

**FINANCIAL CONGLOMERATION IN  
EAST ASIAN REGIONAL  
DEVELOPMENT**

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## EXECUTIVE SUMMARY

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As the wealth and real incomes of nations increase, so do the size and the complexity of their financial infrastructures. Does growth in size always complement a firm's business strength? Is bigger really more efficient and, therefore, definitely better? The spate of changes in the world of finance over the past ten years attests to the seemingly unquestionable positive relationship conjectured about firm size, strength and efficiency in the context of consolidation by financial firms.

This paper takes you on the waters of financial conglomeration, describes how and why it evolved, studies the trends and various conditions of financial firms which chose the path to consolidation, analyzes the challenges that conglomeration presents to different financial communities and examines in what direction this new specie of financial giants is pushing the envelope of prudential supervision, regulation and economic policy.

The paper is divided into **six** parts. **Part 1** (Defining a Financial Conglomerate) discusses the many definitions of the term 'financial conglomerate'. It presents the different models and structural forms financial firms may take when they decide to become a conglomerate, and highlights the characteristic features common to conglomerates. **Part 2** (The Birth Factors and Related Causes of Financial Conglomeration) identifies and explains the roots of financial conglomeration—deregulation, profit-strengthening objectives, changing demand for financial services, technological improvements, globalization, and brand strategy. **Part 3** (Two Sides of the Coin: the Merits and Demerits of Conglomeration) explores the theoretical rationale for conglomeration (efficiency gains, diversification and risk minimization benefits, information and knowledge advantages), as well as the resulting risks and disadvantages (conflicts of interest, reduced competition and increased concentration, supervisory and regulatory issues, and risk issues) it brings. **Part 4** (Changes in the Financial Services Industry in the United States with Emphasis on Bank holding Companies) studies the how business and financial events in the United States resulted to an environment conducive to hatching a new breed of firms – financial holding companies and bank holding companies. Three of the biggest names in the US financial

sector (Citibank, JPMorgan Chase and Bank of America) are presented as case studies to draw attention to the salient changes and major underpinnings upon which these firms build their current dynamism. Additionally, it also enumerates the challenges these firms have overcome in the past and will have to overcome in the future. **Part 5** (Financial Conglomeration in Japan: the Managerial Perspective) discusses how financial conglomeration has been developing in Japan by focusing on the strategies and structures of three Japanese Mega Banks – Mizuho Financial Group, Sumitomo Mitsui Financial Group and Mitsubishi UFJ Financial Group. Moreover, Japan's conglomeration experience is compared to the experience of Western conglomerates and implications of such differences are discussed. **Part 6** concludes the paper.

The term “financial conglomerate” is defined differently in Europe, the United States, and Japan, but in international discussions, financial conglomerates are groups that cover at least two of the major financial sectors from banking, securities, and insurance, and whose core business is finance. There are several forms of integration, or models of financial conglomerates. In addition to a pure financial conglomerate (complete integration model), there is a universal banking model (as in Germany) and a bank-parent with non-bank subsidiary model from England, as well as a model from America, the financial holding company. The features common to financial conglomerates are: (1) financial conglomerates are comprised of different incorporated entities, (2) the use of holding companies is very common among financial conglomerates, (3) most financial conglomerates are led by banks, (4) the operations of financial conglomerates have been shifting, and (5) financial conglomerates tend to offer unique products and services, which reflect its firm's parentage.

Changes in the financial environment were largely responsible for the conception and birth of conglomerates. Old lines of segregation among products, customers and business types in finance were torn down by deregulation. Mergers and acquisitions flourished and universal banking became increasingly popular. As the deregulated financial environment encouraged stiffer competition, traditional banking services became less and less profitable, prompting financial firms to seek other ways of securing revenue, profit and market share. At the same time, rapid advances in technology created a need for

newer and modern forms of financial services. Information technology shook traditional structures of banking, securities and insurance industries. Together with the Internet revolution, it reduced transactions costs and encouraged aggressive business strategies and techniques. Globalization enabled financial conglomerates to take their business reach to international heights, and the entry of foreign financial conglomerates into the developing countries of Asia has the interests of institutional regulators and regional bodies, such as the ASEAN, red-lining. The role and pursuit of brand strategy is also significant for conglomerates, which seek to cement the loyalty of their old customers and entice the patronage of new ones.

Size does matter in the financial industry, but as much as there are benefits to financial conglomeration, there are also disadvantages, largely in the form of increased risks. Most research has focused on the efficiency and stability angles, as conglomeration results to complex and vast businesses. The merits of conglomeration are attributed mostly to efficiency gains (economies of scale, scope, and X-efficiency), increased diversification and risk minimization, and informational and knowledge advantages. There are risks and demerits, and these too are examined: conflict of interest, less competition and more concentration, challenges presented to monitoring and supervision entities, and risk issues.

In the United States, bank mergers and acquisitions (M&A) have been frequent and large in scale especially since the 1990's, because of several factors. A large number of failures of smaller institutions in the 1980's led to save-and-salvage efforts. More important has been legal and regulatory changes, starting in the 1980's and culminating in repeal of the 1933 Glass-Steagall Act. The Gramm-Leach-Bliley Financial Modernization Act of 1999 not only made combinations across financial industries possible; it also came at a time when the environment was favorable for M&A activity. As a result, financial conglomerates, now epitomized by the new structure called "financial holding company" (FHC) have grown rapidly in scale and scope, greatly altering the financial landscape of the U.S.

As shown by case studies of the three largest financial holding companies (Citigroup, JPMorgan Chase and Bank of America), formidable problems are often

encountered in efforts to comply with regulations, attain efficiencies, and achieve economies of scale and scope. The operational structure of the organization, strategy, and leadership of a financial holding company are of critical importance as determinants of whether the promises of financial conglomeration are achieved. At the same time, the powerful presence of large FHCs present challenges to regulators, including the latent problem of the “too big to fail” issue and the systemic risk associated with a higher degree of concentration in the sector. Nevertheless, the sector remains not only dynamic, but highly competitive.

One important lesson of the US conglomeration experience for aspiring Asian conglomerates is the truth that the structure of a holding company will not bring any managerial advances by itself. In banking in the U.S., because of regulations, the holding company structure has been developed as a way to bypass regulations. The large financial conglomerates have adopted the financial service holding company structure; however their group businesses are being operated on the basis of three to six separated business units. In Japan, the financial holding company system was introduced and utilized to facilitate the merger of large banks; naturally, there are pros and cons to this type of structure.

Mergers in Japan have been driven by the need to recover and restructure after the bubble economy of the latter half of the 1980's. Some major banks failed, and many others required recapitalization. Long-standing walls separating long-term lenders from short-term lenders, and trust banking from conventional banking, were torn down. Regulation was changed not only through legislation but also via the establishment of the Financial Services Agency, whereby oversight was withdrawn from the Ministry of Finance. Mergers eventually reduced the twenty major banks to three mega-banks, and are significant in that they are cross-keiretsu mergers. This, with the ongoing process of reduction of crossholding of shares, means that relationship banking is steadily but slowly dying in Japan. At least during the early phase of their existence, these mega-banks are

more agglomerations than conglomerations, as the component banks cannot be fully integrated in the short term, owing to the burden of corporate culture legacy and lingering effects of traditional social forces. As in the United States, mergers have been accompanied by an end to the separation of banking and securities business, a process that has been advancing slowly since the mid-1980s. As in the United States, difficulties are being encountered in achieving synergy, efficiency, and economies of scale and scope. Differences are evident in organizational strategy of the mega-banks, so that Japan, too, can be considered as a financial experiment station.

There are both advantages and disadvantages in becoming a larger and diversified institution. In Japan, mega-banks have less benefit from the advantage of economies of scale, as do their Western counterparts, because of the difficulty of integrating multiple firms. On the other hand, the biggest disadvantage of scale, the millstone of bureaucracy, will become a major problem of Japanese financial conglomerates. The Japanese experience has shown that any effort at imitating Western financial conglomerates is destined to give disappointing results but it is very important to know which banks are successful, which banks are unsuccessful and why so.

Japanese banks need to overcome major challenges to become successful financial conglomerates. Large Japanese banks have adhered to the traditional cultural value of "yoko-narabi" (keeping up with the Joneses) strategies, have emphasized the generalist rather than the specialist, have preferred seniority based wage rather than meritocracy, and long-term employment commitments matched by loyalty to the organization. All these factors hinder the success of globally operated financial conglomerates. At least Japanese banks should recognize that the legal structure of a holding company itself has no structural advantage for the management of large and diversified financial

institutions. In order to run an efficient, large and diversified financial organization, it is very important to look at the managerial side of organization not the structure of the organization. Such managerial factors are leadership, methods of monitoring the performance of businesses, method of allocation of resources, good risk control system and a good incentive system to encourage performance and synergy of business as a group.

Group management is key to a successful conglomeration venture. The critical point is finding and maintaining balance between centralization and decentralization. A conglomerate must have good leadership capability to enable the organization of centralized activity by delegating daily business decisions to well organized business divisions. The management must seek and make available various organizational means to effect good and sustainable company performance.

Banking is the foundation of economic growth of the country and whenever mistakes are made in (re)structuring that industry, economic growth might be compromised and real development may not materialize. Clear strategies and structures suitable to support the development of financial conglomerates must accompany general economic development objectives. Other Asian countries have an advantage in that they can learn not only from Western experiences but also from Japan's struggle to establish a globally competitive financial sector.

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## PART 1. INTRODUCTION: DEFINING A FINANCIAL CONGLOMERATE

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### 1.1 THE DEFINITIONS OF A FINANCIAL CONGLOMERATE

The term 'conglomerate' is a word whose meaning has been polished over time. A true conglomerate, according to Madsen and Walsh [1969] 'produces products or services of several industries that are related only with respect to managerial and financial functions and economies, but not with respect to product development, purchasing, production or marketing'. However, back in the 60s, the strict application of this definition qualified only eight of the two hundred largest US corporations. The definition changed and evolved to "special large corporations that operate in two or more separate product and/or geographic markets" [ibid.].

In finance and capital markets, developments over the past decade indicate how major financial players (i.e. banks, insurance companies, securities firms, investment houses, asset management firms) have progressively realigned themselves and metamorphosed into what is commonly referred to as **FINANCIAL CONGLOMERATES** - 'groups of financial institutions and firms that offer a wide range of services' [Bank of Japan 2005]. While financial conglomerates usually refer to entities competing in a highly charged environment where size matters and bigness is desired, 'there is no single, agreed-upon definition of *financial conglomerate*' [ibid.], and the use of the term differs across countries and regions. Differences in the usage and qualification requirements of the term *financial conglomerate* are observed in Europe, the United States and Japan:<sup>1</sup>

In the European Union, three requirements must be fulfilled by a financial group before it can be called financial conglomerate. **One**, it must have at least one company engaged in either banking or securities and at least one company engaged in insurance. **Two**, the group must be headed by a bank, securities or insurance company or the ratio of the balance-sheet total of the financial sector entities in the group to the total amount outstanding of banking, insurance and securities services must exceed 40 percent. **Three**, for each financial sector, the average of the

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<sup>1</sup> The various definitions of financial conglomeration as it applies to the United States, Europe and Japan can be found in Bank of Japan [2005], Park [2006] and G10 Report [2001], among others.

ratio of the balance sheet total of that financial sector to the balance sheet total of the financial-sector entities in the group and the ratio of the solvency requirements of the same financial sector to the total solvency requirements of the financial entities in the group must exceed 10 percent or the balance sheet total of the smallest financial sector in the group must exceed 6 billion euros.

In the United States, the term ***financial holding company*** is used instead of *financial conglomerate*. The term itself does not require the company to offer a broad range of services; rather, it is merely a status allowing the company to engage such services. In this sense, a financial holding company cannot be assumed to actually own two or more companies in banking, securities and insurance. Hence, a financial conglomerate in Europe may not be characteristically similar to a financial holding company in the United States.

Like the US, the term 'financial conglomerate' is not used in Japanese financial laws. Holding companies and their subsidiaries are subject to specific laws governing the sector in which these firms operate.

In international discussions, *financial conglomerates are groups that cover at least two of the major financial sectors from banking, securities, and insurance, AND whose core business is finance*. They are also defined as "any group of companies under common control whose exclusive and predominant activities consist of providing significant services in at least two different financial sectors" in a 1995 report by Tripartite Group of Bank, Securities and Insurance Regulators); as "conglomerates whose primary business is financial whose regulated entities engage to a significant extent in at least two of the activities of banking, insurance and securities business, and which are not subject to uniform capital adequacy requirements" in a 1999 report by the Joint Forum of Financial Conglomerates; and as "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities and insurance)" by the Group of 10 [2001].<sup>2</sup>

Despite the variations in the definition of the term *financial conglomerate*, a common thread runs through them – it is a group of enterprises formed by different types of financial institutions [Van den Barghe 1995 as cited in Verweire 1999].

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<sup>2</sup> This G-10 definition was taken from van Lelyveld and Schilder [2002].

In regulatory parlance, it refers to 'a group of firms that engage in financial activities that have been kept separate, by law and regulation, for many years in many countries [Van Lelyveld and Schilder, 2002].

Financial conglomerates are characteristically huge and complex organizations offering a wide arrange of financial services across the globe. Citigroup, HSBC and the ING-group are just some of the well-known active conglomerates worldwide. Tables 1-1 and 1-2 list the Top 25 banks in the world as ranked by market capitalization and assets.

## **1.2 MODELS AND STRUCTURAL FORMS OF FINANCIAL CONGLOMERATION**

Not only is there no single definition of a financial conglomerate; financial conglomerates also differ in the manner by which they have evolved into financial behemoths: [Herring and Santomero 1990, as cited in Verweire 1999; Bank of Japan 2005]. The structural forms these entities take to achieve convergence vary across jurisdictions and are dependent on the host country's regulatory and supervisory structures, legal environment, culture, system of taxation, historical development of the financial services industry, market concentration, degree of internationalization, the existence of scale and scope economies and cost efficiencies.<sup>3</sup>

### **1.2.1 PURE FINANCIAL CONGLOMERATE (COMPLETE INTEGRATION MODEL)**

This is a fully integrated financial services provider that combines the production and distribution of all financial products and services in a single corporate entity with neither legal nor operational separateness. All activities are supported by a single capital pool. Theoretically assumed to exploit economies of scope, this type of conglomerate should be able to produce any given output at the lowest cost. The advantage of this model is that since the resources are shared among the organization's various departments, the conglomerate can fully utilize informational advantages, at the same time the bank is able to better diversity its revenue sources [Claessens 2002].

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<sup>3</sup> Taken from "Supervision of Financial Services in the OECD Area" available online at [www.oecd.org/dataoecd/29/27/1939320.pdf](http://www.oecd.org/dataoecd/29/27/1939320.pdf)

Negative concerns towards this type of conglomerate is rooted in its large potential for promoting anti-competitive behavior, conflicts of interest and contagion risks, and hence the large supervisory and monitoring costs it requires. An actual example of this type of model is difficult to find in reality because many financial groups fail to satisfy the criterion of having a single shared capital base.

#### **1.2.2 UNIVERSAL BANKING (GERMAN MODEL)**

This structure typically combines commercial banking and investment banking activities in one corporate entity, while the other financial services, i.e. insurance, are carried out in wholly owned but separately capitalized subsidiaries.

#### **1.2.3 BRITISH MODEL (BANK PARENT WITH NONBANK SUBSIDIARIES)**

There exists a legal separateness in the bank functions conducted by the Bank Parent and the nonbank functions conducted by the separately incorporated subsidiaries. This model may not be as operationally efficient as the German model due to the legal separation, the integration of bank and securities activities can only be achieved partially thus limiting the economies of scope potential. However, it has certain advantages: supervisory and regulatory costs are lower, losses may be limited and there can be tax benefits. This model is the basis of the organization structure where parent financial services (banks, securities or insurance) own subsidiaries in different financial sectors. While model still allows for risk diversification and cross-selling of financial services to increase revenues, it can reduce the potential for conflicts of interest and the extension of the safety net for as long as regulations can successfully keep in place the firewall that exists between the Bank Parent and its subsidiaries [Claessens 2002].

#### **1.2.4 FINANCIAL HOLDING COMPANY STRUCTURE (US MODEL)**

The holding company is the owner of the banking subsidiary and its nonbank counterparts. The legal separateness is more pronounced, hence the potential for scope economies is lower than the British model – the exchange of information, personnel and other inputs among the various units within the conglomerate is limited, thus reducing scale and scope economies and the bank's ability to exploit synergies from informational advantages [Claessens 2002]. Like the British model, this model has more social advantages than the German model to due to its simplified regulation and supervision on the different

activities of the conglomerate. Potential for conflict is reduced and the extension of the safety net may be limited [Santos 1998a, as cited in Claessens 2002]. The HSBC Group is an example of a structure based on this model.

**1.2.5 OTHER LESS INTEGRATED ARRANGEMENTS** (such as joint ventures, cross-shareholdings, distribution alliances and other formal arrangements)

In Europe, universal banks are allowed to provide securities services but are not allowed from directly engaging in insurance services. Insurance-engaged entities are in the form of parent-subsidiary relationship or a holding company. In the US and Japan, banking has traditionally been separate from securities and no single entity is allowed to engage in both types of business, hence the prevalence of parent-subsidiary or holding company type of structure [Bank of Japan 20005].

Specifically for banks entering the insurance industry, [Hoschka 1994, as cited in Verweire 1999] identified **four possible alternative entry vehicles towards integration**. First is the *distribution alliance* where a bank and an insurance firm enter into a cooperation agreement possibly supported by mutual shareholding. Second is a *joint venture*, where there is joint ownership but a separate legal entity underwriting insurance. Third is *merger or acquisition*, which combines and integrates two separate corporations. Fourth is the 'de novo entry', touted as the more successful approach since it involves internal diversification – since capital resources are conjoined in a conglomerate, management advantages and economies in terms of better brand strategizing techniques can be reaped [Van Lelyveld and Schilder, 2002].

### 1.3 FEATURES OF FINANCIAL CONGLOMERATES<sup>4</sup>

Despite having multiple definitions, financial conglomerates have key features:

- ❖ *Financial conglomerates are comprised of different incorporated entities*. Mostly, financial conglomerates establish separate corporations in each of the countries in which they operate. The reason for this is that countries have different business environments and hence have different tools and measures used for regulation.

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<sup>4</sup> This section was sourced largely from the Bank of Japan (2005) report.

- ❖ *The use of holding companies is very common among financial conglomerates.* The reason for this is the potential to realize management cost economies –the reduction in management costs when similar financial services are offered and managed in adjacent geographic locations.
- ❖ *Most financial conglomerates are led by banks.* The entry of banks into other financial sectors in pursuit of revenue and profit bases can explain the prevalence of bank-led conglomeration. There is also the advantage of banks having a broad capital base at the outset.
- ❖ *The operations of financial conglomerates have been shifting* – from offering traditional banking, securities and insurance products in the traditional set-up, financial conglomerates are now focusing on specific customer groups (e.g. individuals, wealthy individuals, small businesses, medium-sized firms, large businesses) and targeting specific clienteles, e.g. private banking for wealthy clients, wholesale services for large firms.
- ❖ *Financial conglomerates tend to offer unique products and services,* which reflect its firm's parentage. These products and services are presented to clients in such a way that the conglomerates' history is reflected and it makes use of the management strategy for which the firm is famous.

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## PART 2. THE BIRTH FACTORS AND RELATED CAUSES OF FINANCIAL CONGLOMERATES

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Despite being a primary global occurrence, the major blossoming of financial conglomerates has taken place only within the last two decades. Changes in the financial environment were responsible for the conception and birth of conglomerates --- deregulation, profit-strengthening objectives, changing demand for financial services, technological improvements, globalization and brand strategy [Chorafas 1992; Verwiere 1999; Shirai 2001; Bank of Japan 2005; Park 2006, among others].

### 2.1 DEREGULATION

The deregulation of the 80's ushered in a new banking environment. It tore down 'old product boundaries, customer boundaries and lines of business segregation' [Chorafas 1992]. With the erosion in these traditional dividing lines and rapid improvements in technology came the growing 'homogenization' among the banking, securities and insurance sectors [Wilmarth 2001]. More players began offering more and diversified products to more customers. Commercial banks, answering the combined challenge of *disintermediation*<sup>5</sup> and profit-related pressures by new capital adequacy rules, widened their financial services (through subsidiaries involved in leasing, mortgage, consumer finance, etc.). This deregulated industry paved the way for some of the biggest mergers and acquisitions (M&As) in business history: UBS-Swiss Bank Corporation (in Europe); Citicorp-Travelers and BankAmerica-NationsBank (in the US); and the Fuji Bank-Dai-Ichi Kangyo Bank-Industrial Bank of Japan, and the Sanwa Bank-Tokai Bank-Asahi Bank in Japan [Berger 2000]. Table 2-1 highlights the major deregulation measures in the EU, USA and Japan.

