# The Risks and Rewards of the Pursuit of Size and Complexity by Japan's Megabanks

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## The Pursuit of Size and Complexity

The pursuit of size and complexity has become one of the main occupations of Japanese bankers. The pursuit of size has led to the unusual state of affairs where one of the four remaining major banking groups, UFJ Holdings, has become a bone of contention between two of the others, Mitsubishi Tokyo Financial Group and Sumitomo Mitsui Financial Group, while the pursuit of complexity has led to the growth of new financial products and activities. As the traditional banking activities of deposit-taking and lending have become unprofitable, so the interest in consumer loans, derivative-based deposits and loans, interest rate swaps, alternative investments and the corporate recovery business, to name only a few, has increased. This process has been accelerated by deregulation as the barriers between the different players in Japan's financial services industry have been removed to allow all the players to market each other's products—be they investment trusts, pension plans, insurance policies, or stocks and shares—and to engage in market-based activities.

As Japan begins to draw a line under the bad debt problem that plagued the country for more than 10 years, its major banking groups now pursue size and complexity in an apparent quest for new goals. It will be very interesting to see where this leads both the banks themselves and Japan's financial system.

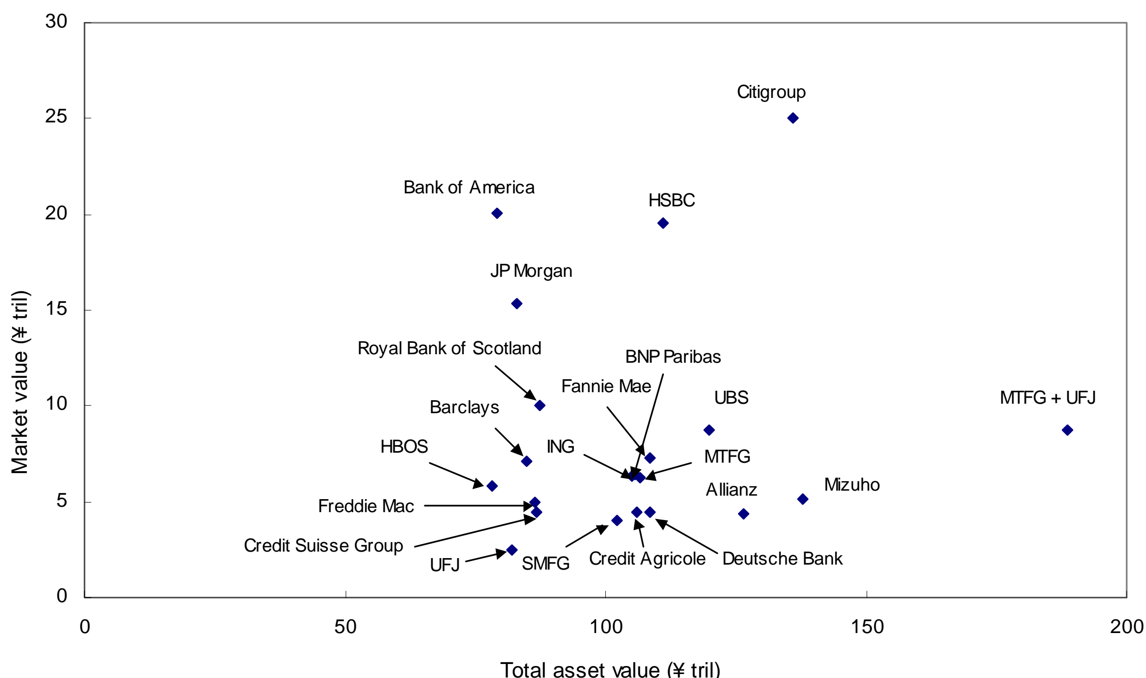
## The Pursuit of Size and Complexity in Relation to Performance

There have been many empirical studies of the impact of the pursuit of size through merger and acquisition on the performance of banks in other countries. The general conclusion is that mergers involving banks with assets of less than $100 million tend to produce economies of scale. However, there is no evidence that this is true of mergers involving megabanks.[1]

[1] For further details of economies of scale and scope in the financial services industry, see the papers in Robert Litan & Richard Herring (ed.), Brookings-Wharton Papers on Financial Services 2003, especially Ingo Walter, "Strategies in Financial Services, the Shareholders, and the System: Is Bigger and Broader Better?."

