Evolving Trend of Consolidation in the Banking Industry: Strategies of Mitsubishi UFJ Financial Group

by

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ABSTRACT

Consolidation in the financial industry has progressed rapidly in many countries. In the United States, large financial corporations, such as Citigroup and JP Morgan Chase, formed complex financial groups and conglomerate structures composed of a commercial bank, a securities company, and an asset management company.

In recent years, the Japanese financial system has become increasingly deregulated. And many of the barriers to competition have been reduced or removed. These regulatory reforms have encouraged Japanese banking institutions to undertake major consolidations that have resulted in larger and more integrated financial conglomerates. In addition, the advent of Internet technology has enabled new entrants, such as Internet service companies, to conduct financial business.

In these new circumstances, Mitsubishi Tokyo Financial Group (MTFG), Japan's third largest banking group, decided to integrate with UFJ Holdings, Japan's fourth largest banking group. This integration created the world's largest financial conglomerate (based on asset size) named Mitsubishi UFJ Financial Group (MUFG).

This thesis discusses trends of consolidation in the U.S., European, and Japanese banking industries. It will analyze the strategic transformation of several financial conglomerates, including Citigroup, J.P. Morgan Chase, and Deutsche Bank. A second objective is to identify the financial and strategic positions of MUFG as they compare with the U.S., Europe, and other Japanese financial conglomerates.

Thesis Supervisor: Henry Birdseye Weil
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Introduction

Consolidation in the banking industry has progressed rapidly in many countries. In the United States, large banking institutions such as Citibank and J.P. Morgan Chase have formed complex financial groups and conglomerates composed of a commercial bank, a securities company, and an asset management company. In Japan, many consolidations among banking institutions and other financial institutions have occurred, with financial conglomerates emerging as a result.

In this thesis, I will analyze consolidation trends in the banking industry in the United States, Europe, and Japan, and I will identify strategies and outcomes of several financial conglomerates.

The structure of the thesis is as follows:

- Chapter 1 provides an overview of consolidation trends in the banking industry including reasons for consolidation.
- In Chapter 2, I discuss structural patterns and organizational issues of consolidation.
- In Chapter 3, I analyze consolidations in the U.S. banking industry, citing specific cases of Citigroup, J.P. Morgan Chase, and Bank of America.
- In Chapter 4, I analyze consolidations in the European banking industry, citiing specific cases of Deutsche Bank, Union Bank of Switzerland, and Hong Kong Shanghai Banking Corporation.
- In Chapter 5, I discuss consolidation in the Japanese banking industry, citing the cases of Mizuho Financial Group and Sumitomo Mitsui Financial Group. In addition I discuss the strategy of two new conglomerates: Sony Financial Corporation and Rakuten Inc.

- In Chapter 6, I analyze and compare the consolidation of Mitsubishi UFJ Financial Group with other Japanese financial conglomerates, and those in the U.S. and Europe. I will also identify strategies utilized by MUFG.

- In the Conclusion, I will summarize current consolidation trends and provide key factors that influence the success of financial conglomerates based on the analyses in Chapter 1 through 6.

Chapter 1

Overview of Consolidation Trends in the Banking Industry

1.1 Evolving Consolidation Trends

In most Western economies, there is an increasing trend toward consolidation among banks and other financial firms. According to a 2001 OECD report covering 13 key industrialized countries, during the 1990s there were more than 7,600 deals involving the acquisition of one financial firm by another, with a total value of $1.6 trillion. Between 1990 and 1999, there was a threefold increase in the number of deals while the total value of M&As increased more than tenfold. Of these M&As, 60% were between banks (see Table 1-1-1), 25% were between securities firms (including investment banks), and 15% involved acquisitions of insurance firms.

Table 1-1. Number of Mergers and Acquisitions in the banking industry

	1990	1995	1999
USA			
National	111	370	242
Global	2	11	13
Total	113	381	255
Value ($m)	3,986	71,417	68,399
Europe[1]			
National	30	99	136
Global	19	45	48
Total	49	144	184
Value ($m)	4,946	27,631	124,873

[1]Europe includes: Belgium, France, Germany, Italy, Netherlands, Spain, Sweden, Switzerland, UK

Source: OECD (2001), Report on Consolidation in the Financial Sector, Annex 1.

In 1998, there were a number of "super mega mergers," or mergers between banks with assets in excess of $100 billion each. These mergers included:

- Citicorp Travelers
- Bank America and Nationsbank
- Bank One and First Chicago
- Norwest and Wells Fargo
- UBS-Swiss Bank Corporation

1.2 Why Do Banks Merge?

The reasons for the trend toward consolidation in the banking industry fall into two broad categories.

- The first is the broad goal of maximizing shareholder wealth.

Banks aim to enhance shareholder wealth by exploiting the potential for profit and cost economies of scale and scope through M&A activities.

Profit Economies of Scale and Scope

One motive for bank mergers is to increase the scale and scope of profit through expanding their product offerings, and by adding non-banking products such as mutual funds, securities, and insurance. In this way, the banks provide more services for existing customers, thereby ensuring loyalty and attracting new clients. Cross-selling of banking and non-banking products brings further opportunities to realize profits from single clients rather than offering only banking products. Clients appreciate the convenience of handling a wide range of financial needs through one institution, which increases their loyalty. Banks can also capture new clients' needs that were previously fulfilled by securities or insurance firms. The managements of merged banks often argue that a broader range of products and client coverage leads to profit increases and shareholder-value enhancement.

Expanding the geographical coverage of their businesses is another way for banks to increase the scale and scope of profit. Entering other domestic regions or countries through M&A enables banks to extend their products into other regional markets and increase their ability to book transactions for corporate or institutional clients that are doing business in those areas.

Cost Economy of Scale and Scope

Realizing greater operating efficiency is another motive for merger. Banks continually seek cost reductions by eliminating redundant branches, human resources, IT capacity, and transaction-processing infrastructures. Consolidation of administrative and corporate management functions through merger also contributes to cost reduction. Merged banks expect that the cost of identifying and adding new clients will be reduced from the level it would be as a separate entity (see Table 1-2-1).

Table 1-2. Announced cost savings in selected U.S. bank mergers

Bank	Announced Savings
Citigroup	$1.3 billion over 2 years after tax
Bank of America	$930 million

Source: Walter, Mergers and Acquisitions in Banking and Finance (2004)

Acquisition of Technical Know-How

Acquisition of technical know-how is another motive for merger. Major financial services, such as investment banking and asset management, require highly specialized expertise. In the late 1990s and early 2000s, many commercial banks acquired independent securities firms or merchant banks as one means of acquiring such expertise (see Table 1-2-2). M&A activities were intended to strengthen the capability of investment banking business and enhance profitability by acquiring highly specialized know-how and combining it with huge capital and a broad client base.

Table 1-3. Recent examples of security firms and merchant bank acquisitions

	Acquired firm	Acquiring firm
1989	Morgan Grenfell (UK)	Deutche bank (Germany)
1995	Kleinwort Benson (UK)	Dresdner bank (Germany)
1995	SG Warburg (UK)	SBC (Switzerland)
1995	Barings (UK)	ING bank (Netherland)
1997	Dillon Read (U.S.)	SBC (Switzerland)
1998	Hambros (UK)	Societe General (France)
1999	Bankers Trust (U.S.)	Deutche bank (Germany)
2000	Robert Fleming (U.S.)	Chase (U.S.)
2000	JP Morgan (U.S.)	Chase (U.S.)
2000	PeineWebber (U.S.)	UBS (Switzerland)

Diversification of the Business Portfolio

One argument for bank mergers is that better diversified income from multiple products, client groups, geographies, and business risks creates more stable, safe, and ultimately more valuable banking institutions. The results are higher credit quality and debt ratings, and lower costs of financing than those faced by narrow, more focused banks.

- The second category of reasons for the trend toward consolidation in the banking industry is the factors that create an environment favorable to M&As. These include changes in the structure of the banking industry, changes in regulations, and development of Information technologies.

Structure Changes in the Banking Industry

The structure of the banking industry is changing as more and more non-bank institutions enter the banking business. Insurance firms are a case in point.

In Germany, Allianz AG, the world's largest property and casualty insurer, acquired Dresdner Bank for the purpose of creating a multi-channel distribution platform and to leverage the complementary distribution strengths of both firms in each of their primary target markets. The acquisition aimed to expand cross-selling opportunities to both firms' clients and to enhance profitability. In the UK, Prudential established "Egg", an Internet-only bank, in 1998. Egg has acquired over three million customers in the four years since its establishment.

Non-financial institutions are also entering into the banking business. In the UK, Tesco, a large supermarket chain, launched its own on-line banking, "Tesco Personal Finance (TPF)," in 1997 through a joint venture with Royal Bank of Scotland, for the purpose of selling loan products, credit cards, and insurance to its over ten million customers. TPF now has provided its financial products to more than five million customers. In the U.S., Wal-Mart applied in 2005 for permission to create and operate an industrial bank. Its announced objective is to internally capture costs currently paid to third- party financial institutions who process debit, credit, and electronic check transactions, however the Wal-Mart bank is expected to begin to offer banking products in the future. In Japan, Ito-Yokado, the largest supermarket chain in Japan, established "IY Bank" in 2001, a sprawling ATM network focused on financial settlement, but it intends to develop its loan and card businesses. Sony, a large electronic manufacturer, launched an Internet-only bank, "Sony Bank" in 2001. By leveraging Sony's brand reputation, Sony Bank acquired over 400,000 accounts.

Increased competition with new entrants encourages banks to merge for the purpose of retaining their competitive advantage and maintaining current market share.

Changes in Regulations

Regulator change is another factor in the environment that favors consolidation. In the U.S., changes to the Bank Holding Company Act of 1970, combined with liberalization of state laws governing the treatment of bank holding companies, has led to increased merger activity. More recently, commercial banks have been allowed to have subsidiaries that engage in securities activities. Also the laws on interstate branches have been relaxed, and the Glass Steagall Act has been repealed, so financial holding companies now can have banking, securities, and insurance subsidiaries, which encourage greater consolidation and nationwide banking.

In Europe, the Banking and Investment Services Directives, the introduction of the euro, and the Lamfalussy Report have encouraged greater integration of EU banking markets. I will explain these changes in the U.S., Europe, and Japanese regulation in greater detail in the following chapters.

Development of Information Technologies

Development of information technologies also encourages banks to merger. Such development enables banks to establish a sophisticated, multiple-product, management system, a customer relations management system, and a risk management system that covers all aspects of the business. It also enables banks to offer a broader array of products and services to larger numbers of clients over wider geographical areas than would have been feasible in the past, and to develop efficient multiple product delivery channels, such as an Internet-based retail financial service. Development of information technologies provides favorable infrastructure that allows banks to merge with another bank or another kind of financial institution.

Chapter 2

Patterns of Consolidation in the Banking Industry

2.1. Financial Conglomerates

In the 1980s, most of the consolidation in the banking industry took place between commercial banks. In the 1990s, major banks began to incorporate other kinds of financial businesses. As a result, in many Western countries financial conglomerates arose. The definition of financial conglomerates is not explicit, but they are typically defined as a firm that undertakes at least two of several financial activities, such as ordinary banking business, investment banking, securities, credit card issuance, asset management, or insurance. In 2002, the EU passed the Financial Conglomerate Directive, which aimed to standardize the way financial conglomerates are supervised across the EU. In the Directive, financial conglomerates were defined as follows:

1. Any group with "significant" involvement in two sectors: banking, investment and insurance.
2. More specifically, in terms of its balance sheet, at least 40% of the group's activities are financial; and the smaller of the two sectors contributes 10% or more to the group's balance sheet and the group's capital requirements.

By this definition, there are 38 financial conglomerates in the EU (2002 figures), and most of them have banking as their main line of business. These financial conglomerates are important players, especially in banking, where they hold 27% of the EU deposit market; their market share in the insurance market is 20% in terms of premium income (Heffernan, 2005).

2.2. Consolidation Structure of Banks and Financial Conglomerates

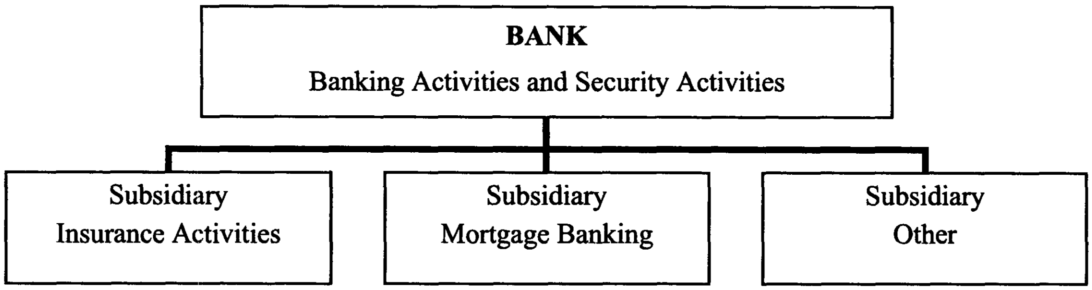
In terms of organizational structure, consolidation between two commercial banks is straightforward. Usually the target bank is folded into the existing organizational structure of the acquiring bank and the target bank disappears. In contrast, the organizational structure of financial conglomerates is more complex, and may take a number of more or less distinct forms. The organizational structures of banks establishing financial conglomerates are stylized as follows:

Type A: FULL INTEGRATION

BANK			
Bank Activities	Securities Activities	Insurance Activities	Other

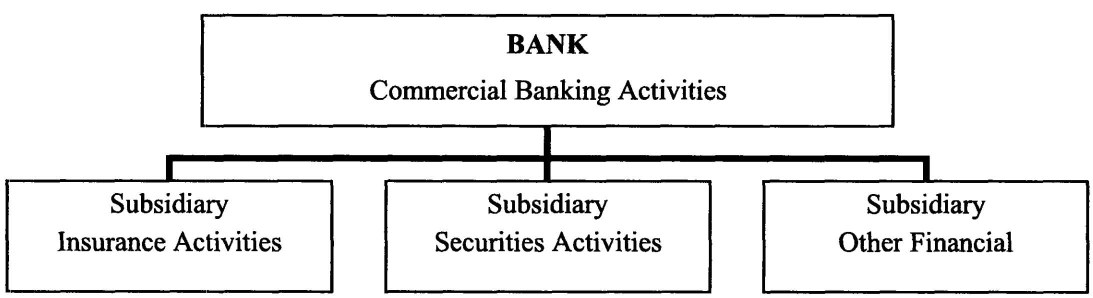
A fully integrated bank (Type A) provides a broad range of financial services (banking, asset management, securities, and insurance) under a single corporate structure supported by a single capital base. This comes close to the classic European-style universal bank. But this model does not seem to exist in Western countries. (Even in Germany, the home of the universal bank, conducting banking activities and insurance activities within a single corporate entity is not allowed.)

Type B: PARTIAL INTEGRATION



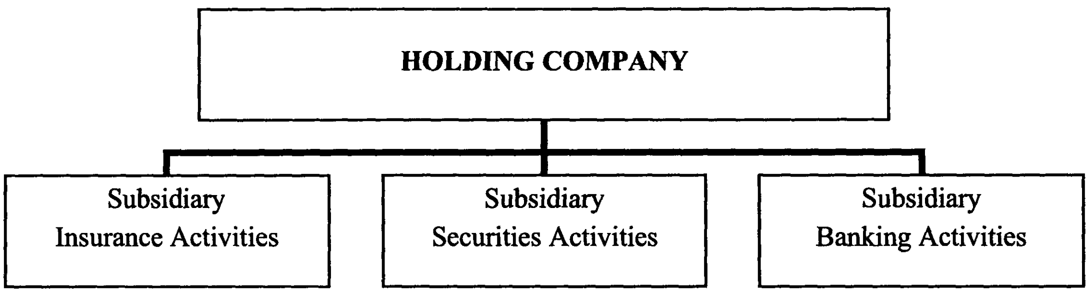
A partially integrated bank (Type B) conducts both commercial and investment banking within the same entity but undertakes insurance underwriting and distribution, as well as perhaps mortgage banking, asset management, lease financing, factoring, management consulting, or other specialized activities through separately capitalized subsidiaries, mainly because such activities are separately regulated. Most continental European countries including Germany, France, Switzerland, follow this model.

Type C: BANK-SUBSIDIARY STRUCTURE



In a Type C, a commercial bank whose core business as a credit institution is taking deposits and making commercial loans is the parent of subsidiaries engaged in a variety of other financial services ranging from investment banking to insurance. British multifunctional banks traditionally follow this model, with securities and insurance activities (if any) carried out via subsidiaries of the bank itself.

Type D: HOLDING COMPANY STRUCTURE



A final multi-line financial firm structure (Type D) involves creating a holding company that controls affiliates engaged in commercial banking, investment banking, insurance, and possibly other types of financial and non-financial businesses. U.S. and Japanese banks, which try to diversify their businesses, fall within this type because U.S. and Japanese regulations mandate this type of organization. Regulations in both countries historically required separation between banking and most types of securities activities, with strict firewalls between them. Recent deregulation in both countries now allows banks to engage in both banking and securities businesses but the regulations continue to mandate the holding company structure.

2.3. Organizational Issues of Consolidation and Financial Conglomerates

As discussed in section 2-2, consolidated banks and financial conglomerates result in complex organizations, and that complexity creates organizational issues. First is the capital misallocation problem. A large portion of capital resource tends to be allocated preferentially to more- profitable business segments. In contrast, less-profitable segments are not given enough capital resources. As a result, the less-profitable business becomes less competitive against more narrowly focused financial institutions. Due to this, some consolidated banks cannot sufficiently exploit the potential synergies from several business segments.

The second issue is promoting collaboration among several business organizations or entities. A performance-driven corporate culture sometimes causes conflicts among several organizations or entities, where each one tries to maximize its own profit instead of collaborating with the others. Without careful attention to limiting such conflicts of interest, it is difficult to realize synergy effects from cross-selling or corporate segments.

The third issue is designing a proper compensation and incentive system. For example, it is often difficult to maintain a high-level, performance-based compensation and incentive structure for employees engaged in investment banking and at the same time a parallel, relatively flat structure for employees engaged in commercial banking – both within one corporate entity. If banks separately subsidize several business segments as Type B, C, D, they can set up different compensation and incentive structures. But when they want to transfer employees across business entities as part of cross-selling initiatives, they need to take special care to align their compensation and incentive structures.

Organizational complexity sometimes results in disadvantages to a bank's clients. The more complex the bank's organization becomes, the more difficult it is for them to maintain strict compliance control across business segments. Recently, many compliance violations by large financial institutions have occurred. In 2003 Citigroup was ordered by Japan's Financial Services Agency (FSA) to shut down its private banking operations for higher-net-worth individuals in Japan after the agency discovered that its private banking division had violated banking laws and regulations. It was said that the lack of cross-functional compliance controls caused this violation. Accordingly, many private clients of Citigroup's Japanese subsidiaries suffered the sudden suspension of their private banking services.

For shareholders and investors, the structural complexity of consolidated banks and financial conglomerates makes it difficult to add pure sectoral exposures to their portfolio. In effect, the forming of financial conglomerates prevents them from optimizing asset allocation across specific segments of the financial industry. Investors may avoid such stocks in their efforts to construct asset-allocation profiles.

It is often argued that the shares of financial conglomerates tend to trade at prices lower than the shares of more narrowly focused financial institutions (portfolio-selection effect). This tendency, called "a conglomerate discount," arises from both capital misallocation and the portfolio-selection effect. I will provide an example of conglomerate discount by Citigroup in the following chapter.

Chapter 3

Consolidation in the U.S. Banking Industry

3.1 The Progress of Regulatory Reform

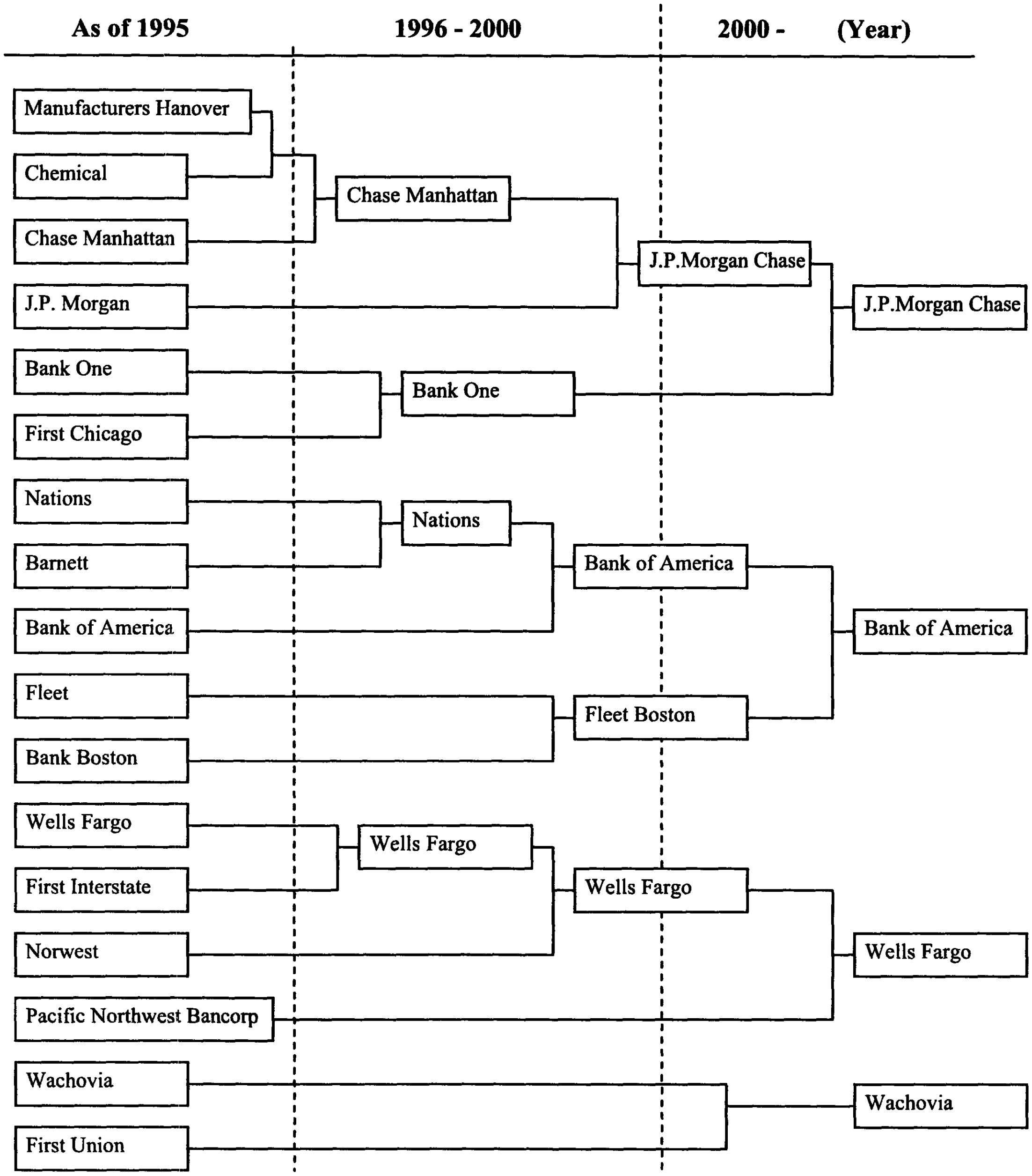
In the 1980s, many U.S. commercial banks suffered losses from failed property loans and loans to emerging countries. In addition, severe competition from investment banks, securities firms, foreign banks, and savings and loans banks (S&Ls) also contributed to lowering the banks' profitability. Under these circumstances, many commercial banks that wanted to expand their business in order to return to profitability, and the Federal Reserve Bank (FRB) which sought recovery for the banking industry in general, asked for regulatory reforms that would prohibit banks from extending their business to other geographic areas and other financial business sectors.

Regarding the geographic aspect, since 1933 most states prohibited out-of-state banks from collecting retail deposits, which effectively excluded them from setting up out-of-state branches. Bank holding companies might establish bank subsidiaries in other states, but each was an individual legal entity that had to be separately capitalized. But in the 1980s the failure of thousands of banks and S&Ls put pressure on individual states to revise their legislation to allow entry to out-of-state banks through the merger of healthy bank holding companies with unsound local banks and S&Ls. Also, some neighboring states entered into regional reciprocal agreements to allow branches across state lines.

In response to these deregulatory moves and intensified pressure for reform from banks and FRB, the Riegle Neal Interstate Banking and Branching Efficiency Act was passed in 1994. This act eliminated the restrictions on interstate banking businesses and, beginning in September 1995, allowed all

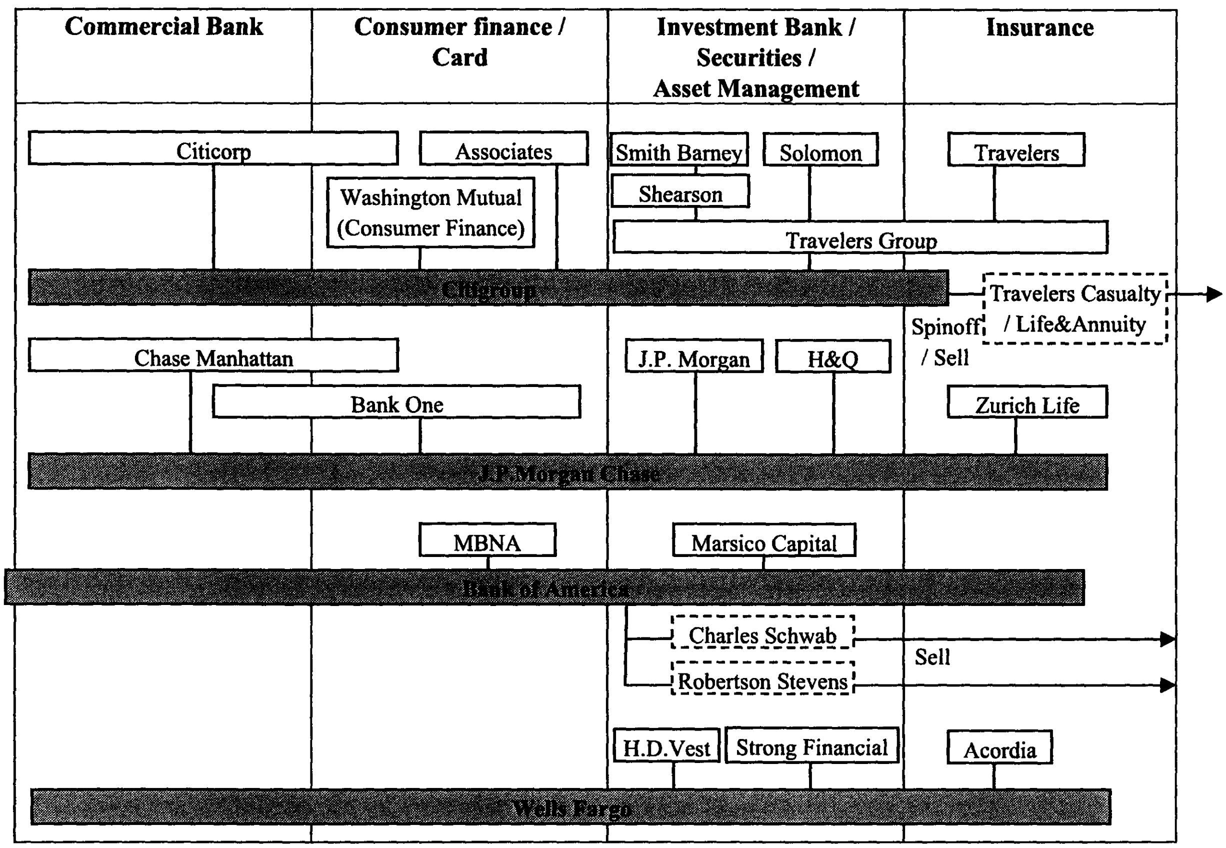
U.S. banks to acquire banks in other states. From June 1997, bank holding companies could convert subsidiaries to branches, and any out-of-state bank taken over by another bank could be converted to a branch. To prevent excessive concentration, a bank holding company may not hold more than 30% of total deposits in any given state, and 10% nationally. As a result, interstate branching through the acquisition of existing banks became easier and more attractive, and many banks acquired other banks in order to expand into other geographic regions. Examples of M&A activities in the 1980s and 1990s are illustrated in Figure 3-1.