In the United States, the deregulation in interstate banking in the 80's encouraged mergers between banks within the sector. Over time, the number of businesses banks could open expanded and in 1999 the passage of the Gramm-Leach-Bliley Act (GLB Act) allowed banks, securities firms and insurance companies to participate in each other's industries.

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<sup>5</sup> The term 'disintermediation', as used by Verweire (1999) refers to the erosion of the intermediation functions of banks.

In Europe, Germany's universal banking system was allowed (in 1989) to extend to the entire European Union. In 1994, a single licensing system for insurance companies promoted mergers and cross-border acquisitions among insurance companies. In 2002, a uniform directive covering banking, securities and insurance industries gave financial conglomeration a rocket boost.

In Japan, banks and securities firms were allowed into each other's industries (via subsidiaries) in 1993. Competition was phased in between banks and insurance companies, and between securities companies and insurance companies. In 1998, holding companies were allowed to exist. These and other laws on corporate consolidation and the establishment of holding companies helped escalate corporate restructuring and financial conglomeration activities [Bank of Japan, 2005].

A number of banned activities affecting financial conglomeration have been allowed over time. Table 2-2 lists the current permissible activities for banking organizations in different countries.

## **2.2 PROFIT-STRENGTHENING OBJECTIVES**

On the look-out for new breeding ground for revenues and profit, banks took to insurance companies, first as agents/brokers for the insurance companies, then later as risk underwriters. It was when banks decided to underwrite the risk themselves that the cooperative interaction between banks and insurance firms became flavored with competition. Establishing their own insurance companies enabled banks to 'recapture deposits they had lost to life insurance companies, which have been extremely successful in attracting money from the public' [Hoschka 1994 as cited in Verweire 1999]. The decline in profits coming from traditional banking services made banks more aggressive in purchasing other financial services providers. Stabilizing earnings and profits through diversification is one of the objectives of financial conglomerates [Bank of Japan 2005]. If banks are must focus on their future strengths, they must do so with a multinational perspective [Chorafas 1992].

In the case of insurance firms, responses to the changing financial environment varied among countries. Some insurance companies decided to enter the banking sector by starting their own bank or by entering into distribution agreements. Increased competition has likewise resulted in rising shareholder

pressures to improve performance and profitability [G10 Report 2001].

### **2.3 CHANGING DEMAND FOR FINANCIAL SERVICES**

As the financial environment became increasingly competitive and complex, individual and company financial needs became increasingly diverse and sophisticated. Individual customers became interested in asset management products while companies became concerned with being more competitive by having access to global financial services [Bank of Japan 2005; Park 2006]. At the same time that financial institutions began widening the scope of their activities, the substitutability prospects between different types of financial products increased as well. For example, the features of many insurance products are similar to those of savings products, indicating the blurring (if not total elimination) of demarcation lines between products coming from different financial entities. Sophisticated consumers (and corporations) began to demand that the full package of financial services be (preferably) supplied by a single provider. At the same time, providers of financial services began to utilize existing client relationships more profitably via more diverse product offerings [Claessens 2002].

### **2.4 TECHNOLOGICAL IMPROVEMENTS**

Advances in information and financial technology have been shaking the old structures of banking, securities and insurance industries. Information technology has significantly reduced transaction costs and resulted to more efficient customer data processing and better management knowledge. It made financial services available via a new distribution channel, the Internet, which complements the greater ability of a financial conglomerate to offer mixed diverse products [van Lelyveld and Schilder 2002].

Improvements in financial technology also made 'unbundling' possible, breaking apart functions that used to be handled only by a single type of financial institution so that they can be handled by those that can do so most effectively. This enables financial conglomerates to better focus on the actual needs of their clientele, and it allows financial providers sophisticated and better risk management techniques [Park 2006]. Sophisticated equipment and new financial instruments also made it possible for many types of business and consumer debts to be securitized,

enabling customers to secure financing from nonbank sources such as finance companies and institutional credit markets. It was also instrumental in establishing aggressive "niche" providers (e.g., credit card banks, discount brokers, mutual fund companies) that offer low-cost cash management and investment management services. As a result, consumers began to shift a rising share of their investment funds from traditional bank products and life insurance policies to mutual funds, variable annuities and other investment vehicles [Wilmarth 2001].

## **2.5 GLOBALIZATION**

A by-product of technological change and deregulation, the greater cross-border movement of financial capital has increased the demand for global financial services, which are primarily provided by financial conglomerates. Seeking wider markets, finance firms expand overseas via mergers with and acquisitions of local financial services firms, making them more adaptable to local business practices and systems.

Globalization's influence in inducing consolidation is strongest among firms engaged in the provision of wholesale financial services [G10 Report 2001]. In developing and newly emerging economies, the entry of financial conglomerates brings in advanced financial services and infrastructure, liberalizing the financial environment and improving country-specific management of risks.

## **2.6 BRAND STRATEGY<sup>6</sup>**

Using the name and logo of a trusted financial brand (from the core company) can extend the competitive advantages to all firms belonging to the conglomerate. These competitive advantages can be in the form of (a) price advantages, where consumers are willing to pay higher prices for an equivalent product that bears a desired brand; (b) customer loyalty, where consumers become repeat buyers of products from the same brand; and (c) potential for expansion, since a strong brand makes it easier for a financial conglomerate to expand into other industries in other locations [Bank of Japan 2005].

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<sup>6</sup> As defined by METI, a brand refers to the different marks used by a company to distinguish its products and services from those of its competitors.

Retail banking, where customers are more influenced by brands, creates positive impact on customers (who are more easily influenced by the competitive advantages of a brand) when they use company brands.

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### PART 3. TWO SIDES OF THE COIN: THE MERITS AND DEMERITS OF FINANCIAL CONGLOMERATION

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Size does matter in the financial industry, but as much as there are benefits to financial conglomeration, there are also disadvantages, largely in the form of increased risks. Most research has focused on the efficiency and stability angles, as conglomeration results to complex and vast businesses. Are financial conglomerates necessarily more efficient entities? When firms are integrated, what aspects of their operations are more apt to be efficient and what areas become more vulnerable to increased risk exposure? When financial services companies integrate (that is, when two or more financial service organizations combine two or more dimensions of their production and distribution structures), what are the merits and demerits, and how does the manner of integration relate to the greater efficiency gains for the conglomerate?

In what respects do financial conglomerates make better firms? Perhaps one of the most comprehensive studies on the research aspect is that of Verweire [1999] whose paper sought to determine the following: (1) if financial conglomerates outperformed specialized banks; (2) if conglomerate-related banks and insurance companies benefit from financial conglomeration strategy; and (3) if there are diversification approach differences among financial conglomerates and if such differences affect firm performance.

In a separate but related paper, the study by Berger [2000] discuss the efficiency effects of integration in the financial services industry, using the two tiers of integration (largely M&As) in the financial services industry (see **Table 3-1** and **Table 3-2**) as backdrop in identifying the various efficiencies firms may realize.

#### SIMPLE TYPES OF INTEGRATION:

- ❖ **Scale integration** occurs when the production or distribution of financial services is consolidated into fewer, larger organizations. An example is the M&A of similar organizations.
  
- ❖ **Scope integration** occurs when the range of services produced or distributed by the financial institutions is



- expanded. An example is an institution that shifts from offering a single category of financial services to offering universal (combined commercial banking, investment banking and insurance) types of services.
- ❖ **Geographic integration** happens when financial institutions expand to produce or distribute financial services in an expanded set of location. An example is cross-regional M&As where subsidiaries are set up in various locations.
  - ❖ **International integration** happens when institutions expands across via M&As or the establishment of new subsidiaries or other viable means.
  - ❖ Financial firms may also **horizontally** (production or distribution systems) or **vertically** (production AND distribution systems) integrate.

#### COMPLEX TYPES OF INTEGRATION:

- ❖ The first complex type of integration is the national integration of financial institutions within a single product category. This is usually achieved via M&A, and always involves scale integration and may involve geographic integration.
- ❖ The second complex type of integration is the integration of providers of different product categories of financial services into universal-type organizations. It always involves scope and scope integration and may involve geographic and international integration.
- ❖ The third complex type of integration is the international consolidation of financial institutions, which typically involves scale, geographic and international integration, as well as scope integration.

Various forms of integration resulted to the creation of financial behemoths, which pose major challenges in management, regulation and supervision. Despite this, bigger might indeed be better as shown in Table 3-3 which lists the Top 25 banks in terms of soundest capital-assets ratio.

**Table 3-4** lists the empirical findings on causes of US bank consolidation. Several researchers have found evidence of an increase in market power (share) with some evidence of price

effects in a concentrated market. There also is some evidence of greater profit efficiencies, some evidence of improvements from geographic diversity, improvements in payment efficiency, some evidence that management may act in self-interest, support for the too big to fail motive, and some potential for increased systemic risk and safety net expansion. Other researchers found mixed evidence on cost efficiencies from scale economies, mixed evidence on cost efficiencies from scope economies, little evidence of any significant and permanent increase in shareholder value, little evidence of a lowering of consumer prices, and little effect on the availability of services to consumers. The effect of bank mergers on loan prices is still developing. There is some evidence of the unfavorable results of increased market concentration due to big bank mergers on deposit rates, personal loan rates, and real-estate loan rates.

### 3.1 MERITS OF FINANCIAL CONGLOMERATION

According to Galbraith [as cited in Madsen and Walsh 1969], conglomerates contribute to economic growth in terms of superior managerial, technological and financial strength. Most of this growth is experienced 'internally' in the form of construction of new plant and equipment, and market expansion. Thus, a conglomerate may be especially able to take an inefficiently managed division and turn it around. Potential social gains from improved production efficiency may be substantial. This is termed "X-efficiency" by Leibenstein and supported by case studies showing realized efficiency gains usually above 25% of unit costs [Madsen and Walsh 1969].

Thirty-five years later, are the claimed (theoretical) efficiency benefits of conglomeration still true? How do such benefits (merits) apply to financial conglomerates? How may these benefits be amplified? With the changing financial landscape, what are the modifications in the risks and demerits of financial conglomeration? How may these risks be minimized?

Claessens [2002] and Park [2006] identified the three major merits of financial conglomerates: it increases profits via economies of scale and scope, it reduces the variability of profits via increased diversification and risk minimization, and it allows for the use of informational advantages.

#### 3.1.1 EFFICIENCY GAINS: ECONOMIES OF SCALE, SCOPE AND X-EFFICIENCY

The primary benefits of a conglomerate are 'the ability to capture economies of scale and scope and to capture synergies across complementary financial services business line', leading to 'lower costs, reduced prices and improved innovation in products and services' [Half 2002].

Berger [2000] identified, defined and analyzed different efficiency types and the probability of such efficiencies occurring against varying integration backdrop:<sup>7</sup>

- ❖ **Cost efficiency** refers to how close an institution's costs are to those of a best practice situation. It is measured using a standard cost function in which available variable

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<sup>7</sup> A significant portion of the succeeding discussion (specifically the definition of terms) was sourced from *The Integration in the Financial Services Industry: Where are the Efficiencies?* by Berger (2000).

- costs depend on the quantities of output, the prices of variable inputs, any fixed inputs or outputs, and other environmental conditions. Cost efficiency may be in the form of scale efficiency (economies of scale), scope efficiency (economies of scope) and X-efficiency.
- ❖ **Cost scale efficiency** (economies of scale) refers to how close average costs are for a best-practice firm at a given scale and output mix to the average costs of a best-practice firm at the minimum-average-cost point for that product mix. Financial conglomerates can create cost efficiency gains by spreading their fixed costs over more units of output, taking better advantage of technology and issuing securities in larger sizes. However, they may also realize cost scale efficiency losses via organizational diseconomies that come with managing huge and complex business structures.
  - ❖ **Cost scope efficiency** (economies of scope) refers to how close the sum of costs for two best-practice firms that each specialize in some of the of the outputs are to the costs of a single best-practice firm that produces all of the outputs. A financial conglomerate may realize this type of efficiency through sharing physical inputs, information systems, databases, or other means. Losses, on the other hand, are also possible from organizational diseconomies from producing or distributing more products or when the parent firm veers away from its core competency.
  - ❖ **Cost X-efficiency** refers to how close a firm's actual costs are to the costs of a best-practice firm producing the same outputs. An example by which a financial conglomerate may increase cost X-efficiency is when the acquiring firm is more efficient than the target firm, and when the acquiring firm spreads its superior managerial expertise over more resources. On the other hand, a financial conglomerate may also reduce its cost X-efficiency gains if managers use more inputs than a best practice firm would (technical inefficiency) or managers employ an input cost that does not minimize cost for a given input price vector (allocative inefficiency).
  - ❖ **Revenue efficiency** refers to how close an institution's revenues are to best-practice revenues under the same environmental conditions. It is measured using the alternative revenue function in which output prices are free to vary and reflect customer preferences and

willingness to pay for the scale, scope, or quality of the conglomerate's output.

- ❖ **Profit efficiency** is an amalgam of cost and revenue efficiencies and is used to determine how successfully a financial conglomerate has achieved its goal of value maximization.

In the context of the preceding definitions, Berger [2000] discussed several efficiency possibilities for **universal-type** organizations: (1) Scope economies could come from sharing physical inputs like offices or computer systems; employing common information systems, investment departments, account service centers or related operations; obtaining capital by issuing debt or equity in larger sizes; or reusing managerial expertise or information; (2) Cost improvements could come from integrating the production of different categories of financial services through risk diversification, since the returns associated with banking, securities, and insurance generally have relatively low correlations; (3) Cost scope efficiency losses may arise, however, due to organizational diseconomies of offering a broad range of products, e.g., simultaneously monitoring banking, securities and insurance underwriting operations may be difficult since senior managers may only have expertise in one of those fields; (4) Revenue efficiency gains are possible through integration of distribution systems, cross-selling different categories of financial services, sharing the reputation associated with a brand preferred and recognized by customers (reputation economies), diversifying risks by combining different categories of financial services, and improved chances of making high risk-high expected return investments.

However, revenue scope efficiency losses are possible for the following reasons: (1) product specialists may differ in their wealth of product knowledge and charge different prices for tailoring products to different customers; (2) combined commercial and investment banking functions may create conflicts in interest (that is, the market may underprice the securities underwritten by a universal bank for its existing loan customers because of concerns that the proceeds from the issue will be used to enhance the value of distressed loans extended to that customer by the bank; as a result, commercial loan customers may not prefer to use their own universal bank's underwriting services.); and (3) it could worsen the risk-expected return trade-off and lower expected revenues.

Among the limited research on revenue scope efficiency, one that studied commercial banks in Europe found that 'they typically had both higher revenues and higher profitability than specializing institutions'. Studies on combined banking and insurance in the UK and the US showed favorable results. Whether scope efficiencies within a category of financial institutions represent efficiencies across institution categories, remain a severely under-researched question.

For financial institutions that merge via international consolidation, various scale, scope and X-efficiency effects are expected:

(1) Whereas internationally consolidated financial institutions are subject to such barriers as language, culture, currency and regulatory and supervisory structures, government policy can significantly modify these barriers.

(2) Risk diversification is also expected to be substantially greater on the average for international consolidation than within-nation consolidation, e.g., a study by Berger et al [2000], as cited in Berger [2000], found that 'the correlations of bank earnings across major developed nations are considerably lower than the cross-regional correlations in the US; the international correlations were very low and even negative, even across EU, which has moved towards a single market'.

(3) Additional revenue X-efficiency effects from cross-border consolidation are also expected since it allows the financial conglomerate to operate in multiple nations hence allowing the conglomerate to follow their customers across international borders and maintain the benefits of their existing relationship with them.

(4) cross-border consolidation allows institutions to be headquartered in nations where they can operate efficiently under more favorable 'home' conditions.

Empirical results regarding the X-efficiency of foreign versus domestic institutions within a single nation have mixed results:

(1) A study of US data [DeYoung and Nolle 1996; Mahajan, Rangan and Zardkoohi 1996, as cited in Berger 2000] found that 'foreign-owned banks are significantly less cost-efficient and profit-efficient than average than domestic banks'. (2) Studies on other nations [Vander Venet 1996; Hassan and Lozano-Vivas 1998; Bhattacharya, Lovell and Sahay 1997; Cummins and Rubio-Misas 1999, as cited in Berger 2000] found that 'foreign institutions have about the same average efficiency as domestic

institutions, although some differences by might exist based on the type of ownership. (3) Research on profit efficiency [Miller and Parkhe 1999; Parkhe and Miller 1999, as cited by Berger 2000] found that domestic banks were more efficient on average than foreign-owned institutions, although foreign banks (from the same type of environment as the host nation) fared better than other foreign institutions.

Claessens [2002] and Park [2006] point out that economies of scope may be realized by financial conglomerates both from the production and consumption of financial services. The increased production of financial products and services can lead to economies of scale or lower average cost advantages. 'Such cost advantages may come in the form of: gains from the concentration of risk management, administration functions and integrated product development; marketing economies in the sense that a common delivery system is used for different services; better information access and data sharing across different product groups; reputational and monetary capital to be shared across different products and services; and enhanced potential for risk for management through diversification gains. On the consumption side, economies of scope may derive from: the potential for lower search, information, monitoring and transaction costs; negotiating better deals because of increased leverage; and lower product prices in a more competitive environment' [ibid.].

However, little evidence of scope economies have been noted in the literature, probably because financial conglomerates are unable to optimize their institutional structure and the complications involving the measurement of banks' diverse product and input scales. Studies on US banks [Berger, Hanweck and Humphrey (1987); Berger, Hunter and Time (1993), as cited in Claessens 2002 and Berger 2000] yielded results that indicated that scope economies in banking are exhausted at very low levels of output. Studies covering European banks, on the other hand, produced inconclusive results: for example, scope economies were absent in German universal banks but present in small cooperative banks [Welzel 1995 as cited in Claessens 2002]; European universal banks are more revenue efficient, more profit efficient and exhibit superior monitoring capabilities compared to specialized banks [Vennet 2002 as cited in Claessens 2002]. Wilmarth [2002] stated, however, that European universal banks have been less efficient, less profitable and less creative than the top US banks and securities firms over the past three decades. Empirical studies on "bancassurance" (banking combined with

insurance) pointed to the limited evidence of the existence of scope economies [Carow 2002 as cited in Claessens 2002].

On a related note, a study of US bank mergers by Wilmarth [2002] found that mergers among big banks 'generally have failed to produce substantial improvements in efficiency, profitability, shareholder value or customer service' – many financial conglomerates faced serious difficulties in the 80's; majority of US bank mergers disappointing profits and long-term losses in shareholder wealth; five big banks (J.P. Chase Morgan, Citigroup, Credit Suisse, Deutsche Bank and UBS) suffered from sharp earnings decline in 2001 and their diversification strategies exposed them to material risks during financial market disruptions – and that the chances of delivering the promises of universal banking may not be as optimistic as originally thought.

Moreover, the failure of US financial conglomerates to generate profitability and efficiency gains was further aggravated by these factors: (1) the complex organizational structure and agency conflicts may prevent financial conglomerates from realizing potential synergies; (2) management pursuit of expansion and diversification programs may have nothing to do at all with customer loyalty or shareholder returns; (3) in the process of paying lip service to shareholder value, acquiring firm managers often issue optimistic forecasts about potential savings and profits. In keeping with these forecasts, acquiring firm managers are tempted to pursue more riskier and highly leveraged activities, in the process alienating customers and producing large scale losses.

### 3.1.2 INCREASED DIVERSIFICATION AND RISK MINIMIZATION

How does diversification relate to conglomeration? How does it produce positive effects for a financial conglomerate? The act of **diversifying** refers to "*the entry of a firm or a business unit into new lines of activity, either by processes of internal business development or acquisition, which entail changes in the administrative structure, systems, and other management processes*" [Verwire (1999:45), citing Ramanujam and Varadarajan, 1989]. The diversified nature of a financial conglomerate may render it more stable than a specialized financial firm in that: [Park 2006:7]



- ❖ Diversification enables the financial conglomerate to earn a more stable stream of revenues compared to a specialized financial firm.
- ❖ It is less affected by disintermediation (when firms bypass banks and raise money directly from public markets).
- ❖ Particularly for developing economies in need of financial capital, the presence and activities of financial conglomerates may produce dynamic economic impacts, provided these external capital flows are used efficiently and do not cause volatility-related shocks on the financial system.

Diversification gains from consolidation, based on a G10 Report [2001], are likely to stem from consolidation across regions of a given nation or from consolidation across national borders. Such gains are likely to come from asset diversification across geographies, although some gains may also be had from diversification on the liabilities side of the balance sheet, as well as from the consolidation of financial products and services.

### 3.1.3 INFORMATIONAL AND KNOWLEDGE ADVANTAGES

Relationship between a banking conglomerate and a client entails the requisite information gathering to aid the bank in making lending and investment decisions. Claessens [2002:17-18] and Park [2006:7] wrote that a banking conglomerate is more willing to invest in gathering client-specific information when the bank-client relationship is expected to last for a long period.

