - Sakura are similarly facing questions concerning their retail banking strategy, how to handle investment banking tie-ups with foreign institutions, and how to bolster their securities operations.

Table 5 Financial indicators

Units:Yen billion

Profits for Year to March 1999	DKB	Fuji	IBJ	DKB-Fuji-IBJ	Sumitomo	Sakura	Sumitomo-Sakura	Tokyo-Mitsubishi	Tokai	Asahi	Tokai-Asahi	Sanwa	Daiwa
Trust fees	—	—	—	—	—	—	—	—	—	—	—	—	56.7
Net trust fees	—	—	—	—	—	—	—	—	—	—	—	—	60.4
trust account	—	—	—	—	—	—	—	—	—	—	—	—	-3.7
Interest income	537.6	505.5	296.2	1,339.3	607.0	567.6	1,174.6	738.2	309.9	355.7	665.6	528.7	141.3
Fees and commissions	70.8	60.8	50.6	182.2	61.2	53.5	114.7	98.2	40.7	31.0	71.7	62.7	30.1
Specified deal	4.9	18.0	22.1	45.0	36.6	10.8	47.4	68.8	12.2	1.8	14.0	35.3	3.4
Other operating income	69.5	82.0	71.4	222.9	45.5	67.3	112.8	175.9	52.5	21.2	73.7	127.8	61.2
of which bond related income	60.3	79.6	55.9	195.8	49.4	51.1	100.5	103.8	38.9	13.1	52.0	98.3	54.2
Gross operating profits	682.8	666.3	440.3	1,789.4	750.3	699.2	1,449.5	1,081.1	415.3	409.7	825.0	754.5	292.7
Expenses etc.	-504.2	-473.5	-228.3	-1,206.0	-530.2	-526.2	-1,056.4	-522.0	-252.3	-325.7	-578.0	-508.1	-200.9
expenses	-388.7	-359.6	-161.7	-910.0	-353.9	-425.1	-779.0	-476.4	-239.6	-252.5	-492.1	-337.7	-180.9
General loan loss provisions	-115.5	-113.9	-66.5	-295.9	-176.3	-101.1	-277.4	-45.6	-12.7	-73.2	-85.9	-170.4	-20.0
Net operating profits	178.6	192.8	212.0	583.4	220.1	173.0	393.1	559.1	163.0	84.0	247.0	246.4	91.8
Net operating profits before loan loss provisions	294.1	306.7	278.5	879.3	396.4	274.1	670.5	604.7	175.7	157.2	332.9	416.8	115.5
Net core operating profits	233.8	227.1	222.6	683.5	347.0	223.0	570.0	500.9	136.8	144.1	280.9	318.5	61.3
Non operating P/L	-783.0	-781.7	-564.0	-2,128.7	-961.2	-927.1	-1,888.3	-581.5	-502.3	-491.4	-993.7	-899.9	-341.8
Equities trading P/L	102.4	-116.0	318.1	304.5	-37.6	12.5	-25.1	305.4	64.7	104.5	169.2	-49.6	13.2
Non-performing loan charges	-856.5	-614.9	-857.8	-2,329.2	-896.1	-922.4	-1,818.5	-843.9	-564.9	-578.8	-1,143.7	-832.7	-345.0
Other non-operating P/L	-29.0	-50.8	-24.3	-104.1	-27.5	-17.2	-44.7	-43.0	-2.1	-17.0	-19.1	-17.6	-10.0
Recurring profits	-604.4	-588.9	-352.0	-1,545.3	-741.1	-754.1	-1,495.2	-22.4	-339.3	-407.4	-746.7	-653.5	-250.0
Extraordinary P/L	-50.0	-75.4	6.5	-118.9	107.6	105.5	213.1	92.1	25.5	32.5	58.0	33.3	50.7
Net profits before tax	-654.4	-664.3	-345.5	-1,664.2	-633.5	-648.6	-1,282.1	69.7	-313.8	-374.9	-688.7	-620.2	-199.3
Corporate & Inhabitants' taxes	-278.3	-271.4	-149.7	-699.4	-259.3	-273.4	-532.7	24.5	-128.0	-155.0	-283.0	-225.7	-82.6
Net profits after tax	-376.1	-392.9	-195.8	-964.8	-374.2	-375.2	-749.4	45.2	-185.8	-219.9	-405.7	-394.5	-116.7
Cost of credit	-972.0	-728.8	-924.3	-2,625.1	-1,072.4	-1,023.5	-2,095.9	-889.5	-577.6	-652.0	-1,229.6	-1,003.1	-368.7

Note: Core operating profits = Net operating profits before general loan loss provisions + trust account - Bond P/L; Cost of credit = General loan loss provisions + Non-performing loan charges