As far as the pursuit of complexity is concerned, there have been relatively few empirical studies of the effects of forming financial conglomerates with banks at the center and other financial services companies (e.g., securities and insurance companies) as subsidiaries or affiliates. However, there have been some studies of whether banks have achieved economies of scope by marketing products and services traditionally offered by other financial services companies. These have found that such attempts have initially led to an increase in costs. However, the fact that these studies were carried out when the banks concerned had just begun to market these products could mean that they tell us little about the banks' longer-term cost curve. On the other hand, studies of the effects on revenue of cross selling paint a mixed picture—some success stories, some failures. What is clear is that cross selling does not automatically increase revenue.

**Figure 1 Size and Market Value of World's Major Banking Groups**




Note: The data for total asset value are those at the end of the banks' last financial year, while those for market value are based on their closing share price on 13 October 2004.
Source: NICMR, from company data.

All this suggests that megabanks cannot count on their pursuit of size and product diversification to lead to success. However, recent developments (e.g., in information technology) could mean that they may be able to achieve greater economies of scale than had hitherto been considered possible, and in Europe and the United States the banking industry continues to consolidate into ever larger groups in spite of the fact that all the studies that have been done so far have failed to find any economic

benefits. As far as economies of scope are concerned, there are indications that these may also exist. For example, US banks have had success in cross-selling corporate loans and M&A advice, and this has helped their securities subsidiaries or affiliates to improve their ranking in the underwriting and M&A tables. Similarly, Japanese banks have been able to steadily increase their sales of investment trusts.

However, although there is isolated evidence that the pursuit of size and complexity can produce benefits, it is probably too soon to conclude that this has a significant impact on shareholder value. In fact, some would say that shareholder value depends more on whether a company has a good strategy than on whether it merges or forms part of a conglomerate. According to this view, any benefits that may accrue to a company after it merges may well be the result of the strategy devised to deal with the merger rather than of the merger itself.

## Possibility That Increases in Asset Size Do Not Lead to Increases in Market Value

Leaving aside the issue of mergers for the moment, the importance of a good strategy is clearly a major issue for Japan's major banking groups. It is clear from Figure 1, which plots the total asset value of the world's major banking groups against their market value, that the market value of Japan's major banking groups is not as high as one might expect from their total asset value.

It has been reported that one of the motives for MTFG to merge with UFJ was the desire to prevent MTFG becoming the target of a foreign takeover bid. Now that share-for-share transactions are to be allowed in Japan, this would have been possible unless MTFG had increased its market value. However, unless Japan's major banking groups are able to change the relation between their total asset value and their market value, it is all too easy to imagine a situation where such a merger leads to a big increase in total asset value but a much smaller increase in market value.

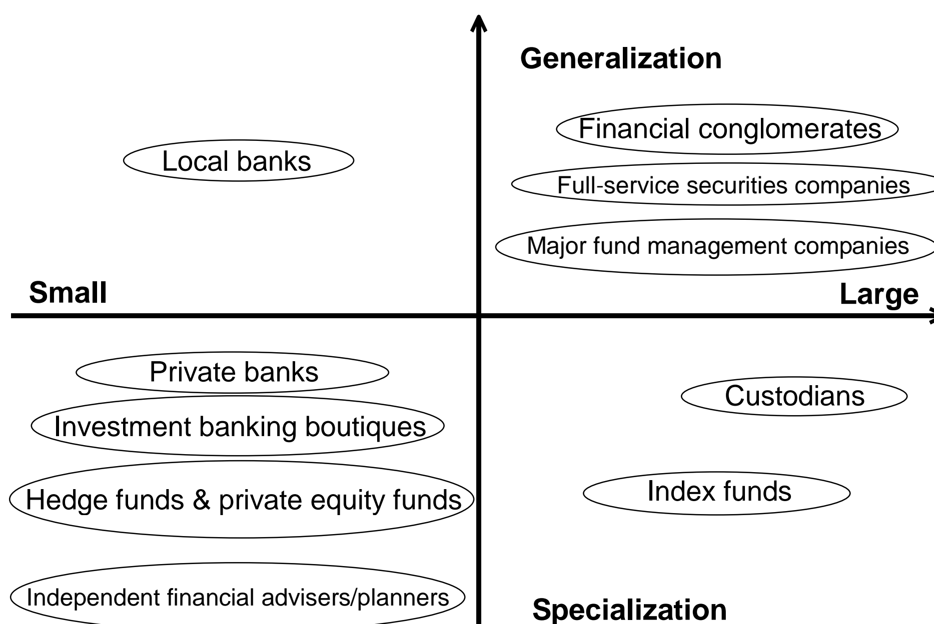
Another way of looking at this would be to say that there must be a way for a bank such as MTFG to increase its market value without having to increase its total asset value by means of a merger.

