Troubled Waters Ahead in the Final Chapter of Japan's Financial Reorganization

By Tani Sadafumi

Mizuho Holdings, Inc. the new holding company for the Dai-ichi Kangyo Bank, Ltd., the Fuji Bank, Ltd., and the Industrial Bank of Japan, Ltd., was established on 29 September. The total assets of the banks under the holding company is ¥140 trillion and this has created the world's largest megabank. Following this, in April 2001, Sumitomo Bank, Ltd., will merge with the Sakura Bank, Ltd., to form Sumitomo Mitsui Banking Corp. (total assets ¥100 trillion), the Bank of Tokyo-Mitsubishi, the Mitsubishi Trust and Banking Corp. and Nippon Trust Bank will join together to form a holding company called Mitsubishi Tokyo Financial Group, Inc. (total assets ¥85 trillion) and the Sanwa Bank, Ltd., the Tokai Bank, Ltd., and the Toyo Trust and Banking Co., Ltd. will together establish UFJ (United Financial of Japan [tentative designation]) Holdings, Inc. (total assets ¥83 trillion). The result of this will be to divide Japan's major banks into four large banking groups and several smaller independent financial groups. The final chapter in the reorganization of the nation's banking system has now been reached but it is very likely that there will be troubled waters ahead.

In the late 1980s, Japan had 23 money center banks, banks with a nationwide business base, which were independently expanding their operations overseas. There were 13 city banks (the Daiwa Bank, Ltd. engaged in both banking and trust business), three long-term credit banks and seven trust banks. As of the end of 2000, their number will have decreased to 14. Leaving out the case of Hokkaido Takushoku Bank, which collapsed in 1997, since then, there have been three mergers between six banks: Mitsui Bank and Taiyo Kobe Bank joining forces in 1990 to create Sakura Bank, Kyowa Bank and Saitama Bank merging to form the Asahi Bank, Ltd. in 1991 and Mitsubishi Bank and the Bank of Tokyo coming together to create the Bank of Tokyo-Mitsubishi in 1996.

As for the long-term credit banks, the Long-Term Credit Bank of Japan (now Shinsei Bank, Ltd.) folded in 1998 and this was soon followed by the bankruptcy of the Nippon Credit Bank, Ltd. (which will be known as the "Aozora" bank from next April). Among the trust banks, owing to their deteriorating operations, Nippon Trust Bank and the Yasuda Trust and Banking Co., Ltd have become subsidiaries of the Bank of Tokyo-Mitsubishi and Fuji Bank, respectively, and Mitsui Trust and Banking and Chuo Trust and Banking have merged to form the Chuo Mitsui Trust and Banking Co., Ltd.

Looking back at the last 10 years, we can see that financial reorganization started early on, but it has really accelerated in the last 1 or 2 years. This has been because of the frequent bankruptcies among financial institutions.

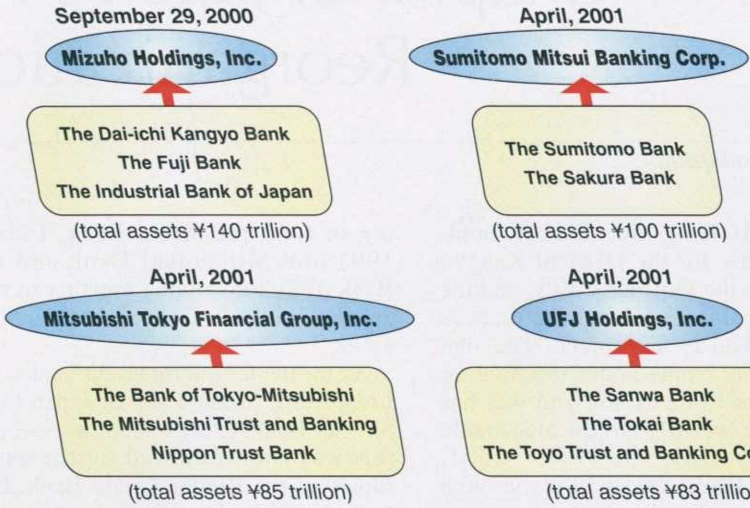
So, why are the major Japanese banks so keen to merge their operations? From the standpoint of the deterioration in their business environment, we could say that it is because they want to become more efficient (to be able to survive against much greater competition in the future) and also achieve more stability in their business (to build a robust operational base), two issues which seem to be conflicting. Such realignment is surely being followed because it is the only way of satisfying these two objectives that the banks have been able to find.