Indicators	DKB	Fuji	IBJ	DKB-Fuji-IBJ	Sumitomo	Sakura	Sumitomo-Sakura	Tokyo-Mitsubishi	Tokai	Asahi	Tokai-Asahi	Sanwa	Daiwa
Total assets	52,534.3	46,384.4	42,089.3	141,008.0	51,531.3	47,208.7	98,740.0	69,806.9	30,363.2	29,267.3	59,630.5	47,592.6	15,514.6
Gross operating profits	68.3	66.6	44.0	178.9	75.0	69.9	145.0	108.1	41.5	41.0	82.5	75.5	29.3
Expenses	-38.9	-36.0	-16.2	-91.0	-35.4	-42.5	-77.9	-47.6	-24.0	-25.3	-49.2	-33.8	-18.1
Net operating profits	17.9	19.3	21.2	58.3	22.0	17.3	39.3	55.9	16.3	8.4	24.7	24.6	9.2
Shareholders' equity	2,404.2	2,321.8	1,623.9	6,349.9	1,846.5	2,223.5	4,070.0	2,496.9	1,611.1	1,372.4	2,983.5	2,105.1	938.2
Expense ratio (expenses/gross operatingprofits)	56.93%	53.97%	36.72%	50.86%	47.17%	60.80%	53.74%	44.07%	57.69%	61.63%	59.65%	44.76%	61.80%
Workforce(persons)	16,090.0	13,976.0	4,752.0	34,818.0	14,995.0	16,330.0	31,325.0	17,878.0	15,501.0	12,594.0	28,095.0	13,747.0	7,546.0
Net profits ROA	-0.125%	-0.143%	-0.082%	-0.118%	-0.123%	-0.137%	-0.130%	0.010%	-0.103%	-0.128%	-0.115%	-0.130%	-0.128%
Core operating ROA	0.045%	0.049%	0.053%	0.048%	0.067%	0.047%	0.058%	0.072%	0.045%	0.049%	0.047%	0.067%	0.040%
Net profits ROE	-1.564%	-1.692%	-1.206%	-1.519%	-2.027%	-1.687%	-1.841%	0.181%	-1.153%	-1.602%	-1.360%	-1.874%	-1.244%
Core operating ROE	0.972%	0.978%	1.371%	1.076%	1.879%	1.003%	1.400%	2.006%	0.849%	1.050%	0.942%	1.513%	0.653%

Shareholders' equity	DKB	Fuji	IBJ	DKB-Fuji-IBJ	Sumitomo	Sakura	Sumitomo-Sakura	Tokyo-Mitsubishi	Tokai	Asahi	Tokai-Asahi	Sanwa	Daiwa
Capital ratio(consolidated)	11.47%	11.22%	11.30%	11.33%	10.96%	12.34%	11.59%	10.47%	12.61%	11.90%	12.26%	11.36%	12.78%
Tier1	2,075	2,359	1,749	6,183	2,180	2,396	4,576	2,658	1,598	1,242	2,840	2,137	851
Tier1 ratio	5.86%	5.73%	6.04%	5.86%	5.58%	7.17%	6.31%	5.24%	7.75%	6.30%	7.04%	6.05%	7.96%
Tier2	1,987	2,259	1,524	5,769	2,102	1,725	3,827	2,658	1,003	1,105	2,109	1,876	514
45% of unrealized gains on securities	1.9	0.0	0.0	1.9	0.0	0.0	0.0	421.3	0.0	0.0	0.0	15.1	0.4
45% of re-evaluation difference	247.6	101.8	77.1	426.5	128.6	53.2	181.8	166.3	71.2	101.7	172.9	121.8	0.0
Quasi-debt capital procurement	1,495.0	1,885.7	1,257.9	4,638.6	1,625.4	1,428.8	3,054.2	1,986.9	834.3	872.8	1,707.1	1437.3	462.8
Risk assets	35,418.0	41,155.6	28,963.5	105,537.1	39,083.9	33,399.2	72,483.1	50,765.7	20,632.8	19,723.6	40,356.4	35327.7	10682.4
Own capital ratio public cash injection	7.76%	7.57%	9.23%	-	8.59%	9.56%	-	10.47%	9.68%	8.53%	-	8.70%	8.29%
Tier1 ratio	3.88%	3.79%	4.83%	-	4.30%	4.78%	-	5.24%	4.84%	4.27%	-	4.35%	4.15%
Deferred tax	617.3	732.6	406.3	1,756.2	719.9	677.7	1,397.6	622.6	365.1	334.2	699.3	592.6	211.2
Preference shares	799.0	975.2	350.0	2,124.2	501.0	822.6	1,323.6	244.2	700.0	413.5	1,113.5	750.0	458.0
(Preference shares) / Tier1	38.5%	41.3%	20.0%	34.4%	23.0%	34.3%	28.9%	9.2%	43.8%	33.3%	39.2%	35.1%	53.8%
(Deferred tax+Preference shares) / Tier1	68.3%	72.4%	43.2%	62.8%	56.0%	62.6%	59.5%	32.6%	66.6%	60.2%	63.8%	62.8%	78.7%