Conglomerates can also offer more diverse product offerings than specialized financial institutions; hence, the lower information and monitoring costs since the information from managing a basic bank account can also be used for selling other financial products to the same client. Such advantages may also be passed on to customers in the form of better and cheaper services from the conglomerate. Rajan and Zingales [1999, as cited in Claessens 2002:19] note that 'the degree to which these informational advantages can be realized and passed on to the customer depends in part on the degree of informational asymmetries: in economies where information is generally poor, close bank-client relationships can be very useful'. A caveat to this close bank-client relationship is that the bank may weaken the monitoring of its client and in turn make less-than optimal decisions that cause poor resource allocation.

### **3.2 DEMERITS AND RISKS OF FINANCIAL CONGLOMERATION**

As much as conglomeration can increase the possibility of risk diversification, it also increases the likelihood for the financial conglomerate to increase and shift risk; hence creating risk management and stability issues. There is greater probability for conflicts of interest to arise as the conglomerate takes on banking, securities and insurance activities simultaneously. Such conflict of interest can aggravate the already difficult job of monitoring and supervising large financial institutions, let alone keep the regulatory structure functional and in place. Financial conglomeration can cause the polarization of the financial system into large financial conglomerates offering diverse products and services on one hand, and independent smaller-scale financial services provider on the other. The consolidation of firms can reduce the number of market participants, especially in cases where the smaller acquired institution is delisted from the stock exchange after it has been taken over by the financial conglomerate. This reduction in market participants and the consequent concentration among financial firms carry possible negative effects on the market's ability to effectively discover prices. The unrestricted activities of conglomerates may also make them especially difficult to monitor and supervise. As conglomerates grow and expand their economic-political reach, there is also the risk that these conglomerates might be "too big to fail" or "too big to disappear". All these factors carry with them the potential to undermine the stability of any financial system.

#### **3.2.1 CONFLICT OF INTEREST**

Conflicts in interest arise when financial institutions are allowed to offer a wider array of products and have a broad set of customers, as in the case of a financial conglomerate. A universal bank that offers both banking and securities investment services faces a conflict of interest (1) when the bank promotes the securities of firms it is lending to when there are other better investment alternatives available in the market; (2) when a bank dumps the unsold portion of the securities it underwrites into the trust accounts of its bank depositors; or (3) when its insurance function that is engaged in asset

management is encouraged to buy securities (that the bank underwrites) at inflated prices [Claessens 2002:20]. The informational advantage present to a financial conglomerate can be a source of conflict of interest when the conglomerate takes advantage of the incentive and opportunity to service 'uninformed' clients.

However, there exist market forces that reduce conflicts of interest, e.g., stiff competition from other financial firms, the potential damage to the conglomerate's reputation and the monitoring by creditors and ratings agencies. Empirical studies [by Lehar and Randall 2001, as cited by Claessens 2002:22] involving German universal banks from 1994 to 1999 found evidence that conflicts of interest are less pronounced for large equity holding by banks. In another study it was found that US financial conglomerates are more likely to borrow from their connected banks but 'do so on terms similar to those of unconnected firms' [Krosner and Strahan 2001, as cited by Claessens 2002:22].

Examining the pricing of debt securities underwritten by subsidiaries of US commercial bank holding companies relative to those underwritten by investment houses, Gande, Puri Saunders and Walter [1997 and 1999, as cited in Claessens 2002:23] found 'NO evidence of conflicts of interest in situations like when the purpose of the bank underwriting is to repay existing bank debt'. Banks were also found to bring relatively larger proportion of smaller sized issues to the market than investment houses do, producing a net benefit to smaller firms [ibid.].

Conflicts of interest are not confined to banking and securities situations alone; it may also exist arise among similar types of services. Its possibility is more pronounced in situations where the banking conglomerate acts as an 'agent', and less when the banking conglomerate looks after its own account. In Israel, it was found that 'bank-managed funds pay too much for bank-underwritten IPOs at the expense of the investors in the funds' [Ber, Yafeh and Yosha (2001) as cited in Claessens (2002:24)]. Similar cases have occurred in the US, spurring a string of lawsuits. Nevertheless, it *cannot* be said that there has been a systematic abuse of conflicts between commercial and investment banking activities [ibid.].

### 3.2.2 LESS COMPETITION, MORE CONCENTRATION

As financial conglomerates allow for greater linkages between financial and non-financial institutions, it can lead to greater market concentration and in the process reduce competition. As a financial sector becomes dominated by conglomerates, the reduction in competition could in turn reduce the efficiency of the sector itself. Conglomeration, however, can lead to innovation in the production and marketing of financial services. Claessens [2002:28] explains: "The combination of different financial services in one organization may also be very useful in countries undertaking financial reform, particularly with respects to insurance and pension or, more broadly, social security systems. The combination can transpose know how from banking to insurance and investment management to find appropriate solutions for pension and social security problems. For countries building new systems, allowing existing banks to expand into insurance and pension activities may also be a quicker way to build these segments of financial services industries."

Empirical evidence on the effect of financial conglomeration on competition offers mixed results. Fohlin [2000 as cited in Claessens 2002:29] compared German universal banks to its American and British counterparts in the pre-WWI period and found that *the combination of commercial and investment banking services did not influence banking industry concentration, levels of market power or financial performance of banks*. That is, German banks 'behave no less competitively than their American counterparts in the provision of loan services, and little evidence of deviation from competitive pricing was found in either country. Universality was not associated with superior profitability, making universal banking neutral to competition' [ibid.].

### 3.2.3 CHALLENGES TO MONITORING AND SUPERVISION

The combination of banking, insurance and securities activities makes monitoring and supervision more difficult because of the differences in the individual objectives of supervising banks, securities companies and insurers. The supervision of banks is carried out with the objective of protecting the net worth the bank and thus the rights of the depositors; that is insurance

companies is to protect the net worth of the insurance company and its policy holders. For securities, the objective is mainly consumer protection. A coordinated approach to supervision and monitoring is the recommended plan of action; however, this would be difficult and challenging to execute in markets where information is generally poor and supervisory linkages are weak to begin with.

If supervision and monitoring systems result to restrictions on banking activities, how would this impact on the financial structure of economy as a whole? A cross-country study by Barth, Carpio and Levine [2001, as cited in Claessens, 2002] found that restricting commercial bank activities (as compared to when banks can diversify their activities) is negatively related to bank performance. The study also found that the lack of regulatory barriers (that is, more financial conglomerates) can promote financial sector stability and that countries with greater regulatory banking restrictions are more likely to suffer a major banking crisis. This positive correlation between regulatory restrictions on banking and financial crises may be explained by the fact that countries with weak supervisory systems usually compensate by imposing more restrictions on banking activities, thus stifling bank performance and negatively impacting on financial development. Government integrity was also found to be lower in countries with more bank-related restrictions and where the government plays a larger role in the financial sector.

Financial conglomeration may also result to the weakening of monitoring functions by outside shareholders and markets [Bank of Japan 2005]. When financial services providers raise funds within the conglomerate itself (via non-listed companies), external monitoring functions are compromised. Opinions of outside shareholders are neither directly sought nor reflected in the management of such non-listed subsidiaries. Overall, the pressing issue with regards to the monitoring and supervision of financial conglomerates is not so much their formal structures as the implications such structures have over proper risk management and oversight [OECD Report, n.d.]

#### **3.2.4 RISK ISSUES**

Financial conglomeration has the potential to increase the concentration and transmission of risk of individual financial institutions (insolvency) and the entire (systemic) financial system. Financial firm (individual) risk occurs because of (1) the natural mismatch between the assets and the liabilities of banks; (2) scale and scope economies in banking which encourage

banks to engage in universal rather than narrow banking; and (3) asymmetry in information makes it hard for banks to know exactly the risk characteristics of loan applicants (a.k.a. 'investment risk'). On the other hand, systemic risk (the danger of a systemic crisis) may be due to (1) aggregate shocks (interest rate, exchange rate or stock market crash); (2) due to contagion. According to Brinkman, systemic risk has increased in the US and the EU in the past 15 years. A study of 115 countries found that a positive correlation exist between concentration ratios and systemic risk [citing De Nicolo et al 2003], lending support to the argument that consolidation can result to greater concentration among banks, which in turn can expose the economy to greater systemic risk [Brinkman, n.d.].

By influencing market expectations, the failure of a single financial firm can affect not only its counterparts but on the financial market in general. Through the interest rate and exchange rate mechanisms, firm failures resulting from imprudent risk management and/or excessive risk-taking behavior can influence outcomes in the real sector as well [Eatwell 2004]. The Group of Ten Report [2001] notes that 'economic shocks that have the potential to become systemic financial risk events are most unlikely to be transmitted to the real sector through the wholesale activities of financial institutions and markets, including payment and settlement systems.' The high social costs associated with financial instability makes it imperative for banking regulators to reduce financial risk while increasing the welfare benefits of a functional banking system [Brinkman, n.d.].

Within a financial conglomerate, the risks faced by individual units in a conglomerate are likely to interact and concentrate within the group, and if managed improperly, such risks may cause potentially large losses for the firm. Rising cross-market correlations, brought about by liberalization and cross-border consolidation, increase transmission risk potential [Eatwell, 2004]. Transmission of risks is occurs when one of the units within a financial conglomerate takes on excessive risks and cause such risks to be transmitted to the entire conglomerate via intra-group transactions, brands and reputation. It is in this regard that the establishment of firewalls within the conglomerate is underscored to contain transmission risk. Reputational risk may also be transmitted any time an institution (part of the conglomerate) losses the confidence of its customers, or even when it is just rumored to be engaged in illegal or illicit transactions.

Investment banking conglomerates are particularly prone to risks associated with their agency-type activities and principal type activities. In agency-type activities, they act as agents and conduct 2-way transactions on behalf of their customers. These activities are considered less risky since they are mainly fee-based. In principal-type activities, the conglomerate conducts transactions for its own account and makes a profit by acquiring securities in the expectation of reselling them at a high price. With such activities, risks occur in case the firm makes commitments to underwrite public issues and are unable to sell securities they underwrote at a price high enough to cover the costs of the operation and the price guaranteed by the issuers.<sup>8</sup> Banks may also face market risks when their shares of securities holdings increase relative to the share of illiquid bank loans [Shirai, 2001].

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<sup>8</sup> 'Underwriting requires that commercial banks bid as primary dealers in bonds, hold unsold bonds and support prices after initial distribution. Commercial banks may allocate unused funds to pay for the costs of providing these services. This means that they are now entering a new economic environment and thus face new types of risks. Regulators need to ensure that commercial banks do not over-optimistically analyze the performance of firms with whom they have long-term relationships when they underwrite bonds' [Shirai, 2001:47].

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**TABLES AND FIGURES FOR CHAPTERS 1-3**

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**TABLE 1-1. TOP 25 BANKS BY MARKET CAPITALIZATION  
AS OF JUNE 2006**

POSITION	BANK	COUNTRY	MARKET CAP (\$million)
1	Citigroup	USA	242,000
2	Bank of America	USA	218,637
3	HSBC Holdings	UK	195,356
4	JP Morgan Chase & Co.	USA	141,067
5	Mitsubishi UFJ Financial Group	Japan	128,278
6	UBS	Switzerland	113,039
7	Wells Fargo and Co.	USA	112,427
8	Royal Bank of Scotland	UK	101,820
9	China Construction Bank	China	95,529
	Mizuho Financial Group	Japan	88,822
11	Santander Central Hispano	Spain	85,263
12	Wachovia	USA	85,041
13	BNP Paribas	France	81,586
14	UniCredit	Italy	75,672
15	Barclays Bank	UK	71,672
16	Sumitomo Mitsui Financial Group	Japan	71,091
17	Credit Suisse	Switzerland	66,932
18	HBOS	UK	66,153
19	Banco Bilbao Vizcaya Argentaria	Spain	65,573
20	Societe Generale	France	59,485
21	US Bancorp	USA	55,710
22	Lloyds TSB	UK	54,619
23	Deutsche Bank	Germany	54,408
24	Credit Agricole	France	52,959
25	Royal Bank of Canada	Canada	51,045

SOURCE: THE BANKER ([www.thebanker.com](http://www.thebanker.com))

TABLE 1-2. TOP 25 BANKS BY ASSETS AS OF JUNE 2006

<i>POSITION</i>	<i>BANK</i>	<i>COUNTRY</i>	<i>ASSETS (\$M)</i>
1	Barclays	UK	242,000
2	UBS	Switzerland	218,637
3	Mitsubishi UFJ Financial Group	Japan	195,356
4	HSBC Holdings	UK	141,067
5	Citigroup	USA	128,278
6	BNP Paribas	France	113,039
7	Credit Agricole Group	France	112,427
8	Royal Bank of Scotland	UK	101,820
9	Bank of America Corp	USA	95,529
	Mizuho Financial Group	Japan	88,822
11	JP Morgan Chase & Co.	USA	85,263
12	Deutsche Bank	Germany	85,041
13	ABN Amro Bank	Netherlands	81,586
14	Credit Suisse Group	Switzerland	75,672
15	Societe Generale	France	71,672
16	ING Bank	Netherlands	71,091
17	Santander Central Hispano	Spain	66,932
18	HBOS	UK	66,153
19	UniCredit	Italy	65,573
20	Sumitomo Mitsui Financial Group	Japan	59,485
21	Industrial and Commercial Bank of China	China	55,710
22	Fortis Bank	Belgium	54,619
23	Group Caisse d'Epargne	France	54,408
24	Dexia	Belgium	52,959
25	Rabobank Group	Netherlands	51,045

*SOURCE: THE BANKER (www.thebanker.com)*

TABLE1-3. ORGANIZATIONAL STRUCTURE OF FINANCIAL CONGLOMERATES

Type	Universal Banking	Parent-Subsidiary Relationship	Financial Holding Company
<i>Model</i>	German model	British model	US model
<i>Governance of the Parent Company by Shareholders</i>	Bank shareholders govern all businesses (banking, securities, insurance).	Bank shareholders directly govern banks and indirectly govern securities and insurance companies.	Holding company shareholders indirectly govern all subsidiaries in the banking, securities, and insurance sectors.
<i>Execution of Business by Executives of the Parent Company</i>	Bank executives directly execute operations in each businesses.	Bank executives directly execute the bank's business and exercise rights for shares held in securities and insurance companies.	Holding company executives exercise rights for shares held in all subsidiaries.
<i>Capital Relationship Between Businesses/Sectors</i>	No legal separation of capital in different businesses (allocation of capital to each business for internal management purposes is possible.)	Banks, securities, and insurance companies hold their own capital. Potential exists for problems between parent companies and subsidiaries, such as double-gearing of capital.	Banks, securities and insurance companies hold their own capital. Potential exists for problems between parent companies and subsidiaries, such as double-gearing of capital.
<i>Risk Insulation Between Businesses/Sectors</i>	It is difficult to insulate risks between businesses; safety net effects on one business extend directly to others.	It is possible to insulate against risks to some extent. Safety net effects on parent banks may extend to subsidiaries.	It is relatively easy to insulate against risks; safety net effects on one sector do not extend indirectly to others.
<i>Examples</i>	In Europe, banks can engage in securities business, but none of the major industrial countries permits a single company to conduct all three businesses of banking, securities and insurance.	In the US, this structure is permitted when banks enter securities or insurance business. This structure is also permitted in Japan (sector-specific subsidiaries).	This structure is seen in many international conglomerates. It is common in the US, allowed in Japan and employed primarily by large banks.

*Source: Most parts were taken from The Expansion of Corporate Groups in Financial Services Industry: Trends in Financial Conglomeration by the Bank of Japan (2005) as cul;led from Financial Conglomerates and Mix of Finance and Commerce by Jae-Ha Park (2006).*

TABLE 2-1. FINANCIAL DEREGULATION MEASURES IN THE USA, EU AND JAPAN

<i>Year</i>	<i>USA and EU</i>	<i>Japan</i> <i>Financial System</i>	<i>Related Systems</i>
1993		Ban on cross-sector entry between banking and securities via subsidiaries was lifted.	
1994	US: Riegle-Neal Interstate Banking and Branching Efficiency Act eliminated interstate regulations.		
1996		Ban on cross-sector entry between life and casualty insurance via subsidiaries was lifted.	
1997			Ban on pure holding companies was lifted.
1998		Bans on the ff. were lifted: financial holding companies; cross-sector entry between securities and insurance via subsidiaries; OTC sales of investment trust products by banks and insurance companies. Licensing system for securities companies was switched to registration system. Restrictions on the scope of business activities for securities companies were eliminated, and ban on OTC sales of insurance products was lifted.	
1999	US: The GLB Act was passed, relaxing restrictions on cross-sector entry into banking, securities and insurance through financial holding companies.	Ban on insurance companies participating in banking (via subsidiaries) was lifted. Brokerage commissions were fully liberalized. Restrictions on the scope of business for securities subsidiaries of banks were eliminated.	Share exchange and transfer system was introduced.
2000		Ban on banks participating in insurance via subsidiaries was lifted.	Shifted to consolidated accounting.
2001		Ban on cross-sector entry into the third sector by life and casualty insurance companies was lifted. Ban on OTC sales of insurance products by banks was partially lifted.	Company division procedures were introduced.
2002	EU: European Commission adopted the Directive in the supplementary supervision of credit institutions, insurance undertakings, and investment firms in a financial conglomerate.	Ban on establishment of joint branches by banks and securities companies was lifted, allowing them to conduct business on the same premises.	Consolidated tax system was introduced.
2004		Ban on securities brokerage business was lifted.	

*Source: The Expansion of Corporate Groups in Financial Services Industry: Trends in Financial Conglomeration by the Bank of Japan (2005) as cul;led from Financial Conglomerates and Mix of Finance and Commerce by Jae-Ha Park (2006).*

TABLE 2-2. PERMISSIBLE ACTIVITIES FOR BANKING ORGANIZATIONS IN SELECTED FINANCIAL CENTERS					
COUNTRY	SECURITIES	INSURANCE	REAL ESTATE	BANK INVESTMENTS IN INDUSTRIAL FIRMS	INDUSTRIAL FIRM INVESTMENTS IN BANKS
<i>Australia</i>	Permitted	Permitted through subsidiaries or sister companies, subject to controls under the insurance laws	Limited	Permitted; a bank (and its consolidated banking group) is required to deduct equity investments in non-subsidiary entities that are not operating in the field of finance in excess of 0.25% of consolidated Tier 1 capital for an individual investment of 5% of consolidated Tier 1 capital in aggregate, from the bank's (and the group's) Tier 1 capital.	Shareholdings of more than 15% in a bank need the approval of the Treasurer. The Treasurer has signaled a willingness to consider an association between a bank and a non-financial company where a sound case can be presented. This policy will be applied conservatively.
<i>China</i>	Not permitted	Not permitted	Not permitted	Not permitted	Permitted; acquisitions of 5% or more require approval of the banking regulatory authority
<i>European Union</i>	Not applicable; permissibility is subject to home country authorization and limited to host country regulation	Not applicable; permissibility is subject to home country and host country regulation	Not applicable; permissibility is subject to home country and host country regulation	Each 10% or more share-holding may not exceed 15% of the bank's own funds and such shareholdings on an aggregate basis may not exceed 60% of own funds	No general restrictions; does not allow investments of 10% or more if home country supervisor is not satisfied with the suitability of the shareholder.
<i>Hong Kong</i>	Permitted, through registration with the Securities and Futures Commission and subject to limits based on the capital of the bank	Agency permitted, subject to regulatory requirements. Underwriting permitted through subsidiaries.	Permitted, subject to limits based on the capital of the bank	Permitted, subject to limits based on the capital of the bank	Permitted, subject to regulatory consent based on suitability of the shareholder with a 10% or more controlling interest.
<i>Indonesia</i>	Permitted though subsidiaries	Permitted though subsidiaries	Not permitted	Not permitted	Permitted

<b>TABLE 2-2. PERMISSIBLE ACTIVITIES FOR BANKING ORGANIZATIONS IN SELECTED FINANCIAL CENTERS</b>					
<i>COUNTRY</i>	<i>SECURITIES</i>	<i>INSURANCE</i>	<i>REAL ESTATE</i>	<i>BANK INVESTMENTS IN INDUSTRIAL FIRMS</i>	<i>INDUSTRIAL FIRM INVESTMENTS IN BANKS</i>
<i>Japan</i>	Some services (e.g., selling of government bonds and investment trusts) permitted to banks, others permitted through subsidiaries	Some services (selling insurance policies in connection with housing loans and others) permitted to banks, others permitted through subsidiaries	Generally limited to holding bank premises	Limited to 5% holding interest	Permitted, provided total investment does not exceed investing firms capital or net assets. Acquisitions of shares in excess of 5% must be filed and shares equal or in excess of 20% subject to regulatory approval.
<i>Korea</i>	Permitted through affiliates	Permitted through affiliates	Generally limited to holding bank premises and to 60% of bank capital	Permitted, but limited to 15% of the total shares of non-financial companies	Permitted, up to 4% of the bank's total shares
<i>New Zealand</i>	Permitted, usually conducted through a subsidiary	Permitted, usually through subsidiaries	Permitted, usually through subsidiaries	Permitted	Permitted, but subject to approval of authorities
<i>Philippines</i>	Permitted, universal banks may engage in securities activities directly or through a subsidiary with limitations; regular commercial banks may engage in securities activities only through the investment house where they have a minority interest	Insurance companies/ insurance agency and brokerage permitted for universal banks through subsidiaries with limitations; insurance agency and brokerage permitted for regular commercial banks through subsidiaries with limitations	Permitted for universal banks through subsidiaries with limitations	Permitted for universal banks through subsidiaries with limitations	Permitted with limitations on foreign and/or corporate ownership.
<i>Singapore</i>	Banks may engage in the full range of	Banks can act as distributor but not as manufacturer of	Investment in real estate is limited in the	Interests in excess of 10%, or that give the bank significant	Acquisitions of 5%, 12% and 20% or more by any single