Figure 3-1. Recent U.S. bank mergers



At the same time interstate branch banking deregulation occurred, rules that imposed functional segmentation were repealed in incremental steps. The Glass Steagall Act prevented banks from trading securities, or underwriting insurance, or owning shares in non-financial companies, and it limited the securities functions of commercial banks to underwriting and dealing in municipal government debt. Since 1987 the act was gradually relaxed so that commercial banks were allowed to enter into securities businesses. In 1999, the Gramm Leach Bliley Financial Modernisation Act was passed and eliminated functional segmentation among banking business, securities, and insurance, As a result banks can establish financial holding companies which own banking, securities, and insurance subsidiaries. The deregulation promoted banks to acquire or merge with securities and insurance firms. Chief examples of recent consolidating movements across different financial sectors are illustrated in Figure 3-2.

Figure 3-2. Recent U.S. bank consolidations across several financial sectors



3.2 Transformation of Banking Institutions in the United States

Regulatory reforms prompted U.S. banks to consolidate with other banks and other kinds of financial institutions. In this chapter, I will analyze the transformation of three large U.S. banking institutions: Citigroup, J.P. Morgan Chase, and Bank of America. These three are experiencing rapid growth through mergers, by consolidating activities, and by establishing large financial conglomerates. The ranking of these three banks among the world's banks, based on market value, is shown in Table 3-1.

Table 3-1. Ranking of the world's banking institutions

	Banking Institution	Country	Total Market value (2004/08) ($million)	Total Asset Amount (2003) ($million)
1	Citigroup	US	240,888	1,264,032
2	Bank of America	US	183,410	936,680
3	HSBC	UK	171,135	1,034,216
4	J.P.Morgan Chase	US	141,037	1,097,475
5	Wells Fargo	US	99,144	387,798
6	Royal Bank of Scotland	UK	87,048	814,227
7	UBS	Switzerland	79,152	1,118,553
8	Wachovia	US	61,675	401,032
9	Barclays	UK	59,738	792,743
10	Mitsubishi Tokyo Financial Group	Japan	58,125	992,695

Source: The Wall Street Journal 2004.9.27

3.3 Citigroup

3.3.1 Recent M&A activities

In 1998 Citigroup came into existence through a merger between Citicorp and Travelers Group. For Citigroup, the first objective of the merger was to strengthen its retail business by adding Travelers' securities and insurance products to its banking products. The second objective was to consolidate its investment banking business by acquiring Salomon Smith Barney, an investment banking subsidiary of Travelers. At the time, and despite its strong position, Citicorp faced severe competition from other banks, credit-card firms, and securities firms in the retail business. Citicorp felt the need to enhance its retail business by rebuilding its investment banking business, by realistically consideration of the slow growth of global financial businesses due to the financial crisis in Asia, and the shift among its individual clients from bank deposits to stocks and/or mutual funds. Travelers' primary objective was to improve profitability through cross-selling its securities and insurance products to Citicorp's large client base.

Citigroup immediately implemented an expansion plan by completing a number of acquisitions. In 1999, it announced two separate acquisitions that would strengthen its consumer lending position. First, it acquired Mellon Bank's credit card business, including a portfolio of $1.9 billion in credit card receivables. Then Citigroup signed an agreement to acquire a $558 million loan portfolio and 128 consumer finance branch offices from Associates First Capital. In 2003, Citigroup acquired Sears' $29 billion portfolio of private label and bankcard credit card receivables. The acquisition also included Sears' financial products business and credit card facilities. It also launched a strategic partnership with Home Depot to provide consumer and commercial credit card accounts to its customers. In 2004, Citigroup acquired the mortgage banking business of the Principal Financial Group, an Iowa-based financial services company, in a move that would bolster its position in the U.S. home lending business. In 2004, it also purchased the consumer finance business from Washington Mutual, the giant U.S. retail financial institution. The acquisition included more than 400 offices in 25 states, adding to Citigroup's consumer finance network in southeastern and southwestern U.S.

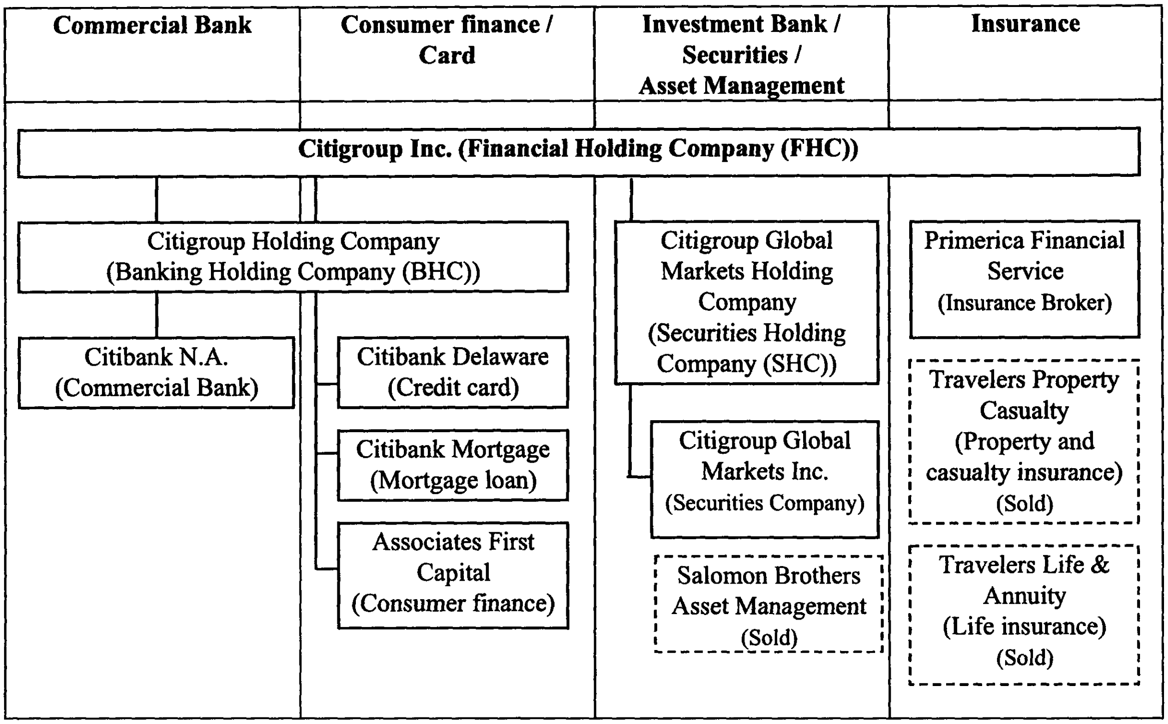
Simultaneously, Citigroup tried to strengthen its retail network. In 2001, it acquired European American bank, a large bank in New York, from ABN AMRO. In 2003, it acquired Golden State Bancorp and expanded its retail distribution franchise in key California and Nevada markets. In 2004, it also acquired First American Bank in Texas, a $3.5 billion asset bank with a strong commercial presence and more than 100 branches in Texas.

In the investment banking sector, Citigroup expanded through a number of acquisitions and strategic alliances. In 1999, Salomon Smith Barney, a subsidiary of Citigroup, established Nikko Salomon Smith Barney (now Nikko Citigroup), a wholesale investment bank in Japan, with Japan Nikko Securities. In 2000, Salomon Smith Barney, agreed to acquire the investment banking businesses of Schroder, a UK investment banking and asset management firm. That acquisition doubled Citigroup's investment banking and equities platforms in Europe. In 2004, Citigroup purchased the derivative business from Knight Trading to expand its derivatives capabilities and add significant scale to its U.S. equities business. It also acquired Lava Trading (the leader in electronic execution and sell-side order management systems) to consolidate its leading market position in electronic trade execution.

Meanwhile, Citigroup sought to enlarge its global business through a number of acquisitions and strategic alliances. In 1999, it acquired Financiero Atlas, a Chile-based consumer finance company with 65 branches throughout Chile and $460 million in assets. In 2000, it acquired acquire Associates First Capital Corporation, the fifth-largest consumer finance company in Japan (now CFJ K.K.). In 2001, it acquired Grupo Financiero Banamex-Accival, a Mexican financial services group that integrates operations in Mexico under the Banamex brand name. In 2003, it agreed to a strategic alliance with Shanghai Pudong Development Bank, a Chinese commercial bank, to enter China's emerging credit card market. In 2004, it acquired KorAm Bank, the sixth-largest commercial bank in Korea. The combined businesses of Citigroup and KorAm now constituted the fifth-largest financial business in Korea based on revenues.

Through its M&A activities, Citigroup has established itself as the world's largest financial conglomerate. The company's organization structure is illustrated in Figure 3-3.

Figure 3-3. Citigroup organization



3.3.2. Performance after consolidation

Five years after the consolidation of Citicorp and Travelers, total net revenue has increased 1.36 times and net income has increased 1.25 times. Total assets have also increased 1.64 times (see Table 3-2 and Figure 3-4).

Table 3-2. Citigroup Five-Year summary of selected financial data

($billion)	2000	2001	2002	2003	2004
Total Net Revenues	58.2	61.6	66.2	71.6	79.6
Operating expenses	34.3	35.0	35.9	37.5	49.8
Net Income	13.5	14.1	15.2	17.8	17.0
Total Assets	902.6	1,051.9	1,097.6	1,264.0	1,484.1
Common Stockholders' Equity	66.2	79.7	85.3	96.8	108.1
Return on Asset (ROA)	1.5%	1.3%	1.4%	1.4%	1.1%
Return on Common Equity (ROE)	20.4%	17.7%	17.8%	18.4%	15.7%
Expense ratio (Operating expenses / Total net revenues)	58.9%	56.9%	54.2%	52.4%	62.5%

Source: Citigroup Form 10K 2004

Figure 3-4. Citigroup total net revenues and income

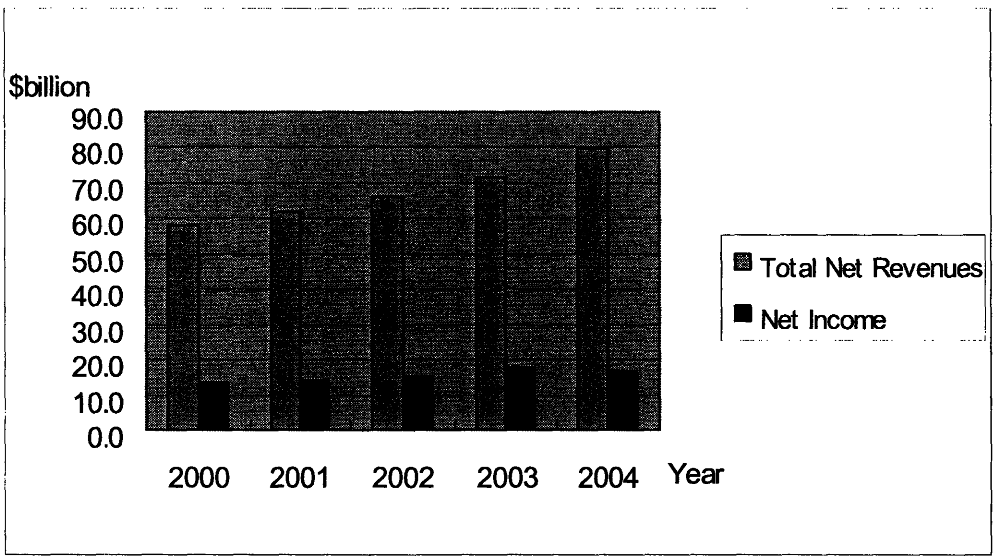


Table 3-2 also shows that among its four business segments, the Global Consumer Group and Corporate & Investment Banking have increased their net incomes.

Table 3-3. Citigroup Segment results of Net Income

($billion)	2002	2003	2004
Global Consumer Group	8.2	9.6	11.9
Corporate & Investment Banking	4.6	5.4	6.4
Global Wealth Management	0.5	1.3	1.2
Global Investment Management	1.1	1.2	1.3

*2002 excludes a $1.4 billion after-tax change related to the Enron and Litigation Reserve Change
*2004 excludes a $4.9 billion after-tax change related to the WorldCom and Litigation Reserve Change

Source: Citigroup Annual report 2003,2004

Based on revenue and income increases, it seems that consolidation has produced positive effects for Citigroup. Also Citigroup can obtain synergy effects through various M&A activities. For example, in the investment banking business Citigroup has enhanced its position in the ranking of world M&A advisory and underwriting of U.S. bonds, as shown in Table 3-4. As a result of the consolidation of Citicorp and Travelers, Citigroup could offer a wide array of financial products to its clients and exploit cross-selling opportunities. The ability to provide total financial solutions have contributed to revenue increases.

Table 3-4. World's M&A Advisory ranking

	Ranking (Market Share)		
	2000	2002	2003
Citigroup	6 (5.3%)	2 (16.8%)	2 (18.0%)
JPMorgan Chase	5 (8.5%)	5 (14.4%)	3 (15.9%)
Goldman Sachs	1 (17.2%)	1 (24.4%)	1 (24.5%)

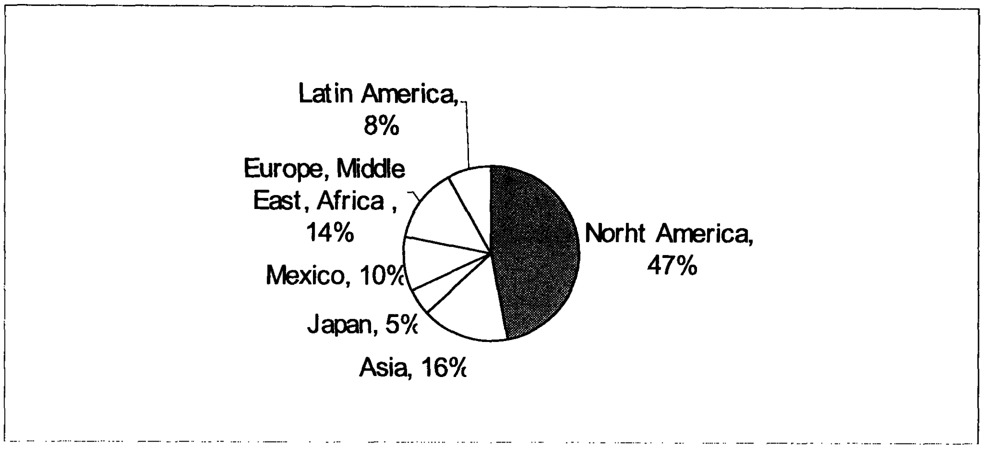
Ranking of underwriting of US Bond

	Ranking (Market Share)		
	2000	2002	2003
Citigroup	2 (13.7%)	1 (15.0%)	1 (13.5%)
JPMorgan Chase	3 (12.2%)	2 (13.4%)	2 (11.1%)
Goldman Sachs	7 (6.9%)	9 (5.0%)	8 (5.7%)

Souce: One-Stop Shopping for Financial Sevices, Shiraishi, 2005

In addition to product diversification, rapid geographic expansion was also a characteristic of Citigroup's M&A activities. As shown in Figure 3-5, Citigroup's revenue stream is regionally diversified. Citigroup attempts to maximize its business opportunities in worldwide regions by extending its business models. In 2004, net revenues from Asia (ex. Japan) increased by 29%; from Europe, the Middle East, and Africa by 21%; and from Mexico by 19%. The geographic expansion has contributed to its total revenue growth and diversification of its business risk. This is one of the positive results of Citigroup's M&A activities.

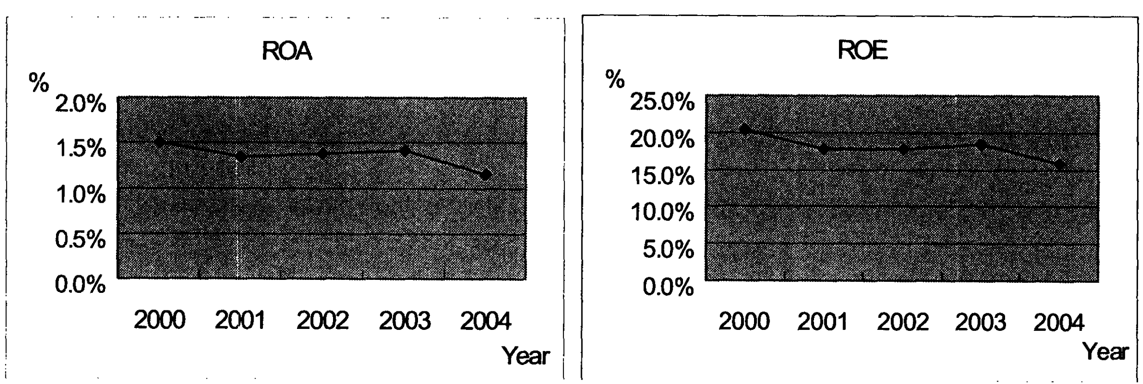
Figure 3-5. Citigroup Geographical split of income (2004)



Source: Citigroup Annual Report 2004

But ROA and ROE have had a downward tendency since 2000 (see Figure 3-6). Those show that the growth of profitability has not kept pace with that of total assets generated through active M&A activities.

Figure 3-6. Citigroup ROA and ROE trends

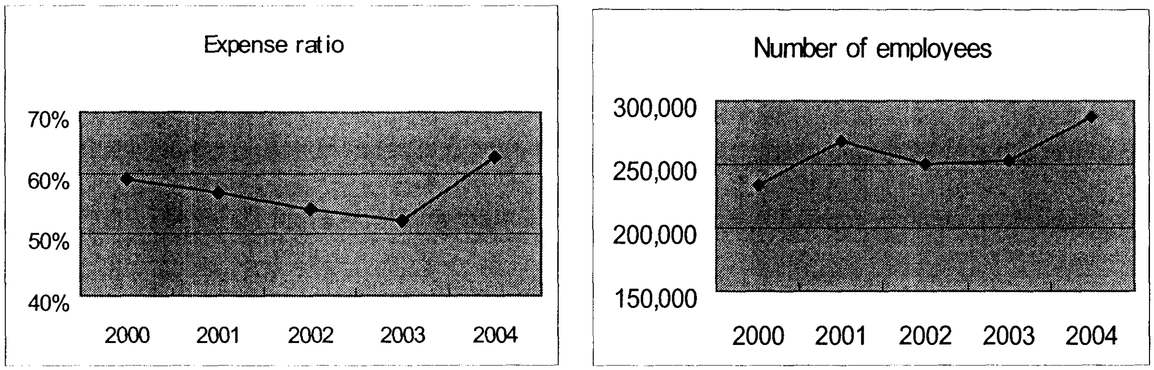


The slower growth of profitability can be primarily attributed to three reasons. The first is that collaboration and cross-selling across several functional divisions has not been fully realized. After the consolidation of Citicorp and Travelers, customer relationship management across several functional divisions has not been integrated. For example, as of 2003, the management of customer relationships for the corporate banking division, transaction service division, and investment banking division (old Salomon Smith Barney) had not been integrated. This hindered cross-selling of bank loans and investment banking products to single corporate clients. Further, this sometimes caused conflicts of interest across several functional divisions. As for insurance products, subsidiaries such as Primerica and Smith Barney execute a large portion of sales, and collaboration with bank branches does not seem to be fully promoted.

The second reason is complexity associated with the existence of several similar business entities. For example, in the consumer finance business sector, Citigroup has two business brands, CitiFinancial and Associates First Capital. The existence of several distribution channels causes overlapping of some business content and related inefficiency. It also causes confusion among individual clients. Associates First Capital was sued by more than 700 clients for insufficient explanation regarding multiple financial products sales (Aonuma, 2000).

The third reason is that cost economies of scale and scope have not yet been realized. As shown in Figure 3-7, expense ratio and number of employees have not decreased noticeably in recent years and in fact increased in 2004. This factor can be attributed primarily to Citigroup's consolidation, which emphasized revenue growth by cross-selling several products and by geographic diversification rather than cost reduction. Citicorp and Travelers had very little duplication in their business activities, so it was difficult to make considerable cut costs.

Figure 3-7. Citigroup five-year trend of operating expenses



Source: Citigroup Form 10K 2004 and Financial Snapshot on HP

3.3.3 Conglomerate discount

In this section I analyze the investors' evaluation of Citigroup's M&A strategy.

As shown in Table 3-5, Citigroup's price earnings ratio (PER) in 2001 was higher than the industry averages of several financial business sectors. But by 2004 PER was lower than the industry average of all financial business sectors. This means that investors do not highly evaluate the stock performance and growth of Citigroup compared with more narrowly focused financial institutions in each financial business sector.

Table 3-5. Citigroup Price earnings ratio (Comparison with industry average)

Year	Citigroup	Industry Average						
		Retail Bank	Transaction Service	Consumer Finance / Card	Life Insurance	Asset Management	Investment Bank	Retail Securities
2001	**18.1**	17.4	24.7	16.5	16.6	23.3	13.2	18.1
2004	**11.8**	15.0	19.0	16.3	14.0	21.6	14.0	17.2

Source: Bank of Tokyo-Mitsubishi UFJ, New York Branch Report

As explained in Chapter 2.3, "Conglomerate discount" became actualized in Citigroup. In addition to lower growth of profitability, several issues caused by organizational complexity negatively affected investors' sentiment. One major problem is the lack of strict compliance control. Citigroup was accused of a number of legal and ethical violations, including the Enron and WorldCom scandals, both of which resulted in enormous financial damage. In 2003 Citigroup was ordered by Japan's Financial Services Agency (FSA) to shut down its private banking operations in Japan for violating banking laws and regulations. Such problems were caused by a lack of strict compliance control, which resulted from the increased complexity of its organization due to the number of M&As. Citigroup bore huge losses, both financially and to its reputation, through a series of scandals. Investors abhor such compliance risk in financial conglomerates, and will avoid holding the stock of financial conglomerates like Citigroup.

3.3.4 Business restructuring

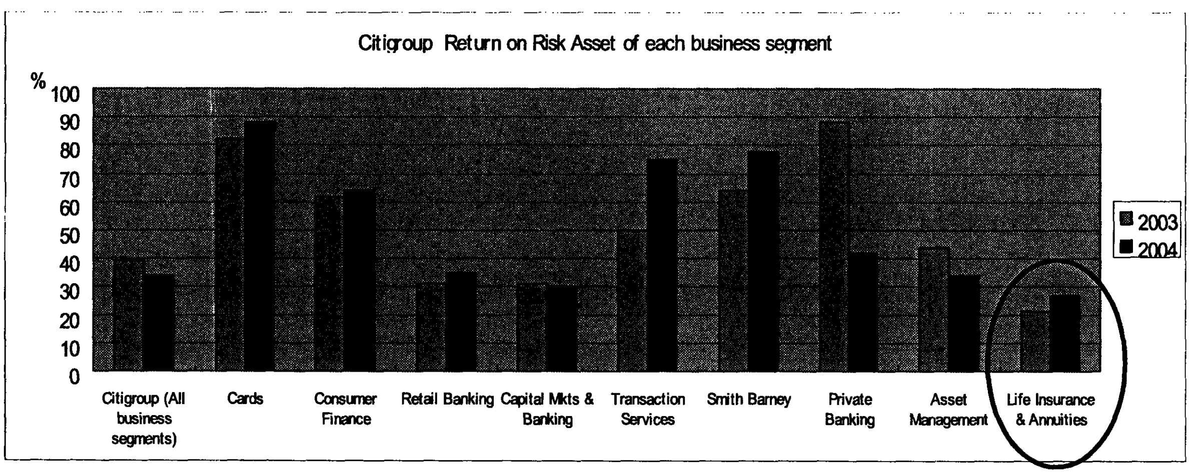
Citigroup has pursued economies of scale and scope through several M&As. But in response to lower growth, it began to review its conglomerate structure and made a decision to restructure its business portfolio. In 2002, it spun off and/or sold its property and casualty insurance businesses conducted by Travelers Property and Casualty Insurance and retreated from underwriting and manufacturing such insurance. At that time the performance of Travelers Property and Casualty Insurance was severely damaged by the impact of the September 11, 2001 attacks as well as a string of hurricane damages. In addition to lower profitability and the slower growth of the property and casualty insurance businesses, the volatility of these profits made Citigroup reluctant to continue in those businesses.

In 2005, Citigroup decided to sell its life insurance subsidiary, Travelers Life & Annuity, to Met Life and to focus on promoting the sales of outsourced insurance products through its distribution channels. Charles Prince, Chief Executive Officer of Citigroup, said:

Travelers Life & Annuity has a long and successful history of providing world-class products and services to its global customer base. This transaction joins Travelers Life & Annuity with one of the world's leading insurance companies and sharpens our focus on Citigroup's long-term growth franchises. We will redeploy the sale proceeds to higher return and higher growth opportunities and to maximize returns to our shareholders. (Citigroup, press release, January 31, 2005).

As shown in Figure 3-8, the profitability of the life insurance and annuities business is lower than other Citigroup business segments. Furthermore, the profit from investment in underwriting assets is influenced by stock market performance and is highly volatile. Those factors are the main reason for this business sellout.

Figure 3-8. Citigroup return on risk capital of each business segment [1]



Source: Citigroup Form 10-K, 2004

1 Risk capital is defined as the amount of capital required to absorb potential unexpected economic losses resulting from severe events over a one-year time period. Return on risk capital is calculated as net income divided by average risk capital.

In 2005, Citigroup decided to sell substantially all of its asset management business to Legg Mason in exchange for Legg Mason's broker-dealer business. As also shown in Figure 3-8, the profitability of the business is not much lower than other business. However, major investment will be required to continue this business due to its scale and technology-driven nature despite the pressure to lower charges for asset management services. Such a decision would be based on the idea that a firm should dispose of non-core and/or unprofitable and unpromising businesses and redeploy the sale proceeds to core or more profitable businesses.