## The Countertrend towards Specialization and Downsizing

However, a quick look at the financial services industry will confirm that not all the players are pursuing size and complexity. Figure 2, which plots size (small vs. large) on the horizontal axis and complexity (specialization vs. generalization) on the

vertical axis, is an attempt to categorize the different players in the industry. We can see that, just as some players prefer the size and complexity offered by huge financial conglomerates, others prefer to specialize in a particular field and to pursue the profits of scale offered by activities such as passive management (index funds) and custody services.

**Figure 2 Size and Scope in Financial Services**




Source: NICMR.

On the other hand, some players, such as hedge funds, investment banking boutiques and independent financial advisers/planners, dislike huge organizations and feel that they can practice their specialist skills more effectively in a less impersonal environment. The rise of hedge funds, in particular, shows that a countertrend to the pursuit of size and complexity exists in the same financial services industry. Likewise, financial planning boutiques that offer face-to-face financial advice to retail customers are a very different beast from the large financial conglomerates and have an equally important role to play. And, last but not least, there are the local players who, though relatively small in scale, cater for a broad range of well-established needs.

This shows that players of many different sizes and with many different skills can coexist in the same industry and that the pursuit of size and complexity is not necessarily the "be all and end all" of financial services.

## Systemic Risk

So much for the costs and benefits of the pursuit of size and complexity by major banking groups in terms of their impact on the groups' shareholder value. However, we also need to consider their impact on the financial system and economic performance. What is good for a particular company is not necessarily good for the economy or society as a whole.

The first issue that this raises is what impact the pursuit of size and complexity by major banking groups has on the stability of the financial system. On the one hand, the sheer size of these institutions means that, if they run into difficulty, the knock-on effects will tend to be severe. On the other hand, the sheer severity of these knock-on effects means that the authorities cannot simply let these institutions fail: in other words, this is an example of the too-big-to-fail problem. Similarly, the sheer complexity of these institutions means that steering them clear of difficulty (e.g., by pinpointing the source of a problem or assessing their risk exposure) is no easy matter.

Every year the Federal Reserve Bank of Chicago holds an international conference on the major economic and financial issues of the day. This year's conference, held on 30 September-1 October, was entitled "Systemic Financial Crises: Resolving Large Bank Insolvencies." The author was struck by the number of speakers who talked of large, complex financial institutions (LCFIs) as, for example, "too large, too complex and too global to save" or "too complex to manage, too complex to supervise."

Much of the discussion focused on some of the problems that arise from the fact that LCFIs operate in a global environment. One example is the fact that different countries have different systems of financial regulation, with some, such as the United States, having a different regulator for each of the various operations (e.g., commercial banking, investment banking and insurance) that go to make up an LCFI. Another is the fact that different countries have different rules for dealing with bank insolvencies.

Although it is probably correct to say that Japan's financial authorities were able to offer a blanket guarantee (extending even to swap positions) during the period that culminated in the demise of Long-Term Credit Bank, it remains to be seen whether the same approach would work with today's megabanks should there be a next time.

## Competition Policy

Another problem that may arise from the pursuit of size and complexity by banks and affect the economy and society as a whole is the risk of unfair competition. In the

United States, bank mergers are subject not only to the usual antitrust law checks but also to a number of rules that were adopted when some of the restrictions on interstate banking were abolished as a result of the enactment of the Riegle-Neale Interstate Banking and Branching Efficiency Act of 1994 and the amendments to the Bank Merger Act and Bank Holding Company Act that were made at the same time. These rules prohibit mergers that would give a single bank a share of more than 10% of the national deposit market or of more than 30% of the deposit market in any one state. In the United States there has been a traditional apprehension that financial conglomerates could spread their tentacles to every nook and cranny of the country, and it is this that gave rise to the restrictions on interstate banking. However, even when these restrictions were lifted, care was taken to prevent financial conglomerates from gaining too big a share of the market.