TABLE 2-2. PERMISSIBLE ACTIVITIES FOR BANKING ORGANIZATIONS IN SELECTED FINANCIAL CENTERS

COUNTRY	SECURITIES	INSURANCE	REAL ESTATE	BANK INVESTMENTS IN INDUSTRIAL FIRMS	INDUSTRIAL FIRM INVESTMENTS IN BANKS
	underwriting, dealing, brokering and mutual fund services	insurance products unless they possess a separate insurance license to conduct insurance business, which is governed by the Insurance Act administered by MAS	aggregate to 20% of bank's capital funds. Banks are generally not allowed to engage in property development or management	influence over the management of the company, require regulatory approval. In addition, a bank may not invest more than 2% of its capital funds in any individual firm.	shareholder require regulatory approval
<i>United Kingdom</i>	Permitted, usually conducted through subsidiaries	Permitted through subsidiaries	Permitted	Permitted, subject to supervisory consultations	No statutory prohibition
<i>United States</i>	Permitted, but underwriting and dealing in corporate securities must be done through (1) a nonblank subsidiary of a bank holding company (subject to revenue limits), (2) a nonblank subsidiary of a financial holding company (no revenue limits) or (3) a financial sub or a national bank (no revenue limits)	Insurance and underwriting and sales are permissible for nonblank subsidiaries of financial holding companies. National banks and their subsidiaries are generally restricted to agency sales activities.	Generally limited to holding bank premises	Permitted to hold up to 5% voting shares through a BHC (bank holding company), but a BHC that is designated as a financial holding company and has a securities affiliate may exercise merchant banking powers to make controlling investments, subject to certain regulatory restrictions	Permitted to make no controlling investments up to 25% of the voting shares

*Source: Institute of International Bankers Global Survey 2006.*



TABLE 3-1. SIMPLE TYPES OF FINANCIAL SERVICES INDUSTRY INTEGRATION

SIMPLE TYPE OF INTEGRATION	EXAMPLE
<i>Scale Integration</i>	M&As of similar organizations
<i>Scope Integration</i>	M&As of commercial banks, investment banks, and insurers
<i>Geographic Integration</i>	Cross-sectional M&As of regional providers
<i>International Integration</i>	Cross-sectional M&As of organization of national providers
<i>Horizontal Integration of distribution systems</i>	Offer "one-stop shopping" for multiple services in a single location
<i>Horizontal Integration of production systems</i>	Share information in underwriting loans, securities, and insurance
<i>Vertical Integration of production and distribution systems</i>	Underwriter shifts from independent agents to direct distributors

Source: The Integration of Financial Services Industry: Where are the Efficiencies? by Allen Berger and Wharton Financial Institutions Center (2000)

TABLE 3-2. COMPLEX TYPES OF FINANCIAL SERVICES INDUSTRY INTEGRATION

COMPLEX TYPE OF INTEGRATION	CORRESPONDING SIMPLE TYPES OF INTEGRATION
<i>National integration of financial institutions within product category (e.g., M&amp;A of two commercial banks, two securities firms or two insurers).</i>	Scale integration. May also involve geographic integration.
<i>Integration of different categories of financial into universal-type organizations (e.g., among banks, securities firms and/or insurers).</i>	Scale and scope integration. May also involve geographic and international integration.
<i>International integration of financial institutions (cross-border M&amp;As)</i>	Scale, geographic and international integration. May also involve scope integration.

Source: The Integration of Financial Services Industry: Where are the Efficiencies? by Allen Berger and Wharton Financial Institutions Center (2000)

**TABLE 3-3. TOP 25 BANKS BY SOUNDEST CAPITAL/ASSETS RATIO  
AS OF JUNE 2006**

<i>POSITION</i>	<i>BANK</i>	<i>COUNTRY</i>	<i>ASSETS</i>
1	Electro Banque	France	88.88
2	Nomura Bank International	UK	87.75
3	SunTrust Banks	US	61.90
4	United National Corporation	US	46.64
5	Belagroprombank	Belarus	43.50
6	Natsionalnyy Reservnyy Bank	Russia	42.50
7	Franklin Resources	US	41.60
8	International Industrial Bank	Russia	41.49
9	General Banking and Trust Company	Hungary	40.39
10	Schroders	UK	39.45
11	Rossiyskiy Kredit Bank	Russia	39.37
12	African Bank	South Africa	37.23
13	National Bank of Umm Al-Qaiwain	UAE	36.77
14	IBTC Chartered Bank	Nigeria	36.12
15	Bank of Sharjah	UAE	30.03
16	Banco Inbursa	Mexico	29.56
17	First Gulf Bank	UAE	29.14
18	First Inland Bank	Nigeria	28.51
19	Bank of Industry and Mine	Iran	27.99
20	Lauritzen Corporation	US	27.79
21	Spring Bank	Nigeria	25.39
22	United Gulf Bank	Bahrain	24.99
23	International Banking Corporation	Bahrain	24.34
24	Banco Latinoamericano de Exportaciones	Panama	23.98
25	Myanmar Oriental Bank	Myanmar	23.81

SOURCE: THE BANKER ([www.thebanker.com](http://www.thebanker.com))

**TABLE 3-4. OUTLINE OF EMPIRICAL FINDINGS ON CAUSES OF  
U.S. BANKING CONSOLIDATION**

<b>Finding</b>	<b>Citations</b>
(1) Some evidence of increase in market power (share) with some evidence of price effects in concentrated market	7
(2) Some evidence of greater profit efficiencies	3
(3) Some evidence of improvements from geographic diversity	4
(4) Some evidence of improvements in payment system efficiency	2
(5) Some evidence that management may act in self-interest	4
(6) Some support for the too-big-to-fail motive	3
(7) Some evidence for increased systemic risk and safety net expansion	3
(8) Mixed evidence on cost efficiencies from scale economies	4
(9) Mixed evidence on cost efficiencies from scope economies	6
(10) Little evidence of any significant, permanent increase in shareholder value	4
(11) Little evidence of lower consumer prices	3
(12) Little effect on the availability of services to customers	9

Source: Jones and Critchfield (2005), *op. cit.*, p. 56-61.

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## **PART 4. CHANGE IN THE FINANCIAL SERVICES INDUSTRY IN THE UNITED STATES WITH EMPHASIS ON BANK HOLDING COMPANIES**

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The banking industry structure has been swiftly evolving amidst great changes in the competitive environment. Several inter-related forces account for this. First is re-regulation and deregulation, particularly in the form of the Gramm-Leach-Bliley Financial Modernization Act of 1999 (GLB), and regulatory changes, particularly by the Federal Reserve.<sup>9</sup> Second is the industry's dynamism in terms of developing and applying technology resulting in innovation of financial products,<sup>10</sup> and IT applications. Third, international and global forces are at work, including governance, capital requirements, disclosure, and geographic scope. This section of the paper examines the growth of banking institutions by means of mergers and acquisitions (M&A), the emergence of financial holding companies (FHC), and implications the U.S. case has for other countries.

### **4.1 GROWTH BY MERGER AND ACQUISITION (M&A): THE VIEW FROM THE MARKET**

In the last ten years, many old players' names have either been changed or have vanished, and new large and diversified financial conglomerates have taken over in the global market. Most of the U.S. money center banks' names have been changed, to the likes of JPMorgan Chase and Citigroup, or have vanished like Manufacturers Hanover, Bankers Trust and Chemical Bank, through mergers. All the U.S. partnership-based major investment banks have become public companies with more diversified business lines than before, having achieved this through M&As.

Some changes seen in the United States are also evident in Europe and Japan. Almost all of the traditional British merchant banks like Barings, Morgan Grenfell, and SG Warburg have vanished. All of major European universal banks tried to further diversify and become bigger through both domestic and cross-border mergers and acquisitions including moves intended to establish or strengthen their activities in the U.S. financial market.

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<sup>9</sup> The Office of the Comptroller of Currency in the Treasury Department, and the Securities and Exchange Commission, have also been involved.

<sup>10</sup> Banking industry innovations include loan sales, asset-backed securities, index CDs, swaps, and mezzanine finance.

All of major and many minor Japanese bank names have been changed in the course of rectifying the "overbanked" condition of that country; the sector is now characterized by three mega banks—Mitsubishi UFJ, Mitsui Sumitomo and Mizuho—which would have been unfamiliar five years ago.

#### 4.1.1 BROAD BACKGROUND OF THE CHANGES IN THE UNITED STATES

Most of the changes were initiated in the U.S. where financial innovation and disintermediation of finance occurred first and leading financial conglomerates were created. Now four of top five largest global financial institutions in terms of market capitalization are US banks [see **Figure 4-1**].



Source: [www.ing.com/group/showdoc.jsp?docid=092825-EN&menopt=abo%7Cfct](http://www.ing.com/group/showdoc.jsp?docid=092825-EN&menopt=abo%7Cfct).

During the 1980s and 1990s, the U.S. financial industry enjoyed continuous economic and financial prosperity. The burden of effectively managing such rapid growth was significant for U.S. financial institutions. As a result, a number of U.S. firms including Dillon Read, Banker's Trust, Chase Manhattan, JP Morgan, and PaineWebber found merger with an equal of stronger partner their best strategic alternative.<sup>11</sup>

Regulatory change and business initiatives made disintermediation possible. These changes coerced traditional financial institutions, including relation-based investment banks, to look for new strategies in order to compete and thrive.

<sup>11</sup> Smith & Walter, 2003:398-401.

The competition they faced, however, was new; it included non-bank organizations, such as mutual funds, and the offering and supply of banking-like services by the likes of automobile manufacturers, insurance companies, and securities brokers.

As traditional customer relations became ineffective, environmental developments pushed traditional investment banks and commercial banks to do their business differently. Innovation was encouraged, as well as development of new ways of managing risk. It was time to trade in the traditional banking business model. Efforts to more closely integrate investment and corporate banking became prevalent in the industry and made many independent firms merge with much stronger firms. The same thing happened in consumer banking, and the returns to scale and cost effectiveness became important strategic factors for competing in this environment. There was a limit to what could be accomplished within the restrictions of the existing framework of laws and regulations; eventually, they were changed. The internationalization of financial markets and progress in the international expansion of industry, moreover, was such that many banks had to make a decision on what policy set it should have for business outside of the U.S., and had to take action.

#### **4.1.2 DEREGULATION**

Deregulation of banking has been progressing at a rate unprecedented in American history. Some of the regulatory changes have promoted institutional growth through M&A processes; none have served to deter such growth.

Historically, the Federal government has not been particularly friendly to the banking industry. There was always latent fear that if financial power became too concentrated, it would be too dangerous. The U.S. tradition of vigorous efforts to prevent monopolistic activities, particularly since the start of the 20<sup>th</sup> century, bears witness to this concern, and when the importance of state's rights is also considered, the large number of banking organizations in the United States becomes readily understandable.

A second factor has been the emphasis on transparency, on disclosure, and on freedom of information. Further, the government has not been greatly concerned with the international competitiveness of American banks, nor has it made a strong effort to prevent foreign banks from doing business in the U.S.

These aspects had not changed greatly until the GLB effectively repealed the Glass-Steagall Act, and other legislative and regulatory changes since the early 1990s that have facilitated the diversification and growth through acquisition of bank organizations.

#### 4.1.3 THE SURGE IN M&As<sup>12</sup>

The turbulent, rapid torrent that is today's business environment requires many companies to revise traditional business models and create new vessels that can navigate difficult waters. M&A has become the most important factor behind the growth of bank organizations, and many financial conglomerates appeared from the late 1990s to the early 2000s, such as Citigroup, JPMorgan Chase and the British HSBC [see **Figure4-2**].<sup>13</sup>

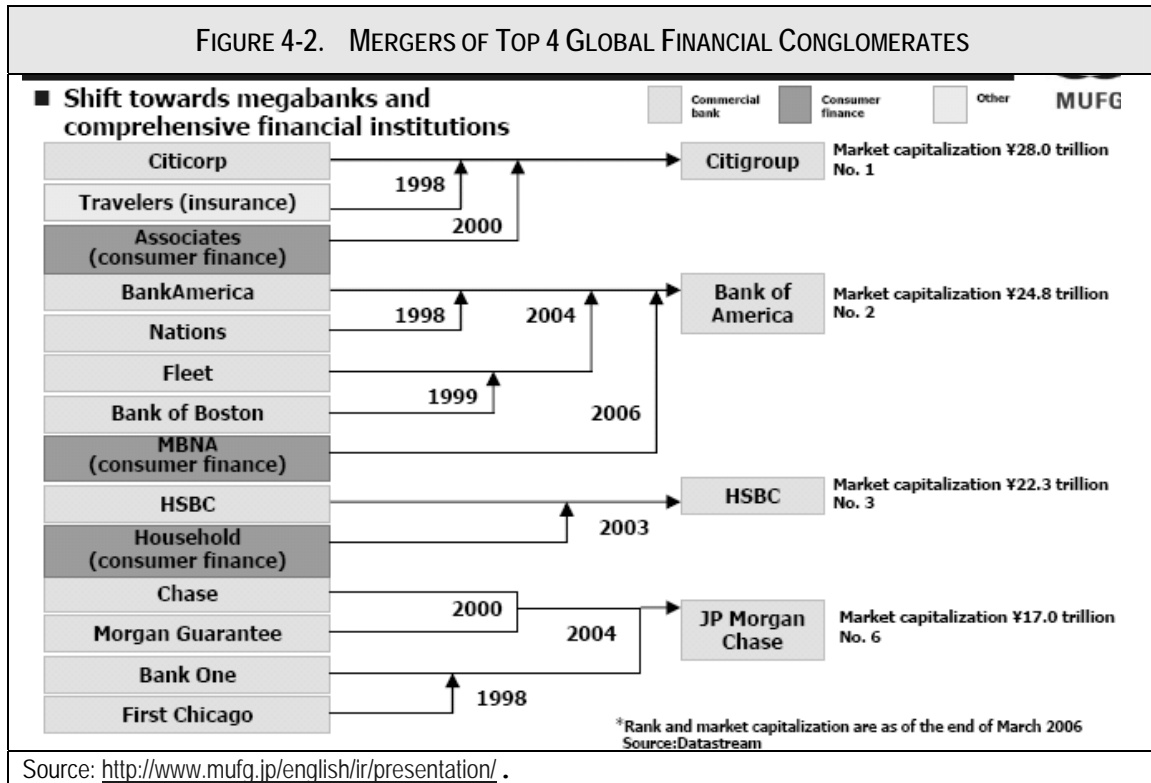
In short, the phenomenon of consolidation came to represent a vital part of the banking sector's response to the dynamics of the rapid and far-reaching change taking place in the environment.<sup>14</sup> For many operating companies, it has become necessary to change their business model frequently, even if it means abandoning one that had acquired a precious patina over the years. A similar situation exists for financial service companies.

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<sup>12</sup> In general terms, the level of M&A activity in banking, or the advance of consolidation, can be considered as being largely determined by a number of factors, as follows: (1) Market cap and price-earnings ratios; (2) Share prices; (3) The regulatory environment; (4) the regulatory burden; (5) Investor activism and governance; (6) Non-U.S. acquirers; (7) Cross-segment acquisition; (8) Structures; (9) Macroeconomic developments; (10) Geo-political developments; and (11) Internationalization [Taken from Cohen, H. and Mitchell S. Eitel (2005) "10 Factors That Will Guide Consolidation in 2005", *American Banker M&A Annual Review*, (February):8a-b, for the first 10 items.]

<sup>13</sup> For perspective, highs for bank mergers and acquisitions were during the 1990's: 565 and 504 in 1994 and 1998 respectively. Since 2000, there have been less than 300 a year, and in 2005 the total was 255.

<sup>14</sup> The factors behind consolidation have been examined in the literature by many researchers; citations of these can be seen in Jones and Critchfield (2005), p. 36 and references; their paper is used for the summary of external factors presented here.



#### 4.1.4 STRUCTURE OF THE US BANKING SECTOR

In the U.S., where the concept of "states' rights" has been firmly embedded since independence was attained, banks may be chartered by either a state or by the Federal government. Thus, in many communities, competition has the aspect of rivalry between one or more state banks and one or more national banks. Laws and regulations must take this dual structure into account. Because of the powers of individual states to regulate and supervise banking, GLB provides to continue the exercise of such power over components of financial conglomerates.

Historically, average bank size in the United States and the number of banks has been large relative to other industrial nations. In 1984, the nation had 14,884 banking organizations. By 2003 this number had declined to 7,842 (see **Figure 4-3**), but still was larger than the banking organizations in the E.U. Most of the decline was among the smaller banks (often called "community banks") but these still account for about 94% of all banking organizations (as of the end of 2003). Many of the banks that were closed were savings and loan (S&L) or savings banks (together, "thrift" institutions).





Source : Jones and Critchfield (2005), p. 32

The mergers of the 1990's were significantly different from those of the 1980's. During the 1980's, economic conditions were far from favorable, and the legal and regulatory framework had become out of date. From the middle to the late 1990's, however, the economy was strong, interest rates were at comfortable levels, and banks were highly profitable, and cash was plentiful. If a rising tide lifts all ships, the rising stock market certainly lifted bank valuations, facilitating the use of shares to pay for acquisitions. The lessons of the 1980's stimulated a change in attitude among regulators.<sup>15</sup> Regulations were bent enough to permit "distress mergers," and the need for greater flexibility created perceived demand for re-regulation (see Table 4-1). Among the results were removal of barriers to interstate banking and branch opening, and the way was cleared for banking institutions to expand geographically, by themselves and through acquisitions.

#### 4.1.5 REGULATION AND CONSOLIDATION

Inevitably, change in laws, court rulings, and their subsidiary regulations of laws, are of quintessential importance as an influence on growth and diversification (that often go together, in M&A activity) of banks. The major changes in recent years are summarized in **Table 4-1** (Table 2-1 in Part 2 provides a similar timeline with additional information on what was happening in the E.U. and Japan at the same time).

<sup>15</sup> Gary A. Dymski, "The Global Bank Merger Wave: Implications for Developing Countries." *The Developing Economies* XL:4 (Dec. 2002), Internet version at [www.ide.go.jp/English/Publish/De/pdf/02\\_-04\\_03.pdf](http://www.ide.go.jp/English/Publish/De/pdf/02_-04_03.pdf).

**TABLE 4-1. MAJOR LEGISLATIVE AND REGULATORY CHANGES AFFECTING BANKING CONSOLIDATION, 1993-2001**

1993	Court ruling in <i>Independent Insurance Agents of America v. Ludwig</i> allowed national banks to sell insurance from small towns.
1994	Riegle-Neal Interstate Banking and Branching Efficiency Act (Riegle-Neal). Permitted banks and bank holding companies (BHCs) to purchase banks or establish subsidiary banks in any state nationwide. Permitted national banks to open branches or convert subsidiary banks into branches across states lines.
1995	Court ruling in <i>NationsBank v. Valic</i> allowed banks to sell annuities.
1996	Court ruling in <i>Barnett Bank v. Nelson</i> overturned states' restrictions on bank insurance sales.
1996	Federal Reserve announced the elimination of many firewalls between bank and nonbank subsidiaries within BHCs.
1996	Federal Reserve raised limit on revenue from Section 20 eligible securities activities from 10 percent to 25 percent.
1997	Federal Reserve eliminated many of the remaining firewalls between bank and nonbank subsidiaries within BHCs.
1999	Gramm-Leach-Bliley Financial Modernization Act (GLB). Authorized financial holding companies (FHCs) to engage in a full range of financial services such as commercial banking, insurance, securities, and merchant banking. Gave the Federal Reserve, in consultation with the Treasury, discretion to authorize new financial activities for FHCs. Gave the Federal Reserve discretion to authorize complementary activities for FHCs. Established the Federal Reserve as the "umbrella" regulator of FHCs. Provided low-cost credit to community banks. Reformed the Community Reinvestment Act. Eliminated the ability of commercial firms to acquire or charter a single thrift in a unitary thrift holding company.
2001	Federal Reserve issued revisions to Regulation K. Expanded permissible activities abroad for U.S. banking organizations. Reduced regulatory burden for U.S. banks operating abroad and streamlined the application and notice process for foreign banks operating in the United States. Allowed banks to invest up to 20 percent of capital and surplus in Edge Corporations. Liberalized provisions regarding the qualification of foreign organizations for exemptions from the nonbanking prohibitions of Section 4 of the Bank Holding Company Act. Implemented provisions of Riegle-Neal that affect foreign banks.