Citigroup's recent restructuring activities show that a financial conglomerate is not necessarily an ideal business model in the banking industry. In particular, synergies between the banking and insurance businesses cannot be easily realized.

As to the business model in which banks undertake the insurance business, an "open architecture" model that focuses on the distribution of external products by outsourcing product manufacturing, will become common practice in the banking industry.

3.4. J.P. Morgan Chase

3.4.1. Recent M&A activities

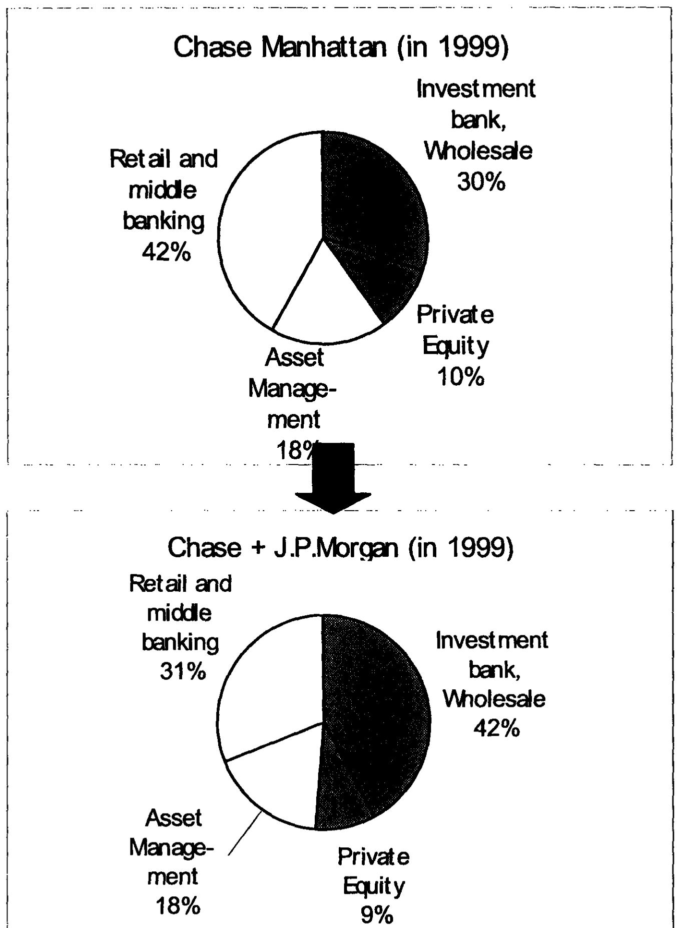
J.P. Morgan Chase created its current configuration through four major mergers. In 1991, Manufacturers Hanover and Chemical Bank merged to consolidate their business base in the New York area. In 1996, Chemical Bank merged with Chase Manhattan Bank to further consolidate its business base in that region. As a result, the new Chase Manhattan Bank (CMB) became the largest bank in the U.S. (based on assets), exceeding Citicorp. Both of those mergers aimed to consolidate the base of business in New York and other focused regions, and to cut costs by eliminating overlap in the branch network and redundant managerial resources.

These two mergers were good for CMB. It acquired more than 20% of the market share of deposit balances in the New York area. Its operating expense ratio decreased from around 70% in 1990 (Manufacturers Hanover and Chemical Bank) to 55% in 1999. In 1999, CMB's ROE was higher than Citicorp and Bank of America, and its stock enjoyed the best performance of the three banks.

Meanwhile, CMB was trying to strengthen its investment banking businesses, which were expected to bring higher profitability. In 1999, it acquired Hambrecht & Quist (H&Q), an investment bank that specialized in IPOs of IT venture companies. In 2000, CMB acquired Robert Fleming, a UK investment bank and Beacon Group, which specialized in M&As. However, CMB's investment banking business presence remained largely behind specialized investment banks such as Goldman Sachs or Morgan Stanley. CMB's global market share of investment banking business in 1999 was even lower than Citicorp: 7.8% in M&A advisory (Citigroup 12.6%), debt underwriting 5.0% (Citigroup 9.2%), and IPO 1.8% (Citigroup 4.1%) (UBS, 1999).

To enhance its investment banking capabilities, in 2000 CMB decided to acquire J.P. Morgan, a leading global investment bank, thus creating a new entity named J.P. Morgan Chase. This acquisition significantly changed its business structure. As shown in Figure 3-9, the weight of the investment banking business (investment bank / wholesale + private equity) in net income increased by 11% after merging Chase Manhattan with J.P. Morgan.

Figure 3-9. Comparison of business segment split of net income of Chase and Chase + J.P. Morgan



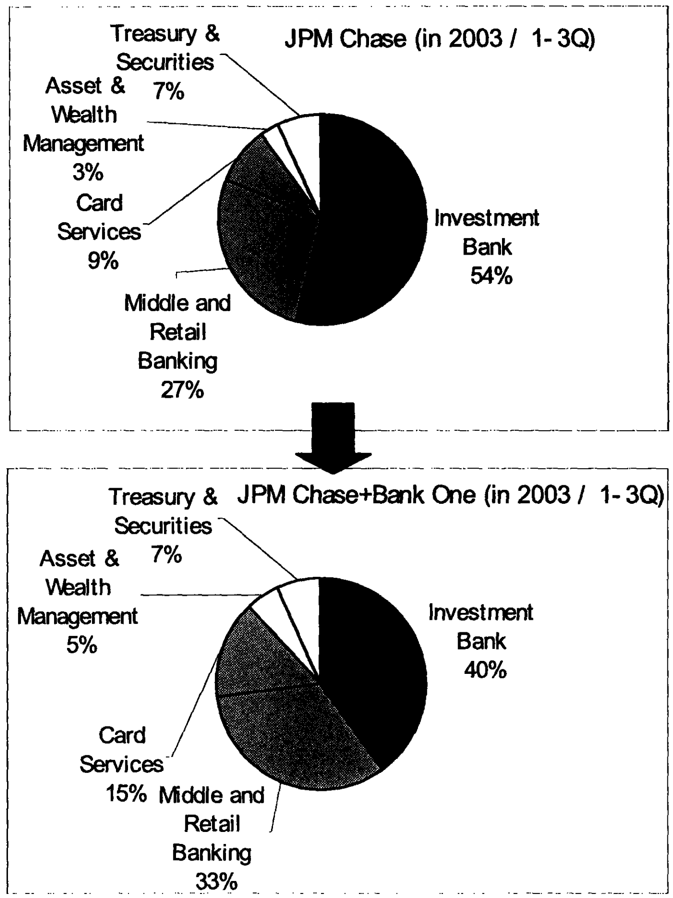
Source: Chase Manhattan and J.P. Morgan Form 10K, 1999

The shift to the investment banking business caused major damage to the financial performance of J.P. Morgan Chase following the burst of the IT bubble economy; in 2001 and 2002 its profit dropped considerably. These results showed its executives that the investment banking business was highly volatile and unsustainable. In response, the bank began to revise its strategic business focus on the investment banking business.

In 2003, J.P. Morgan Chase acquired the U.S. insurance business from Zurich Life. The aim of this acquisition was to strengthen its retail business capability through cross-selling of banking and insurance products. The consolidation of Citicorp and Travelers also influenced this decision.

In 2004, J.P. Morgan Chase decided to merge with Bank One, a New York-based commercial bank that had a competitive advantage in the consumer finance and credit card business. As a result of this merger, J.P. Morgan Chase attempted to shift to the investment banking business and to achieve a business portfolio that was well-balanced between investment banking and retail banking. As shown in Figure 3-10, the weight of the investment banking business on net income decreased by 14% and the combined weight of the middle/retail banking and credit card businesses increased by 12% after the merger with Bank One.

Figure 3-10. Business segment split of net income of JPM Chase and JPM Chase + Bank One



Source: J.P. Morgan Chase and Bank One Form 10K, 2003

3.4.2 Performance after consolidation

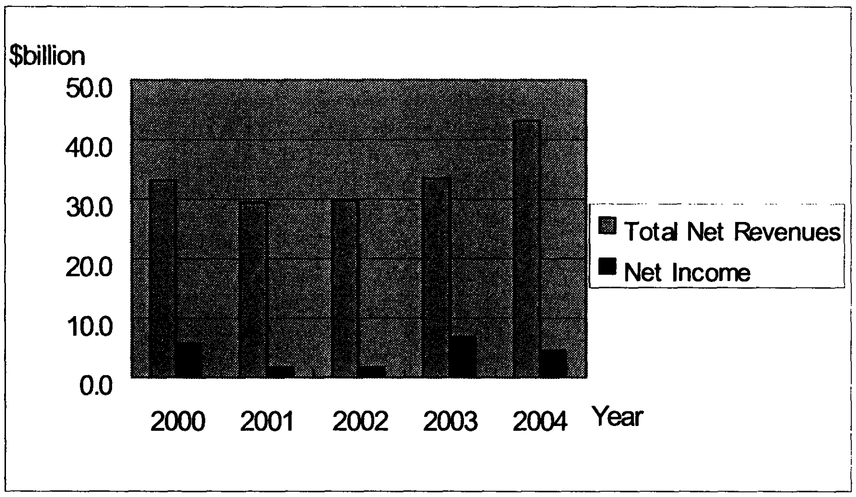
For the five years following the consolidation of Chase Manhattan and J.P. Morgan, total net revenue increased 1.3 times, but net income decreased 1.26 times. (In 2004, the litigation reserve cost (3.7 billion) had a negative impact on net income). Total assets also increased 1.61 times (see Table 3-6 and Figure 3-11).

Table 3-6. J.P. Morgan Chase Five-Year summary of selected financial

($billion)	2000	2001	2002	2003	2004
Total Net Revenues	33.2	29.3	29.6	33.4	43.1
Operating expenses	21.6	21.1	20.3	21.7	29.3
Net Income	5.7	1.7	1.7	6.7	4.5
Total Assets	715.3	693.5	758.8	770.9	1,157.2
Common Stockholders' Equity	40.8	40.0	41.2	45.1	105.3
Return on Asset (ROA)	0.8%	0.2%	0.2%	0.9%	0.4%
Return on Common Equity (ROE)	14.0%	4.2%	4.0%	14.9%	4.2%
Expense ratio (Operating expenses / Total net revenues)	65.2%	71.8%	68.4%	65.0%	68.0%

Source: J.P. Morgan Chase Form 10K 2004

Figure 3-11. J.P. Morgan total net revenues and income



In 2001 and 2002, J.P. Morgan Chase suffered a decline in revenue and net income due to the burst of the IT bubble. In 2003 its financial performance improved as the stock markets recovered. As shown in Table 3-7, in 2002 net income from the investment banking business was small, but in 2003 it improved significantly. In 2004, it maintained the same level as 2003.

Comparing results, it is clear that the investment banking business is volatile and not sustainable. In contrast, net income from retail financial and card services was relatively sustainable, and the 2004 merger with Bank One contributed to income increases for those services.

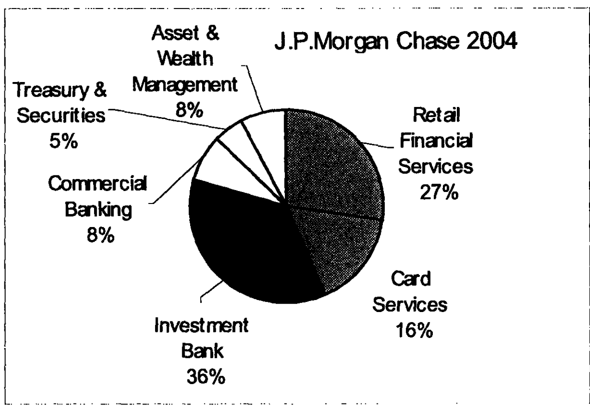
Table3-7. J.P.Morgan Chase Segment results of Net Income

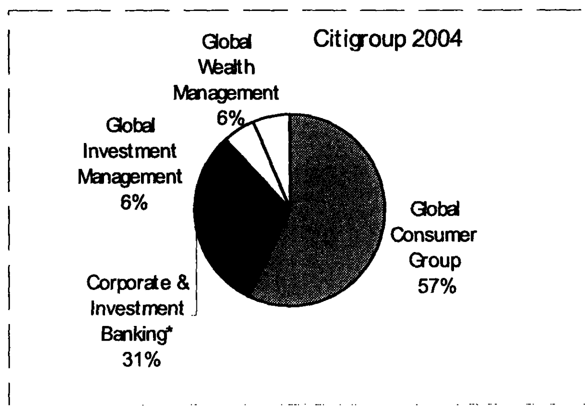
($billion)	2002	2003	2004
Investment Bank	0.4	4.5	4.6
Retail Financial Services	2.2	2.4	3.5
Card Services	1.0	1.0	2.0
Commercial Banking	0.5	0.5	1.0
Treasury & Securities	0.8	0.6	0.6
Asset & Wealth Management	0.4	0.4	1.0

Source: J.P. Morgan Chase Form 10K 2004

As shown in Figure 3-12, net income from the J.P. Morgan Chase retail financial, credit card, and investment banking businesses became equally diversified as a result of the merger with Bank One, and its business portfolio came close to Citigroup's. This diversification will mitigate business risk depending on the investment banking sector.

Figure 3-12. Business segment splits of net income of JPM Chase and Citigroup

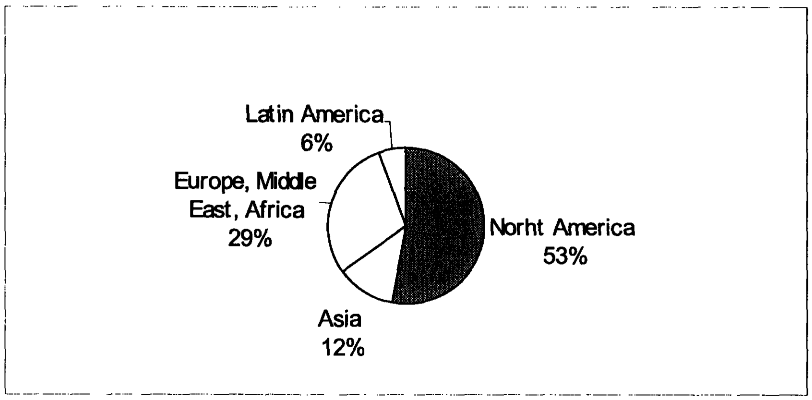




Source: J.P. Morgan Chase and Citigroup Form 10K, 2004

As shown in Figure 3-13, J.P. Morgan Chase also diversified its geographical business portfolio like Citigroup, but net income from the Europe/ Middle East/Africa segment is larger than other foreign areas. This can be attributed to the fact that most of its international business is based on J.P. Morgan's and Robert Fleming's investment banking businesses in Europe.

Figure 3-13. J.P. Morgan Chase Geographical split of income (2004)

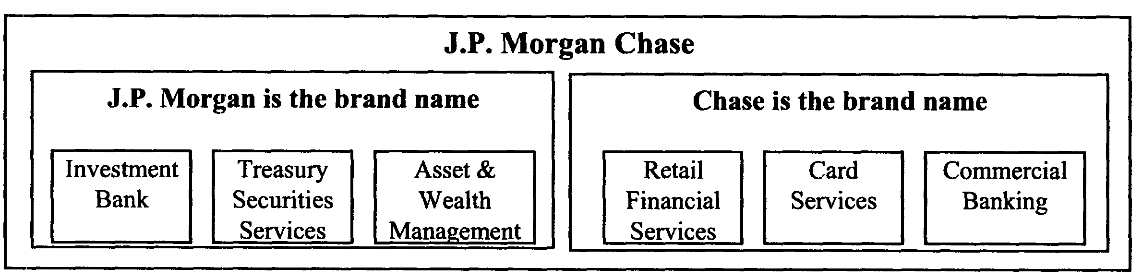


Source: J.P. Morgan Chase Form 10K 2004

3.4.3 Organizational Issues Following Consolidation

The series of consolidations caused some organizational problems within J.P. Morgan Chase. One problem was the difficulty of blending people from the former Chase Manhattan with those from J.P. Morgan. According to Walter (2004), many key Morgan managers left the new organization due to what they believed to be unfair treatment. Despite the fact that several business divisions were being conducted under the J.P. Morgan brand (see Figure 3-14), it was said that most key managerial positions were held by former Chase people. In addition, there were cultural differences between the two entities which contributed to the difficulty of blending the entities following consolidation.

Figure 3-14. Organization of J.P. Morgan Chase



Source: J.P. Morgan Chase Form 10K 2004

3.5. Bank of America

3.5.1 Recent M&A activities

Bank of America was created through the merger of NationsBank and BankAmerica in 1999. NationsBank had a strong presence in southeastern U.S., and BankAmerica had a major presence in the West Coast. The merger of these two super-regional banks was complementary in geographic terms and the goal was to create significant geographic coverage throughout the U.S. as well as creating advantages of profit and cost economies of scale by spreading marketing and reducing administrative costs.

In 2003 Bank of America acquired Fleet Boston, the seventh largest bank in the U.S. with a solid base in the northeast. The merger created the second largest bank in the U.S. with the largest nationwide branch network and the largest share of deposit amounts in the U.S.

The main reasons for the merger were geographic expansion and consolidation of the business base in the nationwide retail and middle banking business. The business structures of the former NationsBank, BankAmerica, and Fleet Boston were quite similar in terms of their focus on the retail and middle banking business. This was quite a contrast with the Citigroup consolidation which emphasized products and international diversification, or the J.P. Morgan Chase consolidation which emphasized the investment banking business.

In 2005, Bank of America acquired MBNA Corporation, the largest independent credit card lender in the U.S., for the purpose of further consolidating its retail banking business. Through this acquisition, Bank of America became the largest card issuer in the U.S., based on number of accounts, with 40 million account holders. Bank of America and MBNA together held a total of approximately \$143 billion in outstanding card balances at the end of 2004, compared to J.P. Morgan Chase's \$134.7 billion and Citigroup's \$116 billion (Creditsights, 2005).

3.5.2 Performance after consolidation

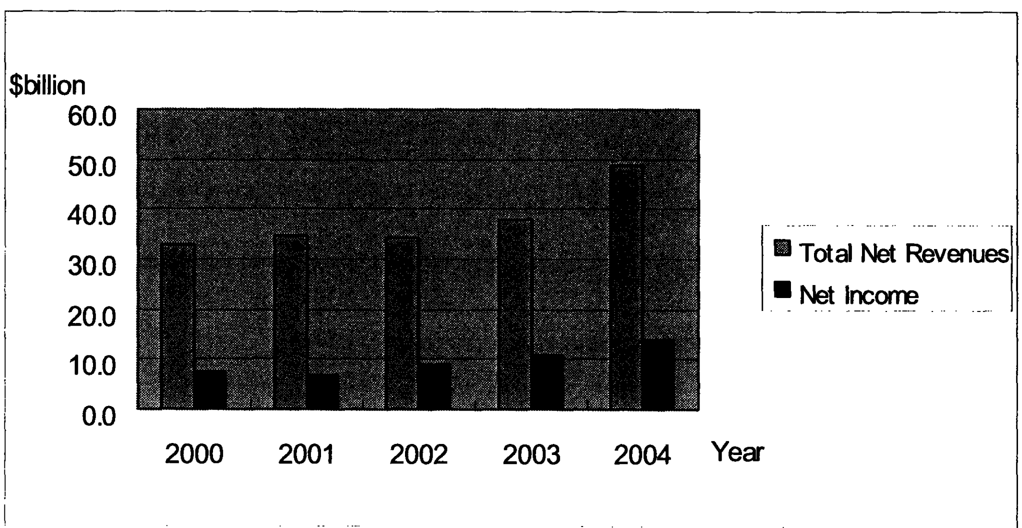
In the past five years, total net revenue has increased 1.48 times and net income has increased 1.88 times, while total assets have increased 1.55 times (see Table 3-8 and Figure 3-15). Among the three case studies, Bank of America recorded the largest increase of net revenue and net income over the past five years. In this sense, it achieved the most success through its M&A strategy of the three banking institutions.

Table 3-8. Bank of America Five-Year summary of selected financial data

($billion)	2000	2001	2002	2003	2004
Total Net Revenues	32.9	34.6	34.5	37.9	48.8
Operating expenses	18.6	20.7	18.4	20.1	27.0
Net Income	7.5	6.7	9.2	10.8	14.1
Total Assets	670.0	644.8	653.7	749.0	1,044.6
Common Stockholders' Equity	47.0	48.6	47.5	49.1	83.9
Return on Asset (ROA)	1.1%	1.0%	1.4%	1.4%	1.3%
Return on Common Equity (ROE)	16.0%	13.8%	19.4%	22.0%	16.8%
Expense ratio (Operating expenses / Total net revenues)	56.5%	59.8%	53.3%	53.0%	55.3%

Source: Bank of America Annual Report 2004

Figure 3-15. Bank of America total net revenues and income



This success can be attributed to the bank's unrivaled presence in the nationwide retail and middle banking markets, which were consolidated through a series of M&A. For example, the largest holding share of banking accounts generated large amount of non-interest revenue solely from account service charges in US$ 6.9 billion in 2004. It could successfully increase its market share in the U.S. syndicate loan to corporate clients, especially medium and small companies, and achieve the largest share in 2004 (see Table 3-9).

Table 3-9. Market share in the U.S. syndicate loan

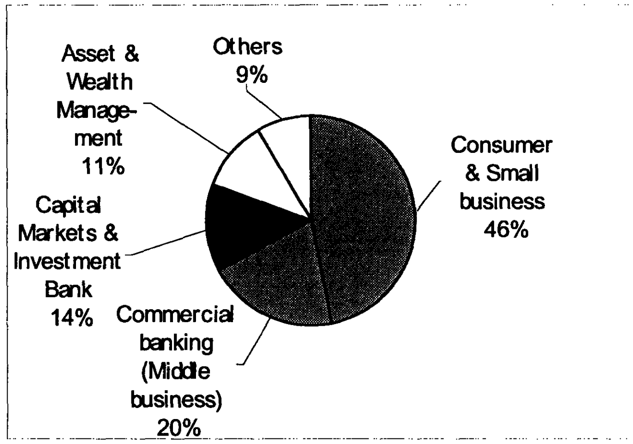
1991		
		Share(%)
1	Citicorp	16%
2	Chemical	9%
3	Chase	7%
5	JP Morgan	6%
8	BankAmerica	3%
9	Nations	3%

2004		
		Share(%)
1	Bank of America	30%
2	JPM Chase	29%
3	Citigroup	11%

Source: Gold Sheets, IDD

Success also can be attributed to the less-volatile nature of its business structure. Bank of America's revenue stream comes primarily from retail and middle banking business and is not largely dependent on the investment banking business. As shown in Figure 3-16, the percentage of net income from the investment banking business is small compared to Citigroup and J.P. Morgan Chase, which meant that the bank suffered less impact when the IT bubble economy burst in 2001 and 2002, and the bank has been able to achieve sustainable income growth in recent years.

Figure 3-16. Business segment split of Net Income



Source: Bank of America Annual Report 2004

Bank of America's relatively conservative attitude toward credit risk is one factor in its success. In 2004, 70% of its consumer loan portfolio consisted of residential mortgages which have lower risk than card loans or consumer finance, instead of lower interest margin. This is higher than Citigroup's 46%, which is weighted toward card loans and consumer finance. This results in better credit quality (the percentage of impaired loan is 0.24%) than Citigroup (0.52%) and J.P. Morgan Chase (0.45%) and in smaller losses related to impaired loans.

The cost scale of economy is another factor in Bank of America's success. In addition to its nationwide branch banking network, Bank of America has established extensive delivery channels such as ATMs, customer service via telephone, and online banking. It is estimated that Bank of America has a largest number of online banking users in the U.S. banking industry. Active online banking subscribers increased 73% in 2004 (approximately half of which was due to the acquisition of Fleet Boston customers) (Datamonitor, 2005). Its large size allows Bank of America to invest huge amounts of capital into the development of a common system platform and efficient delivery channels across merged entities. As a result, it could achieve cost efficiencies following its merger between BankAmerica and

NationsBank. As shown in Table 3-10, its expense ratio in 2004 was lower (55.3%) than before the merger (57.2%).

Table 3-10. Bank of America Five-Year trend of operating expenses

($billion) (Expense ratio: %)	1997 (Nations+ BankAmerica)	2000	2001	2002	2003	2004
Total Net Revenues	27.8	32.9	34.6	34.5	37.9	48.8
Operating expenses	15.9	18.6	20.7	18.4	20.1	27.0
Expense ratio (Operating expenses / Total net revenues)	57.2%	56.5%	59.8%	53.3%	53.0%	55.3%

Source: Bank of America Annual Report 2004

3.5.3 Low valuation for growth opportunity

Bank of America will likely achieve success as a result of its M&A activities. However, it currently suffers from lower valuation for its growth opportunity. Its price/earning ratio is lower than Citigroup and J.P. Morgan Chase, although its performance is better than those institutions in recent years (see Table 3-11).

Table 3-11: Valuation ratio of U.S. three mega banks

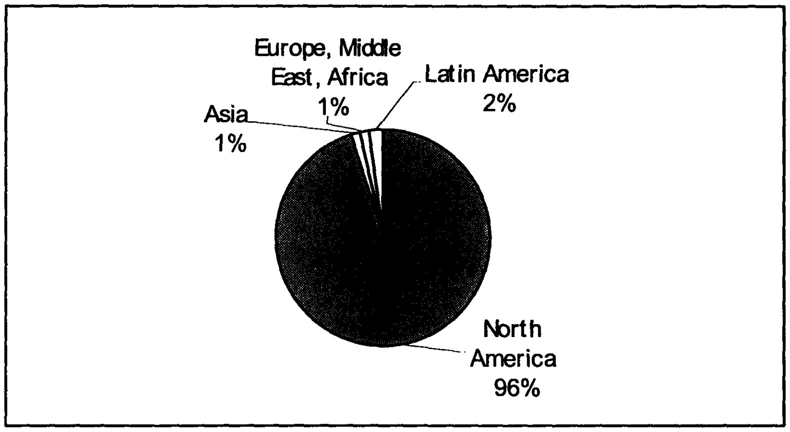
(%) (January 2006)	**Bank of America**	Citigroup	JP Morgan Chase
Price/Earnings[1]	**10.6**	11.4	18.0
Forward P/E[2]	**10.3**	11.5	12.9
Return on common stock (in 2004)	16.8	15.7	4.2
Dividend Yield	4.3	3.9	3.6

[1]Price/Earnings : A stock's current price divided by the company's trailing 12-month earnings per share.
[2]Forward P/E: A stock's current price divided by the mean EPS estimate for the current fiscal year.
EPS Estimates are provided by Reuters Estimates.
Source: Morningstar, January 2006

These results indicate that investors put a lower value on the future growth of Bank of America. Investors may expect lower growth for several reasons. First is the limited opportunity for further geographical expansion in the U.S. The bank already holds the largest market share in many states and it would be difficult to pursue further extension. Second is Bank of America's lesser capability in the investment banking business compared to Citigroup and J.P. Morgan Chase. In recent years it has emphasized less on investment banking business than retail and medium banking business. As shown in its segment result of net income in Chapter 3.5.2, the weight of investment banking business is small in comparison to Citigroup and J.P. Morgan Chase. This business strategy resulted in smaller competitiveness in the business. For example, its share in M&A advisory at 2004 (11.4%) is behind Citigroup (13.3%) and J.P. Morgan Chase (19.4%) (Gold Sheets, 2005). As discussed in Chapter 3.5.2, the business strategy enabled it to avoid negative impact from the burst of IT bubble economy and to achieve good financial results in recent years. But investment banking business has an opportunity for higher profits than retail and middle banking business instead of huge volatility. Smaller capability in the business would give investors little expectation for the rapid and strong earning growth of Bank of America.