Bank mergers also have to be approved in the United Kingdom, and there is usually considerable interest in the decisions of the body responsible for this, the Competition Commission. In July 2001, when Lloyds TSB made a bid for Abbey National, the Commission blocked the bid on the grounds that a merger would not be in the interests of the retail current account market and the market for small business banking services. As a result, none of the major UK banks made a counteroffer when, in July 2004, Spain's biggest bank, Banco Santander Central (SCH), made a bid since they knew the Commission's views on market share.

In Canada, in 1998, when four of the country's top five banks (Royal Bank/Bank of Montreal and CIBC/Toronto-Dominion) attempted to merge, the moves were blocked by the then Finance Minister (and current Prime Minister), Paul Martin, on the grounds that the concentration of such economic power in the hands of a few banks would reduce competition in the financial services sector.

## Megabank Mergers and Competition Policy in Japan

When, in 2001, two of Japan's biggest city banks (Dai-ichi Kangyo and Fuji) and one of its long-term credit banks (Industrial Bank of Japan) announced that they were planning to merge to form what was to be the Mizuho Financial Group, the Fair Trade Commission assessed the likely impact on the country's bank deposit market as follows (May 2001, first three points only):

(1) Although the new group would have a share of more than 20% of the deposit market (comprising 18 city, long-term credit and trust banks), just over 8% more than its nearest rival, it would face competition from rival financial products, such as investment trusts, offered by securities and insurance companies.

(2) It would also face competition from the Post Office savings scheme.

(3) It was likely to face increasing competition from online banks and banks operating in cooperation with convenience stores.

After considering the impact of the merger on the markets for other financial products, the Commission expressed its concern that the banks might try to pressurize corporate customers in which they would now have a higher share (in terms of loans or equity) in a number of ways (e.g., to give them business other than simply deposit business or to appoint a particular securities company as the lead manager (or a member of the group as the trustee) of a bond issue) and treat them unfairly if they refused. It therefore asked the banks to take whatever action was needed to ensure that this did not occur. Likewise, the Commission expressed its concern that the banks might try to cement relations within the group to the exclusion of outside companies and asked them to take whatever action was needed to ensure that this did not occur, either.

In the end, after receiving assurances from the banks that they would, first, improve their compliance in order to address its concerns that they might try to pressurize corporate customers and, second, change the way in which group meetings were held in order to address its concerns that they might try to adopt exclusionary business practices, the Commission concluded that the merger would not infringe the Antimonopoly Law.

Figure 3 shows the share of the bank deposit market that UFJ and Mitsubishi Tokyo would have if they merged. At nearly 40% it is considerably bigger than Mizuho's share when it was formed, and the Commission's definition of "market" (namely, "principal banks") is virtually the same as it was then ("city banks + long-term credit banks + trust banks"). Moreover, the first point made by the Commission ((1) above) when it approved Mizuho's formation (namely, that the new group would face competition from rival financial products, such as investment trusts, offered by securities and insurance companies) scarcely applies any longer as banks are now allowed to sell such products, anyway. Nor does the Post Office savings scheme, which is still shedding deposits, pose the same competitive threat that it did then. Similarly, we know with the benefit of hindsight that the Commission overestimated the potential for online banks and banks operating in cooperation with convenience stores.

**Figure 3  The Rise of the Megabanks**

| | Share of deposit market | Share of deposit market + postal savings | Share of principal banks' deposit market |
|---|---|---|---|
| Mizuho FG | 13.6% | 9.6% | 25.4% |
| SMFG | 11.8% | 8.4% | 22.2% |
| MTFG | 10.4% | 7.4% | 19.5% |
| UFJHD | 10.3% | 7.3% | 19.4% |
| MTFG+UFJHD | 20.8% | 14.7% | 38.9% |
| SMFG+UFJHD | 22.2% | 15.7% | 41.5% |

Note: Data as of end-March 2004.
Source: NICMR, from company data

It should perhaps be mentioned that Mizuho has been reported to have later put considerable pressure on its corporate customers to subscribe to a large share offering. If this was indeed the case, it would only confirm that the Commission's concerns were justified and cast doubt on the group's efforts to improve its compliance.