Source : Jones and Critchfield 2005: 55.

Of particular importance is GLB, as it specifically enabled financial conglomerates to cross-sell a variety of financial products to their customers. Further, the Act deals with permissible structures for the resulting organizations and how they will be regulated, incorporates various kinds of consumer protections, including provisions addressing the privacy of personal financial information, and community reinvestment, including many issues that were very controversial.<sup>16</sup>

Although the prevailing view is that the US is still "overbanked" in terms of the number of banks and branches, there also is room for growth by reducing the "underbanked" population, that is, the Americans who have no bank account. Further, some growth can be expected from the entry of and expansion by foreign banks.

<sup>16</sup> F. Jean Wells and William D. Jackson, "Major Financial Services Legislation, The Gramm-Leach-Bliley Act (P.L. 106-102): An Overview." CRS Report for Congress, updated December 16, 1999; at [www.epic.org/privacy/glba/RL30375.pdf](http://www.epic.org/privacy/glba/RL30375.pdf).

#### 4.1.6 CONCENTRATION AND COMPETITION

The decline in the number of bank organizations has been accompanied by an increase in concentration. This is best viewed across a range of metrics. The changes in the years from 1990 to 2000 have been remarkable. Table 4-2 provides a tabular summary.

The large-scale mergers by major conglomerates have not raised major issues of potential market distortions through a higher degree of concentration or market share that might result. This reflects, *inter alia*, the highly competitive nature of the banking business in the U.S. Nevertheless, it is not unimportant in considerations of industrial structure and, for regulators in particular, of systemic risk and the TBTF issue. Monopolistic power in banking has been a subject of interest to the Federal government from time to time.<sup>17</sup>

TABLE 4-2. FINANCIAL CONCENTRATION RATIOS

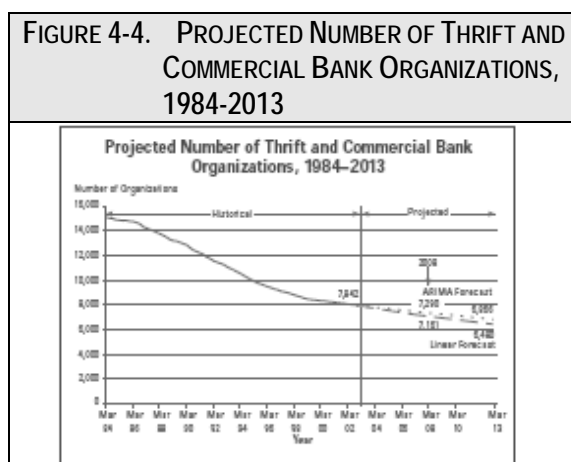
	1990	1995	2000
<i>Retail banking (Percentage of total deposits held by the top 30 bank holding companies)</i>			
<i>Bank holding companies</i>		45	39
<i>Other banks, thrifts and credit unions</i>		55	61
<i>Mortgage origination (Percentage of origination by the top 10; ranked by value of loans outstanding)</i>		26.7	39.7
<i>Credit cards (Percentage of total credit issued by top five, ranked by value of outstanding)</i>		37.5	61.9
<i>Corporate lending (Percentage of syndicated loans to large corporations in which the top five players served as the agent bank(arranged the financing pool for participating banks)</i>	26		61
<i>Custody banks (Percentage of total held by the top 10; ranked by global asset management)</i>	40		92.5
<i>Investment banking (Percentage of wholesale origination held by the top 10 firms (global)</i>	40.6		92.5

Source: Ingo Walter, "Financial integration across borders and across sectors: implications for regulatory structures," June 2002, after First Manhattan Consulting Corp., Inside Mortgage Finance, the Nilson Report, Loan Pricing Corp, Federal Reserve, Institutional Investor data. Internet publication at: [pages.stern.nyu.edu/~walter/financial%20integration.pdf](http://pages.stern.nyu.edu/~walter/financial%20integration.pdf).

<sup>17</sup> A major example of this was when, in 1999, Fleet Financial Group Inc. (then the ninth largest bank holding company) and BankBoston Corporation (then 15th largest) were to merge. The Department of Justice required the banks to sell \$13.2 million in deposits in 306 branches in four New England states in order to eliminate the danger of a loss of competitiveness.<sup>17</sup> This was the largest divestiture by a bank in American history.

#### 4.1.7 OUTLOOK FOR CONSOLIDATION

In the near term, while the stock market has recovered following its decline in 2000, interest rates have begun to rise and uncertainty regarding the outlook for political, social and economic aspects of the situation in Iraq and Afghanistan, the Middle East in general, suggest that the pace of M&A activity of the 1990's will not be repeated in the near future.



Source: Jones and Critchfield (2005), p. 47.

From 2006, an increase in M&As of smaller institutions, including both banks and thrifts, is expected because of a regulatory condition (see **Figure 4-4**).<sup>18</sup> These banks, having subchapter S status ("S-corp banks") comprise 25% of the U.S. bank and thrift total, and are required, by the tax code, to pay a high gains tax if they are sold before they are 10 years old; buyers normally absorb this cost. Hundreds of S-corp banks are nearing their tenth anniversary and are likely to be attractive to buyers.

#### 4.2 BANK HOLDING COMPANIES AND FINANCIAL HOLDING COMPANIES

A bank holding company (BHC) is defined by the Bank Holding Company Act of 1956 as any company that owns a bank.<sup>19</sup> It can own or control one or more than one bank, or another bank holding company (the company at the top is called the "top holder"). This same law prohibited banks from engaging in non-banking business, but the definition of what is a non-banking business is critical; if a company is engaged in, for example, technical services to

<sup>18</sup> Ben Jackson/ 2006. Why S-Corps May Capture M&A Spotlight. American Banker (January):1-4.

<sup>19</sup> The definition of a "bank" may vary among Federal agencies and departments.

support interactive financial websites, the company can be owned by a bank.

The Glass-Steagall Act (also known as the Banking Act of 1933) provided for some regulation of bank holding companies but did little to restrain them from competing in other lines of commerce. Consistent with the basic policy of restricting the behavior of banks, the Bank Holding Company Act was passed in 1956.<sup>20</sup> A 1966 amendment to the law restricted banks from buying banking organizations in other states unless the host state laws specifically so authorized. A further amendment, in 1970, provided that the restrictions of the law were to apply to one-bank holding companies, because although it had been postulated that one-bank holding companies would typically be a small commercial bank affiliated with one or more companies, such as insurance companies, too many of them had been formed by large corporations. The amendment provided for authorization of some of the companies under a grandfather clause and required others to divest.

Under the Bank Holding Company Act, a BHC was permitted to (1) hold shares in an investment company provided that the latter was not a BHC and not doing anything other than investing in securities, (2) to hold shares of an export trading company, and to own up to 5% of any company including non-financial companies. Foreign banks were exempted from this amendment and could avail themselves of privileges not open to American banks.

GLB enabled banks to engage in securities and insurance business, but as a new structure, the financial holding company (FHC) through subsidiaries, and did not tear down completely the regulatory wall separating banking from commerce. Often, government officials have had a difficult time in deciding on whether a certain type of business was banking-related.

The Federal Reserve is the primary regulatory agency of the FHCs; this was established by GLB; this is also the case even if the holding company's bank is under the primary supervision of the

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<sup>20</sup> The immediate motives for enacting this law were:<sup>20</sup> (1) Fear of financial concentration; (2) Fear that a few major non-financial companies, by affiliating with banks, could control the national economy; (3) The idea that banks should not be exposed to undue risk. An act that might be unsafe for a commercial bank should also be considered unsafe for a BHC; and (4) Non-financial firms, if affiliated with a bank, would have an unfair advantage over those without such an affiliation. Taken from Hazel J. Johnson, *Global Positioning for Financial Services* (Singapore: World Scientific, 2000:98.

Office of the Comptroller of Currency or the Federal Deposit Insurance Corporation.<sup>21</sup>

Each of an FHC's depository subsidiaries must meet the standards for capital, management and other requirements. An FHC can engage in non-bank activities over a significantly broader range than permitted to a BHC, and, moreover, is not required to secure prior approval of the Fed for such activity.

A FHC that is formed by a securities company is permitted to engage in commercial activities to the extent of up to 15% of consolidated annual gross revenue excluding bank subsidiaries; this was allowed as a grandfather provision and will expire after a specified time.

The large number of banks and strong decentralization of bank formation (in the form of state-chartered banks) has been the basis for special provisions for the formation of small BHCs. In a 2006 Fed ruling regarding these BHCs, debt levels at small BHCs are permitted to be higher than at larger ones, on the grounds that capital requirements include a special provision for small banks. The size of a small BHC, in terms of assets, is \$150 to \$500 million.

The ten largest BHCs in terms of assets are as in **Table 4-3**. Information on BHCs can be accessed through the FDIC website.<sup>22</sup> The top three are the subject of case studies in the following chapter of this part of the study. All FHCs are listed at the Fed's website.<sup>23</sup>

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<sup>21</sup> The FED's definition of a financial holding company is as follows: A financial entity engaged in a broad range of banking-related activities, created by the Gramm-Leach-Bliley Act of 1999. These activities include: insurance underwriting, securities dealing and underwriting, financial and investment advisory services, merchant banking, issuing or selling securitized interests in bank-eligible assets, and generally engaging in any non-banking activity authorized by the Bank Holding Company Act. The Federal Reserve Board is responsible for supervising the financial condition and activities of financial holding companies. Similarly, any non-bank commercial company that is predominantly engaged in financial activities, earning 85% or more of its gross revenues from financial services, may choose to become a financial holding company. These companies are required to sell any non-financial (commercial) businesses within ten years.

<sup>22</sup> <http://192.147.69.47/IDASP>.

<sup>23</sup> [www.federalreserve.gov/generalinfo/Fhc](http://www.federalreserve.gov/generalinfo/Fhc).

TABLE 4-3. THE TOP TEN BANK HOLDING COMPANIES

<i>Rank</i>	Institution Name	Location	Total Assets 09/30/2006	Total Assets 06/30/2006
1	Citigroup Inc.	New York, NY		\$1,626,551,000
2	Bank Of America Corporation	Charlotte, NC		\$1,447,538,298
3	JPMorgan Chase & Co.	New York, NY		\$1,328,001,000
4	Wachovia Corporation	Charlotte, NC	\$559,922,000	\$553,614,000
5	Wells Fargo & Company	San Francisco, CA	\$483,441,000	\$499,516,000
6	HSBC North America Holdings Inc.	Prospect Heights, IL		\$466,008,463
7	Taunus Corporation	New York, NY		\$411,251,000
8	U.S. Bancorp (1119794)	Minneapolis, MN		\$213,405,000
9	Countrywide Financial Corporation	Calabasas, CA	\$193,194,572	\$194,984,463
10	Suntrust Banks, Inc.	Atlanta, GA		\$181,143,444

*Source: Insurance Information Institute, at [www.financialservicesfacts.org/financial2/convergence/bhc](http://www.financialservicesfacts.org/financial2/convergence/bhc).*

#### 4.3 INTERNATIONAL DEVELOPMENTS THAT CAN INFLUENCE BANKING SECTOR M&A

Globalization in the financial sector can influence the M&A of banks in several ways. Some very large banks may feel that incursion of foreign banks in the domestic U.S. market, or their expansion anywhere outside of the home country of each, is a competitive threat that is best met by expansion, and that it will be swifter by acquisition, as opposed to organic growth. The shrinking barriers to cross-border financial activities may encourage some American banks of medium to large or very large scale to increase their presence overseas through acquisition, if the host country's regulations permit. On the side of the seller banking organization, overseas conditions may conversely provide encourage to divest, as indeed domestic conditions such as the performance of the bank or a major change of policy can provide. Special mention can be made of possibilities created by the work of the Basle Committee of the BIS.

The Basel II Agreement has the potential of influencing M&A behavior of U.S. banks. This is because compliance will involve redefining capital regulations, particularly for risk-based capital (RBC), and depending on the regulations adopted by the Fed it is possible that smaller banks will be absorbed by larger ones and specialized banks will be absorbed by diversified or diversifying ones. Further, revision of RBC standards could have

the effect of decreasing the competitiveness of large banks; one estimate, made by the Basle Committee, is that an operational RBC charge could add 13% to regulatory capital of the 25 largest U.S. banks. The cost of this would come to about \$67 billion.<sup>24</sup>

In the spring of 2006, the Federal Reserve released the exposure draft of its ruling on American compliance with Basel II, in which it provided for a charge for operational risk. A 120-day period for public comment is provided, to start when the ruling is published. All very large, internationally active U.S. banks ("core banks"), and bank holding companies, will be subject to the regulations. These are banks with total consolidated assets of \$250 billion or more and or who have a consolidated total on-balance sheet foreign exposure of at least \$10 billion.<sup>25</sup> It is possible that some banks will engage in "regulatory arbitrage," and rewrite their charters as a means of influencing regulatory requirements, and it is also to be noted that other "opt-in" banks may voluntarily comply with the Basle II standards. In addition to Basle II standards, however, regulators and bankers are preparing for adoption of standards under Basle IA, which deals with risk-based capital requirements for banking entities that are not subject to Basle II. Thus, the impact on banking acquisitiveness of these international changes bears monitoring.

#### 4.4 ISSUES FOR REGULATORS

Financial holding companies present certain challenges to regulators. These challenges may be summarized as follows.<sup>26</sup>

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<sup>24</sup> Karen Shaw Petrou, Testimony on Basle II Regulations: U.S. Market and Competitiveness Implications, before the Subcommittee on Financial Institutions and Consumer Credit ... U.S. House of Representatives, May 11, 2005 ([financialservices.house.gov/media/pdf/051105ksp.pdf](http://financialservices.house.gov/media/pdf/051105ksp.pdf)).

<sup>25</sup> Institute of International Bankers, Global Survey 2600, p. 205, at [www.iib.org/GS2006.pdf](http://www.iib.org/GS2006.pdf).

<sup>26</sup> IOSCO, "A Resolution on the Supervision of Financial /Conglomerates (Oct. 1992), at [www.iosco.org/library/resolutions/pdf/IOSCORES7.pdf](http://www.iosco.org/library/resolutions/pdf/IOSCORES7.pdf). for items 1 to 8; for 9-10, Howell E. Jackson, "The Regulation of Financial Holding Companies -- Entry for New Palgrave Dictionary of Law and Economics," Sept. 26, 1997, at [www.law.harvard.edu/programs/olin\\_center/pAPers/pdf/221.pdf](http://www.law.harvard.edu/programs/olin_center/pAPers/pdf/221.pdf). Jackson also had given attention to activities restricting financial holding companies, the GLB has rendered the comment out of date, although certainly GLB deals with restrictions.



- ❖ **Group-Based Risk Assessment.** Where a regulated firm, which is part of a financial conglomerate and subject to supervision on a solo basis, is vulnerable to the risk of contagion, supervision of the regulated firm should be complemented by group-based risk assessment.
- ❖ **Investments in Other Group Companies.** Where a regulated firm has an investment in another group company or has provided regulatory capital to another group company, these amounts should be controlled by appropriate regulations.
- ❖ **Intra-Group Exposures.** Effective risk assessment of financial conglomerates requires careful monitoring of intra-group exposures, and where necessary limits on such exposures in the regulated entity.
- ❖ **Structure of Financial Conglomerates.** The corporate and managerial structure of the financial conglomerate should be fully understood by the regulator and should not create undue difficulties for effective regulation. Regulators should consider whether it is feasible and practical to acquire powers to prevent the manipulation of group structures, which makes effective regulation difficult.
- ❖ **Relationships with Shareholders.** Regulators should seek as far as possible to identify shareholders with a stake in a financial conglomerate, which enables them to exert material influence on a regulated firm; the regulator should seek to ensure that these shareholders meet applicable fitness standards.
- ❖ **Management:** Regulators should ensure that managers who directly or indirectly exert control on a regulated entity are subject to appropriate regulatory standards; and should seek as far as possible to be able to impose sanctions on managers who have influenced the policy and decisions of a regulated entity in ways which are inconsistent with those regulatory standards.
- ❖ **Supervisory Cooperation.** Wherever possible, regulators should seek to cooperate to improve the effectiveness of the supervision of financial conglomerates. In many cases where more than one regulator has responsibility for some part of the financial conglomerate, it may be desirable to identify one regulator who will have primary responsibility for group-based risk assessment.

- ❖ **External Auditors.** Regulators should recognize the importance of the role of the external auditors of a regulated firm and the possible contribution they may be able to make to group-based risk assessment. Auditors should be encouraged, where they have serious concerns regarding the financial or operational condition of the regulated entity or the group, to ensure that such concerns are brought to the attention of the supervisor.
- ❖ **Solvency Regulation.** Consolidated capital requirements are imposed on banks and also bank holding companies.
- ❖ **Enforcing Distributive Goals and Other Political Considerations:** Geographic restrictions are one form of political consideration in the U.S., where individual states have authority over banks.

#### 4.5 BUSINESS STRATEGIES OF U.S. FINANCIAL CONGLOMERATES

In the preceding sections, we review and analyze the external and internal factors behind the trend for consolidation, increased size and diversification of banks in the United States based on case studies of the three largest conglomerates: Citigroup, JPMorgan Chase and Bank of America.

**Table 4-4** indicates how all of the three large U.S. financial conglomerates expanded their asset size tremendously during 2001-2005 through M&As. The profitability of Citigroup has been very stable; the ROE has been around 19% which is high in this industry. Bank of America's performance has been also very good but a little bit unstable. Its ROA surpasses that of Citigroup because Bank of America focuses on riskier retail portfolio. JPMorgan Chase's performance has been unstable and has lagged the other two competitors because of its failure to integrate investment banking business well into their group structure and their weakness in consumer banking. Overall, Citigroup and Bank of America's performances surpass other global financial conglomerates.

TABLE 4-4. COMPARATIVE PERFORMANCE OF THREE FINANCIAL CONGLOMERATES						
		2001	2002	2003	2004	2005
Total Assets Million \$	Citigroup	1051450	1097190	1264032	1484101	1494037
	Bank of America	621764	660458	736445	1110457	1291803
	JPMorgan Chase	693575	758800	770248	1157248	1198942
Net Income Million \$	Citigroup	14284	13448	17853	17046	19806
	Bank of America	6792	9249	10810	14143	16465
	JPMorgan Chase	1719	1633	6719	4466	8483
ROA %	Citigroup	1.5	1.2	1.5	1.2	1.3
	Bank of America	1.1	1.4	1.5	1.5	1.4
	JPMorgan Chase	0.2	0.2	0.9	0.5	0.7
ROE %	Citigroup	19.7	16.2	19.5	16.6	18
	Bank of America	14.1	18.7	22	19.2	16.4
	JPMorgan Chase	4.1	4	15.4	5.9	8

Source: Prepared by the author from the data of Standard and Poor's Industrial survey.

#### THE ORGANIZATIONAL STRUCTURE OF LARGE, DIVERSIFIED FINANCIAL INSTITUTIONS:

An organizational structure determines how efficiently the bank can manage its diversified business. Financial firms diversify in order to attain the cost and revenue synergies, stabilization of earnings and risk reduction. In order to attain these objectives the firm should balance centralization and decentralization functions within the firm. Centralization will create benefits in the form of reduced transaction costs as an entire group through economy of scale and of scope, and decentralization will bring benefit by a decrease of agency costs that is realized by delegating management closer to the operations level.<sup>27</sup> All of the U.S. financial conglomerates have adopted the financial holding company structure.

Several considerations for diversification strategy are related to organizational structure. These include the balance of centralization and decentralization issues, safety and soundness of banking issues, economy of scale and scope issues, conflict of interest issues, deposit insurance issues, regulatory oversight issues and competition issues.<sup>28</sup> **As a diversified organization, the most important issue is the efficiency of organization.**

<sup>27</sup> Yidrim (2005), p. 13-17.

<sup>28</sup> Yidrim (2005), p. 33-34.

The holding company is the most popular structure of U.S. banks<sup>29</sup> and now most of the large U.S. financial conglomerates are organized as financial holding companies (FHCs).<sup>30</sup> This is mainly because of regulatory reasons. This structure is suitable for separate operation of different businesses and avoids conflict of interest problems, but there is not much economic efficiency attained by use of this structure because of a lack of synergetic effects between the separated subsidiaries. Through our research we found that many U.S. financial conglomerates follow this structure on the surface but strategic business units—no matter what the legal structure—do actual management in order to attain organizational efficiency and balance centralization and decentralization of business. The adoption of a structure characterized by subsidiaries implies potential for synergy effects, but also for conflicts of interest. The details of this are discussed in the case studies.