For the sake of finding new growth opportunities, Bank of America takes on extending the international reach. Reflecting on the failure in business in emerging markets of former BankAmerica, it scaled down business in foreign countries in the 1980s and 1990s. As shown in Figure 3-18, the weight of net income from foreign countries is only 4%.

Figure 3-18. Geographical spilt of income (2004)



Source: Bank of America Annual Report 2004

In 2002, Bank of America acquired a 24.9% stake in Grupo Financiero Santander Serfin, Mexico's most profitable bank, from Santander Central Hispano. In 2005, it acquired 9% of the stock of China Construction Bank, the second largest commercial bank in China, seeking to build long-term prospects in the high-potential Chinese markets. But its attempt to extend its international reach remains focused largely on the acquisition of minor interests in several foreign banking institutions, and it may take longer to realize strong growth in the international business.

3.6 Summary

In this chapter, I discussed the trend of consolidation in the banking industry in the United States. It was confirmed that regulatory reform encouraged banking institutions to consolidate. Some created a financial conglomerate through merger with non-bank financial institutions. However, the objective of consolidation was different among several financial conglomerates.

I analyzed three financial conglomerates: Citigroup, J.P. Morgan Chase, and Bank of America, and each bank's objectives were different. Citigroup primarily pursued products and international geographic diversification through consolidation. J.P. Morgan Chase initially aimed to strengthen its investment banking business, but recently adjusted its focus to target a better balance between investment and retail banking. Bank of America emphasized the extension of its geographical outreach in the U.S. and the realization of profit and cost economies of scale.

The five-year financial performance trend among the three conglomerates found that Bank of America achieved the best performance in net income growth and return on assets (see Figures 3-18 and 3-19). This implies that profit and cost economies of scale are the most effective of several objectives for considering consolidation. On the other hand, it is difficult to realize synergy effects through cross-selling of several financial products for a short period.

Figure 3-18. Comparison of net income growth of three financial conglomerates

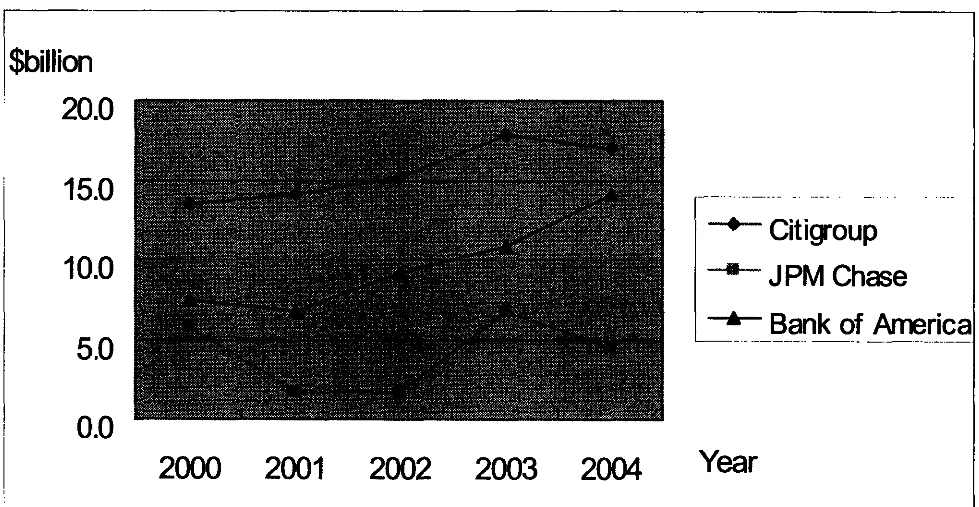
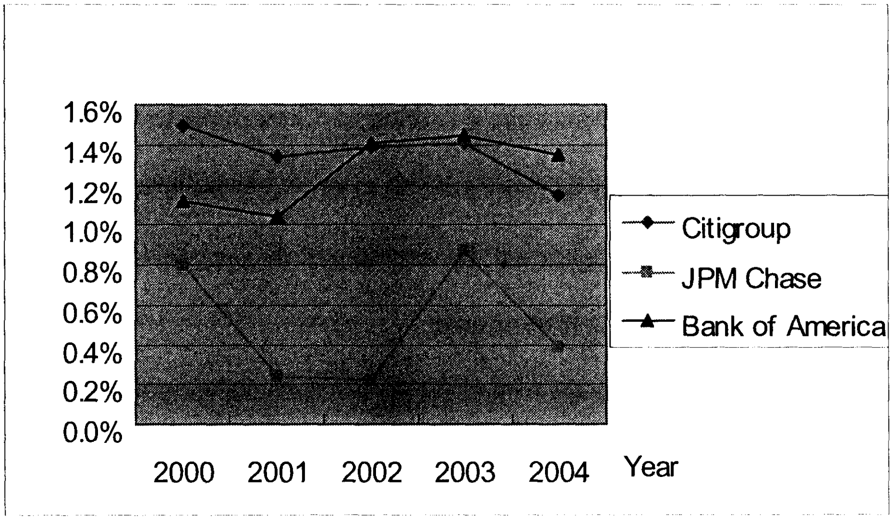


Figure 3-19. Comparison of Return on Asset (ROA) of three financial conglomerates



Source: Author, 2006

At this stage, investors do not put a higher value on financial conglomerates. As shown in Table 3-12, all forward price/earnings ratios of the three financial conglomerates are lower than the industry average for commercial banks.

Table3-12: Valuation ratio of U.S. three financial conglomerates

(%) (January 2006)	Citigroup	JP Morgan Chase	Bank of America	Industry Average	S&P 500
Price/Earnings	11.4	18.0	10.6	16.6	21.8
Forward P/E	11.5	12.9	10.3	13.2	18.7

Source: MORNINGSTAR, January 2006

The so-called "conglomerate discount" arises from several issues associated with financial conglomerates. The first issue is inefficient capital use and distribution across several business segments. As discussed in section 3-3, Citigroup finally decided to sell a large part of its insurance business to improve its profitability even though it had infused capital into the business for several years after the merger.

The second issue is compliance risk. Organizational complexity resulted in the lack of strict compliance control across several business segments and became one of the factors causing the scandals. Citigroup and J.P. Morgan Chase suffered huge losses as a result of the Enron and WorldCom scandals.

The third issue is the unsuccessful fusion of several business entities. As discussed in section 3.4., J.P. Morgan Chase failed to harmoniously integrate employees from the two predecessor entities. This failure prevented it from realizing the potential synergies that might have taken place between the investment banking and corporate banking business segments. This is an example of the difficulty of consolidating different corporate cultures during a merger.

Chapter 4

Consolidation in the European Banking Industry

4.1 Emergence of a Single Market for Financial Services

Since the end of World War II, most European countries had made major efforts to integrate their economic markets. In 1986, the Single European Act was introduced to speed up the movement toward a single internal market. In January 1993, the single internal market was created so that cross-border barriers between European countries were largely eliminated, and people and commodities could move freely.

At the same time, the integration of financial markets was also promoted. In 1989, the Second Banking Directive was passed by the Commission of European Communities. This directive granted financial institutions in the European Union (EU) a "passport" to offer financial services in the EU, provided member states have banking laws that meet certain minimum standards. The passport means that if a bank is licensed to conduct activities in its home country, it can offer any of these services in an EU country without having to seek additional authorization from the host country. This rule encouraged financial institutions in the EU to expand their businesses in other European countries or across the entire European region.

The directive also covered third country banks, that is, banks headquartered in countries outside the EU. The principle of equal treatment applies: the EU has the right to either suspend new banking licenses or negotiate with the third country if EU financial institutions find themselves at a competitive disadvantage because foreign and domestic banks are treated differently.

These articles established a favorable environment for foreign financial institutions, whose home country allows European financial institutions to conduct business there, to enter the European market. The directive also allowed financial institutions in the EU to conduct "universal banking" including deposit taking, lending, mortgages, financial leasing, underwriting and dealing securities, and asset management.

In January 1999, a single currency, the euro, was introduced for general use in the EU, and it has been adopted by Germany, France, Italy, Spain, Portugal, Finland, Austria, Belgium, Luxembourg, Netherlands, and Ireland (UK, Denmark, and Sweden have not yet adopted the euro). This further promoted the integration of EU financial markets, and enabled EU companies to access the most favorable financial markets in the EU to raise money, while enabling individuals to invest in securities products of other European countries.

Although it has not adopted the euro, the UK has promoted deregulation in financial markets in parallel with the integration of the EU financial markets. Unlike European continental countries, the UK had prohibited commercial banks from conducting business in securities and insurance. But the Building Societies Act passed in 1986 triggered the financial "Big Bang," which eliminated the "firewall" between banking, securities, and insurance. The Act proposed reforming building societies (mutual associations that offer their subscribers funds for house purchasing or building) by allowing them to convert into commercial banks. In return, commercial banks were allowed to conduct securities and insurance businesses. At that time, as the country's population grew older, the demand for annuity and life insurance products rapidly increased. In response, UK commercial banks established insurance subsidiaries or acquired insurance companies.

The financial "Big Bang" encouraged non-financial firms to enter the banking businesses. As discussed in Chapter 1, both Tesco and Sainsburys, large UK supermarket chains, launched on-line banking. In addition, banking institutions in continental Europe and the U.S. expanded their presence by acquiring UK merchant banks. New entrants from the non-banking sector and from foreign countries made competition in the UK banking industry fierce.

The integration of financial markets and the introduction of a single currency encouraged the EU banking institutions to expand their businesses throughout the entire EU region. Also foreign banking institutions, including U.S. banks, also entered the EU market. As a result, competition in the EU banking market became fierce. More and more corporate and individual clients asked for services that covered the entire EU. Under these circumstances, many EU banks were encouraged to consolidate in order to enhance their business capabilities. Examples of major bank consolidations in the EU are shown in Table 4-1.

Table 4-1. Examples of recent consolidation in the European banking industry

Year	Acquirer Name	Target Name
1997	Bayerische Verainsbank (Germany)	Bayerische Hypotheken (Germany)
1998	UBS (Switzerland)	SBC (Switzerland)
1999	Banco de Santander (Spain)	Banco Central Hispano (Spain)
1999	BNP (France)	Paribas (France)
1999	Banca Intensa (Italy)	Banca Commerciale Italiana (Italy)
2000	Royal bank of Scotland (UK)	National Westminster (UK)
2000	HSBC (UK)	Credit Commercial de France (France)
2001	Halifax (UK)	Bank of Scotland (UK)
2002	Credit Agricole (France)	Credit Lyonnais (France)
2004	Banco de Santander (Spain)	Abbey National (UK)

Source: Walter, *"Mergers and Acquisitions in Banking and Finance"*, Oxford, 2004

In addition to consolidations between banks, there were also frequent consolidations between banks and insurance firms, creating "Bankcasurance." Acquisition of banking institutions was attractive to insurance firms since they could use the bank's network as an extended delivery channel for their insurance products and could pool clients' funds internally. Examples of banking and insurance firm consolidations are illustrated in Table 4-2.

Table 4-2. Examples of banking and insurance firm consolidations

	Insurance firm	Banking institution
1998	Fortis (Belgium)	Generale de Banque (Belgium)
2000	Lloyds TSB	Scottish Widows (UK)
2001	Allianz (Germany)	Dresdner (Germany)

Source: Author, 2006

4.2 Transformation of Banking Institutions in Europe

The integration of financial markets and the introduction of a single currency encouraged European banks to consolidate with another banks and insurance firms. I will analyze the transformation of Deutsche Bank, UBS, and HSBC, three large European banks. Deutsche Bank and UBS have long been universal banks and conducted a wide range of financial businesses in their respective single entities. During the past twenty years each bank sought to strengthen its business through M&A activities that would establish larger business entities like some U.S. banking institutions. The ranking of these three banks among the world's other banks, based on market value, is shown in Table 4-3.

Table 4-3. Ranking of world's banking institutions

	Banking Institution	Country	Total Market value (2004/08) ($million)	Total Asset Amount (2003) ($million)
1	Citigroup	US	240,888	1,264,032
2	Bank of America	US	183,410	936,680
3	HSBC	UK	171,135	1,034,216
4	J.P.Morgan Chase	US	141,037	1,097,475
5	Wells Fargo	US	99,144	387,798
6	Royal Bank of Scotland	UK	87,048	814,227
7	UBS	Switzerland	79,152	1,118,553
8	Wachovia	US	61,675	401,032
9	Barclays	UK	59,738	792,743
10	Mitsubishi Tokyo Financial Group	Japan	58,125	992,695
17	Deutsche Bank	Germany	39,521	1,011,991

Source: The Wall Street Journal 2004.9.27

4.3 Deutsche Bank

4.3.1 Recent M&A activities

Deutsche Bank has long been the largest bank in Europe, with strong relationships with many other German large companies through cross-shareholding and delegation of company auditors. Traditionally, Deutsche Bank's core business has been conventional commercial banking activities, such as loans and foreign currency trading. Its securities business was another key business line because many German corporations depended on bank loans to raise capital.

However, the emergence of a single EU financial market encouraged many German companies to shift to capital markets in other European countries if they could find more favorable term. Furthermore, an increase of new European and U.S. banking institutions into Germany's capital market created fierce competition. In those circumstances, Deutsche Bank's loan balance was restricted and its loan margin declined from 3% in the 1980s to 2% in the early 1990s, producing a negative impact on earnings and growth. In response, Deutsche Bank attempted to move its business out of conventional commercial banking and strengthen its investment banking.

Deutsche Bank had another reason for shifting to the investment banking business: the retail and middle banking businesses in Germany were becoming increasingly unattractive. In these markets, state-owned regional and local savings banks still maintain a strong position with about 80% share of retail deposits and loans, while Deutsche Bank had a 5% share of retail deposits. In addition, high operating expense ratios as a result of labor conditions had a negative impact on profitability. In response, Deutsche Bank sought to extend its retail business into other European countries, such as Italy and Spain, through acquisitions of those countries' small banks. However, this strategy requires considerable time before improved profitability is realized.

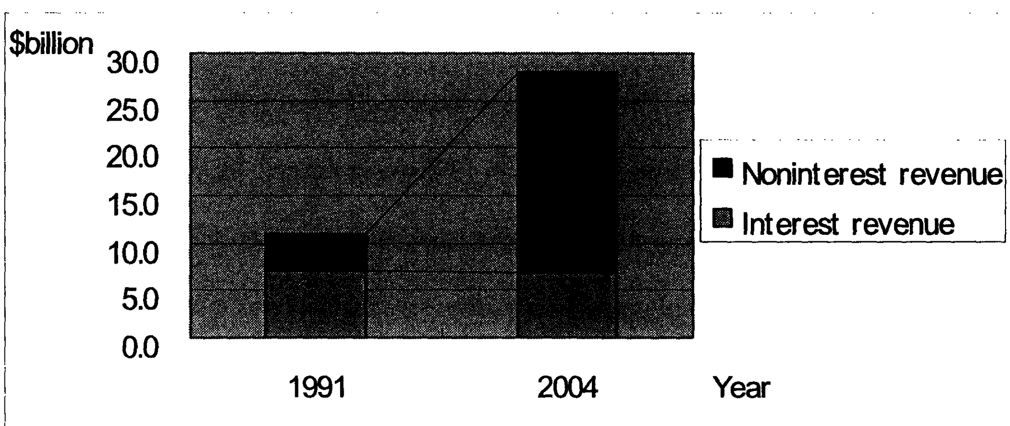
To enhance its investment-banking capability, Deutsche Bank acquired the UK merchant bank Morgan Grenfell in 1989. But Deutsche Bank did not succeed in integrating the two organizations and many of the specialist personnel at Morgan Grenfell left the new entity. Consequently, this acquisition did not produce the hoped-for capability enhancements. To improve the situation, Deutsche Bank attempted to fully integrate Morgan Grenfell into its London corporate finance headquarters by establishing Deutsche Morgan Grenfell (DMG) in 1995. Through those efforts, it gradually enhanced Deutsche Bank's presence in capital markets. For example, Deutsche Bank's ranking in the U.S. security underwriting table improved, moving from twentieth in 1996 to seventeenth in 1997. However, Deutsche Bank was never appointed lead manager for major deals, such as the restructuring of AEG or the merger between Daimler and Chrysler, which prompted the bank to take further steps to strengthen its investment banking capability.

In 1998, Deutsche Bank acquired Bankers Trust, the eighth-largest bank in the U.S. The objective of this acquisition was to establish a strong position in the derivative markets, risk management, and high-yield debt finance which was important in the run-up to IPOs and in leveraged buyouts, which were expected to experience above-average growth in Europe in the future.

Meanwhile, Deutsche Bank also strengthened its asset and wealth management businesses to improve profitability in the private banking business and to build a second pillar of growth in investment banking. It acquired the institutional asset management business of Prudential UK as well as First Australian Property Group in 2000. In 2002 it acquired the U.S. asset manager Zurich Scudder Investments from Zurich Financial Services. In 2005, Deutsche Bank announced its entry into the China fund management market through a joint venture with Harvest Fund Management Company.

Through this series of M&As, Deutsche Bank took several steps to transform itself from a conventional commercial bank to a firm that specializes in investment banking and asset management. As Figure 4-1 shows, non-interest revenue (i.e., commissions and fee income + trading revenues) rose dramatically from 1991 to 2004 while interest revenue remained at a plateau. This illustrates the shifting of Deutsche Bank's business structure from dependence on loan assets to a fee business based on trading and advisory services.

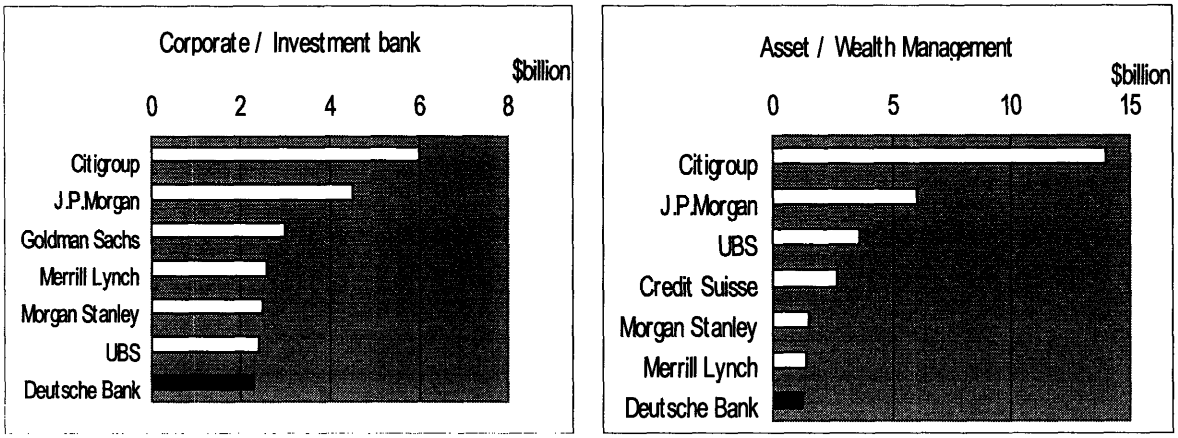
Figure 4-1. Deutsche Bank revenue transformation



Source: Deutsche Bank Annual Report 1999 and 2004

In 2004, Deutsche Bank rose to seventh position in the corporate and investment banking and in asset/wealth management businesses handled by global banking institutions (see Figure 4-2).

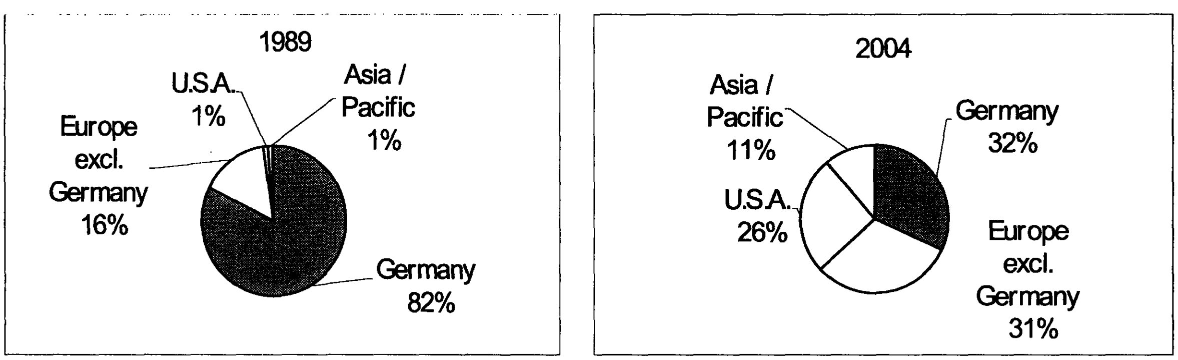
Figure 4-2. Deutsche Bank's corporate/investment banking and asset/wealth management, 2004



Source: Deutsche Bank Investors Presentation 2004

Deutsche Bank also grew internationally through its M&A activities. As Figure 4-3 shows, in the past its revenue stream depended on the German market. Today its dependence on the German market has declined and greater geographic diversification has been achieved.

Figure 4-3. Deutsche Bank's revenue diversification and geographic split



Source: Deutsche Bank Investors Presentation 2004

4.3.2 Performance after consolidation

In 2000, income tax benefit from the effective tax rate and the reversing effect increased total net revenues and net income. For four years since 2001, net income has increased 16 times while total net revenue has decreased by 25%. Total asset has decreased by 10% (see Table 4-4, and Figure 4-4). The increase of impaired loans had a negative effect on revenues in 2001, 2002, and 2003. Revenue growth and asset decrease in 2004 mainly came from reducing of impaired loan.

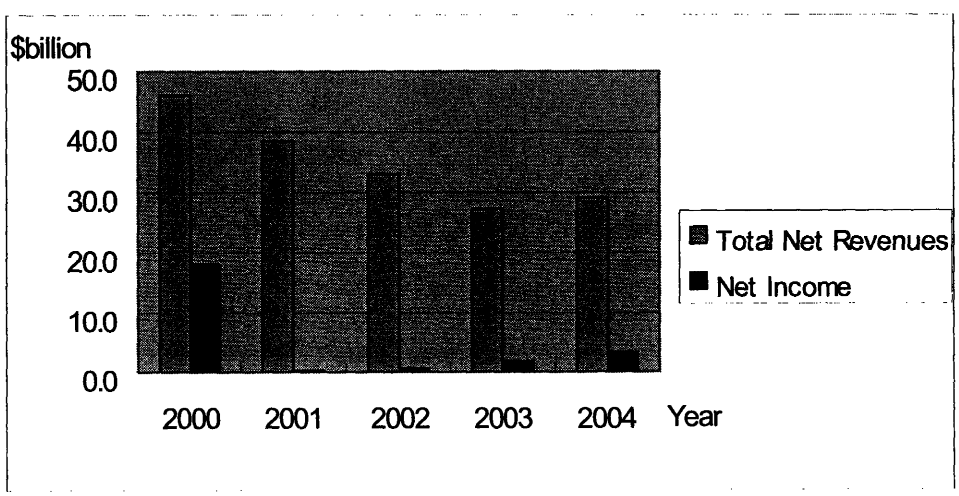
Table 4-4. Five-year summary of selected financial data for Deutsche Bank

($billion)	2000	2001	2002	2003	2004
Total Net Revenues	46.0	38.6	33.0	27.2	29.1
Operating expenses	36.7	36.1	28.3	23.4	23.7
Net Income[1]	18.3	0.2	0.5	1.8	3.2
Total Assets	1,257.5	1,243.1	1,026.6	1,087.9	1,137.2
Total Stockholders' Equity	59.0	54.3	40.5	38.2	35.1
Return on Asset (ROA)	1.5%	0.0%	0.1%	0.2%	0.3%
Return on Common Equity (ROE)	31.0%	0.4%	1.3%	4.6%	9.3%
Expense ratio (Operating expenses / Total net revenues)	79.7%	93.7%	85.7%	86.1%	81.4%

[1] In 2003, 2002 and 2001, these figures reflect the cumulative effect of changes in accounting principle.

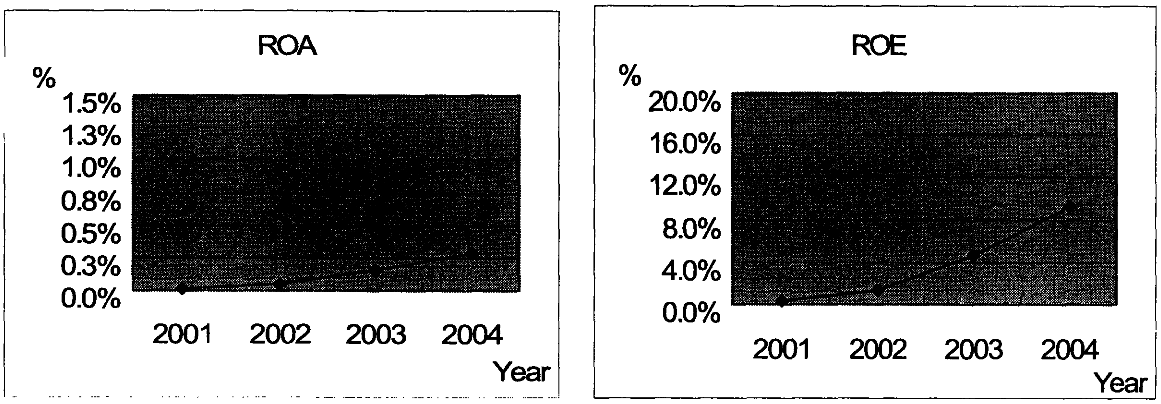
Source: Deutsche Bank Annual Report 2004

Figure 4-4. Deutsche Bank's total net revenues and income



Total net revenues and net income have shown some recovery, and accordingly, profitability has improved. But ROA and ROE are still lower than U.S. rivals such as Citigroup and J.P. Morgan (see Figure 4-5).