In other words, when the Commission finds on the merger between UFJ and Mitsubishi Tokyo, it is unlikely to ignore the fact (to take just the deposit market as an example) that the new group would have a much bigger market share than even Mizuho had when it was formed, that the products and players that it (the Commission) believed would exert competitive pressure on Mizuho can no longer be considered capable of exerting such pressure, and that Mizuho may have tried to put pressure on its corporate customers to subscribe to its shares.

Judging from the reaction of the media, however, it would seem that no one is entertaining the possibility that the Commission might block the merger. In other words, it would seem that, in Japan, competition policy is implemented less rigorously than in some other countries and that it is easier for megabanks to become even bigger.

As a result, a handful of players appear free to gain dominance in a banking sector that already dominates the flow of money in the economy on a scale not seen in any other country. Moreover, this growing economic and political dominance raises a number of concerns. It may be that, in a banking sector where the players have traditionally pursued market share at the expense of profitability, overcompetition poses a greater threat and that the risk of banks charging monopoly prices for their services as competition declines is small. Nevertheless, it would be unwise to ignore the risk of tied deals and dumping.

If we also remember that Japanese banks are pursuing complexity as well as size (by expanding into areas such as securities and insurance), the risk becomes greater. When a dominant financial group becomes even more dominant (in a sector that already dominates the economy) and expands into other areas, there is a risk that independent niche players in these areas will be unable to compete on equal terms and that customers will also suffer. Nor is it simply a matter of being able to compete on equal terms. When an economically and politically dominant player emerges, not only does the risk of conflicts of interest increase, but, when such conflicts occur, they tend to become increasingly difficult to identify.

## The Risks and Rewards of the Pursuit of Size and Complexity in the Japanese Environment

As has often been pointed out in recent years, one of the consequences of the fact that much of the money circulating in the Japanese economy has tended to find its way into the banking sector is that this has led to an overconcentration of risk that has threatened the stability of the financial system. This overconcentration has also obliged the banks to invest as much of their deposits as possible. As a result, they have often not paid as much attention to profitability as they should have done.

Therefore, by expanding into areas such as selling securities and insurance, banks are not only reducing the risk that this overconcentration poses to the financial system but also helping to improve their own fundamentals. In addition, consolidation may help to ease the pressure on banks to lend for lending's sake.

In other words, given the environment in which Japanese banks operate, the pursuit of size by individual banks and the concentration of market share may benefit not only the banks themselves but also the financial system as a whole.

However, given the sheer volume of the money that finds its way into the banking sector and the fact that the environment in which banks tend to ignore profitability remains largely unchanged, we perhaps need to be more aware of the economic and political risks posed by the pursuit of size and complexity (e.g., the risk to the financial system, the risk to competition policy and the risk of conflicts of interest) than do people in countries where the environment in which banks operate is different.

If, as the empirical studies tend to suggest, the benefits of the pursuit of size and complexity by individual banks are by no means certain and there are also possible

costs, the banks' pursuit of economic efficiency should restrain their pursuit of size and complexity and avert a situation where these economic and political risks continue to increase ad infinitum.

However, Japanese banks have a long history of offering services with little regard to their profitability, so we cannot be certain that economic efficiency will act as an automatic restraint and that they will not continue to vie with one other in the pursuit of size and complexity.

## The Right Response

As we have seen in this report, Japan's major banking groups continue to pursue size and complexity with all the risks and rewards that that entails. However, if they are to achieve a better risk-reward balance, they will need to improve their governance and market discipline, and pay more attention to economic efficiency. For their part, Japan's financial regulators will, first of all, need to ensure that in each area of the financial services industry customers (be they depositors, investors or policyholders) are properly protected. Then they will need to accept that LCFIs are here to stay and that, in order to meet the challenge they present, they (the regulators) will need to create a new regulatory framework that takes into account the need for a stable financial system and a level playing field.

Given also that the bigger the bank, the greater the risk of conflicts of interest or tied deals (as well as of damage to the bank's reputation in such a case), both banks and regulators might be well advised to focus on the types of transaction most likely to lead to such problems. A good example of the kind of cohesive response required is the "Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities" issued by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) and the Securities and Exchange Commission (SEC) in May 2004 in response to the transactions carried out by a number of banks, including Citigroup and Merrill Lynch, to disguise the illegal activities of a major corporate client—Enron.