The actual structure of large financial conglomerates will be one of the types, namely a financial holding company, a parent-subsidiary structure, or a universal bank. The choice of one over the others will depend on the regulatory environment and the balance of centralization and decentralization. It is interesting to find that most of the American conglomerates actually run their operations as strategic business units in order to attain the agility and efficient management of large institutions no matter what is their legal structure.

#### **4.6 CASE STUDIES of US FINANCIAL CONGLOMERATES: STRATEGY and ORGANIZATION**

We will analyze the strategies and organization of three large U.S. financial conglomerates, Citigroup, JP Morgan Chase, and Bank of America, mainly based on their homepage data and reportage in business and financial publications.

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<sup>29</sup> In Europe the holding company form is usually legal but is not often used in banking except in the Netherlands and Italy (Rose & Hudgins (2005), p. 87.

<sup>30</sup> GLB enabled large banks to undertake securities and insurance business together with commercial banking under a financial service holding company umbrella.

#### 4.6.1 CITIGROUP

##### 4.6.1.1 Birth of an American Financial Conglomerate

In April 1998, Citicorp<sup>31</sup> and Travelers group announced their merger and the first financial conglomerate in the U.S. was born in October 1998, as **Citigroup**. The purchase price was \$82.8 billion. This is the first U.S. case when a commercial bank and insurance brokerage firm merged to expand their activities over a wide range of bank and non-bank activities. The merged group's total assets became the largest among all U.S. banks. The new company had from the outset offices in 40 different countries. Today it is a \$1.5 trillion-asset company, the largest issuer of credit cards in the world and is diversified into brokerage, investment banking, commercial banking, investment services, life and casualty insurance, consumer credit and business credit lines.

At the time of the merger, under the 1933 Glass-Steagall Act, commercial banks were prohibited to do both commercial banking and underwriting business at the same organization. It was GLB that made it possible for U.S. financial institutions to become conglomerates doing commercial banking, underwriting and insurance business by means of a financial holding company structure. The reality is the development of Citicorp and Travelers merger pushed the realization of new law allowing financial conglomerate.<sup>32</sup> Fed Chairman Alan Greenspan, in 1998, indicated that the merger should go ahead, saying this at the same time that Congress was considering the GLB bill.

The strategy of Citigroup when it merged was to focus on the businesses of commercial banking, consumer banking, credit card, investment banking, security brokerage, asset management, life insurance and casualty insurance. The company determined its three core businesses would be (1) Global Private Finance, (2) Global Corporate Finance and Investment Banking, and (3) Asset Management. The key for the success of this new conglomerate was how to materialize the benefit of cross-selling of banking, securities, and Insurance products to the same customer.

The corporate culture that Citigroup brought to the newly merged company included drawbacks to diversification at the large scale such as was undertaken. As Johnson retells it, under Walter

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<sup>31</sup> For a summary of the history of Citigroup, see, *inter alia*, Hazel J. Johnson, *op. cit.*, *Global Positioning for Financial Services* (Singapore: World Scientific, 2000), p. 128-131.

<sup>32</sup> Geisst [2005:269-272].

Wriston, president from 1967 and CEO from 1970 to 1984, a strong entrepreneurial spirit was fostered to the extent that at times the same assignment was given to two different divisions, so that they would compete. "As the organization developed into autonomous divisions," as Hazel J. Johnson writes,<sup>33</sup> this sometimes spilled over to other areas. For instance, product teams sometimes served the same customer without awareness of the others of coordination of their efforts." Later on, a schism between commercial bankers and the higher-paid investment bankers developed, and was self-defeating when work had to be done on certain deals. The former group did not trust the latter, and thought that the investment bankers were short on loyalty and driven by personal gain motivations. As can be readily imagined from the nature of the banking business, commercial bankers at Citigroup were oriented toward tradition, organizational goals, and protocol, while the investment bankers were unorthodox and more entrepreneurial in spirit. The orientation of the latter group was such that they did not handle managerial responsibilities well, and in 1987 Citigroup consolidated the investment and institutional banks and created a division of labor (the institutional bankers would originate the deals and the investment bankers would handle execution and trading) to solve the problem.

#### **4.6.1.2 The Present Organization Structure**

As of July 2006 Citigroup is organized into three major business groups: (1) Global Consumer, (2) Corporate and Investment Banking, (3) Global Wealth Management, and one stand-alone business, (4) Citigroup Alternative Investment.

The Citigroup Global Consumer business provides various consumer products including banking services, credit cards, loans and insurance. Corporate and Investment banking business serves for the client in about 100 countries around the world for their investment banking and advisory business. The Global Wealth Management group comprises of The Citigroup Private bank, Smith Barney and Citigroup Investment research. The last one was separated from Investment Banking group after the research scandal during 2002, that revealed gaping holes in what should have been a firewall separating underwriting from trading.

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<sup>33</sup> Johnson (2000), *op. cit.*, p. 130.

TABLE 4-5. CITIGROUP HOLDING COMPANY ORGANIZATION STRUCTURE (AS OF OCTOBER 2006)		
Business group	Sub group	Major Legal entity
Global Consumer Group	US Cards US Retail Distribution US Consumer Lending Commercial Business Group International Cards Int'l Consumer Finance International Retail Banking Women's and Co.	Citibank Citi Financial Primamerica Financial Services Citi Mortgage Citi Capital Banamex
Corporate and Investment Banking	Global Banking Global Capital Markets Transaction Services	Citigroup Global Markets Inc.
Global Wealth Management	The Citigroup Private Banking Smith Barney Citigroup Investment Research	The Citigroup Private Banking Smith Barney
Citigroup Alternative Investment		Citigroup Private Equity Citigroup Venture Capital International Citigroup Property Investors

Source: Compiled by the author from information at [www.citigroup.com/citigroup/about](http://www.citigroup.com/citigroup/about)

Legally, Citigroup is organized as a financial holding service company, Citigroup Inc. There are many subsidiaries and affiliated companies under the holding company. These companies were acquired or merged through numerous M&A transactions. All of these subsidiaries and affiliates are controlled under the CEO of one or another of the four business groups. In some cases, the legal structure and business group structure is identical but in other cases it is not. No matter what the legal structure, Citigroup operates on the basis of this business group structure where it is assumed that each group is an independent unit. Because of the size, diversity of business and geographic spread, it would be very difficult to control this organization without such decentralized independent business divisions. Manager's responsibility, reporting lines and resource and profit allocation determine the borders of business divisions.

Large organizations such as Citigroup frequently adjust their macrostructure in response to management and governance policy, bank performance, and the bank business environment. There have been several large-scale reorganizations after the birth of Citigroup reflecting various problems including the conflict of interests between groups and lack of synergy between banking and insurance business. Originally in the global Consumer Group, synergy between the asset management and insurance was anticipated but in vain and most of the insurance business was sold.

In February 2005, the company merged two intermediate bank holding companies, and formed a fully-guaranteed funding supplier. The merger was undertaken to simplify capital management, improve liquidity, and facilitate acquisitions.

#### 4.6.1.3 Post-Merger History

Citigroup had been an aggressive seeker of external growth from earlier, but after the birth of Citigroup, Associate First Capital was acquired (2000), followed by Banamex-Accival Mexico was European American Bank (from ABN AMRO) and Bank Handlowy (all in 2001). Expansion through continuous acquisition and aligning the bottom line through restructuring of acquired firms was a basic strategy of Citigroup top executives to enhance shareholder value.<sup>34</sup>

In January 2005 Citigroup sold its core business of life and casualty insurance (originally from Travelers) because of the low profitability of the division. The assets management unit was also sold. These moves are evidence of the bank's failure to find cross-selling synergy between consumer banking platform and insurance products originated by itself.

In the investment banking business a number of wrongdoings were revealed after they had taken place in the permissive atmosphere that prevailed at Salomon Brothers and Citicorp's investment banking arm.<sup>35</sup> Those scandals include structured finance to manipulate accounting results for Enron, WorldCom and other companies, and conflict of interest between underwriting and research and IPO stock splitting. In its 2004 term Citigroup made a provision of \$4.95 billion dollars for legal expenses in the aftermath of these wrongdoings.

In addition, wrongdoings were also revealed in the global operations of this bank, the most aggressive of the U.S. banks in terms of internationalization of its operations. On August 18, 2004, The British Financial Service Authority launched a formal investigation into the London bond group. Citigroup apologized for what had happened and promised not to repeat the behavior. Within weeks, in September 2004, Japanese authorities ordered it to shut down its local private bank by next September. An investigation, that had been began in August, 2001, had revealed extensive legal violations over seven years, including lax governance and money laundering controls and numerous

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<sup>34</sup> Weill and Kraushaar (2006), p. 373-386.

<sup>35</sup> For an examination of earlier problems of the bank, see Richard B. Miller, *Citicorp: The Story of a Bank in Crisis* (NY: McGraw-Hill, 1993).



instances of unfair transactions in which large profits were obtained through unsound means. Citigroup issued an apology, with deep regret for its failure to comply with regulatory requirements, fired six bankers, slashed the salaries of eight other employees, and promised to improve its internal control for all of Citigroup's operations in the country. Before the week was up, Japan's Finance Ministry banned Citigroup from participating in its government bond auctions.<sup>36</sup>

The root cause of these global scandals was organizational structure. The local professionals are directly reporting to their U.S. headquarters division head through local middle managers in that particular business group. Local management in London or Tokyo had no authority to supervise these businesses.

After the scandal in its investment banking arm in the U.S., Citigroup reached final agreements with the New York State Attorney General and regulators to resolve outstanding investigations into research, IPO allocation and distribution practices.

The main reason of these problems stems from being an organization that is too big to manage. Instead of enhancing synergy, the globally decentralized organization revealed the corporate culture to be colored by excessive pursuit of profit and too little control as a group. Controlling and compliance of whole group became loose.<sup>37</sup>

Emphasis was put on the consumer and retail finance where 60% of group profit came. Focused business and internal control was strengthened. After various scandals, Weill was succeeded by Prince who remains chairman until the 2006 annual shareholders meeting. Since the changeover, Citigroup's problems have only become worse. It was revealed in 2004 that the bank was one of several involved in shady deals with Italy's Parmalat Company.<sup>38</sup> The Fed, in early 2004, prohibited Citigroup from making any

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<sup>36</sup> *Business Week*, Oct. 4, 2004.

<sup>37</sup> High profitability at retail businesses enabled Citigroup to produce a good return despite its post-merger problems.

<sup>38</sup> Citigroup had done a structured finance deal for a Parmalat subsidiary based in the Cayman Islands in 1999; this was made an issue in 2004 when fraud at illegal activities at the Italian company were discovered. Parmalat recognized the \$137 million deal as equity but it was accused of doing this improperly as it should have been a debt. Chase Manhattan, BoA, Midland Bank (HSBC), Credit Suisse, Deutsche Bank and others were among the lenders to Parmalat. Citigroup had to face a \$10 billion lawsuit over its Parmalat involvement.

large acquisitions for one year during which time it was required to improve internal controls and rectify regulatory problems. In 2005 it became the first company to be accused of insider trading in Australia.

In late 2005, the basic plans for the bank were stated as "Invest heavily in the consumer businesses, capitalize on fast-growing international markets, build up the corporate investment bank, and restore Citi's battered reputation."<sup>39</sup>

Other than these problems the bank also faces a challenge in the form of voluntary separation by key executives, and there also is the danger that human resources problems will be bothersome at middle management to new-hire levels. There is also the possibility of breaking up the company, perhaps into retail, investment banking, and global operations.

The Fed is on record as being prepared to scrutinize any future large acquisition contemplated by the bank, but in the near term it is expected that acquisitions, if any, would be small, as the company is concentrating on organic growth. This would include greater attention to cross-selling, as evidenced by the purchase in early 2006 of an electronic communications network, Ontrade, that it could be used to offer related products to institutional customers or a new service to the 200 million retail customers the bank has throughout the world.<sup>40</sup>

#### 4.6.1.4 Summary

Because of the complex, large and decentralized organization structure at Citigroup with performance-based control, it is very difficult to discern what is happening at the operations level. However, once a problem has been revealed the organization has functioned very well to quickly resolve the problem and change the direction of business with improved compliance to law, regulation and rules. The corporate governance structure, with its independent board members, also now helps to change the strategic direction quickly. Nevertheless, the magnitude and frequency and diversity of scandals, unethical behavior, and other problems that have become public knowledge, even if in the past, are equally pertinent to this study, as they suggest

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<sup>39</sup> Mara Der Hovanesian, "Chuck Prince's Citi Planning / The CEO has a strategy for the financial giant. Those who don't like it can quit." *Business Week*, Sept. 5, 2005. See also Tim Mazzucca, "Citi Reemphasizes Focus This Year On Growth Abroad," *American Banker*, Feb. 27, 2006, p.23.

<sup>40</sup> Tim Mazzucca. 2006. "Citi on Why It Decided to Buy an ECN," *American Banker* (Feb. 7).

that not only do large organizations have large problems of governance but perhaps that very large organizations cannot be governed so as to prevent major problems from occurring.

Our brief narrative and analysis of Citigroup's strategy and organization issues after the merger clearly shows the difficulty of managing such a large institution. A large institution necessarily faces an increased possibility of problems -- apart from the matter of the scale of such problems -- which can take precedence over efforts at enhancing synergy and realizing economies of scale and scope.

As far as may be concluded from Citigroup's case, U.S. financial conglomerates may have structural problems and impediments by being too big to manage as smoothly and effectively as anticipated, but strong, capable leadership can correct problems and overcome failure quickly.

#### **4.6.2 JPMORGAN CHASE**

##### **4.6.2.1 Merger of JP Morgan and Chase, and Post-Merger Activity**

JP Morgan Chase & Co., a major player in commercial and investment banking, is a Fortune 50 financial firm. It was formed in December 2000 by the merger of J.P. Morgan and the Chase Manhattan Corporation.

J.P. Morgan was one of the most prestigious U.S. financial institutions and had been a major factor in the building of U.S. industry through its relationship-based corporate finance. Its subsidiary, J.P. Morgan Securities, was a strong player in Government security underwriting and trading. As a united organization, J.P. Morgan controlled all market risks in banking and securities subsidiaries jointly and offers diversified services of commercial banking and investment banking to the same customer. This had been materialized by means of an efficient management and risk control structure which observed legal compliance regulations separating banking and security businesses. Using their experience in risk control in diversified business J.P. Morgan developed a total risk control system for diversified finance business called Value at Risk (VaR)<sup>41</sup> and that system became basic for standard total risk control and capital allocation of modern banking.<sup>42</sup>

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<sup>41</sup> Value at Risk is the method of united risk control system developed at JP Morgan. Under this system whole portfolio of banking business are translated into the potential and maximum risk capital through statistical

Traditionally and typically only elite WASPs who graduated from Ivy League schools joined J.P. Morgan and worked there for many years creating the collective elite culture of the bank. Such an elitist bank found that it had become difficult to do well during 1990's, given the heavy competition in corporate finance and loss of customers to the capital market. J.P. Morgan thus decided to merge with another large financial institution.

Chase Manhattan was originally established by the Rockefeller family and became a leading money center bank based in New York. Chase Manhattan, however, found it difficult to survive independently and was acquired by Chemical Bank in the late 1980's. Chase Manhattan became the largest U.S. bank in terms of assets in 1997, after the merger. Chemical Bank was a well-managed money center bank that was strong in market-based and trading businesses. Chase Manhattan's two main businesses were global corporate banking and nationwide consumer banking in the U.S. Although Chemical Bank management took over Chase Manhattan, they chose to keep the Chase name which has strong brand value in the retail market as well as among some corporations.

When J.P. Morgan and Chase merged, the resulting new bank possessed a strong franchise in corporate finance and retail network as well as trading activities.

JPMorgan Chase was the combination of legacy institutions -- J.P. Morgan, Chase Manhattan, Chemical, Manufacturers Hanover, BankOne, First Chicago, and National Bank of Detroit -- many of which were leading money center banks. Its corporate history is intertwined with the tradition of investment banking by JP Morgan, commercial banking by Chase and, more recently, retail and card operations by BankOne.

JPMorgan Chase after the merger could not attain profit performance comparative to Citigroup because their investment banking area was not as strong as at the specialized investment banks such as Goldman Sachs or Morgan Stanley, especially regarding the profitable advisory business of M&A and underwriting of IPOs. Also, their retail business was not as efficient as that of Citigroup and other large commercial banks.

The result was another merger. The bank acquired BankOne in the second largest bank merger in American history in 2004. BankOne

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method reflecting past data. This risk control method became standard of global banking during 1990s.

<sup>42</sup> Kuhara [1997].

was also a merger product, of then former First Chicago, National Bank of Detroit and BankOne. The head office was located in Chicago, and it was strong in both retail banking and credit card business in the Midwest, Texas and Arizona.

The merger of JPMorgan Chase & Co. and BankOne, completed in July 2004, created one of the largest financial services company in investment banking, financial services for consumers and businesses, financial transaction processing, asset and wealth management, and private equity. The merger made sense in that BankOne's strengths corresponded to relative weakness at JPMorgan Chase. BankOne had more small customers than JPMorgan Chase, and the middle-market and small-customer base of BankOne did not overlap with the characteristics of JP Morgan Chase. Being strong in servicing small and medium size businesses, BankOne had a solid lockbox system, which JPMorgan Chase could market to its existing customers as a completely new service.

Accordingly, the present JPMorgan Chase is the product of many mergers (including some that were never fully integrated) and its headquarters is split, with investment banking and securities business in New York and consumer and corporate banking business in Chicago.<sup>43</sup>

With so many mergers, how could this kind of financial firm with be run well? There are two reasons. First, after every merger or acquisition, the stronger group is retained in the same business and other weaker groups are dissolved. Through this kind of restructuring, significant improvements in business and cost savings were realized. Second, the capability of top management ensured the success of these large merged institutions. Both in the case of Citigroup and JPMorgan Chase, cost cutting and restructuring by the strong leadership has been the crucial factor of economic success.

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<sup>43</sup> It is worth to look at which side of merged banks grasped power in each business. There had been not so much exception that stronger players of same group stayed at new bank and the weaker group left the bank. In the case of the merger between Chemical and Chase, Chemical people took the power of management and most of the market and corporate businesses. Those players formerly belonged to Chase Manhattan left the new bank and many of them in the corporate banking joined Japanese bank's New York operation in 90s when Japanese banking activities in the US was at its peak. In the case of JP Morgan and Chase, former Chase people (which means original Chemical) took the power of management. Most of the bank mergers in the U.S. this kind of one side take all the power happens and that makes cost cutting though merger very easy. This is the most different part of bank mergers in Japan where both party stays and shares management responsibilities and make the organization very inefficient after the merger [Kuhara 2000].

#### 4.6.2.2 Strategy and Organization

##### Divisions, Acquisitions, Divestments

The company today concentrates on investment banking by JP Morgan, commercial banking by the former Chase organization, and retail and credit card business by the former BankOne, and seeks to combine them. The organization is comprised of the following six strategic businesses units (see **Table 4-6** below).

Business lines	Brand	Major subsidiary
Investment bank	JPMorgan	JPMorgan Securities
Retail financial services	Chase	
Card services	Chase	Chase USA
Commercial banking	Chase	JPMorgan Chase Bank
Asset & wealth management	JPMorgan	
Treasury & securities services	JPMorgan	JPMorgan Securities

Source: <http://www.jpmorganchase.com/cm/cs?pagename=Chase/Href&urlname=jpmc/about>.

There is a relatively good balance among these, as shown by **Table 4-7**.

Business lines	Operating earnings	Revenues
Investment bank	34.8	24.6
Retail financial services	32.6	24.1
Card services	18.1	26.0
Commercial banking	9.6	6.1
Asset & wealth management	11.6	10.6
Treasury & securities services	9.9	9.6

Source: *American Banker*, Feb. 24, 2006, p. 10, after JPMorgan Chase.

Note: Earnings equals 100% after loss from administrative unit is subtracted.

The company is, on record, as not interested in selling its asset management business. When the bank purchased BankOne, it also acquired its subsidiary, Zurich Life Insurance Co. of America, and sold it in early 2006.<sup>44</sup> The reason was that insurance underwriting was not at the same scale as the bank's core businesses, and low profitability. In 2005, the bank sold another non-core business, BrownCo., an online trading company, for essentially the same reason. It is interested in increasing its




<sup>44</sup> Matthias Rieker, "JPM Insurance Sale Endnote On a Nontrend," *American Banker*, Feb. 9, 2006.

increasing its private-label card portfolios; in early 2004 it bought Circuit City Inc. and Sears Canada Inc. card portfolios; Circuit City had about 1.5 million active customers at acquisition time. In 2006 it took over the BP card business. Further, in a major acquisition in 2006 it took over the retail banking business of the Bank of New York.

Although a quarter of the bank's earnings are obtained outside of the U.S., none of it is from retail business. Expansion abroad has been by means of the M&A route.<sup>45</sup>

### **Brand strategy**

In order to utilize its franchise value, JPMorgan Chase uses three brands depending on its business.