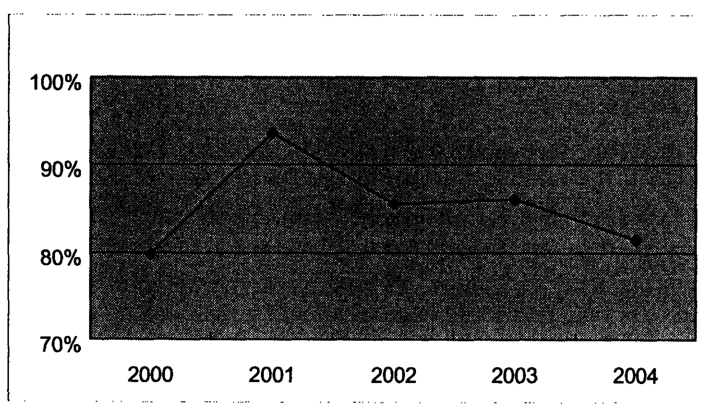
Figure 4-5. Deutsche Bank's ROA and ROE trends



Source: Deutsche Bank Annual Report 2004

The lower profitability can be attributed mainly to an inefficient cost structure. As shown in Figure 4-6, the operating expense ratio remains very high (around 80%). This means that Deutsch Bank did not achieve cost economies of scale through its M&A, and further consolidation and restructuring in its merged businesses will be required.

Figure 4-6. Deutsche Bank's five-year trend of operating expenses



Source: Deutsche Bank Annual Report 2004

4.3.3 Integrating a Commercial Bank with an Investment Bank

Deutsche Bank's various M&As offer some insights into the process of integrating the very different cultures of a commercial bank with an investment bank. As a conventional commercial bank, Deutsche Bank had long emphasized long-term results, organizational performance, and a conservative attitude toward risk. In contrast, investment banks usually emphasize short-term results, individual performance, and active risk-taking. As mentioned in section 4-3-1, Deutsche Bank experienced some difficulty in its attempt to integrate Morgan Grenfell into the Deutsche Bank culture, and in the end, Deutsche Bank decided to allow the merger to take an independent course. This lack of control caused several problems, including a rogue employee scandal and the defection of key staff.

After considering the failure, Deutsche Bank decided to change its management structure. In 1997, it appointed Rolf Breuer, from the investment banking division, as chairman. In 1996, it picked Josef Ackermann, a member of the board of managing directors from Credit Suisse, as its current chairman. Those two experts from investment banks tried to change Deutsche Bank's culture by introducing a performance-based compensation system and hiring outside professionals. They also tried to preserve the good aspects of Deutsche Bank's culture: a strong focus on client and relationship-based business. The primary reason why they selected Bankers Trust of many investment banks was that both banks had similar philosophy focusing on long-term relation with clients.

After its acquisition of Bankers Trust, Deutsche Bank worked to make the integration of the two cultures work more smoothly than had happened with Morgan Grenfell. In this case, Breuer and Ackermann paid special attention to the integration, and made use of their experience and deep understanding of the investment banking culture. This illustrates the importance of management structure and careful consideration of culture during the process of M&A.

4.4 Union Bank of Switzerland (UBS)

4.4.1 Recent M&A activities

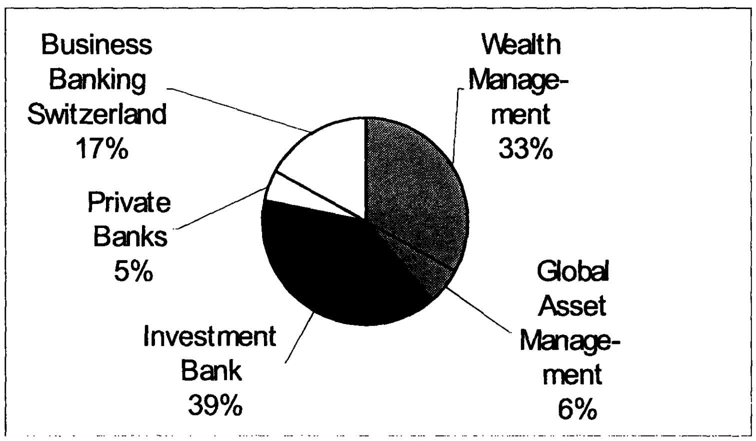
In 1998, Union Bank of Switzerland (UBS) merged with Swiss Bank Corporation (SBC) to become the largest banking institution in Europe based on total assets. The purpose of the merger was to attain the leading position in investment banking and asset/wealth management at the global level.

Until the mid-1980s, banks in Switzerland held their leading position based on strong financial markets in their home country. But the emergence of the single European financial market and the decline in value of the Swiss franc through the decrease of capital flight, eroded the competitive advantage of the Swiss financial market and its banking institutions. In response, UBS (which was strongly competitive in the asset management business) decided to merge with SBC (whose strength was investment banking). Earlier, SBC had enhanced its investment-banking capability through the acquisition of SG Warburg (UK), and Dillon Read (US)—both investment banks.

After the merger with SBC, UBS sought to strengthen its position in both business areas. In 2000 it acquired the US investment bank, PaineWebber. In 2004 it acquired Charles Schwab Sound View Capital markets to strengthen its stock-trading capability on the NASDAQ. In 2004 it also acquired the private-client business of Merrill Lynch in Germany and (IFA) Sauberborn Trust, a major German financial advisor. It also purchased IFA Scott Goodman Harris and Laing & Cruickshank (both UK institutions) in 2004. Outside Europe and the U.S., UBS tried to enlarge its business base through M&A. For example, it acquired 49% of China Dragon Fund Management and Latin American Wealth Management unit of Dresdner Bank Latinamerika. As a result of these mergers and acquisitions, UBS now ranks fifth in Germany and the UK in the asset/wealth management business.

All these M&A activities were focused on the investment banking and asset/wealth management businesses. Through several M&As, UBS became one of the leading financial institutions in the both businesses. As shown previously in Figure 4-2, UBS is positioned sixth in investment banking and third in asset/wealth management based on 2004 pretax profits. Approximately 80% of its profit comes from these two business segments (see Figure 4-7). This proportion is the largest of the six U.S. and European banks that are part of this thesis analysis.

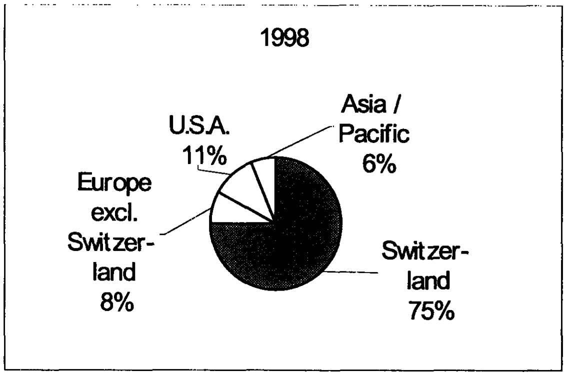
Figure 4-7. UBS business segment income split, 2004

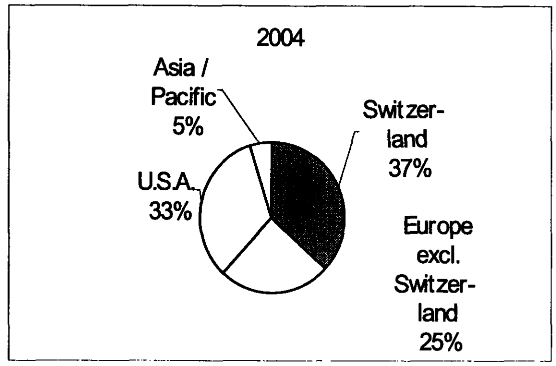


Source: UBS Annual Report 2004

As was the case for Deutsche Bank, UBS was able to grow internationally through M&As. As shown in Figure 4-8, the revenue stream from the Swiss market has declined, while the U.S. and other European markets have increased. But UBS has a smaller presence in the Asia Pacific region than other competitors as Citigroup and Deutsche Bank.

Figure 4-8. UBS Geographic split of revenues





Source: UBS Annual Report 1999 and 2004

4.4.2 Performance after consolidation

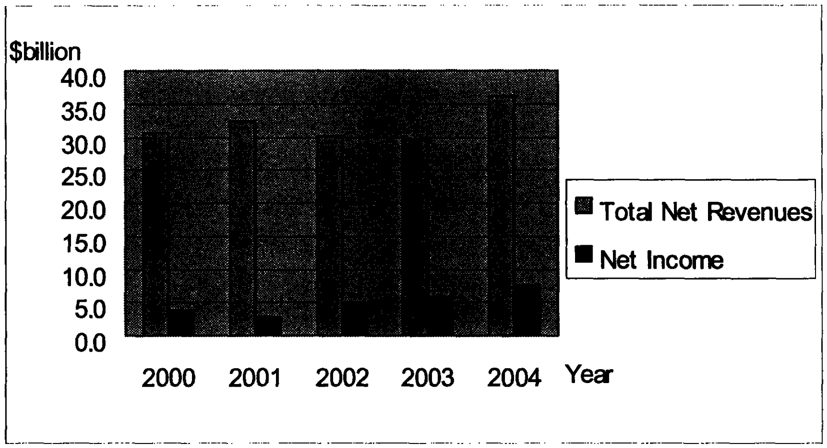
From 1999 to 2004, total net revenues increased 1.2 times, net income increased 1.9 times, and total assets also increased 1.6 times (see Table 4.5 and Figure 4-9).

Table 4-5. UBS five-year summary of selected financial data

($billion)	2000	2001	2002	2003	2004
Total Net Revenues	30.6	32.5	30.2	29.7	36.1
Operating expenses	24.7	28.1	25.2	22.1	26.1
Net Income	3.9	2.8	4.8	5.7	7.5
Total Assets	953.9	1,099.3	1,181.2	1,359.6	1,521.7
Total Stockholders' Equity	39.3	38.2	34.1	31.0	30.6
Return on Asset (ROA)	0.4%	0.3%	0.4%	0.4%	0.5%
Return on Common Equity (ROE)	9.8%	7.4%	14.1%	18.4%	24.6%
Expense ratio (Operating expenses / Total net revenues)	80.8%	86.5%	83.4%	74.3%	72.3%

Source: UBS Annual Report 2004

Figure 4-9. UBS total net revenues and net income



Source: UBS Annual Report 2004

Since 2001, UBS's profitability has steadily increased, even thought its total assets also increased. This can be attributed to three reasons: (1) increased revenue and income, (2) strict control of operating expenses, and (3) the repurchase of its own stock. UBS also has utilized a flexible financial strategy to reducing excess capital acquired through its M&As. It appears that UBS successfully captured profit and cost economies of scale through its M&A.

4.4.3 Integration of IT infrastructure

Many bank consolidations are intent on reducing costs by integrating IT technologies. Given a sensible merger strategy and the existing IT setups of the merging firms, four IT integration strategies can be identified.

- Full integration or absorption of one firm's IT systems into the other's existing systems
- Keeping the systems separate and running the two IT platforms in parallel
- Combining the most efficient pieces of both firms' systems
- Developing a new, state-of-the-art IT system

From the standpoint of cost reduction and quick integration, full integration or absorption would be the best strategy, but it is often difficult to decide which system should be adopted since the IT staffs of each bank naturally claim that their technology is superior.

According to Walter (2004), the merger between UBS and SBC faced this difficulty. UBS had its own Abacus suite that only worked on Unisys computers; SBC's software only ran on its IBM-compatible mainframes. The two banks had invested decades in the development of their respective systems, and both IT staffs were hesitant to abandon them. But top management of the new UBS did not waste time making a decision. Soon after the merger, an external consultant was retained to evaluate the competing systems, and the consultant recommended keeping the former UBS system. Top management of the new UBS heeded this recommendation and by the end of 1999, the introduction of the UBS system into SBC branches was complete. This quick decision and the speedy integration enabled the new UBS to avoid added IT expenses and to realize operational efficiency. The new UBS reduced its IT outsourcing expenses by 25%, from $1.4 billion in 1998 to $1.08 billion in 2004. The UBS case shows the importance of an IT integration strategy as part of the merger process.

4.5 Hong Kong and Shanghai Banking Corporation (HSBC)

4.5.1 Recent M&A activities

The Hong Kong and Shanghai Banking Corporation (HSBC), which originated in Hong Kong, has eagerly expanded numerous M&As. The main reason for this expansion was to adjust the bank's heavy dependence on the domestic market in Hong Kong due to fierce competition in the Hong Kong market and strong concerns about geopolitical risks associated with the reversion to China. HSBC generated about half of its revenue in the Hong Kong market until it acquired Marine Midland Bank in the U.S. in 1980 (Aono, 2005).

HSBC's most important acquisition was Midland Bank, the UK's fourth largest bank, in 1992, in order to establish a strong presence in the UK. In 1993, HSBC moved its headquarters to London. HSBC continued its policy of growth through M&A, with acquisitions of banks in Brazil and Argentina, and the purchase of Republic New York Corporation in 1999. In 2000, it acquired Credit Commercial de France and increased its shareholdings in Egyptian British Bank to over 90% (now HSBC Bank Egypt S.A.E.). In 2001, it acquired Demirbank TAS, now HSBC Bank A.S., Turkey's fifth-largest private bank. In 2002 it acquired Grupo Financiero Bital de in Mexico and also Household International, the second-largest U.S. consumer finance company. In 2003, HSBC Insurance Brokers Limited formed a joint venture with Ping An Insurance Company in China to offer insurance broking and risk management services in Mainland China. It also acquired a stake in UTI bank, an India-based retail bank. It also acquired a 19.9% stake in China's Bank of Communication and set up a business to offer local currency credit cards in China (see Table 4-6).

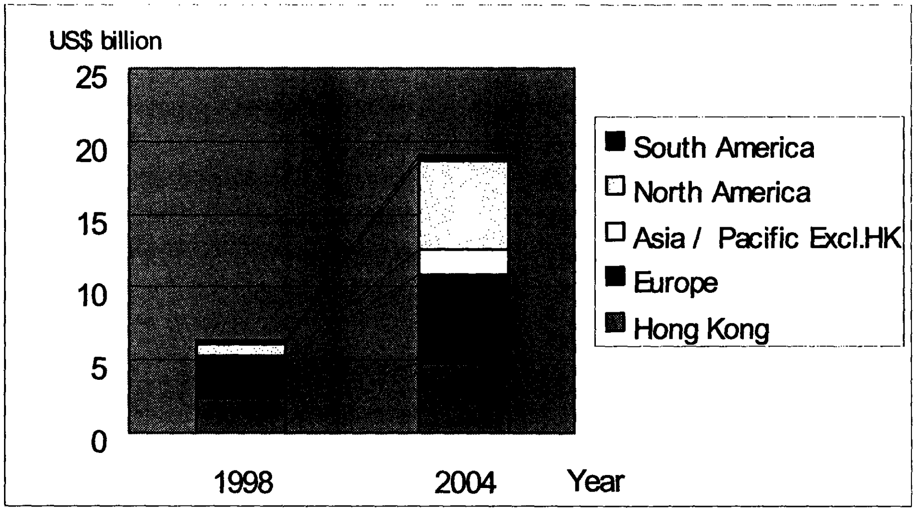
Table 4-6. Recent M&A activities of HSBC

North America	Europe / Middle East	Asia	South America
(1980) Acquires New York State's Marine Midland (now HSBC bank USA)	(1982) Establishes Egyptian British Bank	(1994) Establishes HSBC Malaysia	(1997) Establishes HSBC Brazil
(1981) Establishes HSBC Canada	(1992) Acquires Midland Bank	(2001) Acquires 8% stake in Bank of Shanghai	(1997) Acquires Roberts S.A. de Invesiones in Argentina
(1983) Acquires Carroll McEntee & McGinley (now HSBC Securities (USA))	(1999) Acquires Mid-Med Bank in Malta	(2003) HSBC Insurance forms a joint venture, Beijing HSBC Insurance in China	(2002) Acquires Grupo Financiero Bital in Mexico
(1999) Acquires Republic New York	(1999) Acquires Safra Republic Holdings (now HSBC Luxembourg)	(2003) Hang Seng Bank acquires 15.98% of Industrial Bank, a China commercial bank	(2003) Acquires Lloyds TSB's Brazilian assets including Losango Promotora de Vendas, a major consumer credit institution
(2003) Acquires Household International, US consumer finance company	(2000) Acquires Credit Commercial de France	(2003) Acquires Fujian Asia Bank	(2004) Acquires The Bank of Bermuda
	(2001) Acquires Demirbank TAS in Turkey	(2004) Acquires 19.9% of Bank of Communications, China's fifth largest bank	
	(2003)Establishes HSBC Private Bank France		

Source: Author 2006

The first objective of HSBC's M&A strategy was geographic expansion. HSBC attempted to enhance its presence, not only in countries such as the U.S. and the U.K., but also in high-growth countries such as China, India, Turkey, and those in South America. To date, HSBC has experienced major revenue growth, especially in the Asia/Pacific (excl. HK) and North American regions for the past six years (see Figure 4-10)

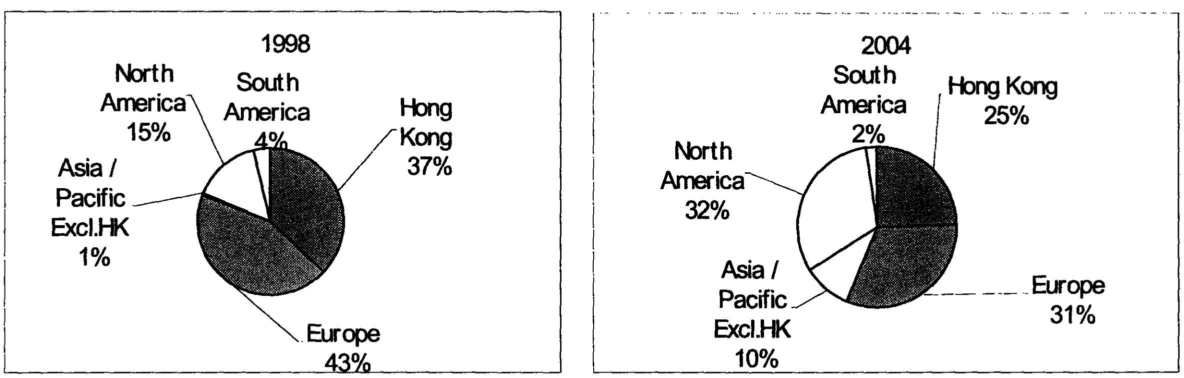
Figure 4-10. Revenue growth in each region



Source: HSBC Annual Report 1998 and 2004

As a result, the total amount of revenues in Asia/Pacific (excl. HK), North America, and South America increased in 2004 compared to 1998 (see Figure 4-11).

Figure 4-11. HSBC Geographical split of revenues



Source: HSBC Annual Report 1998 and 2004

A distinctive feature of HSBC's geographical expansion through M&As is the expansion of its business in higher-growth countries such as Brazil, India, and China. As shown in Table 4-7, profits from those three countries increased in recent three years by 78%.

Table 4-7. HSBC Profit before tax in China, India, and Brazil

(US$million)	2002	2003	2004
Brazil	54	65	113
India	85	94	180
China (Mainland)	50	42	44
Total	189	201	337

Source: HSBC Annual Report 2003,2004

For example, HSBC gained a foothold in Brazil by acquiring a domestic retail bank, Bamerindus, in1997. It had been under Central Bank intervention after speculation put it near collapse. HSBC restructured Bamerindus to improve its profitability, and Bamerindus is now growing at 15% annually despite a series of financial crises, including the 1999 devaluation of the local currency. By 2003, HSBC was the ninth-largest bank in Brazil.

After restructuring Bamerindus, HSBC attempted to expand through repeated acquisitions. In 2000, HSBC doubled its asset-management portfolio by acquiring Credit Commercial de France, whose Brazilian subsidiary was also active in corporate finance and private pensions. In 2003, HSBC purchased Lloyds TSB's Brazilian assets, including its consumer finance business, Losango. In 2004, it acquired CrediMatone SA, the consumer finance arm of Banco Matone SA.

One HSBC strategy is to extend the business models of banks obtained in the U.S. or European countries. For example, it tried to transplant the consumer finance business model of Household International, whose strength lines in high-risk consumer loans, mortgages, and auto loans. Several Household staff are already working in Brazil to improve apply their know-how in credit scoring, payment collection, and marketing. Profit from private financial services in Brazil increased from US$11 million in 2002 to US$51 million in 2004.

Losango already boasts 7.5 million customers, a figure HSBC plans to double within four years.

4.5.2 Performance after Consolidation

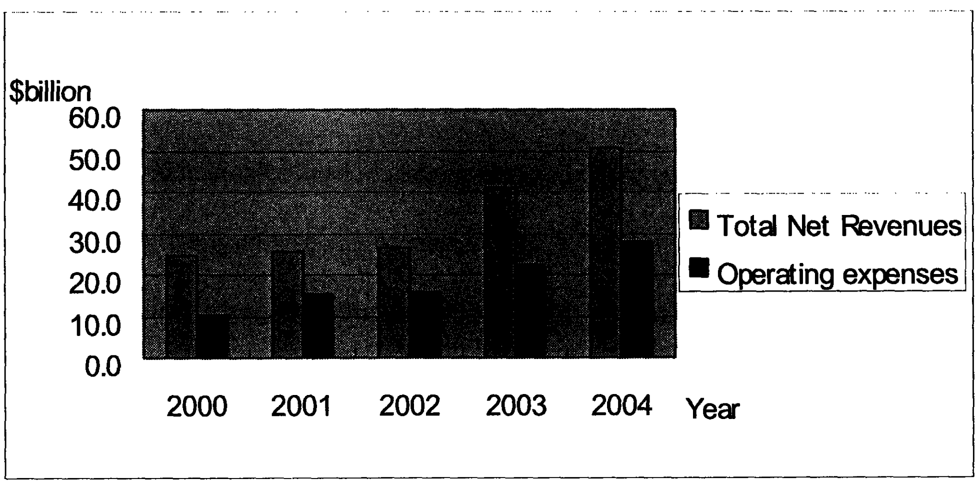
From 1999 to 2004, HSBC doubled its total net revenue (2.1 times), net income (1.8 times), and total asset (1.9 times) (see Table 4-8 and Figure 4-12).

Table 4-8. HSBC Five-Year summary of selected financial data

(US$ billion)	2000	2001	2002	2003	2004
Total Net Revenues	24.5	25.8	26.5	40.9	50.5
Operating expenses	10.1	15.4	15.8	22.4	27.7
Net Income	6.4	4.9	6.2	8.7	11.8
Total Assets	673.5	695.5	758.6	1,034.2	1,276.7
Total Stochholders' Equity	48.0	48.4	55.8	80.2	90.0
Return on Asset (ROA)	1.0%	0.7%	0.8%	0.8%	0.9%
Return on Common Equity (ROE)	13.3%	10.1%	11.1%	10.8%	13.1%
Expense ratio (Operating expenses / Total net revenues)	41.2%	59.7%	59.6%	54.8%	54.9%

Source: HSBC Annual Report 2004

Figure 4.12. HSBC total net revenues and income



Among the six U.S. and European banking institutions analyzed in this thesis, HSBC has experienced the most rapid growth of revenue, income, and assets. Its basic M&A strategy was to invest surplus profits from its dominant position in Hong Kong to acquire distressed assets and improve their performance. For example, Midland Bank in California had been hurt by bad debts, but after HSBC acquired it, performance improved and net income increased 2.8 times for four years since 1995 (Aono, 2005).

4.5.3 Control of Geographically Diversified Organizations

The example of HSBC provides some insight into managing a rapidly expanding and functionally diversified organization. A headquarters holding company in London controls the geographically scattered subsidiaries. To promote rapid decision making and local accountability, the holding company provides only essential functions such as strategic planning, human resource management, and legal, administrative, and financial planning and control. It also maintains the HSBC universal banking system, the platform on which most IT applications run, as well as a multifaceted risk and credit control system. HSBC delegates operational authority to subsidiary heads, each of whom strive to meet annual operating targets as part of a five-year group strategic plan.

While HSBC emphasizes local accountability in order to maintain local flexibility, its risk and credit functions in the holding company strictly control the implementation of group lending guidelines on a global basis according to country, sector, line of business, financial instrument, and counterparty bank ratings. All transactions exceeding $50 million are submitted to London for same-day approval. In this respect, HSBC differs from several of its competitors that allocate risk limits geographically and leave it to local managers to decide what instruments to use to generate revenue locally.

HSBC utilizes a global matrix organization structure, which overlays "customer groups," or lines of business, on its geographic organization. The customer groups include Corporate and Investment Banking and Markets, Personal Financial Services, Private Banking, Commercial Middle Market, and Consumer Finance. This structure helps keep the geographic and customer group perspectives closely linked. In addition, HSBC attempts to enhance its knowledge management. For example, it established an enterprise knowledge platform in the Asian region which can be accessed by its 37 million employees.

This structure also helps HSBC make the best use of its global reach and shared best practices in product development, management, and marketing. One example of extending best practice across multiple regions is HSBC's insurance business. Through the acquisition of Midland Bank, the company tried to extend its insurance business knowledge to the Asian region, including its knowledge of on-line insurance products. HSBC successfully increased its insurance business revenue by 7% annually in Hong Kong, and its insurance commission income in Asian countries (excl. HK) by 134% from 2003 to 2004.

A balance between regional accountability and global integrity, and strategic knowledge sharing/extension are key aspects of HSBC's geographic expansion through M&As .

4.6 Summary

In this chapter, I discussed consolidation trends in the banking industry in Europe. The analysis confirmed that the integration of financial markets and the introduction of a single currency encouraged banking institutions to consolidate.

The primary objectives of consolidation for Deutsche Bank, UBS, and HSBC were similar. Through M&A, the three institutions expanded out from their home country markets where they could not longer expect rapid growth.

However, the focus and process of their M&A activities were not the same. Deutsche Bank changed its business structure from that of a conventional commercial bank to one focused on investment banking. UBS experienced the horizontal integration of two banks that had similar strategies focused on investment banking and asset management, and enhanced its competitive advantage in those business segments. HSBC expanded geographically by focusing on higher-growth countries and on the retail/consumer finance business.

In analyzing the financial performance of the three conglomerates, HSBC achieved the best performance in net income growth and return on assets (see Figures 4-13 and 4-14). One reason is that HSBC has the lowest operating expense ratio (54.9% in 2004) compared to Deutsche Bank (81.4%) and UBS (72.3%). This can be attributed to its human resource practices. It pays executives much less compared with other European and U.S. bank executives. It recruits better-than-average people rather than paying millions of dollars to get star-quality people, which many European and U.S. banks rely on in the investment banking business (TARUN and David, 2005).