On the subject of efficiency, backed by their huge assets, Japanese banks expanded overseas en masse in the late 1980s and early 1990s in the economic

Photo : Kyodo News

Yamamoto Yoshiro (President & CEO of the Fuji Bank), Sugita Katsuyuki (President & CEO of the Dai-ichi Kangyo Bank) and Nishimura Masao (President & CEO of the Industrial Bank of Japan) (from left) at the inauguration ceremony of Mizuho Holdings, Inc. on September 29, 2000

Emerging Four Large Financial Groups



bubble era, but apart from the affiliates of Japanese companies they had hardly any other business. They also lagged far behind European and American banks as regards derivatives and other financial techniques. In the slump that followed the bursting of Japan's economic bubble, the drop in the international competitiveness of the banks became obvious to everyone. In addition, being much more regulated than London or New York, Tokyo's position as one of the top financial markets started to look a little precarious and not being very user-friendly, the hollowing of the market, that had until then been kept at bay in Tokyo, became increasingly apparent.

It was under these circumstances that former Prime Minister Hashimoto Ryutaro unveiled a plan for the Japanese version of the "Big Bang" in 1996. Under the slogan of "free, fair, global" the Big Bang called for the relaxation of regulations comprising the liberalization of commissions on stock trading, revision of the Foreign Exchange and Foreign Trade Control Law, lifting the prohibition on over-the-counter sales of mutual funds by banks and rescinding the prohibition on the establishment of holding companies by financial institutions, in order to revive the Tokyo market and internationalize the yen. Though the Big Bang appears to have been successful, Japanese banks now face very difficult operating conditions.

The Ministry of Finance oversees the financial industry. Since the War, it has been following a "convoy system" policy for banks whose fundamental idea was to prevent even the most inefficient of banks from falling by the wayside. The convoy system created the myth that it was impossible for banks to collapse and through it stability has been maintained in the Japanese financial system. Although this administrative policy seems a natural thing to do, it has been a barrier to efficiency in the banks' operations. While the Big Bang should mean increased business opportunities for strong banks, it has the effect of weeding out banks having a weak operational base. If Japanese financial institutions continued to lack global competitiveness, they would have found themselves in a time when they had to fight for their lives.

Moreover, Japanese financial institutions are holding vast amounts of bad debts as an after-effect of the economic bubble. In the 1980s, the bad debt rate of most banks was below the 0.3% ceiling of the general reserve for the provision of bad debts that could be accumulated tax free, while recently a bad debt rate of 3-4% has become the norm for the major banks. For the Nippon Credit Bank, which went bankrupt, the bad debt rate had reached about 30%. Japanese banks are now faced with an extremely difficult issue to address, that of increasing competitiveness at the same time as clearing off their bad debts.

This is also a headache for the government authorities. For instance, the temporary placement of the Long-Term Credit Bank of Japan and the Nippon Credit Bank under public control was a temporary measure that had to be taken to prevent an upheaval in the financial system and was a clear departure from the policy of liberalization and deregulation. The Government had been pursuing the two seemingly conflicting goals of greater efficiency and stability and this move was undeniably like pressing a car's accelerator and applying its brakes at the same time. Though there were some who wanted the Big Bang to be put on hold, this was unrealistic. Thus both the Government and the financial institutions have been forced to continue to pursue efficiency and stability at the same time.

Merging operations is seem to be the most effective means of attaining these objectives. As expressed by a leading official at a certain city bank, "there is no bank executive who has not considered a merger." And the Government has supported financial reorganization by lifting the ban on financial holding companies and providing public funds for capital injections. The creation of the four huge financial groups, including the Chuo-Mitsui Trust and Banking and Mizuho Holdings, are the result of this.