<b>JPMorganChase</b> 	JPMorgan Chase is the brand used to express JPMorgan Chase & Co., which includes all of the firm's subsidiaries.
<b>JPMorgan</b> 	JPMorgan is the brand for Investment Bank, Worldwide Securities Service, Private Bank, Asset management and Private Client Services which clients are corporations, governments, wealthy individuals and institutional investors.
<b>CHASE</b> 	The U.S. consumer and commercial banking businesses serve customers under the Chase brand. The consumer businesses include credit card, small business, home finance, auto and education finance and insurance. The commercial banking businesses include: middle market, corporate, commercial real estate, business credit and equipment leasing.

This manner of brand management shows that the bank assigns more emphasis to the legacy of these franchises than to the synergy between the group components and decentralization of these different business groups. Strong management is needed to unite this diversified group with strong control of cost and risks.

#### **4.6.2.3 Summary**

In both consumer and corporate banking, JPMorgan Chase attained sizable market share but their performance has been unstable and comparatively behind their competitors. In consumer banking, they are not as strong as their competitors in both branch networks and the product base. In the investment banking business, where former JP Morgan had competitive advantage in their quality

<sup>45</sup> For example, acquisitions included Highbridge Capital Management, a hedge fund. There also is a joint venture (made in 2004) for expansion of investment banking in the U.K. and Europe, with Cazenove Group PLC.

of services to large corporations, they could not catch up with players like Goldman Sachs or Morgan Stanley, perhaps because they failed to keep investment banking culture and could not attract and keep talented professionals. This shows the difficulty to achieving synergy between commercial and investment banking. It is interesting to see their strategy of utilizing former franchise value by putting different brand in each business.

With the company, JPMorgan Chase acquired a capable CEO in the person of Jamie Dimon.<sup>46</sup> After leaving Citigroup in 2001 after a disagreement with Weill he was recruited by BankOne in 2003 and restructured its management, making BankOne a profitable retail bank at the same time, with his leadership and his management team brought from Citigroup.<sup>47</sup>

#### 4.6.3. BANK OF AMERICA

##### 4.6.3.1 History and Overview

Bank of America (BoA), more than a century old,<sup>48</sup> has been the major rival of Citibank as the largest or the second largest bank in the U.S. and had an extensive branch network, particularly in the Southeast and the West.

During the 1980s, BoA experienced a decline of profitability and dismantled much of its international operations, and focused on U.S. domestic business. Nations Bank, the leading super-regional bank, acquired the BoA in 1998 and the head office was moved from San Francisco to Charlotte, North Carolina where Nations Bank was. Since then, BoA has grown to become a much larger domestic bank with retail business in the most of states and 55 million customers.

BoA is one of the largest financial institutions in the world, second in market capitalization after Citigroup (see **Table 4-1** for other comparisons) and the largest commercial bank in the US measured in deposits (although Citigroup has higher assets worldwide). In July 2006, BoA reported second quarter 2006 net income of \$5.48 billion, surpassing that of Citigroup for the first time. They have a small international network compared to the competitor Citigroup and JPMorgan Chase. Their investment banking activities were made through subsidiary Bank of America

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<sup>46</sup> Mara Der Hovanesian, "Dimon's Grand Design" (*Business Week*, March 28, 2005).

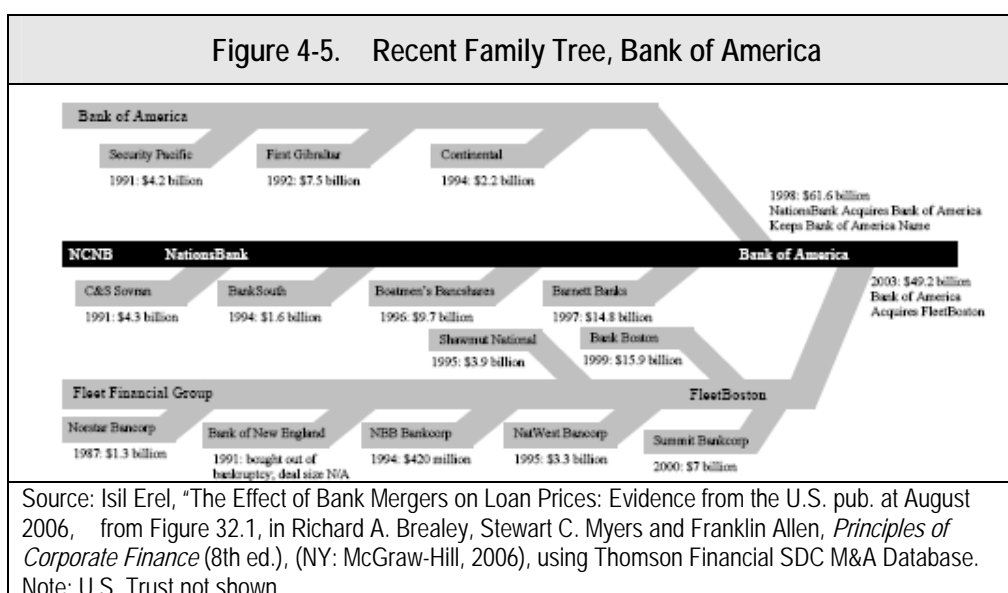
<sup>47</sup> Kuhara (2003)

<sup>48</sup> The bank's early history is documented in Marquis James and Bessie R. James, *The Story of Bank of America: Biography of a Bank* (N.p.: Beard Books, 2002 (reprint ed.)).



Securities. The pre-merger banks had acquired the investment bank Robertson Stevens (bought by BoA) and broker Montgomery Securities (bought by Nations Bank) both specialized in the West Coast market during late 1990's but after the dot com bubble burst in 2000 and Silicon Valley lost some of its appeal their activities declined. They have no insurance business.

In November 2006, BoA announced it will pay \$3.3 billion in cash to acquire U.S. Trust Corporation, a very old American institution that primarily serves high net worth households; this is the most recent of a series of moves by American banks to expand private banking with wealthy customers as the target. The acquisition will be folded into the Private Bank of America; before the acquisition the BoA was second largest in America as a manager of private wealth, in terms of assets under management, and U.S. Trust was fourth.



#### 4.6.3.2 Core Business

Bank of America's core businesses are consumer banking and small business (see Table 2-5), for which the bank can rely on the largest retail network in the U.S. and strength in Internet banking activities (the bank has more than 20 million active users of its on-line banking services). It is well known as a major lender to small business.

On January 2006 the bank -- that had been, in 1958, the first bank to issue a revolving-credit card widely accepted by retail merchants, that later became the Visa card -- announced it would purchase credit card giant MBNA for \$35 billion in cash and stock, and the completion of the deal solidifies the bank's position as the largest issuer of credit cards in the U.S., surpassing rival JPMorgan Chase.

BoA has become aggressively growth-oriented. And is seeking to improve in one of its two weak areas: investment banking.<sup>49</sup> The bank has allocated \$675 million to do this, on the basis of its evaluation that this is the area that offers greatest growth potential for the bank, as it would provide revenue streams from fees for underwriting issues, leading IPOs, and advising others on M&A deals. It remains to be seen how successful BoA will be, and whether, as has been speculated, it will buy into investment banking through a large-scale acquisition.

#### 4.6.3.3 STRUCTURE AND PERFORMANCE

Under the bank holding company arm, Bank of America Corporation (Delaware) BoA has various subsidiaries in banking and non banking activities. Besides this legal organization structure, the bank has four strategic business divisions each of which is run by a group president. Although each business division has a global interest, their global activities are more focused on the U.S. domestic customers' international business activities.

The four business divisions are: Global Consumer and Small Business Banking, Global Wealth and Investment Management, Global Business and Financial Services, and Global Capital Markets and Investment Banking. Revenue and net income from each segment is shown in **Table 4-8** below.

	Revenue			Net Income		
	2003	2004	2005	2003	2004	2005
Consumer and Small Business Banking	19.6	25.2	28.9	5.3	6.0	7.2
Wealth and Investment Management	4.0	5.9	7.4	1.2	1.6	2.4
Business and Financial Services	5.9	9.3	11.2	2.1	3.8	4.6
Capital Markets and Investment Banking	8.4	9.0	9.0	1.8	1.9	1.7

Source: Annual Report for 2005 ([www.bankofamerica.com/annualreport2005/lines\\_of\\_b usiness\\_1.cfm](http://www.bankofamerica.com/annualreport2005/lines_of_business_1.cfm))

<sup>49</sup> Mara Der Hovanesian, "(Investment) Bank Of America? / BofA aims to build its way up to the top tier of investment banks. It won't be easy." *Business Week*, May 22, 2006 ([http://www.businessweek.com/print/magazine/content/06\\_21/b3985081](http://www.businessweek.com/print/magazine/content/06_21/b3985081)).

#### 4.6.3.4 Organization and Executive Structure

There are nine senior executive officers responsible for the management of the group. The backgrounds of these executives indicate how a bank organization can seek a high level of performance by exploiting strengths from disparate pre-merger sources.

The Chairman and CEO Kenneth D. Lewis is formerly CEO of Nations Bank. At the head office there are four senior administrative officers, in charge of risk (Nations), CFO (BoA), technology (BoA) and administration (Nations). The other three executives are the president of each strategic business unit, namely Global Consumer and Small Business Banking (BoA), Global Wealth and Investment Management (Fleet Boston), and President (and Vice Chairman), Global Corporate and Investment Banking (Nations).

This executive structure shows at the top the chairman and CEO, the vice chairman, and the head of risk management are from the former Nations bank and others are from former institutions that had a competitive advantage in the fields these persons now cover. The pre-merger BoA was a strong player in consumer and small business banking and the head of this unit is from BoA. Fleet Boston, which was acquired by BoA, was a very strong player in asset management and treasury business and the head of this department is from Fleet Boston.

Through the mergers the bank has combined the strong parts of the previous institution but the top management is from the acquiring, not the acquired, bank. BoA announced that when U.S. Trust is combined with its private bank the head will be the present head of U.S. Trust, so from the outset the merged organization will be run by a newcomer. He will report to the president of Global Wealth and Investment Management.

It may be that BoA will turn out to be the pacesetter among the three companies surveyed in terms of tying executive compensation to performance. Changes were made in the industry during the lean years, but now the driving force seems to be based on aligning compensation with the interests of shareholders.<sup>50</sup> In March 2004 the chairman, president, and CEO of BoA (all hats worn by the same person) gave up part of his guaranteed compensation in exchange for some pay based on performance.

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<sup>50</sup> Paul Davis, "Is Trend in Compensation to Reward Performance?" *American Banker*, Jan. 5, 2006, p. 2.

#### 4.6.3.5 Summary

Among the top three U.S. financial conglomerates, Bank of America focuses more on its retail network in the domestic U.S. market. Its recent performance has been very good among the financial conglomerates. Their global franchise, however, is weak and the investment banking arm is inferior compared to its competitors. Because the majority of executives have been primarily oriented to the domestic market, it is questionable as to whether truly international business can be increased without a major acquisition, which could be the next step after the current effort to improve investment banking. They are selling a wide variety of retail products through an impressive distribution network and have attained synergy in that area. A similar scale of synergies could not be expected from international expansion.

#### 4.6.4 SALIENT POINTS DERIVED FROM THE CASE STUDIES

##### 4.6.4.1 Prevalence of Multi-Divisional Structure

Although each structure of a diversified U.S. financial conglomerate discussed here is that of a financial service holding company, this is mainly because of legal and regulatory reasons. ***The actual organizational structure for managing large and diversified conglomerates is different at each firm.*** Basically, each of them established some kind of multi-divisional structure by establishing decentralized independent strategic business group organizations.

All of these financial conglomerates take focused strategy emphasizing their strength compared to others. That is, there are certain practical limitations to the idea of one-stop financial services. It is very difficult to discern what some call a nerd type strategy of diversifying into all kinds of financial business as in the case of Japanese financial conglomerates (especially after the economic catastrophe following the bursting of the bubble forced manufacturers in Japan to rethink their ideal of a being "full-line" producers!). They divide their organization into strategic business groups and run each group within a decentralized structure. Top leader's commitment to focused business is very important as well as leading strict risk control of these diversified and decentralized businesses. In most of the cases the top leader has hands-on control of those star teams or star players who are producing huge profits.

By means of the multi-divisional structure, the decision-making of each business unit is decentralized closer to the customer and this thereby reduces the scale of internal complexity of each division, contained transaction costs and agency costs. Interdependence of divisions is established by sharing customer and production platforms as well as technology platforms. The head office can concentrate on strategic issues and allocation of resources and risk control. Operational strategies, as well as human resource management, are basically decentralized to each business unit so that quick response to the environmental change and on the customer side are more easily attained.

#### 4.6.4.2 Management of Synergy

According to Rogers [1992], there will be three types of synergies in financial conglomerates:<sup>51</sup>

- ❖ ***Synergy among retail business.*** This is rather easy to manage because the retail franchise will have a customer platform from which the company can cross-sell various retail products like deposits, mutual funds and insurance. It is important, however, to establish a technological and information infrastructure for such cross-selling as well as well to align the incentive scheme for the sales people.
- ❖ ***Synergy among wholesale business.*** The success of this is relative to how investment bankers can team up to pursue projects for their customers. It is very important to design a good compensation sharing system, as well as ensure that the corporate culture works to encourage such teamwork.
- ❖ ***Synergy between wholesale and retail business.*** This is a most difficult task and most of the financial conglomerates have failed to achieve synergy of this kind. This area a big challenge for the success of diversified financial firms.

Most of the U.S. cases show the first type of synergy was very successful because cross selling works well with their very strong nationwide retail and distribution network. In the case of Citigroup, they also use Smith Barney's brokerage network for this purpose.

To a lesser degree, there is good synergy within their wholesale business by selling different type of services and products to

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<sup>51</sup> Rogers (1992), p. 204.

their corporate customers. Of the three examined, JPMorgan Chase seems most successful in this area of business. Those former large commercial banks diversified into various corporate businesses have much more advantage to their competitors from former investment banking and brokerage firms like Goldman Sachs, Morgan Stanley and Merrill Lynch. This is mainly because former commercial banks have capability compared to competitors to leverage their strong balance sheet. Their huge capital base also benefits them to underwrite corporate bonds and equities.

It is very clear that no bank was successful in the synergy between wholesale and retail businesses. Differences of culture and compensation systems make this work very difficult. It is very interesting that there are some signs that the stock market is urging Citigroup to separate these businesses to increase the profitability and increase the stock price.<sup>52</sup>

#### **4.6.4.3 Difficulty of Managing Investment Banking**

Through M&As, many U.S. commercial banks added investment banking divisions but many problems subsequently occurred because of the difficulty of managing that kind of business. Investment banking business needs a flat, decentralized, organic and self-designing organization with entrepreneurial culture in order to create good performance. All of these characteristics contradict with the traditional commercial banking which is based on more top-down and bureaucratic organization. The essence of managing effective investment banking is to customize a package of financial products and services to the particular needs of customer. This involves getting the various products specialists together in collaborative teams. Investment bankers tend to have a minimum commitment to the firm they are currently working for, and always looking for an opportunity to move to a highest paying firm. They do not like to be managed and prefer as much autonomy as possible.<sup>53</sup> So they are not loyal and are mobile. This kind of person only can be managed by professional managers in the investment banking. Wholesale and retail financial service businesses have such different cultures and modes of operations as to be inherently incompatible within the same enterprise.

It is important for the traditional commercial banks to change their culture and incentive structures when they enter into new

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<sup>52</sup> *Business Week*, Oct. 5, 2006.

<sup>53</sup> Smith and Walter (2003) predict that the wholesale banking business organization might revert to small specialized boutique organizations after experiencing the control problems of large organization (p. 411).

activities and must adjust their organizational, compensation and control structure accordingly.<sup>54</sup>

It is also very clear that each institution cares much about their reputation and risk to it, and they have established code of conduct policy for all the employees, obliging them to observe the rules and regulations in the industry. The financial press provides many examples of flagrant and large-scale violations, so the measures adopted are far from functioning well. All the same, the incentive designs of profit-making players in these institutions are very asymmetric to the profits and risks. These players have a big incentive to take more risks and if they lose out they just change to another firm. U.S. executives at the financial conglomerates are facing these two challenges, one from shareholders and other from star players who are not loyal to the firm but only loyal to the profit motive.

#### **4.6.4.4 Importance of Managerial Capabilities to Realize Synergetic Organizational Efficiencies**

Because of the huge size of business, as well as very diversified products and markets, it is very difficult to manage large FHCs efficiently. By observing U.S. conglomerates, we can deduce that it is vital that the management has the capability to manage such large and complicated organization. Middle management should be also capable and efficient. It is an advantage of U.S. financial firms that there is good market for both senior and middle management human resources (and disadvantage in that it is a very liquid market). The multi-divisional nature of U.S. financial firms has encouraged the development of human managerial talent because each division is managed just like a smaller independent financial firm and those heads of divisions have experienced managerial capabilities.<sup>55</sup>

Pressures from shareholders to ensure stable and higher profits are very big at U.S. financial conglomerates and that disciplines those at the top. Although Weil says he ran the Citigroup from

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<sup>54</sup> Rajan (1996).

<sup>55</sup> The nature of these managerial capabilities will be such as the following: (1) Defining the core competence of the firm; (2) Transferring the old resources to new combinations of products to achieve competitive advantage; (3) Allocating of fixed cost to different products; (4) Merging different cultures; (5) Transferring managerial know-how from traditional to new markets; (5) Realizing economies of scale and scope; and (6) Sharing managerial know-how, value systems, and management [Yidrim 2005:33-35].

long term perspective of growth, his daily hands-on management in monitoring risks and avoiding the taking of high risks in such divisions as propriety trading shows what is the management's incentive to lead the organization.<sup>56</sup> That is, stable shareholders return and higher value as determined by the stock market.

#### **4.7 ADDITIONAL OBSERVATIONS AND IMPLICATIONS FOR ASEAN NATIONS**

Banking systems necessarily have intimate relations to the diverse and unique historical aspects of the economy and society of the nations where they exist.<sup>57</sup> As such, it is not reasonable to advocate adoption of this model or that model, from another country.<sup>58</sup> Nevertheless, the experience and situation in other countries provide much as a resource for consideration of policy and administration for the banking sector.

From the above narrative and analytical examination of the situation in the United States, the following are implications for other nations. Here, we are concerned primarily with thoughts relating to merger and acquisition activities in the domestic banking sector of each country, but it deserves mention that the foregoing discussion may also be of reference in anticipating the evolution of the American financial sector, for purposes of policy planning or monitoring international trends that can have domestic ramifications.

##### **4.7.1 SYSTEMIC RISK, MERGER SCREENING, AND THE "TOO BIG TO FAIL" ISSUE**

The most recent incidence of a real TBTF issue was in 1998, when a hedge fund, Long-Term Capital Management,<sup>59</sup> lost more than 90% of its capital. A private-sector recapitalization was arranged by the Fed because of the risk created for global financial markets. This serves as a reminder of the special situation presented by the possible failure of a very large financial

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<sup>56</sup> Weill and Kraushaar [2006: 329-333].

<sup>57</sup> For example, most countries have a single bank regulator, but the U.S. has three: the OCC (national banks), the Fed (mostly the bank holding companies and state chartered members of the Fed) and the FDIC, in addition to 50 state banking authorities.

<sup>58</sup> For example, Mishikin [2006] show us that institutional development is a complex process, and warns against the "one size fits all" approach of taking institutions from the advanced countries and transplanting them to economically disadvantaged countries.

<sup>59</sup> See Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management*. NY: Random House, 2006.



institution. Larger banking organizations and higher levels of concentration increase systemic risk. Guarding against such risk becoming a real problem must be a major objective of banking supervision. Systemic risk can arise from various causes; here we are concerned with the increase of that risk that may be result from large merger and acquisition deals.

The magnitude of the largest banking organizations (see **Table 4-9**, Bank Holding Companies Subject to Market Risk Capital Standards), as well as the increase in concentration, presents a special issue of the "too big to fail" or TBTF banks. The subject has surfaced from time to time, especially after 1984 when eleven banks were identified as being "too big to fail." The subject has become much more relevant recently because of the large magnitude of merging institutions, as well as the increase in concentration in banking and finance.<sup>60</sup> The matter of TBTF banks is an issue of growing concern, and provisions have not yet been adequately deployed by the Federal agencies concerned. This is not a matter of preventing failure, but of preventing losses that could become a systemic problem, by the Federal Deposit Insurance Corporation which will pay all depositors and creditors. Two central bankers, in a recent book, take up policy issues of the TBTF banks.<sup>61</sup> As they also discuss in a Federal Reserve publication, the danger is that if a creditor suspects that a bank might fail, and it is so large that the government is likely to pay off, the creditor will fail to properly exert a disciplinary influence on the bank, and provide more funds to the bank than would be appropriate, leading to a high level of risk at the bank and a waste of economic resources.<sup>62</sup>

Because a merger increases the possibility of systemic risk, and because some mergers are of two already large banking organizations, these two bankers argue that attention should be given to the TBTF issue when a proposed merger is reviewed.