Figure 4-13. Comparison of net income growth

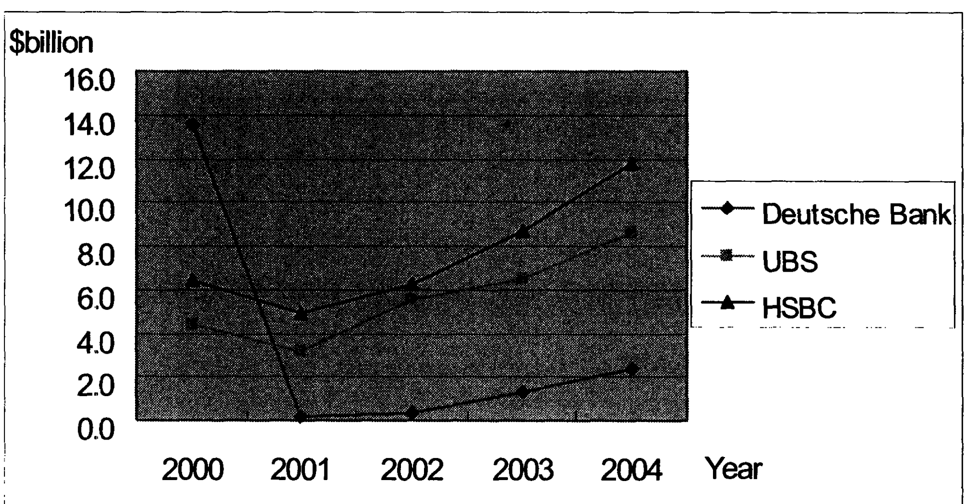
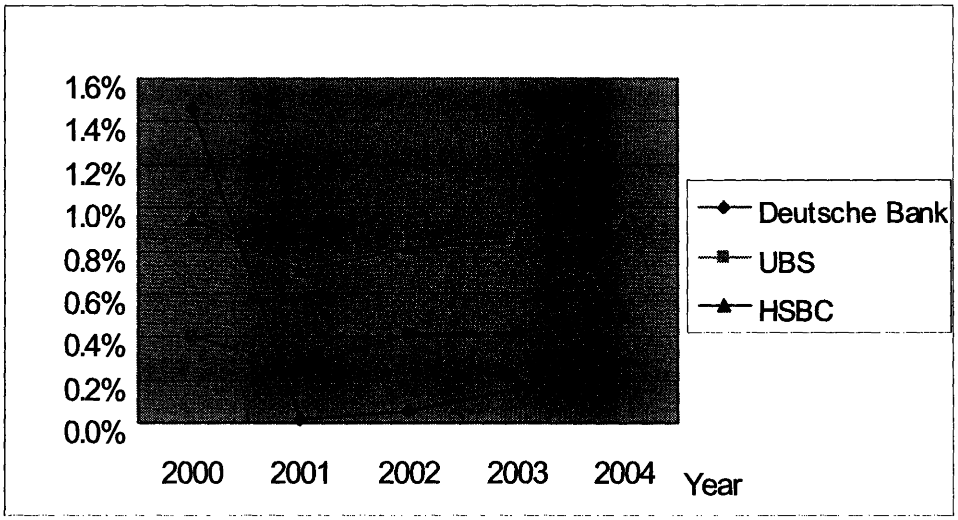


Figure 4-14. Comparison of return on assets



Source: Author, 2006

Today, investors place somewhat higher value on European financial conglomerates than on those based in the U.S, but not much higher than the industry average (see Table 4-9).

Table 4-9. Valuation ratio of the three European financial conglomerates

(%) (January 2006)	Deutsche Bank	UBS	HSBC	Industry Average	S&P 500
Price/Earnings	18.5	17.8	15.4	16.6	21.8
Forward P/E	12.2	13.7	13.1	13.2	18.7

Source: MORNINGSTAR, January 2006

The analysis of these three European financial conglomerates illustrates some important points of managing a consolidated financial firm.

- ***The governance capacity of top management***. It is important for top management to show strong governance capability and expertise in the acquired business in order to facilitate integration of disparate firms with different business structures. As described in Section 4-3-3, Deutsche Bank, formerly a conventional commercial bank, was able to integrate its acquired investment banks through strong governance practices implemented by its top management, which had considerable experience in the investment banking business.

- ***A well-defined IT integration strategy***. It is important to map out an IT integration strategy in the early phase of consolidation, and then carefully implement it. An early and smooth integration of IT enables the consolidated financial firm to avoid increased operating expenses and to capture scale economies following the M&A. As discussed in section 4-4-3, UBS captured operational efficiency through early integration of the IT infrastructures of two banking institutions.

- ***Balancing regional accountability and global integrity***. Following global expansion through M&A, it is essential to establish an effective and efficient authority structure to control the geographically diversified institutions. As discussed in section 4-5-2, HSBC experiences its successful growth through a well-coordinated authority mechanism and actively sharing and extending its strong in-house knowledge.

Chapter 5

Consolidation in the Japanese Banking Industry

5.1 Non-Performing Loans

The collapse of Japan's bubble economy in the late 1980s brought considerable damage to the Japanese banking industry. In the early and mid-1980s, the Bank of Japan relaxed its monetary policy in order to reduce the value of the yen against the US dollar in response to repeated U.S. requests for Japan to reduce its trade surplus, which was undermining the value of the dollar. The change of the monetary policy caused huge amounts of capital inflow into assets such as stocks and real estate in Japan. Many finance companies (called "non-banks" in Japan) and even manufacturing firms invested in stocks and real estate. As a result, stock market prices increased six-fold from 1979 to 1989. In 1985 the Nikkei stock index was hovering around 10,000; by September 1989 it had risen to a peak of 38,916. Japanese banks enthusiastically lent money to those companies to increase their profits and assets.

In 1989, the governor of the Bank of Japan, influenced by the Ministry of Finance, expressed concern that the Japanese economy was overheating and was being threatened by inflation. In early 1990 the Bank of Japan tightened its monetary policy and interest rates spiked. This sharp rise in interest rates pricked the bubble economy and triggered a decline of asset prices. The Nikkei index fell sharply to less than 15,000—down 62% from its 1989 peak.

The collapse of assets prices caused major financial distress at many finance companies. In addition, many non-financial companies suffered from the failure of investment into assets uncorrelated to their core business. This financial distress at many Japanese companies harmed the loan assets of Japanese banking institutions and non-performing loans quickly piled up.

In 1997, a major bank, Hokkaido Takushoku Bank, collapsed as a result of the amount of non-performing loan, followed in 1998 by Long Term Credit Bank and Nippon Credit Bank. Soon the Japanese population began to worry about the possible insolvency of the Japanese banking industry because the collapse of major banks was one of the first experiences after World War II. To mitigate these fears, the Japanese government decided to infuse public funds (¥21 trillion/US$200 billion) into several banking institutions to restructure their impaired capital. This "bail out" rescued the Japanese banking industry, but it brought severe criticism from the Japanese public for "overprotection" of the banking industry, and led to rising demand for independent management of the banking institutions.

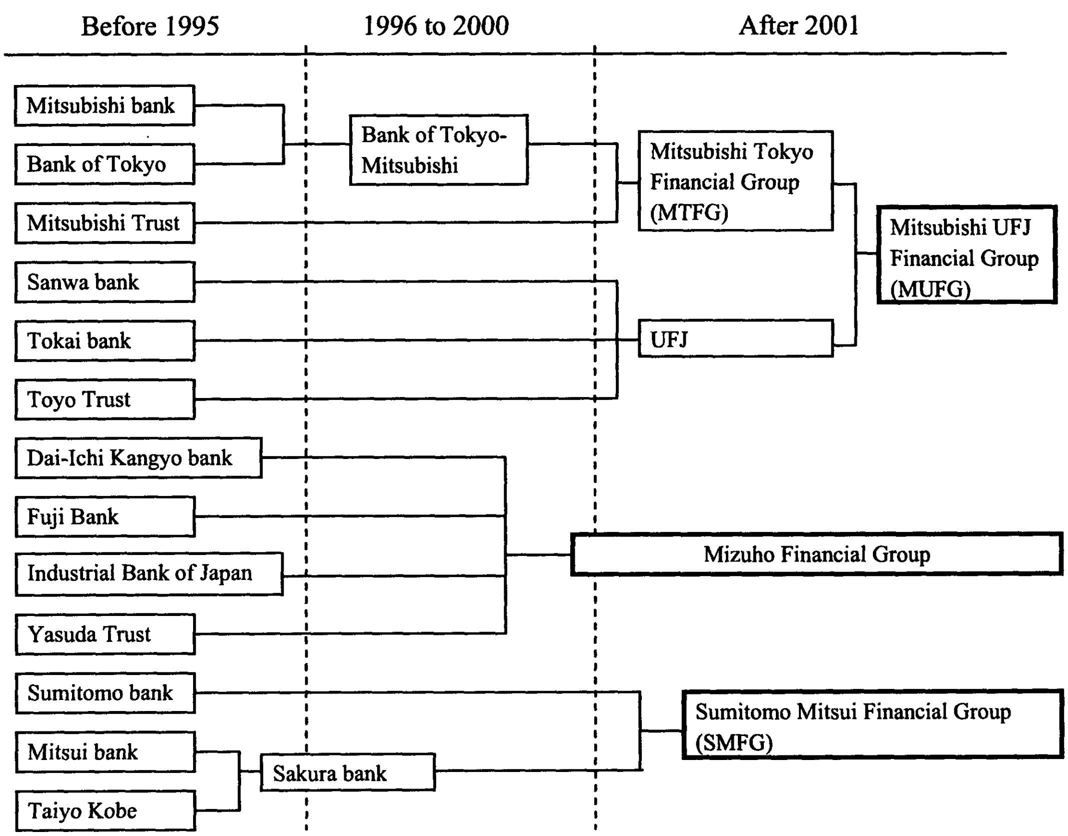
As a result, many Japanese banks began to consider consolidation as one way to strengthen their ability to cope with non-performing loans. It was also hoped that consolidation would expand their revenue sources to cover the write-off costs of non-performing loans. The banks asked the government to eliminate the regulation that prevented them from moving into other financial business sectors such as securities and insurance, whether by themselves or by their subsidiaries.

The Japanese government, which hoped to liberalize the financial markets and strengthen the competitiveness of the Japanese financial industry, embarked on regulatory reform in the 1990s. In 1993, banks were allowed to establish a securities subsidiary. In 1996, the "Big Bang" was announced which created barriers separating the ownership of banks, trusts, securities firms, and insurance companies. Establishment of financial holding companies was allowed. In 1998, banks were allowed to sell mutual funds, and soon thereafter annuity insurance and securities products.

In 2005, the Japanese financial supervisory authorities (FSA) set a "Guideline for Financial Conglomerates Supervision" which prescribes basic regulatory principles for financial conglomerates. It is expected to facilitate the consolidation of Japanese financial institutions.

The combination of financial difficulties related to non-performing loans and regulatory reform caused many mergers, and the Japanese government encouraged such consolidation. In the past fifteen years (1990-2005), major Japanese banking institutions became largely integrated into three financial groups (see Figure 5-1).

Figure 5-1. Recent bank mergers



Regulatory reforms also encouraged banks to integrate with other kinds of financial firms such as securities and consumer finance firms. At the current rate, however, such integration across different financial entities is not occurring on the large scale seen in the U.S. and Europe. Typically, such integration is taking place between small and medium-size security firms and banks. Three major security firms—Nomura, Daiwa, and Nikko Cordial securities—still maintain managerial independence although they have formed a strategic alliance with banking institutions, especially in business areas. The integration between banking institutions and insurance firms has not yet happened except among some new entrants that are Internet-only banks.

Regulatory reforms also motivated non-financial institutions to enter the banking business and form a financial conglomerate. Sony established a financial holding company that subsidizes its banking and insurance functions. Rakuten Inc., an Internet service company, provides insurance products and credit card services through its Web portal site, and also plans to enter into banking business. I will discuss these new types of financial conglomerates in the following chapter.

5.2 Transformation of Japanese Banking Institutions

The combination of financial difficulties related to non-performing loans and regulatory reform encouraged Japanese banks to consolidate with each other. In this chapter, I will analyze the strategic transformations of two major Japanese banking institutions: Mizuho Financial Group and Sumitomo Mitsui Financial Group. I will analyze Mitsubishi UFJ Financial Group, the largest banking institutions in Japan, in Chapter 6.

Before the bubble economy burst, Japanese banking institutions were a major presence in the world markets. In 1990, they dominated the first to seventh positions among top banking institutions based on market capitalization. But the bursting of the bubble economy, and the consolidation of U.S. and

European banking institutions eroded the market presence of Japanese banks. In 2004, only one, Mitsubishi Tokyo Financial Group (current Mitsubishi UFJ Financial Group), remained within the top ten world banking institutions (see Table 5-1).

Table 5-1. Ranking of world banking institutions

	Banking Institution	Country	Total Market value (2004/08) ($million)	Total Asset Amount (2003) ($million)
1	Citigroup	US	240,888	1,264,032
2	Bank of America	US	183,410	936,680
3	HSBC	UK	171,135	1,034,216
4	J.P.Morgan Chase	US	141,037	1,097,475
5	Wells Fargo	US	99,144	387,798
6	Royal Bank of Scotland	UK	87,048	814,227
7	UBS	Switzerland	79,152	1,118,553
8	Wachovia	US	61,675	401,032
9	Barclays	UK	59,738	792,743
10	Mitsubishi Tokyo Financial Group	Japan	58,125	992,695
12	Mizuho Financial Group	Japan	48,070	1,282,589
21	Sumitomo Mitsui Financial Group	Japan	34,910	951,724

Source: The Wall Street Journal 2004.9.27

5.3 Mizuho Financial Group

5.3.1 History

Mizuho Financial Group (Mizuho) was formed in 2000 as the holding company for Dai-Ichi Kangyo Bank (DKB), Fuji Bank, and the Industrial Bank of Japan (IBJ). DKB and Fuji had been the largest commercial banks in Japan, while IBJ was a wholesale bank that provided loans and financial services to large corporations. In 2002, these three banking institutions under Mizuho were reorganized into two banking institutions: Mizuho Corporate Bank, which focuses on wholesale and investment banking, and Mizuho Bank, which focuses on retail and middle banking. At the same time, the affiliated security companies were consolidated into two security companies: Mizuho Securities, which focuses on the wholesale market, and Mizuho Investors Securities, which focuses on retail and middle markets. In addition, an affiliated trust bank, asset management companies, and credit card companies were subsidized and a financial conglomerate was formed. The organization structure of Mizuho is illustrated in Figure 5-2.

Figure 5-2. Organization structure of Mizuho Financial Group

	Commercial bank	Credit Card	Securities	Trust /Asset management	Others
Wholesale	Mizuho Corporate Bank		Mizuho Securities	Trust & Custody Services Bank	
Retail & Middle	Mizuho Bank	UC Card	Mizuho Investors Securities	Mizuho Trust Banking	
			Shinko Securities	DKB Asset Management Fuji Investment DLIBJ Asset Management	Mizuho Capital (Venture Capital) Mizuho Research Institute Mizuho Information & Research (IT)

Mizuho has made several attempts to enhance its business capability through alliances. In 2004, Mizuho agreed to cooperate with Orient Corporation, one of the largest consumer finance companies, to expanding its consumer finance business. In 2005, Mizuho established business alliances with Credit Saison, the third largest credit company in Japan, and with Japan East Railway Company to enlarge its credit card marketing share. In 2005, Mizuho entered into an alliance with the third-largest security company in Japan, Nikko Cordial Securities, to cooperate in the security business.

5.3.2 Performance after consolidation

From 2002 to 2004, total net revenue has decreased by 9.1% while net income has increased due to reduced operating expenses.

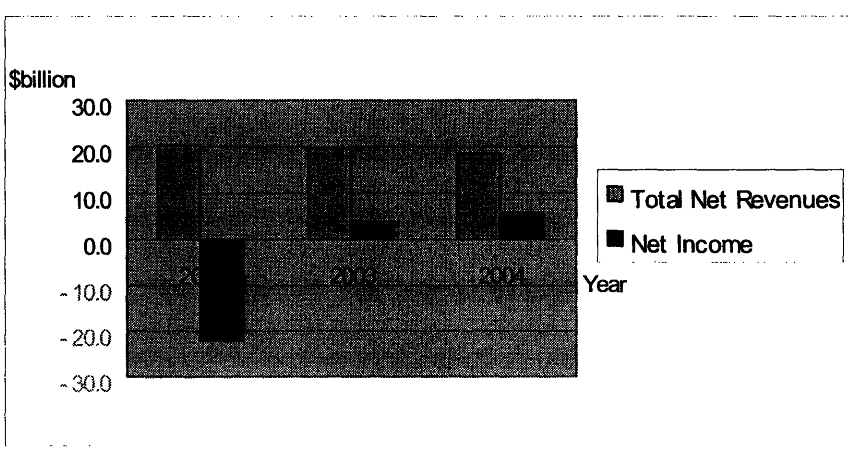
Mizuho achieved cost efficiencies through consolidation but did not realize increased revenues (see Table 5.2 and Figure 5-3). The primary reason was the decline of interest revenue due to loan asset reduction caused by adjusting clients' loan transaction shares which were duplicated among the three former banking institutions and the write-off of non-performing loans. The loan transaction share adjustment was one of the negative effects of consolidation. On the other hand, Mizuho has successfully reduced its outstanding non-performing loans from US$50 billion in 2002 (6.4% of total loan) to US$14 billion in 2005 (2.1%).

Table 5-2. Mizuho four-rear summary of selected financial data

($billion)	2002	2003	2004
Total Net Revenues	20.4	19.7	18.6
Operating expenses	11.5	10.5	10.2
Net Income	-22.1	3.8	5.8
Total Assets	1,248.0	1,282.6	1,332.2
Total Stockholders' Equity	26.6	33.9	36.4
Return on Asset (ROA)	-1.8%	0.3%	0.4%
Return on Common Equity (ROE)	-83.1%	11.2%	16.1%

Source: Mizuho Financial Group Annual Report 2004

Figure 5-3. Mizuho total net revenues and net income



A distinctive characteristic of Mizuho's revenue structure is its heavy dependence on the corporate and wholesale banking segments (see Figure 5-4). In contrast, its consumer and retail banking segments are smaller compared to U.S. banks. Another distinctive characteristic is heavy dependence on the domestic Japanese market (see Figure 5-5).

Figure 5-4. Mizuho business segment split of net revenue, 2004

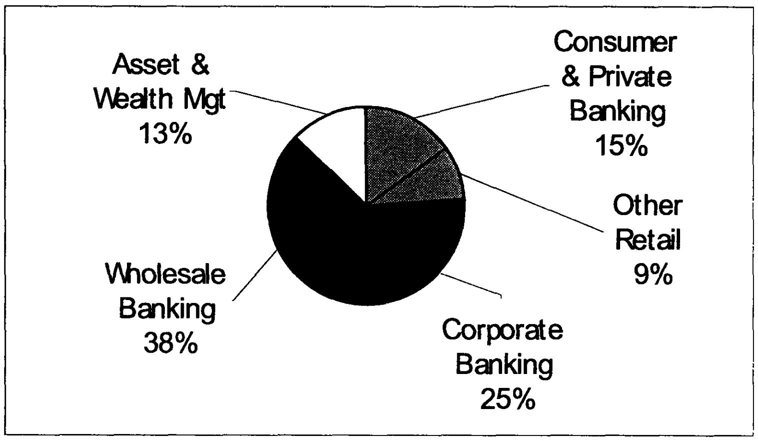
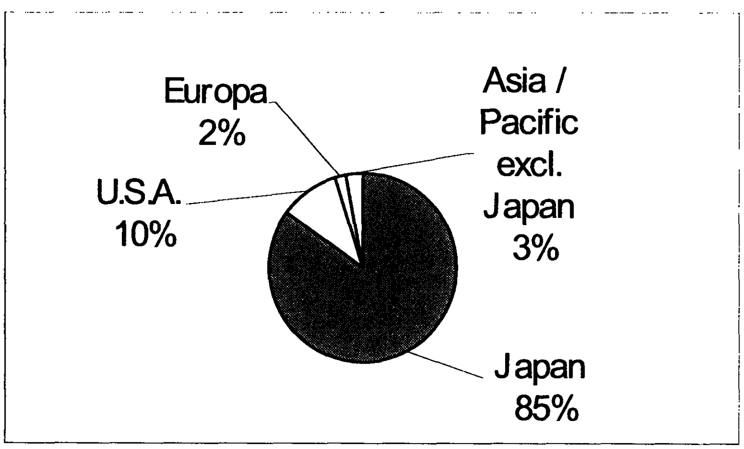


Figure 5-5. Mizuho Geographic split of income, 2004



Source: Mizuho Financial Group Investors presentation 2005

5.3.3. Issues regarding merger on the equal term

A distinctive feature of Misuho's consolidations is that the three legacy banks involved in the merger—Dai-Ichi Kangyo Bank, Fuji Bank, and Industrial Bank of Japan—were equal partners in the merger. But that very equality caused power struggles among the three that caused problems and delayed the integration of the three banks.

One key challenge was how to integrate the three banks' respective IT infrastructures. In 1999, the three banks decided that a merged retail bank should adopt Dai-Ichi Kangyo Bank's IT system. However, that decision was rescinded in 2000 due to strong opposition from Fuji Bank, which was concerned that Dai-Ichi Kangyo Bank would take a leadership role in developing any combined retail banking platform. The banks eventually reached a compromise to install relay computers that connected the three separate IT platforms, thus maintaining the existing systems for a period of time. In April 2002, Mizuho encountered major IT problems that caused most of its 7,000 ATMs to malfunction and delayed money transfers. The total number of pending money transfer orders reached 2.5 million. That problem damaged public confidence in Mizuho. In the end, it took five years for Mizuho to complete the IT integration once the merger was announced.

The second challenge was the integration of subsidiary companies of the three banks. Mizuho maintains three security subsidiaries and asset management firms that formerly belonged to one of the three banks. Power struggles occurred within the subsidiaries, which delayed group integration. The lack of integration caused inefficiencies and less synergy. Additionally, it resulted in confusion among the bank's clients. For example, Mizuho Bank opened new branches jointly with two security subsidiaries—Mizuho Investors Securities and Shinko Securities. Even with three security subsidiaries of its own, it still engaged in a business alliance with an out-of-group security company, Nikko Cordial Securities. It seems to me that Mizuho Group's strategy was ambiguous.

5.4 Sumitomo Mitsui Financial Group

5.4.1 History

In 2001, Sumitomo Mitsui Banking Corporation (SMBC) was established as a result of a merger between Sumitomo Bank and Sakura Bank. Sumitomo Bank was part of Sumitomo Group, a Japanese large company network, while Sakura Bank (formerly Taiyo Kobe Mitsui Bank) had been part of another large company network, Mitsui Group. The Sumitomo/Sakura merger was distinctive because it was a consolidation across two separate company networks, Sumitomo and Mitsui. In 2002, Sumitomo Mitsui Financial Group (SMFG) was formed as the holding company for SMBC.

SMFG holds the credit card business, lease business, and the research/IT subsidiary. It also holds two securities subsidiaries: SMBC Friend Securities, which focuses on retail and middle markets, and Daiwa Securities SMBC, which was established in 1999 as a joint venture between Sumitomo Bank and Daiwa Securities, and is focused on the wholesale market. Sumitomo Bank transferred its investment banking business function to Daiwa Securities SMBC. The organization structure of SMFG is illustrated in Figure 5-6.

Figure 5-6. Organization structure of SMFG

	Commercial bank	Credit Card	Securities	Asset management	Others
Wholesale	Sumitomo Mitsui Banking Corporation (SMBC)		Daiwa Securities SMBC	Daiwa SB Investment	SMBC Leasing (Lease)
Retail & Middle		Sumitomo Mitsui Card	SMBC Friend Securities		
					The Japan Research Institute (Research/IT)

SMFG also attempted to enhance its business capability in consumer finance and the credit card business through business alliances. In 2004, SMFG entered into a strategic alliance with PROMISE, one of the largest consumer finance companies. In 2005, it formed a business alliance with NTT DoCoMo, the largest mobile phone company in Japan, to create a new credit card market using mobile phones.

5.4.2 Performance after consolidation

SMFG's total net revenue remained at the same level following consolidation. Net income became negative due to write-off expenses for non-performing loans (see Table 5-3). However, SMFG achieved cost synergies after consolidation by reducing its operating expenses. The number of SMBC employees was reduced from 27,000 at the merger to 21,000. The operating expense ratio declined to 37.4% in 2004—lower than other Japanese and foreign competitors. SMFG has also successfully reduced its outstanding non-performing loans from US$54 billion at 2002 (9% of total loans) to US$16 billion in 2004 (3.3%).

Table 5-3. SMFG four-year summary of selected financial data

($billion)	2002	2003	2004
Total Net Revenues	21.4	21.2	21.3
Operating expenses	8.1	8.3	7.9
Net Income	-4.8	3.2	-0.3
Total Assets	974.0	951.7	928.6
Total Stockholders' Equity	22.6	28.6	25.8
Return on Asset (ROA)	-0.5%	0.3%	0.0%
Return on Common Equity (ROE)	-21.3%	11.2%	-1.1%

Source: Sumitomo Mitsui Financial Group Annual Report 2004

SMFG's revenue structure is similar to that of Mizuho. The percentage of corporate banking segments, including middle market and international banking segments, is larger while the consumer banking segment is smaller compared to U.S. banks (see Figure 5-7). SMFG also earns a large part of its revenue in the Japanese domestic market (see Figure 5-8).

Figure 5-7. SMFG business segment split of net revenue, 2004

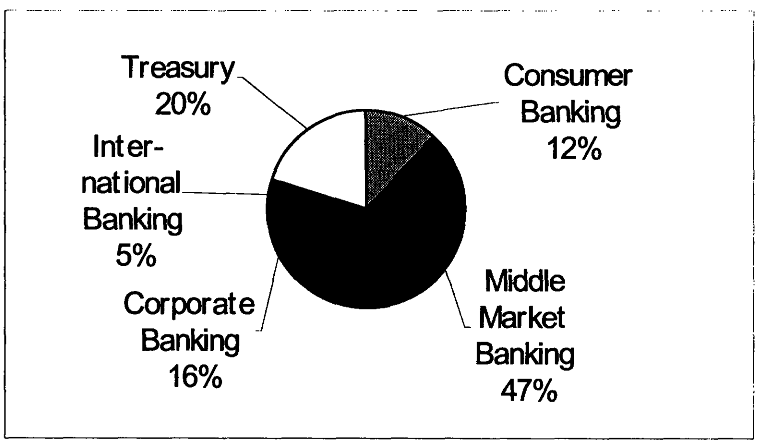
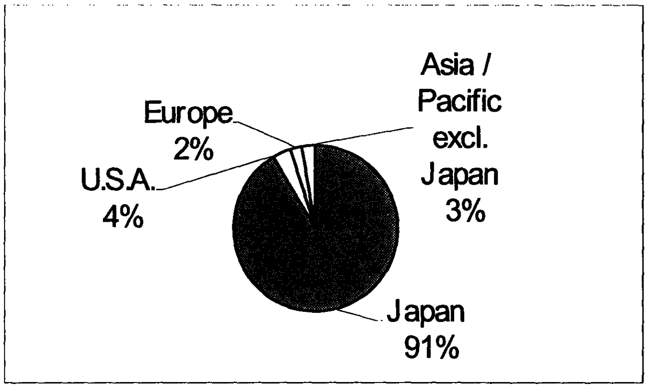


Figure 5-8. SMFG Geographic split of income, 2004



Source: Sumitomo Mitsui Financial Group Investors presentation 2005

5.5 Financial Strategies of New Conglomerates

Technological advances and deregulation have changed the competitiveness of the banking industry. Like U.S and European countries, several Japanese non-financial institutions have decided to enter the banking and other financial sectors in order to establish financial conglomerates. The emergence of these new entrants is an important force that encourages consolidation among existing banks for the purpose of retaining their competitive advantage and maintaining current market share. In this section, I will present examples of the strategies of two financial conglomerates: Sony Financial Holdings and Rakuten Inc.