Capacitytodisposeofnon-performingloans	DKB	Fuji	IBJ	DKB-Fuji-IBJ	Sumitomo	Sakura	Sumitomo-Sakura	Tokyo-Mitsubishi	Tokai	Asahi	Tokai-Asahi	Sanwa	Daiwa
Non-performing loans as per the Financial Revitalization Law	2,253.4	1,386.6	1,872.4	5,512.4	2,013.7	1,799.8	3,813.5	2,160.6	753.2	929.9	1,683.1	1,730.9	794.0
Loans to bankrupt / reorganizing borrowers	506.5	330.5	111.7	948.7	217.3	390.1	607.4	421.3	215.5	169.9	385.4	326.0	217.4
Loans indanger of default	1,379.2	688.4	1,197.8	3,265.4	1,476.3	809.2	2,285.5	1,365.1	426.8	553.4	980.2	1,083.1	407.8
Loans requiring attention	367.7	369.7	562.9	1,300.3	320.1	600.5	920.6	374.2	111.0	206.7	317.7	321.8	168.7
Performing loans	34,152.6	32,222.2	25,437.4	91,812.2	35,421.0	33,896.9	69,317.9	44,670.2	19,964.8	21,469.0	41,433.8	33,669.1	10,516.8
Total outstanding credit	36,406.0	33,610.9	27,309.8	97,326.7	37,434.7	35,696.7	73,131.4	46,830.8	20,718.0	22,398.9	43,116.9	35,400.0	11,310.8
Non-performing loan ratio	6.19%	4.13%	6.86%	5.66%	5.38%	5.04%	5.21%	4.61%	3.64%	4.15%	3.90%	4.89%	7.02%
Core net operating profits (company estimates)	265.0	232.0	155.0	652.0	330.0	303.0	633.0	480.0	159.0	127.5	286.5	300.0	70.0
General loan loss provisions	223.1	185.2	172.8	581.1	318.7	213.4	532.1	314.4	92.0	126.1	218.1	277.9	51.5
Unrealized P/L on securities	286.3	173.2	23.8	483.3	431.6	-120.1	311.5	1,129.6	203.7	119.8	323.5	380.7	-222.1
Unrealized P/L on real-estate holdings	498.5	209.1	168.3	875.9	258.6	71.8	330.4	327.8	136.2	198.0	334.2	246.4	-
Surplus	381.0	127.7	200.9	709.6	186.8	114.3	301.1	1,129.0	78.8	58.7	137.5	276.8	24.2
Disposal capacity(40%tax rebate)	1,907.9	1,012.3	854.7	3,775.0	1,650.2	658.6	2,308.8	4,133.5	722.2	669.2	1,391.5	1,666.3	-60.3

Source: NRI, from own materials and company annual reports

4. Outlook

In addition to the city-bank restructuring moves covered in this report, consolidation moves in the trust banking sector are also suddenly intensifying: Sumitomo Trust & Banking announced on October 7 it was purchasing the shares of Daiwa International Trust Bank and SB Trust Bank, to make them subsidiaries before absorbing them several months later, plus the merger of Toyo Trust & Banking and Sanwa Trust & Banking. Now that the Long Term Credit Bank of Japan has effectively ceased to exist, and with consolidation in the trust bank sector, Japan will now be left with just 6 large banking groups.

Now market attention is turning to what action Bank of Tokyo-Mitsubishi and Sanwa Bank will take - in order for them to compete rather than just survive they will also have to restructure. Tokyo-Mitsubishi is undeniably inferior in terms of its securities business when compared to Sumitomo - Sakura or DKB-Fuji-IBJ. Also Sanwa will have to now take stock and strengthen its current planned alliance with 5 other financial sector companies in response to restructuring moves in the non-life insurance sector.

Japan's major banks are entering a new age of competition, but this new age is not necessarily going to be given over to the new financial behemoths. Citigroup, Deutsche Bank and UBS have all gone through successive rounds of merger / acquisition by outside groups, in anticipation of the synergy effects of merging banking, securities and insurance operations. So far only financial institutions that are already competitive and have a focused and distinctive business strategy are re-bundling their financial products and services in an effort to expand their customer base and reach critical mass. In Japan's case, these new banking alliances are perhaps coming from a combination of panic (to obtain market share quickly before it is eaten up by someone else) and peer pressure (sparked off by previous merger announcements). The clear warning from previous mergers however is that the new group's resources may instead be spent on solving internal personnel issues arising from a clash of business cultures, without making any gains in competitiveness. Having already tackled their first priority of achieving a certain scale of operations, these major new banking alliances will sooner or later be faced with a further problem in achieving global competitiveness – a new business model built around their own specific strengths.