The benefits of merging operations are seen in reduced costs, whether this is through a merger or a holding company. For instance, the Dai-ichi Kangyo Bank and Fuji Bank in the Mizuho group and Sakura Bank and Sumitomo Bank in the Sumitomo-Mitsui group all have several branches close together in Japanese cities. There is also duplication of branches and subsidiaries in their overseas operations. Mizuho therefore plans to close 150 branches and Sumitomo-Mitsui 180 branches. Mizuho will reduce its workforce by 6,000 (17%) and Sumitomo-Mitsui by 8,100 (26%). Another major advantage will be savings through joint investment in computer systems and software, which has become a tremendous burden on banks.

However, in Japan, as lifetime employment is still the norm and the workforce has low mobility, aggressively laying off workers in the American way would not be possible here. According to financial industry sources, headcounts are reduced by transferring employees to affiliated companies or business partners. In this case banks normally shoulder 30% of the employee's original salary and make an extra payment for early retirement. The bank is thus able to save 70% of the labor cost. The cost of changing company signs and other costs related to mergers are huge, however.

The long-term benefits of merging are not just in cutting expenses, they also enable large cuts in human resources. With their limited management resources, if banks do not focus investment on areas with high growth potential, they will not survive the competition. Although it is for this reason that there is great enthusiasm for reorganization in the financial industry, there still remain many difficulties to merging that do not show up in figures.

Recently, there have been several cases in which a merger has been announced but then talks have been broken off, among them those between Hokkaido Takushoku Bank and Hokkaido Bank, Shokusan Bank and Shonai Bank, and Sanwa Bank, Tokai Bank and Asahi Bank. Further, in the insurance industry, there has been the case in which Mitsui Marine & Fire Insurance Co., Ltd. announced that it would merge with the Nippon Fire & Marine Insurance Co., Ltd. and Koa Fire & Marine Insurance Co., Ltd. at a press conference and then changed its merger partner to the Sumitomo Marine & Fire Insurance Co., Ltd. Though the circumstances vary, the overall reason for management going back on a decision to merge has been because of growing dissatisfaction regarding such points as employees, customers and non-mainstream executives. What these cases have in common however, is that the parties have announced their mergers as a result of the strong urging of the Japanese monetary authorities and the feeling of not wanting to "miss the boat", but without carefully considering the merits and demerits of merging.

As an example, in the background to Asahi Bank withdrawing from the original alliance consisting of Sanwa Bank, Tokai Bank and Asahi Bank, there was concern that, being stronger, Sanwa would assume the leading role. The result of this was that UFJ Holdings would now have to expand its business in the Tokyo metropolitan area without Asahi, which could have added its strength in retail banking. In the case of the Bank of Tokyo-Mitsubishi, an existing merger, there has been a tendency for the original partners to consolidate within the Bank of Tokyo-Mitsubishi and there have been cases of the individual banks criticizing each other. It is difficult for harmony to develop in such companies because with lifetime employment being an essential feature of Japanese companies, there are great differences between their individual corporate cultures.

Japan's reorganization of its financial system has had a major impact on Kabuto-cho, one of Tokyo's major financial districts

The four large financial groups are now in the process of formation. Though the holding company for the Mizuho group has already been established, the Dai-ichi Kangyo Bank, Fuji Bank and the Industrial Bank of Japan continue to exist as subsidiaries and it will not be until April 2002 that the group will be completely reorganized into retail banking, corporate customer banking and other discreet functions. However, there are already signs of discord regarding corporate posts and other matters and this will certainly become greater as time goes on.

The upheaval in the Japanese financial system has abated compared to some time ago and the sense of crisis surrounding the banks that are the driving force behind reorganization has lessened. A top official at a city bank has said, "fundamentally, we would rather not join up with other banks if possible," indicating the potential for dissatisfaction to arise within banks formed from mergers.

In order to prevent dissatisfaction from building up, it will be necessary for the management of merger banks to show that there are greater benefits from the union than just cost savings. Mergers will only bear fruit if management can present and carry out an ambitious vision for future growth and surefire strategies for achieving it. If this does not happen, megabanks would only be huge, low efficiency organizations and could become "dinosaurs" which even lack stability. JJTI

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