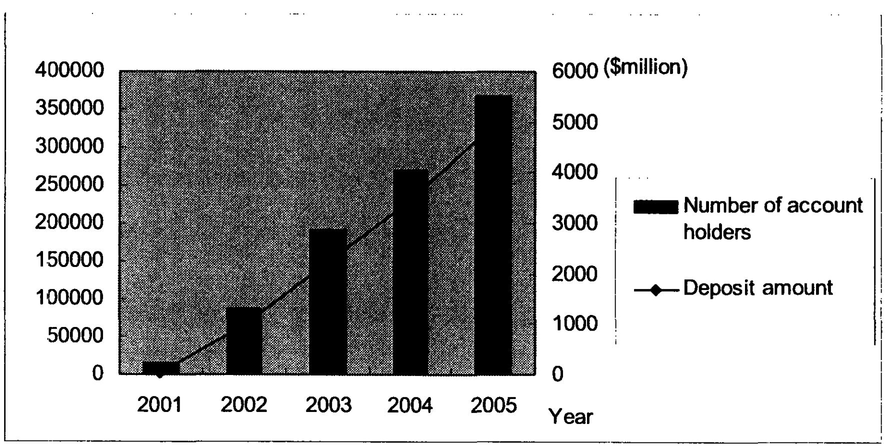
5.5.1 Sony Financial Holdings

Sony Financial Holdings (SFH) was established in 2004 as wholly owned subsidiary of Sony Corporation, one of the world's largest electronic firms, by subsidizing Sony Bank, Sony Life (a life insurance company), and Sony Assurance (a casualty insurance company). SFH was the first financial group in Japan to offer banking and insurance service under one umbrella. Sony Bank was launched in 2001 as an Internet-only bank offering settlements, deposits, and loan services. Sony Life began operations in 1981 delivering life insurance products through life planners or partners. Sony Assurance was established in 1998 and offers non-life insurance products directly over the telephone or via the Internet. The primary objective of consolidating the three financial companies was to realize synergies across them and to create more optimal capital allocation.

SFH is eager to maximize its cross-selling of banking and insurance products. For example, Sony Bank offers insurance products supplied by Sony Life on its Internet website. It also offers fire insurance from Sony Assurance to its mortgage loan clients. Financial planners and partners of Sony Life propose mortgage loans and mutual funds to their clients. They are expected to leverage their understanding of clients' life planning to promote savings, investing, and borrowing services.

One of SFH's competitive advantages is the public's strong brand recognition of the Sony name. By leveraging that brand power, Sony Banks has rapidly increased the number of account holders and the deposit amount (see Figure 5-9). Sony Life holds the ninth largest share of the life insurance market in Japan.

Figure 5-9. Number of account holders and deposits at Sony Bank



Source: Sony Bank HP, 2006

SFH also tried to expand its business by launching a security brokerage service on the Sony Bank website. At the end of third quarter 2005, Sony had gained US$1.6 billion in revenue (8% of total revenue) and US$399 million in operating income (23% of total operating income) from its financial business segments.

5.5.2 Rakuten

Rakuten Inc. is an entrepreneurial Internet service company established in 1997. Its core business is the operation of an electronic shopping mall that offers a wide range of products and services through the Internet. It has become one of the largest Internet sites and a major rival to Yahoo Japan.

Since 2003, Rakuten has expanded its business into other areas, including financial services. In 2003, it subsidized DLJ Direct SFG Securities, an Internet securities company (now called Rakuten Securities). It established credit card and consumer finance subsidiaries in 2005. In early 2006, it formed business alliances with three financial firms: (1) American International Group, Inc., to launch into sales of small-amount, short-term insurance products; (2) Shinsei Bank, to advance mortgage loans over the Internet; and (3) Tokyo Tomin Bank to offer online banking services at Rakuten's website. Rakuten aims to leverage its experience in Internet services and database marketing know-how to improve synergies between each business company (E-commerce, portal and media, travel) and its financial business.

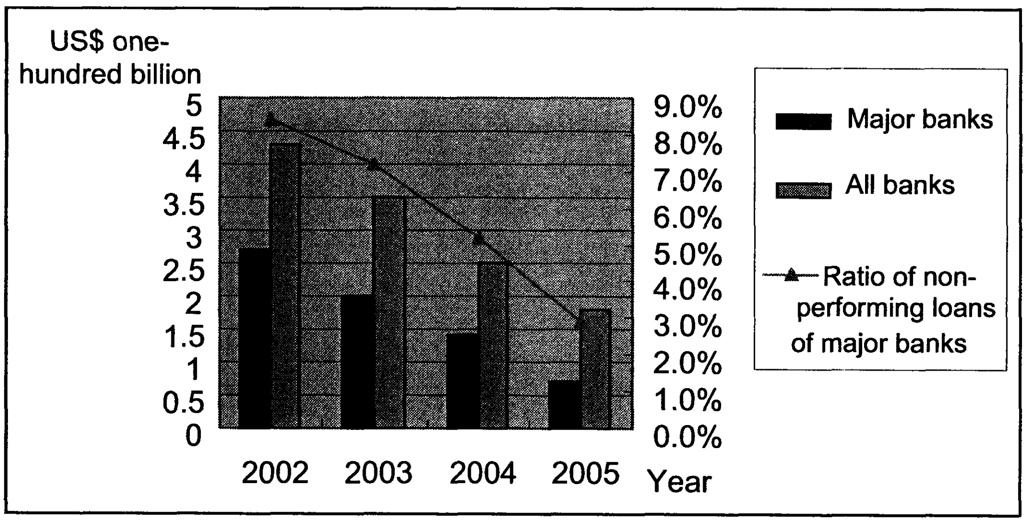
Rakuten has a huge potential to sell financial products to its fifteen million E-commerce member clients. For example, Rakuten Securities rapidly increased the number of new account: from 3,000-4,000 per month before Rakuten's acquisition, to 18,000 today. In 2005, Rakuten generated US$670 million in revenue (55% of total revenue) and US$174 million in operating income (53% of operating income) in its financial business.

5.6 Summary

In this chapter, I discussed the consolidation trend in Japan's banking industry. It was confirmed that the problem of non-performing loans coupled with deregulation encouraged banking institutions to consolidate. Some created a financial conglomerate through merger with non-bank financial institutions in the U.S. and Europe. However, the objective of consolidation was different among each financial conglomerate.

Although the problem of non-performing loans in the Japanese banking industry has not yet been solved, banks such as Mizuho and SMFG successfully overcame the problem through consolidation. As shown in Figure 5-10, the balance of non-performing loans has decreased in all banks.

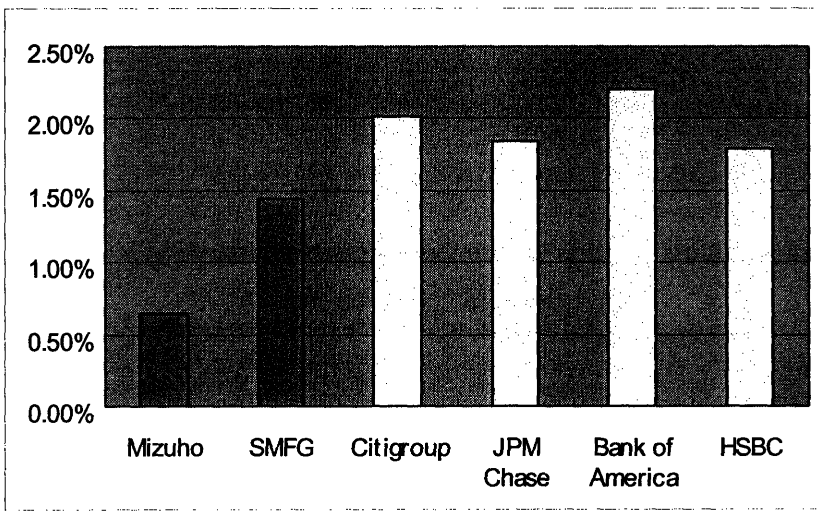
Figure 5-10. Trends in outstanding non-performing loans in the Japanese banking industry



Source: FSA

Mizuho and SMFG utilized consolidation to achieve their original objective of addressing the problem of non-performing loans, and to enter the next stage where they pursue synergies across different financial businesses in order to increase profitability. Although both conglomerates realized large assets through the process of conglomeration, their profitability remains lower than some U.S. and European financial conglomerates (see Figure 5-11). (I will analyze the profitability of Japanese banks in the next chapter.) In addition, both conglomerates will have to deal with the arrival of new entrants such as Sony Financial Holdings or Rakuten, both of which gained new clients rapidly. Faced with such a situation, Mizuho and SMFG will be required to establish a future conglomeration strategy rapidly.

Figure 5-11. Comparison of profitability, 2004



Source: Author, 2006

Chapter 6

Case Study: Mitsubishi UFJ Financial Group

6.1 History

In this chapter I will analyze the position and strategy of Mitsubishi UFJ Financial Group (MUFG), the world's largest financial conglomerate (based on total assets), compared to other Japanese, U.S., and European financial conglomerates.

MUFG was formed in 2005 as a result of a merger between Mitsubishi Tokyo Financial Group (MTFG) and UFJ Group (UFJ), Japan's third- and fourth-largest financial conglomerates. Prior to the merger, MTFG consisted of a commercial bank (Bank of Tokyo-Mitsubishi), a trust bank (Mitsubishi Trust Bank), a securities firm (Mitsubishi Securities), and other subsidiaries. UFJ consisted of a commercial bank (UFJ Bank), a trust bank (UFJ Trust bank), a securities firm (UFJ Tsubasa Securities) and other subsidiaries. The merged entity known as MUFG consolidated the subsidiaries into the following major subsidiaries: a commercial bank (Bank of Tokyo-Mitsubishi UFJ), a trust bank (Mitsubishi UFJ Trust and Banking), and a securities firm (Mitsubishi UFJ Securities) (see Figure 6-1).

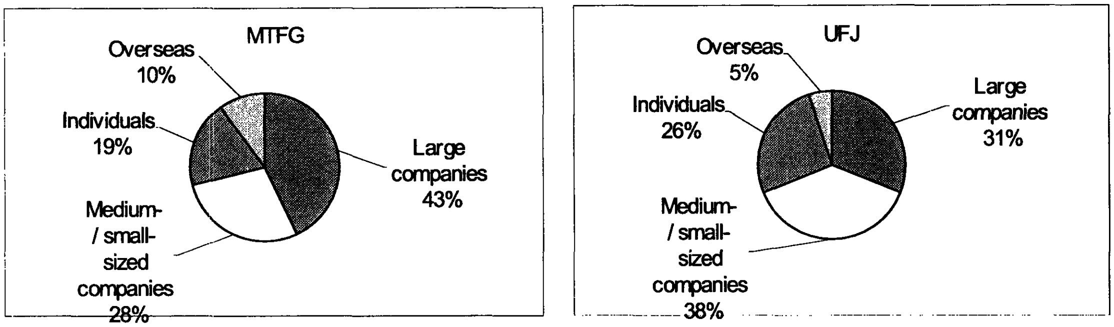
Figure 6-1. MUFG Organization Structure

Commercial bank	Credit Card Consumer Finance	Securities	Trust /Asset management	Others
Bank of Tokyo-Mitsubishi UFJ	DC Card	Mitsubishi UFJ Securities	Mitsubishi UFJ Trust & Banking	Mitsubishi UFJ Research & Consulting
Union Bank of California (US subsidiary)	UFJ Nicos	Kabu.com Securities (Internet Securities)	Mitsubishi UFJ Asset Management	Diamond Computer Service (IT)
	DC Cash One			Diamond Lease
	Mobit			

MUFG's objective for the merger was to establish an overwhelming presence in the Japanese and Asian financial markets by adding the geographic coverage and customer portfolios of MTFG and UFJ. Regarding geographic coverage, 77% of MTFG's domestic branches were concentrated in eastern Japan; in contrast, UFJ was more balanced, with 28% of its branches in central Japan and 34% in western Japan. Furthermore, MTFG had the largest overseas network among all Japanese financial institutions, so MUFG hoped to add UFJ's customer base.

The respective customer portfolios were also complementary. Over half of MTFG's loan portfolio was to large companies (53% at end of March 2004), and UFJ's lending was weighted toward medium- and small-size companies and individuals (64%) (see Figure 6-2).

Figure 6-2. Lending portfolios of MTFG and UFJ (as of March 31, 2004)



Source: Source : Mitsubishi UFJ Financial Group Investors press release, February 2005

MUFG became the world's largest financial institution based on total assets, but it is the world's seventh-largest based on total market value (see Table 6-1). MUFG aims to become one of the top five global financial institutions based on market value by the end of FY 2008.

Table 6-1. Ranking of world's banking institutions

	Banking Institution	Country	Total Market value (2004/08) ($million)	Total Asset Amount (2003) ($million)
1	Citigroup	US	240,888	1,264,032
2	Bank of America	US	183,410	936,680
3	HSBC	UK	171,135	1,034,216
4	J.P.Morgan Chase	US	141,037	1,097,475
5	Wells Fargo	US	99,144	387,798
6	Royal Bank of Scotland	UK	87,048	814,227
7	MUFG (MTFG + UFJ)	Japan	83,558	1,757,447
8	UBS	Switzerland	79,152	1,118,553
9	Wachovia	US	61,675	401,032
10	Barclays	UK	59,738	792,743

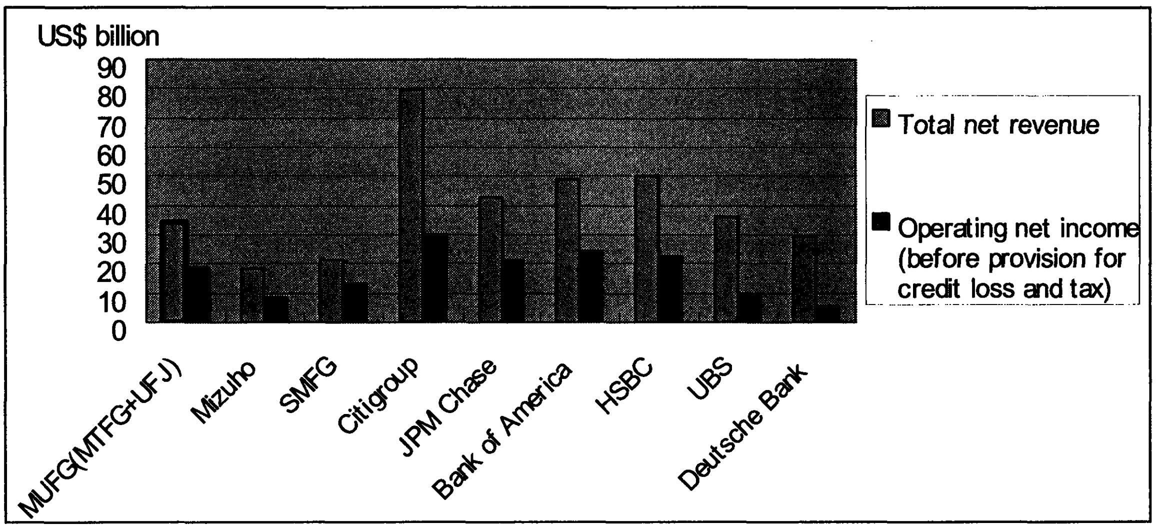
Source: The Wall Street Journal 2004.9.27

6.2 Comparative Analysis

6.2.1 Profitability

In terms of total net revenue and net operating income, MUFG exceeds Mizuho and SMFG, other Japanese financial conglomerates in this study, but lags behind the U.S. three financial conglomerates and HSBC (see Figure 6-3).

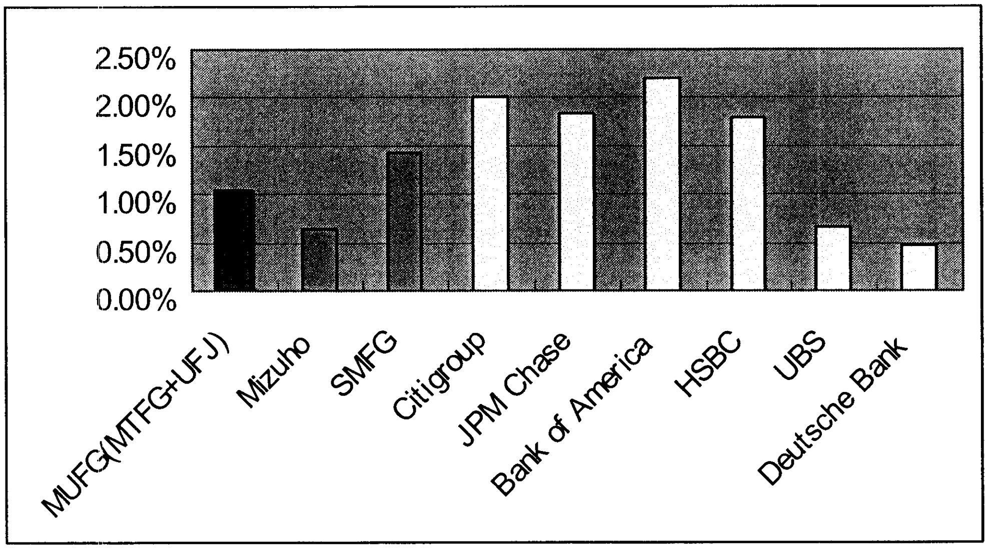
Figure 6-3. Comparison of total net revenue and operating net income (2004)



Source: Author, 2006

In terms of ROA, MUFG is higher than Mizuho but lower than SMFG, the U.S. three financial conglomerates and HSBC (see Figure 6-4).

Figure 6-4. Comparison of ROA (2004)



Source: Author, 2006

MUFG's lower profitability compared to the three U.S. financial conglomerates and HSBC can be attributed to two reasons. The first is lower loan and deposit margins, as shown in Figure 6-5. MUFG depends to a large extent on loan transactions for large corporate customers; this comprised 43% of its loan portfolio in 2004. However, competition in this segment is severe, so it is difficult to earn high loan margins. In comparison, the percentage of its loan portfolio to private customers, from which higher loan margins can be expected, is only 24%. The percentage of loans provided to individual customers at Citigroup is 78% and Bank of America is 62% (see Figure 6-6).

Figure 6-5. Comparison of loan and deposit margin (2004)

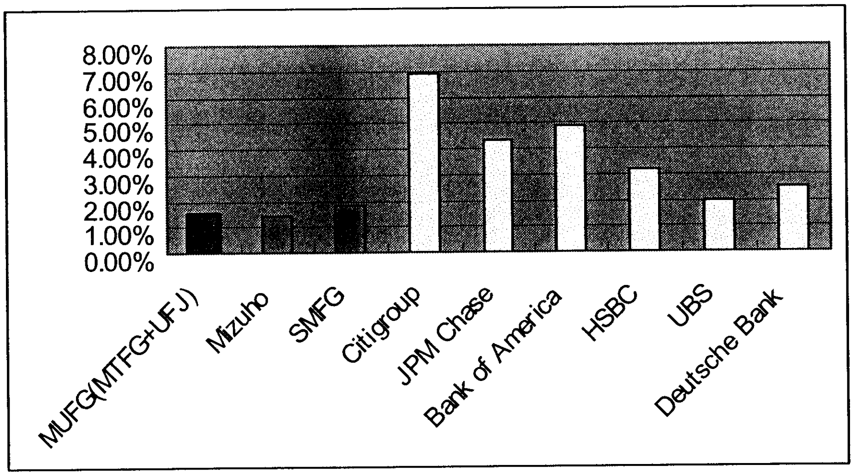
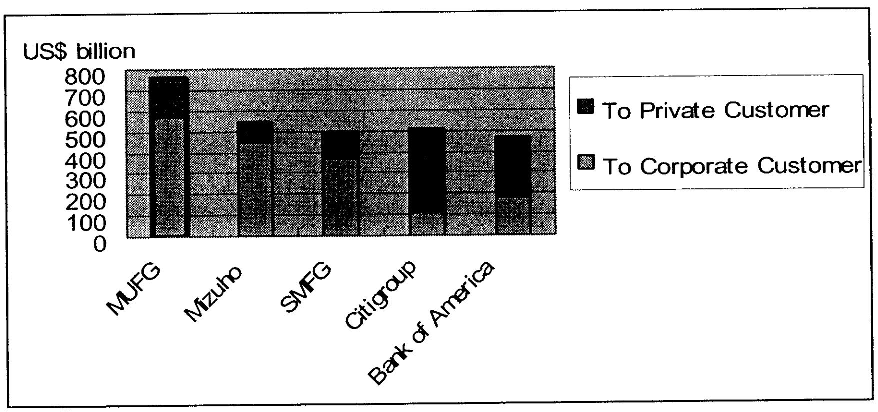


Figure 6-6. Comparison of loan portfolio (2004)



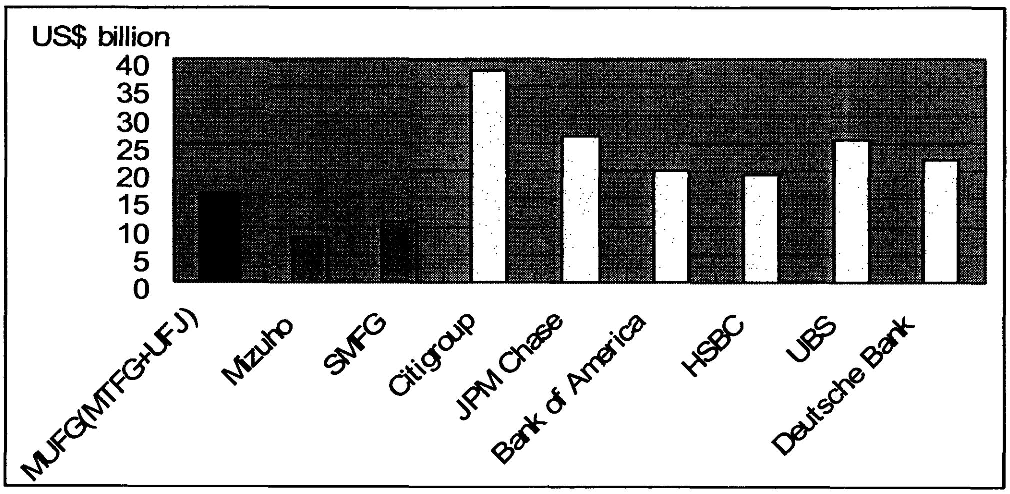
Source: Author, 2006

Recently, Japanese banking institutions have not participated actively in the consumer finance business due to regulations that set an upper limit on the loan interest rate. As a result, the market share of consumer loans at Japanese banking institutions was only 17% in 2003; independent consumer finance companies held the largest share.

Japanese banking institutions were not allowed to provide revolving credit card loan service until a few years ago, again owing to regulations—another reason for few consumer loans. Today, as a result of less restrictive regulations, Japanese banking institutions are eagerly expanding their consumer finance business by establishing consumer finance and credit card subsidiaries or forming business alliances with such companies. More time will be needed, however, to realize significant revenue in the consumer finance business.

A second reason for lower profitability is a weak capability to earn non-interest revenue (see Figure 6-7). This weakness arises from two facts. First, until recently Japanese banking institutions were not allowed to offer mutual funds and annuity insurance products for regulatory reasons, which

Figure 6-7. Non-interest revenue (2004)



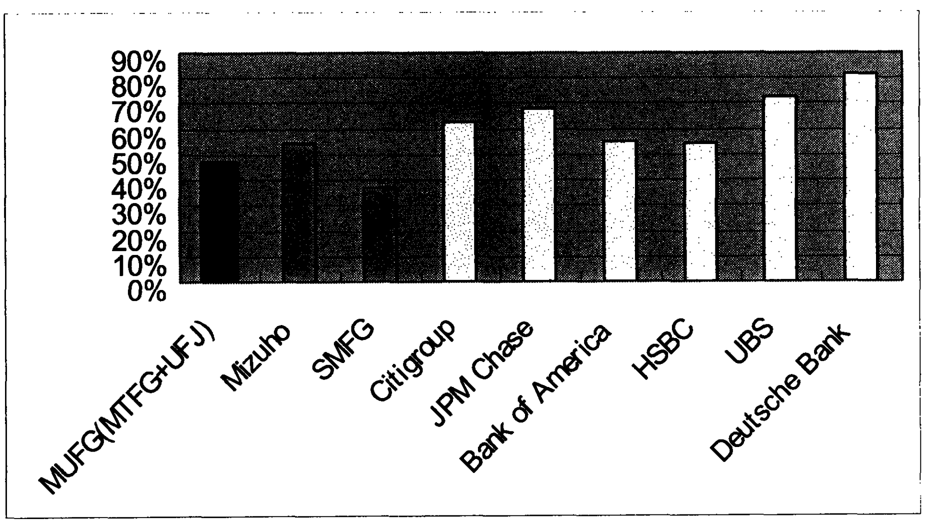
Source: Author, 2006

in the U.S. and Europe are a major source of non-interest revenue for the financial conglomerates. Second, investment banking competence among Japanese banking institutions is not as strong as their counterparts in U.S. and Europe due to earlier regulatory firewalls between banking and the securities business. Among Japanese financial conglomerates, including MUFG, commercial banks play a central role, and securities subsidiaries have a lesser role compared to independent securities firms. As a result, in areas such as large-scale M&A advising or stock underwriting, Japanese financial conglomerates still rank well behind independent securities firms or foreign investment banks. Unlike the U.S. and Europe, mergers between commercial banks and investment banks/securities firms have not yet occurred in Japan, except as joint ventures or business alliances.

6.2.2 Operational Efficiency

Operational efficiency at MUFG is higher than that of U.S. and European financial conglomerates, but lower than SMFG (see Figure 6-8). As described in Chapter 5.4, SMFG achieved

Figure 6-8. Operating expense ratios* (2004)



* Operating expenses as a percentage of total net revenue

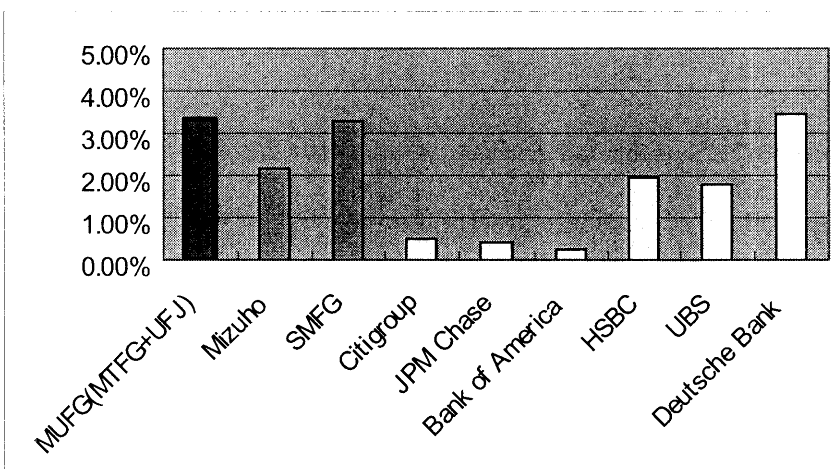
Source: Author, 2006

greater efficiency by reducing its abundant resources following consolidation. MUFG has only recently been formed, so it too can pursue efficiencies by eliminating overlapping resources between former MTFG and UFJ. This will be an important factor in actualizing future growth whether it successfully restructures or not.

6.2.3 Asset Quality and Equity Capital

As described in Chapter 5, Japanese banking institutions has made tremendous efforts to improve asset quality by reducing the number of non-performing loans. Although non-performing loans have been decreased significantly, MUFG and other Japanese financial conglomerates still have far more compared to U.S. and European financial conglomerates (see Figures 6-9 and 6-10). Charges for write-offs for the non-performing loans undermined the equity capital of MUFG and other Japanese financial conglomerates. As a result, they have smaller equity capital against total asset in comparison with U.S. and European financial conglomerates.

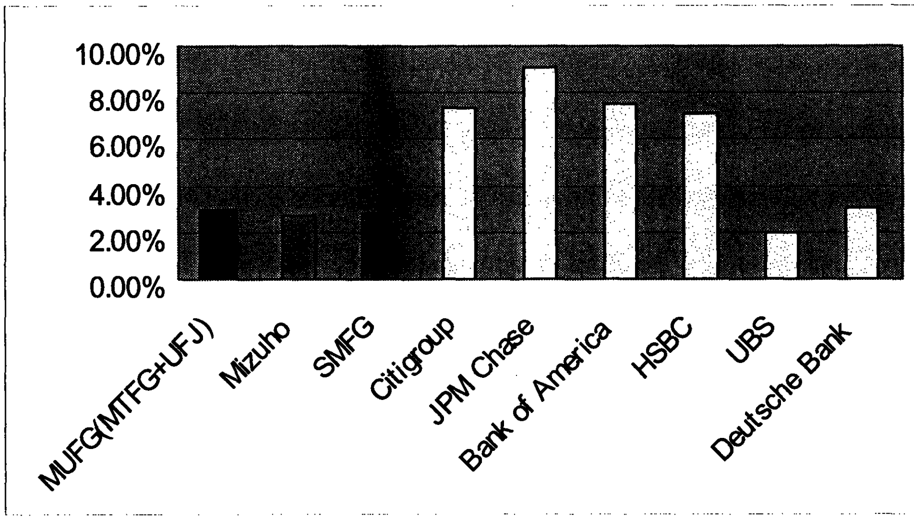
Figure 6-9. Comparison of non-performing loan ratios* (2004)



* Outstanding non-performing loans as a percentage of total assets

Source: Author, 2006

Figure 6-10: Comparison of equity capital ratios* (2004)



* Stockholder's equity as a percentage of total assets

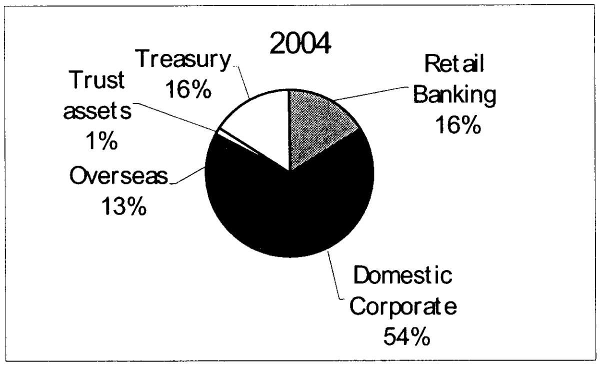
Source: Author, 2006

The former MTFG was the only financial conglomerate that did not accept public bailout funds from the government, since it had sufficient capital of its own to bear the credit cost. On the other hand, the former UFJ suffered huge capital losses due to many non-performing loans. Soon after MTFG decided to merge with UFJ, MTFG infused approximately US$7 billion into UFJ to cover its capital loss. Therefore, for MUFG it is essential to recover and further enhance its equity capital through increasing profit for future growth.

6.2.4 Strategic Positioning

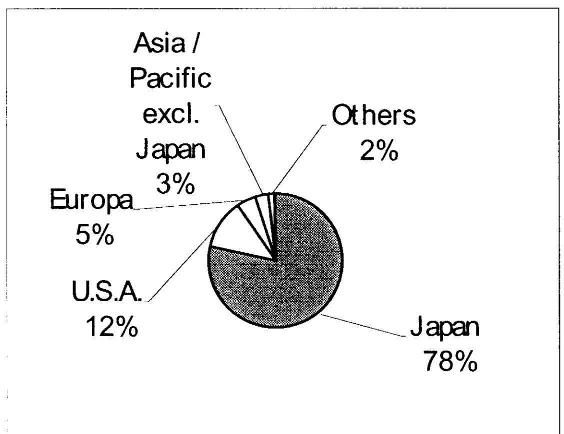
MUFG's business structure is similar to that of Mizuho and SMFG in terms of major dependence on wholesale banking rather than retail banking (see Figure 6-11). MUFG has a slightly larger geographic diversification than Mizuho and SMFG, but it still remains heavily dependent on the domestic Japanese market for revenue (see Figure 6-12).

Figure 6-11. MUFG Net Revenue by segment (first half of 2005)



Source: Mitsubishi UFJ Financial Group Investors press release, February 2005

Figure 6-12. MUFG net revenue by geographic segments (2004)



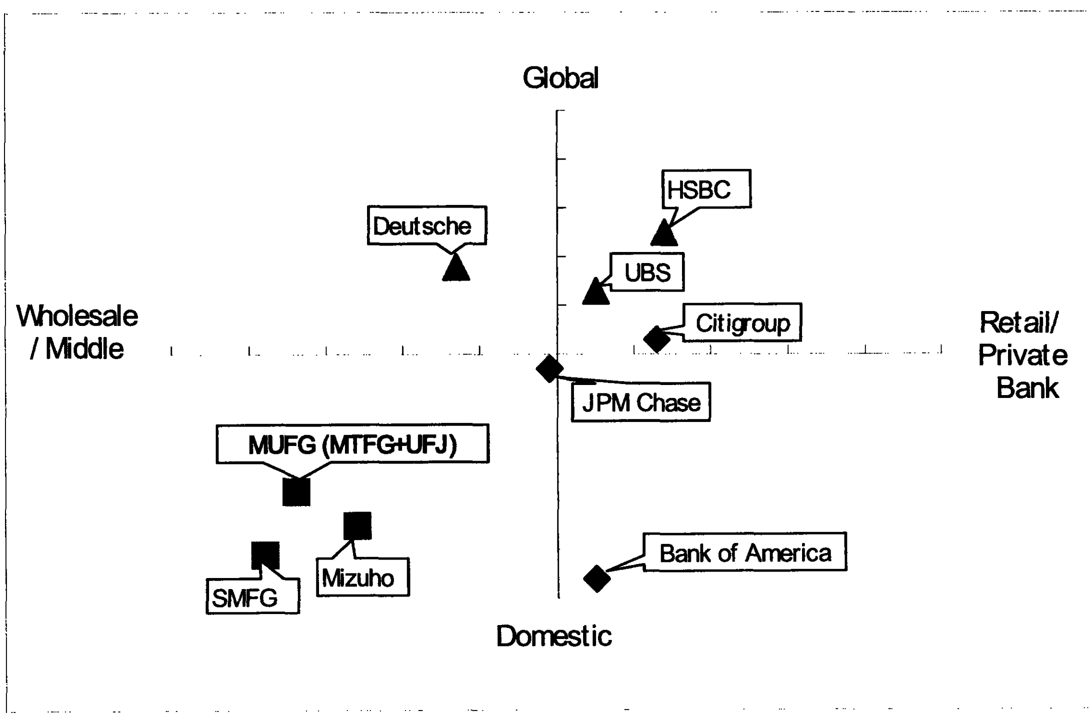
Source: MTFG and UFJ Annual report 2004

MUFG's business structure as well as that of other Japanese financial conglomerates, is explicit compared with U.S. and European financial conglomerates (see Figure 6-13). A major portion of profit comes from wholesale and middle-business segments (i.e., business for corporate customers, including investment banking) and the domestic markets while the retail/private banking business segment (individual customers) remains small.

In contrast, the business structure of U.S. and European financial conglomerates is not like that shown in the figure. The typical features of these banks are summarized as follows:

- Citigroup: Retail/Private banking is larger. Geographically diversified.
- JPM Chase: Retail and Wholesale are equally balanced. Geographically diversified.
- Bank of America: Retail/Private banking is larger. Geographically not diversified
- HSBC: Retail/Private banking is larger. Geographically diversified.
- Deutsche: Wholesale is larger. Geographically diversified.
- UBS: Retail/Private banking is larger. Geographically diversified.

Figure 6-13. Profit by business and geographic segments (2004)



Source: Author, 2006

The characteristics of the business structures of U.S. and European financial conglomerates align with consolidation objectives, as summarized in Table 6-2.

Table 6-2. Summary of consolidation objectives

Citigroup	Maximize profit in retail market through cross-selling. Emphasize investment banking in corporate banking business. Pursue geographic diversification.
JP Morgan Chase	Balance the retail and wholesale (investment) banking business.
Bank of America	Establish overwhelming presence in the U.S. retail and middle market.
HSBC	Enhance retail and middle banking capability worldwide. Aggressively pursue geographic diversification, including emerging markets.
Deutsche Bank	Strengthen wealth management, investment banking, and asset management business capability. Pursue geographic diversification.
UBS	Strengthen investment banking and asset management business capability. Pursue geographic diversification.

Source: Author, 2006

MUFG and other Japanese financial conglomerates largely fulfilled their initial purposes for consolidation: to reduce non-performing loans. However, their current business structures are not strong enough to drive future growth. The next objectives of consolidation include the following strategies:

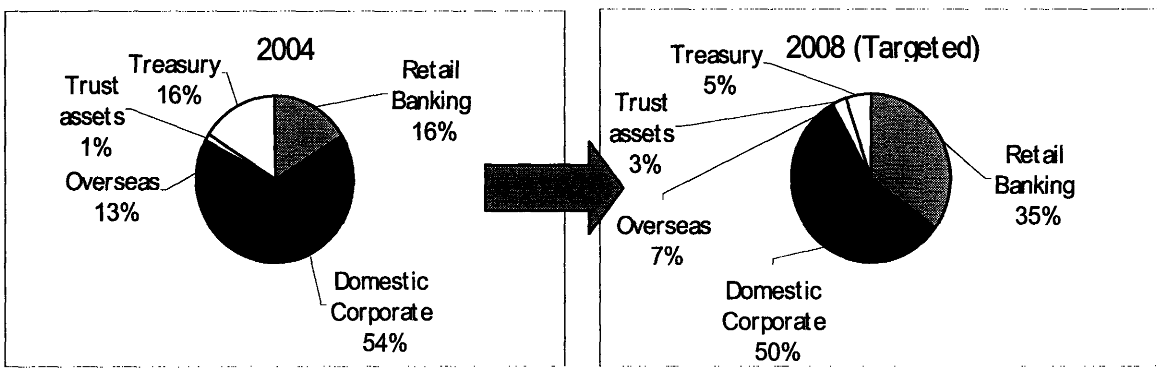
- <u>In the individual customer segment</u> – more focus on retail financial business. Maximize synergy across multiple financial products such as deposits and loans, consumer finance, credit cards, securities, mutual funds, and insurance. Strengthen private banking business to increase non-interest revenue.

- <u>In the corporate customer segment</u> – strengthen business relationships with small and medium-size companies. For large companies, emphasize investment banking services rather than corporate loan services.

- In the overseas business segment – enhance business capability in China and other Asian countries.

MUFG has set targets for increasing the weight of retail business in its business portfolio, from 16% in 2004 to over 35% in 2008 (see Figure 6-14).

Figure 6-14. MUFG business portfolio targets



Source : Mitsubishi UFJ Financial Group Investors press release, February 2005

6.3 Strategies for Strengthening Business Capability

MUFG is taking specific steps to enhance it profitability by strengthening its business capability in the retail and middle financial business segments. In this section I will provide examples of MUFG's concrete strategies in those business areas.

6.3.1 Cross-Selling Across Intra-Group Companies

One-stop access

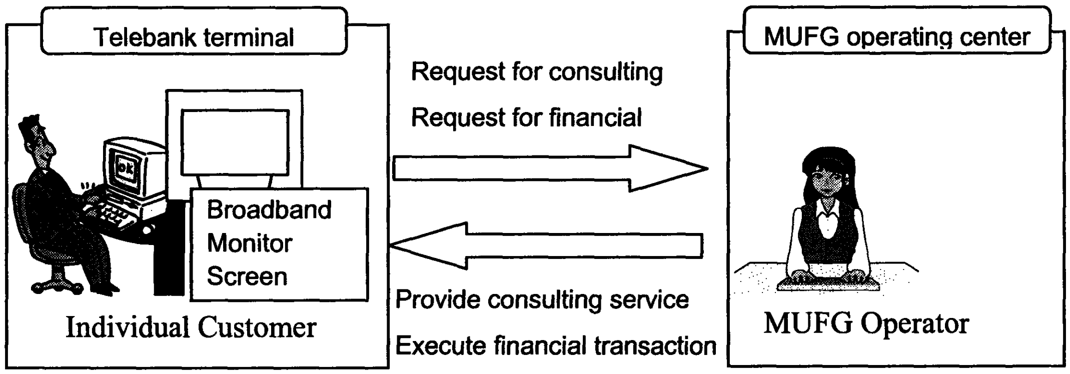
In 2004, former Bank of Tokyo-Mitsubishi (BTM), Mitsubishi Trust Banking, and Mitsubishi Securities opened "MTFG Plaza," a jointly managed branch that gives customers one-stop access to all essential financial products and services, including deposits, housing loans, mutual funds, investment trusts, and securities. Since its opening, MTFG Plaza has proved to be highly attractive to customers, and the number of customers is growing rapidly.

Former UFJ also opened a jointly managed branch named "UFJ Plus," which offers services like a banking and securities subsidiary in combination with 24/7/365 ATM service—a unique service in Japan provided only by UFJ. MUFG will try to combine the advantages of both group's services and to expand its service locations.

Innovative delivery channel

MUFG also plans to provide one-stop access in more remote areas. In 2005, the former BTM commenced its Telebank service, a new financial service utilizing broadband technology. Telebank is an automated contract terminal that uses video-conferencing technology to allow customers to perform various financial transactions and consult face-to-face with a bank officer via a monitor screen. Plans are being developed to offer multiple financial products from group companies. Telebank is available until 8:00 pm on weekday, weekends, and public holidays, which gives customers who work during the day a convenient access to MUFG financial consulting services (see Figure 6-15). Combination of geographic coverage of MTFG and UFJ enables MUFG to easily increase the location of Telebank.

Figure 6-15. Telebank service



6.3.2 Expanded Range of Services

Consumer finance and credit card business

In 2004, the former MTFG formed a strategic alliance with ACOM, a large consumer finance company in Japan. The aim was to widen the consumer loan products line to respond to customer needs for short-term finance. MUFG plans to leverage ACOM's credit know-how into a credit card loan service. Mitsubishi UFJ Bank issues its "Super IC Card," which provides multiple innovative services that utilize the latest integrated circuit (IC) technology. An IC chip embedded in the card contains useful customer information that enables the bank to provide value-added services such as accumulating service points, preferential interest rates on banking products, various credit card settlement options, and customized revolving credit functions. The new card also provides greatly improved cash card security through the use of hand-vein recognition—a highly secure identification method that allows only the cardholder to use the card. The alliance with ACOM was the driving force behind the rollout of the Super IC Card service.

In addition, MUFG plans to consolidate its credit card subsidiaries, UFJ NICOS and DC Card. The new company, to be called MUFG NICOS, will become the number one credit card company in

Japan. MUFG is also considering whether to consolidate its credit card business with that of MUFG NICOS, to offer comprehensive and cutting-edge services to customers.

Insurance products

MUFG is planning to broaden its life and annuity insurance products as another pillar of its retail financial products. The business model is an "open architecture" model that focuses on the distribution of external, high-quality products by outsourcing product manufacturing to companies such as Citigroup. MUFG has built several alliances with domestic and foreign insurance companies such as ManuLife, ING, and AXA, which gives it access to high-quality products.

Private banking and wealth management

MUFG plans to strengthen its private banking and wealth management business by increasing its financial advisory staff. In addition, MUFG has entered into an agreement with Merrill Lynch to establish a private banking and wealth management joint venture in Japan. The new entity will serve high-net-worth individuals as well as small- and medium-size institutions in Japan. The new company will combine Merrill Lynch's global reach, expertise in wealth management, and sophisticated product line with MUFG's substantial high-net-worth client base. This strategy will enable MUFG to provide a higher quality of service, increased product innovations, and faster growth than it could achieve alone.

6.3.3 Expansion of Retail Customer Base

In order to aggressively expand its customer base, MUFG has decided to enter into a strategic alliance with Norinchukin Bank, the central bank for Japan's agricultural, forestry, and fishery cooperatives (4,919 cooperatives) and, of course, its related strong customer base of farmers, fishermen, and foresters. This alliance will enables MUFG to provide credit card and trust banking services to customer of Norinchukin Bank. In turn, Norinchukin Bank will acquire various retail banking products and know-how. This alliance will help MTFG strengthen its customer base and overtake other Japanese financial conglomerates in terms of market share.

6.3.4 Strengthen relationships with small and medium-size corporate customers

In its corporate banking segments, MUFG tries to meet its customers' financing needs more quickly by offering unsecured loans that utilize a simple yet sophisticated credit review model. This loan service enables MUFG to strengthen its business relationships with small and medium corporate customers and also to obtain a higher loan/deposit margin than transactions with large corporate customers.

MUFG is aggressively establishing small branches that will specialize in this loan service in regional areas where it did not formerly have business locations. The rollout of this loan service will give MUFG the largest market share of small and medium-size corporate customers among the three Japanese financial conglomerates.

6.3.5 Leverage its overseas network

The former MTFG was especially strong in overseas operations among the three Japanese financial conglomerates. It had the largest overseas branch network (81 locations as of March 31, 2005) compared with Mizuho (40) and SMFG (40). MUFG aims to build synergies between the former MTFG's overseas network and UFJ's broad customer base. MUFG will increase its customer service staff and develop innovative services, such as a sophisticated cash management service.

Its overseas strategy focuses on business relationships with excellent Japanese or domestic companies worldwide, with a special focus in Asia. Its strong competitors, Citigroup and HSBC, emphasize consumer financial business and business relationships with large companies in their overseas operations. By enhancing its market presence through a merger between MTFG and UFJ, and concentrating its managerial resources on the corporate banking business, MUFG hopes to enhance its business capability in its overseas operation to effectively compete with Citigroup and HSBC.

6.3.6 Pursue new business opportunities

MUFG is planning to offer an E-payment option for online or mobile-phone small purchases by forming a joint venture with DeNA, a Japanese Internet service company. MUFG is also planning to offer an escrow service to add take advantage of its high public credibility. MUFG aims to satisfy the growing demand for inexpensive and trusted payment solutions for the purchase of low-priced goods on the Internet, mobile phone shopping, and auctions. It also aims to compete with new entrants such as Rakuten, which is trying to capture the market for online or mobile small purchases.

6.4 Assessment of MUFG's Consolidation and Strategies

MUFG's consolidation can be positively assessed in terms of the following potential competitive advantages:

- ***Increased competency for developing innovative services***

  MUFG's consolidation has obtained more investment capability for developing innovative services than MTFG and UFJ could have achieved as separate entities. In 2006 MUFG plans to invest US$16 billion in new service developments, such as its IC credit card, Telebank, and E-payment solutions. Without the consolidation, MTFG would have invested only US$9 billion.

- ***Enhanced competitiveness of its affiliated companies***

  MUFG holds the largest commercial bank as a core entity under its umbrella. Furthermore, its affiliated trust bank and credit card company have become the largest in Japan, and its affiliated securities company is now the fourth-largest in Japan. MUFG is n a position to achieve a large market presence and potential synergies in a broad array of Japanese financial markets.

- ***Strengthened capability in its international financial business***

  By leveraging an expanded customer base, MUFG will be able to take advantage of the profitability and service capability of the former MTFG's overseas network. MUFG will be able to enjoy greater competitiveness with foreign financial institutions in several business areas, especially in corporate banking business in Asian countries.

- ***More opportunities for service coverage and enhanced service quality***

  MUFG's strong market presence and broad customer base will be attractive to external companies that may want to enter into collaborations with MUFG. It can make maximum use of its alliance strategy to extend service coverage and enhance service quality. It can also use an alliance strategy, like the one with DeNA, to meet the challenges of new entrants.

The urgent task for MUFG is to enhance its equity capital for future growth. MUFG's strategy of emphasizing retail and middle financial business is appropriate because these businesses are less volatile and risky than investment banking, and they contribute to MUFG's sustainable growth. While investment banking is generally lucrative in terms of huge upside profit potential, it also has the possibility of exposing equity capital to higher risk and volatility. MUFG should pursue the investment banking business prudently until it accumulates sufficient equity capital.

Chapter 7

Conclusion

I have discussed consolidation trends in the U.S., European, and Japanese banking industries and analyzed the strategic transformation of several financial conglomerates in those regions. It is apparent that the banks' desire to maximize shareholder wealth while responding to the external environment, including changes in the structure of the banking industry, regulatory changes, and the development of cutting-edge information technologies has motivated and encouraged the banking institutions to consolidate.

Does consolidation bring benefits to banking institutions? Some find that it enhances their ability to effectively compete with others and that consolidation enables them to retain their market presence. However, as described in Chapters 3 and 4, investors do not put a higher value on conglomerates, largely because new financial conglomerates have not yet fully exploited any potential advantages of consolidation, including increased profits or cost economies of scale and scope.

Exploiting the possibilities of increased profit and cost economies are the primary motivators behind bank consolidation. Chapters 3 and 4 confirmed that ***profit and cost economies of scale*** are achievable in a relatively short time horizon. For example, Bank of America achieved the best performance among three U.S financial conglomerates. On the other hand, ***profit and cost economies of scope*** (cross-selling, synergy across different business segments) require longer time to be achieved. The so-called "conglomerate discount" arising from inefficient capital use, compliance risk, and the unsuccessful fusion of several business entities, makes it difficult for profit and cost economies of scope to be achieved.

However, just achieving profit increases and cost economies of scale are not enough for investors because opportunities for further geographic expansion and cost reduction become limited as banks continue to exploit those options. For example, Bank of America currently suffers from lower valuation of its growth opportunity, which implies that exploiting profit and cost economies of scope is much more important for consolidated financial firms in order to obtain higher evaluation than specialized financial firms.

Following elements are important considerations in the pursuit of increased profit and cost economies of scope.

The governance capacity of top management It is important for top management to demonstrate strong governance capability in order to overcome the "conglomerate discount" factor. This can be done by facilitating the integration of disparate firms with different business structures, establishing a strong cross-selling organization, and executing strict compliance control.

Efficient monitoring of multiple business segments Efficient monitoring of profit and cost performance, and appropriate capital distribution across multiple business segments are essential for pursuing synergies. Restructuring business segments that are unprofitable and do not contribute to synergy will be inevitable.

A well-defined IT integration strategy A well-defined IT infrastructure that enables integrated customer relationship management, multiple products management, and efficient managerial control of several business segments, is essential to maximizing synergy.

Enhanced platform for cross-selling An enhanced customer relations management system and precise product sales data are key elements for promoting cross-selling. Product sales data should be categorized by customer and geographic segments. Promotional strategies for multiple products based on detailed sales data-mining are critical for effective cross-selling. Mike Harris, former Chief Executive of Egg plc and now advisor to the Chief Executive of Royal Bank of Scotland, said:

> *Royal Bank of Scotland (RBS) became one of the most successful banks by growing through a number of M&As. RBS is also very successful in cross-selling multiple products, especially in retail banking. One of the key factors of success is our business format based on a detailed analysis of product sales data at each bank branch. It is important to precisely capture the sales trend of each product along with each customer and geographic segment. Based on that, it is possible to carry out effective promotional activities for cross-selling. (Interview, 4/25/06)*

Optimum Brand Strategy Strategies for corporate branding following consolidation are also important. It is critical to decide whether the acquired company's brand should be pulled into the acquiring company, or if the acquired company's brand should be maintained. RBS maintains the brands of banks it has acquired, such as NatWest and Citizens. Harris said:

> *RBS is pursuing geographic and product expansion through M&A and cost and profit economies of scale by transplanting its own business format into the acquired companies. However, a policy is needed to maintain the acquired company's brand because many customers feel loyalty to the brand. For a service company like a banking institution, brand is the most decisive factor for differentiating itself from other banks and retaining*

> *customers. It is risky to thoughtlessly integrate brands of former entities following consolidation. (Interview, 4/25/06)*

In contrast, HSBC takes the opposite policy when it comes to brand. HSBC tries to stretch its own brand into the acquired companies. HSBC emphasizes providing an integrated, single-brand experience for its customers worldwide. Sir John Bond, HSBC Group Chairman, said:

> *One important customer of former Midland Bank, who had visited Thailand and got into financial trouble there, told us after he came back that he had not been able to depend on Midland in Thailand since he could not find a Midland branch there. If Midland had had a branch in Thailand, it would have been very helpful. However, at that time HSBC was the largest foreign bank in Thailand If Midland had been renamed to HSBC at that time, he would have noticed our existence there and depended on us. But he felt inconvenienced due to the unintegrated brand policy of our group. Enhancement of customer awareness of a single brand is very important for us as we conduct financial business all over the world. (*Aono, 2005, p.160)

These two examples confirm that brand strategy has a great influence on customer loyalty toward consolidated banks. The banks must make deliberate decisions about brand policy in order to retain customers following consolidation.

Achieving the above elements is critical to determining whether consolidation is successful or not. Just executing a consolidation does not necessarily mean success for the banking institutions involved. Successful management after the consolidation is much more important in order to achieve a higher evaluation than the bank's competitors.

Japanese banking institutions, including MUFG, are also experiencing consolidation. However, most consolidations occur between banking institutions. Establishing financial conglomerates that include non-banking entities has only recently begun, so it is challenging for the banks to realize increased profit and cost economies of scope. However, to increase profitability and effectively compete with foreign financial conglomerates, achieving increased profit and cost economies of scope is inevitable. As described in Chapter 6, MUFG is eager to try a number of strategies for achieving these goals.

New conglomerates established with non-financial institutions add a new dimension to competition in the banking industry. They have the potential to become strong competitors with incumbent financial conglomerates. An effective strategy for incumbent financial conglomerates is to form strategic alliances with the non-financial institutions and deal with them not as competitors but as collaborators. When MUFG formed an alliance with DeNA, the ensuing collaboration with new entrants brought new business opportunities to the incumbent financial conglomerates. It also gives them new distribution channels for their financial products.

In the UK, Royal Bank of Scotland formed an alliance with Tesco, a large supermarket chain. Bank of Scotland (HBOS) collaborates with Sainsbury's, another supermarket chain. In both cases, they have efficiently expanded their distribution of products through using the non-financial institution's channel instead of establishing new banking branches.

Effective alliance strategies will be the critical factor for the success of financial conglomerates.

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