The review process is undertaken both by the Fed and the Department of Justice. The latter is concerned with market concentration and structure, and the outlook for competitive conditions. The Fed examines competitive issues but also (1)

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<sup>60</sup> See, for example, Morgan, Donald P. and Stiroh, Kevin J., "Too Big to Fail After All These Years" (Sept. 2005), FRB NY Staff Report No. 220 (available at <http://ssm.com/abstract=813967>).

<sup>61</sup> Gary H. Stern and Ron J. Feldman, *Too Big to Fail: The Hazard of Bank Bailouts* The Brookings Institution Press.

<sup>62</sup> Gary H. Stern and Ron J. Feldman. 2005. "Addressing TBTF When Banks Merge: A Proposal." *The Region Banking and Policy Issues Magazine* (September). At <http://woodrow.mpls.frb.fed.us/pubs/region/05-09/TRBTF.cfm>

"considers the financial and managerial resources and future prospects for merging institutions," and (2) "considers the effects of the proposed M&A on the convenience and needs of the community to be served."<sup>63</sup>

TABLE 4-9. BANK HOLDING COMPANIES SUBJECT TO MARKET RISK CAPITAL STANDARDS			
Bank Holding Companies Subject to Market Risk Capital Standards December 2001			
Banking Organization	Market Risk Capital Requirement (Billions of Dollars)	Total Assets (Billions of Dollars)	Asset Size Rank
Citigroup Inc.	2,510	1,051	1
J.P. Morgan Chase & Co.	1,929	694	2
Bank of America Corporation	2,355	622	3
Wachovia Corporation	0,370	331	4
Wells Fargo & Co.	0,164	308	5
Bank One Corporation	0,156	269	6
Taunus Corporation	0,261	227	8
FleetBoston Financial Corporation	0,257	204	9
ABN Amro North America Holding Co.	0,093	172	10
U.S. Bancorp	0,038	171	11
HSBC North America Inc.	0,138	110	12
Suntrust Banks, Inc.	0,023	105	14
The Bank of New York Company, Inc.	0,043	81	15
Keycorp	0,017	80	16
State Street Corporation	0,056	70	19
PNC Financial Services Group	0,017	70	20
Countrywide Credit Industries, Inc.	0,001	37	30
Mellon Financial Corporation	0,050	36	32
CIBC Delaware Holdings Inc.	0,134	32	35

Source: Federal Reserve FR Y-9C Reports.

Note: The commercial bank holding companies listed are those that reported positive market risk equivalent assets on Schedule HC-1 of the Federal Reserve FR Y-9C Reports in December 2001.

Source: Beverly Hirtle, What Market Risk Capital Reporting Tells Us about Bank Risk. *FRBNY Economic Policy Review*, September 2003, p. 40.

The proposed remedy is concerned with mergers among the nation's 509 largest banks, and calls for public reports by the Fed, by the FDIC, and by the U.S. Treasury (operating through the OCC) on "their respective efforts to address and manager potential TBTF concerns."<sup>64</sup>

With suitable adjustments for local conditions, in any nation where large-scale banking organization mergers are expected or are taking place, it would be advisable for regulators to monitor the merger approval examination process from the viewpoint of preventing a TBTF problem (including deterioration of the quality and capability of bank management, and the possibility of having to consider covering depositors and creditor positions

<sup>63</sup> Ibid.

<sup>64</sup> Ibid.

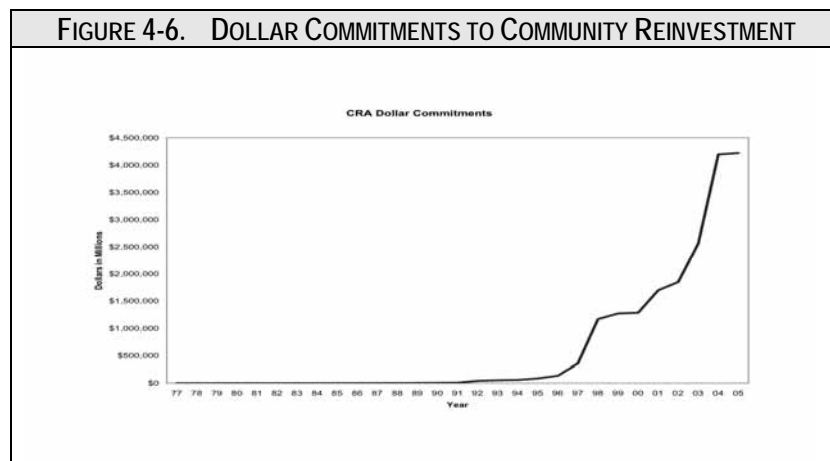
in order to prevent destabilization of the banking system or runs on banks.

#### 4.7.2 COMPETITION POLICY

Most mergers and acquisitions have not presented a threat to free competition in the market, but a major reason for this is the large scale of the total market and the dynamism of market players, as evidenced by the scale of new bank formations and organic growth of banking organizations. Competition in the U.S. does not have to take into account the Post Office, even though it provides a money order service for small-scale transactions. In other countries, however, mergers may more easily reduce competition, and if the postal system has an important giro, savings or insurance service function, this would have to be considered as well.

#### 4.7.3 COMMITMENT TO THE LOCAL COMMUNITY

Acquisitions have the effect of assuring that the acquiring bank will lend or invest money in its local communities. This is because the Community Reinvestment Act of 1977 requires banks to make multiyear commitments of loans, investments and banking services to communities in need, as a measure to seek economic justice. The act had the immediate objective of eliminating discrimination in lending ("redlining"), and provides that if a bank wishes to expand, it must demonstrate that it is not neglecting areas that are



Source: NCRC, at [www.ncrc.org](http://www.ncrc.org).

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under-served or disadvantaged and are in the area served by the bank.<sup>65</sup> Low- and middle-income neighborhoods are routinely included in the scope of the evaluation. It is estimated that under the act, \$4.2 trillion has been allocated and provided for minority and low-income communities.<sup>66</sup> Banks are well aware of the importance of satisfying this requirement, and of obtaining favorable exposure in the media by announcing programs.

This effect of mergers on banking activities is incidental to the subject of this paper and hence is reported as an observation without any recommendation that it be considered in the context of banking regulation directed at matters relating to institution size and M&A activities.

In the U.S., the principle of community reinvestment is an example of a political restriction on financial activity. In any nation, a large-scale merger of banking organizations has the potential of influencing the accessibility to and the supply of banking services to a large population. Therefore it could be recommendable to incorporate, in the guidelines for merger, provisions intended to ensure that local communities do not suffer from a given merger.

The experience of BoA in 2004 will serve to illustrate the matter of requiring banks to make a commitment to the local community. After the BoA announced it wishes to acquire FleetBoston Financial Corporation, the Federal Reserve scheduled hearings in Boston and San Francisco, as part of its review of the proposed acquisition. One week prior to the hearings, the BoA announced the largest community development commitment ever made by a bank: \$750 billion that would be lent or invested in affordable housing and community development over the course of ten years.<sup>67</sup> Prior to this, the largest amount that had been pledged was \$375 billion, by Washington Mutual Inc., in 2001, after it announced plans to acquire Dime Bancorp, of New York. At the time, BoA had committed \$230 billion of a \$350 billion commitment made when BoA had been purchased by NationsBank, and FleetBoston was

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<sup>65</sup> The law was strengthened by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, that requires regulators to regularly prepare a written evaluation of what each bank is doing in terms of community reinvestment. Johnson (2000), p. 93.

<sup>66</sup> For information on community commitments, see the website of the National Community Reinvestment Coalition, [www.ncrc.org](http://www.ncrc.org).

<sup>67</sup> David Boraks and Damian Paletta, 2004. "Will \$750B Pledge -- Biggest Ever -- Be Enough for B of A?" *American Banker*. (January 8):1-2.

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approaching the end to a \$14.6 billion pledge made when Fleet Financial and Bank-Boston had merged.

In other countries, central government policy for rectification of regional disparities, or on behalf of social justice, can be reflected in bank monitoring, including monitoring at the time a merger or acquisition is proposed.

#### **4.7.4 DIFFICULTY IN MANAGING FINANCIAL CONGLOMERATES**

It is amply evident that there are immense difficulties in managing a large diversified financial conglomerate. In many cases it appeared these institutions are too big to manage and many problems, scandals and sudden losses of operation happen. It is very clear that the U.S. financial conglomerates might have a competitive advantage in running these conglomerates because of various factors combined together. These advantages were materialized by a talented leader to run these institutions with good governance structure. These factors seem America-specific and would be very difficult to imitate.

#### **4.7.5 POLITICAL INFLUENCE AND AGGRANDIZEMENT OF POWER**

The traditional American wariness with regard to a high degree of concentration of economic power is one of the suitable, relevant aspects for a discussion of the formation and growth of large bank organizations. And the starting point is, properly, the efforts and accomplishments of the industry through their lobbying Washington lawmakers and regulators (see Table 2-7), and influencing the media.

When the bankruptcy code was revised in 2005, it was after a period of 10 years of industry lobbying and use of more than \$100 million.<sup>68</sup> Although the provenance of this number, published by the *New York Times*, is not known, at very minimum we can refer to official data for Political Action Committee donations. In recent years, no industrial category has contributed more to politicians through PACs than the financial industry; only Organized Labor contributed more. Industry sources indicate that in 2003, Citigroup spent "millions" on retooling its lobbying to convince Washington that Weill was not too close to the Democratic Party.<sup>69</sup> Health Care has been the only close competitor for the No. 1 position.

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<sup>68</sup> Timothy Egan, "Newly Bankrupt Raking in Piles of Credit Offers," *New York Times*, Dec. 11, 2005, at [www.nytimes.com/2005/12/11/national/11credit](http://www.nytimes.com/2005/12/11/national/11credit)

<sup>69</sup> *American Banker*. 2004. (January 9):5.

Grouping	2005-2006 (partial)	2003-2004	2001-2002
Real Estate/Construction	18,595,851	17,062,421	14,164,267
Communication, Technology	19,833,955	18,077,288	15,703,935
Defense	9,596,848	8,257,115	7,063,091
Energy, Natural Resources	20,729,534	19,182,143	18,706,662
<b>Finance, Insurance</b>	<b>48,752,126</b>	<b>43,760,053</b>	<b>37,292,937</b>
Business - Retail, Services	19,811,013	18,760,384	16,625,637
Health Care	37,501,365	32,598,660	26,198,330
Organized Labor	54,450,284	53,664,047	55,114,648
Manufacturing	6,536,815	5,783,199	5,440,282

Source: [www.politicalmoneyline.com/cgi-win/x\\_sic.exe?DOFn=](http://www.politicalmoneyline.com/cgi-win/x_sic.exe?DOFn=)  
Note: SIC classification.

In any nation, there should be suitable, effective mechanisms to ensure that a given interest group does not unduly influence policy or government administration. The financial sector and particularly banks should be no exception to this.

#### **4.7.6 CUSTOMER SATISFACTION**

At the micro level, it would seem that the retail customers of merging or merged banks are taken for granted as being beneficiaries of the merger. They are merely stakeholders from the viewpoint of a merger. Some are certainly benefited and so think; others not. Usually, there are no major immediate changes of importance for retail customers, but since mergers often lead to efficiency-seeking closing of branches, some groups are likely to be inconvenienced, even in this age of omnipresent ATMS and electronic payments. The regulators appear to have no direct interest in retail customers' interests in considering merger approvals, and must assume that the greater efficiency that results provides adequate benefits.

But according to the American Customer Satisfaction Index, compiled by the University of Michigan, the rating given to banks during the 1990's was low; this coincided with a high level of

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mergers.<sup>70</sup> The university's researcher in charge of the survey stated that some loss of customer satisfaction is low for several years after a merger. This appears to have been the case recently. In February 2005 the university reported that "The customer satisfaction score for banks stands at 75, matching its highest level achieved a year ago. Satisfaction with smaller banks has actually improved slightly, but among the larger banks, JPMorgan Chase is unchanged at 70, while Bank of America has declined by 3 percent to 72."<sup>71</sup> The university commented that the results for these two banks may be related to their recent acquisitions. There are technical limitations to what can be judged from the Michigan survey, however, and while banks undertake their own surveys of customer satisfaction,<sup>72</sup> it is reaction of the share price to the announcement and effectuation of a merger that is most often used as an indication of general reaction to the event. At the micro level, nevertheless, banks know that there is danger that will vote with their feet. Industry sources say that 5-10% of deposits in key markets can be lost because customers are displeased with either the merger or changes that follow it such as changes in systems, products, and brands. Knowing this, competitors of the merged bank will make a special effort to pull in customers. The need to try for economies of scale requires merging systems, and glitches can easily occur at that time, causing some inconvenienced customers to leave.<sup>73</sup>

Customer satisfaction involves not only depositors in the household sector but also business, including small and medium enterprises, especially in countries where bank loans are relatively important sources of investment and working capital. Bank supervision, including the process of review of proposed M&A activity, should anticipate the maintenance of necessary and important services to the local communities, and thereby ensure customer satisfaction.

#### 4.7.7 REGULATION

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<sup>70</sup> Cole, Jim. 2005. Mixed Signals on Customer Satisfaction. *American Banker* (February 15):1-2.

<sup>71</sup> See the university press release, at <http://www.umich.edu/news/index.html?Releases/2005/Feb05/r021505>.

<sup>72</sup> BoA provides a good example of a major banking organization's approach to customer satisfaction; this has been written up as an American Society for Quality case study and reported in *Quality Progress* in Feb. 2005 ([www.asq.org/fiancial/bank-of-america-case-study](http://www.asq.org/fiancial/bank-of-america-case-study)).

<sup>73</sup> Boracks, David. 2005. "Will Dreams of Merger Runoff Come True?" *American Banker* (January 3):2.

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The U.S. deserves criticism for not giving due consideration to the cost of regulation, and the cost of compliance, when enacting legislation. Other countries may well avoid emulating this.

If the nature of banking organizations and the business they do change, or those organizations grow in scale and especially if there is consolidation and an increase in concentration to the extent that threats to competition may emerge, appropriate regulatory and supervision behavior is incumbent on the government.



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## PART 5. FINANCIAL CONGLOMERATION IN JAPAN: THE MANAGERIAL PERSPECTIVE

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### 5.1 BACKGROUND OF JAPANESE FINANCIAL CONGLOMERATION

The Japanese financial system has been weakened after the bubble burst in 1991 and in the non-performing loan (NPL) problems aftermath. The Ministry of Finance, the sole regulator of the financial industry at that time, preferred to deal with these problems on a case-to-case basis, a policy that incidentally caused delay of genuine reform in the financial system, which was necessary at that time.

Although the Ministry of Finance had great power to oversee the Japanese banking industry through informal personal relationships as well as various formal guidelines, it was not prepared to close problem banks and reform the financial market thoroughly. It had defined its own priority as collecting tax payments and balancing the budget, which was politically more important for the ministry; facing banking problems was an unpopular task both politically and financially and became secondary in priority. As a result, Finance officials took a step-by-step approach for the restructuring of the banking industry, while the industry was, in actuality, experiencing rapid and formidable change in its competitive environment.

During the economic slowdown of the 1990's (the so-called "lost decade"), banks' provisioning for NPLs lagged. New NPLs accumulated and all the major banks had to draw down their hidden reserves from crossholdings of shares, and current profits, in order to write off the burgeoning NPLs. As the profitability of banks declined, they restricted lending in order to maintain their capital ratios and solvency. Three of the top 20 banks, The Long-term Credit Bank of Japan, Nippon Credit Bank and Hokkaido Takushoku Bank, failed in 1997-98. The government finally introduced necessary registration for recapitalizing weak banks.

In October 1998, the government enacted special registration to move the responsibility of financial supervisory from the Ministry of Finance to a new, independent Financial Services Agency and made a second capital injection to the banks. Capital

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injection to 15 banks was made in March 1999 with strict conditions for financial targets. During the 1990's Japan's large banks had been among the largest in size but mediocre in terms of profits when viewed in the context of the global banking industry.

Survival became the most important strategy of major banks because every bank's financial standing was similar and all had adopted similar strategies during the preceding high economic growth period. Every large bank tried to merge with another large bank in order to survive and this process finally ended in three large financial conglomerates with too big to fail strategy.

This changed the structure of the Japanese banking sector completely:

- ❖ Departmentalization of the banking system ended with the demise of the specialized long-term credit banks, as two banks failed and one bank was merged into new Mizuho group, while most of the trust banks merged to their group commercial banks.
- ❖ Keiretsu finance ended by the cross-keiretsu mergers, namely Sumitomo with Mitsui, Daiichi with Fuji, and Mitsubishi with Sanwa.

## 5.2 THE BIRTH OF THREE MEGA BANKS

In year 2000, Daiichi Kangyo, Fuji and Industrial Bank merged to establish Mizuho Holding Inc. In March 2003, the **Mizuho Financial Group** became the financial holding company of Mizuho group.

In April 2001, Sakura Bank and Sumitomo Bank merged to form Sumitomo Mitsui Banking Corporation. Sakura Bank was a product of merger between Mitsui and Taiyo Kobe bank in 1990. In December 2002 Sumitomo Mitsui Banking Corporation established a holding company named **Sumitomo Mitsui Financial Group** and Sumitomo Mitsui Banking became a subsidiary of the holding company.

**Mitsubishi UFJ Financial Group** was formed on October 2005 by the merger of Mitsubishi Tokyo Financial Group and UFJ holdings. Mitsubishi Tokyo Financial Group was a product of merger among Mitsubishi Bank, Bank of Tokyo, Mitsubishi Trust Bank and Nippon Trust Bank which occurred during late 1990's to early 2000. UFJ group was also the product of an earlier merger between Sanwa Bank, Tokai Bank and Toyo Trust Bank, in April 2001. All three

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groups either acquired or allied with a securities brokerage company and diversified into securities brokerage and underwriting businesses.

The 20 major banks in 1995 ended up being three mega-banks and two middle-size trust banks (Sumitomo Trust and Mitsui Chuo Trust) in 2005. From the viewpoints of both size and the diversified nature of business, these three mega-banks are financial conglomerates. However their financial performances and activities in global markets are way behind their US and European counterparts.

### 5.3 COMPETITIVE EFFICIENCY OF JAPANESE MEGA-BANKS

As shown in **Table 5-1**, the performance of the three Japanese mega-banks is far behind that of other major world financial conglomerates. Mitsubishi UFJ's size is almost same as Citigroup and Citi is the largest group of financial conglomerates. But its net income is less than half of that of Citi. All three mega-banks had a return on assets in 2005 of between 0.4 and 0.6% , far inferior to the 3% of Citigroup and 1.2 % of the HSBC group. A special case exists for the return on equity of Japanese banks; the unusual figures are due to the recapitalization program by the government being still underway for the Sumitomo Mitsui and Mizuho groups.

In accordance with traditional Japanese management customs, it is difficult to fire redundant employees after a merger and that, and corporate culture (e.g., strong keiretsu orientation) makes it difficult to restructure a merged organization. Merger does not produce cost efficiencies as in the case of American banks, and in many cases mergers cause organizational inefficiencies.

For example, Mizuho created three legal entities, Mizuho Holding, Mizuho Corporate Bank and Mizuho Bank, and assigned at the top post of Mizuho Holding an executive from Fuji Bank, while the top post at Mizuho Bank went to an executive from Daiichi-Kangyo Bank and the top post at Mizuho Corporate Bank to one from the Industrial Bank of Japan. Although Mizuho officially stated that the senior posts were assigned according to the ability and suitability, we can state that maintaining a balance among the former three institutions was most important objective.

TABLE 5-1. COMPARISON OF PERFORMANCE OF FINANCIAL CONGLOMERATES						
		2001	2002	2003	2004	2005
Total Assets US\$ Million	Citigroup	1051450	1097190	1264032	1484101	1494037
	Bank of America	621764	660458	736445	1110457	1291803
	JPMorgan Chase	693575	758800	770248	1157248	1198942
	HSBC Holdings PLC	695877	759246	1034216	1276778	1501970
	UBS AG	754862	854306	1121022	1526333	1563448
	Deutsche Bank AG	817558	795979	1013375	1141434	1170553
	ABN-AMRO Holdings NV	531875	583603	706724	826960	1039156
	Mitsubishi-UFJ	829140	826460.99	888462	919046	1558723
	Sumitomo Mitsui		871729	851793	831099	891755
	Mizuho		1124807.5	1149148	1129679	1153784
Net Income US\$ Million	Citigroup	14284	13448	17853	17046	19806
	Bank of America	6792	9249	10810	14143	16465
	JPMorgan Chase	1719	1633	6719	4466	8483
	HSBC Holdings PLC	5406	6239	8774	11840	15081
	UBS AG	2948	2278	4750	6516	7911
	Deutsche Bank AG	334	340	1373	3074	4391
	ABN-AMRO Holdings NV	9033	9307	11003	12022	11343
	Mitsubishi-UFJ	-2614	-1346	4673	2820	6423
	Sumitomo Mitsui	na	-3878	2753	-1952	5574
	Mizuho	na	-19809	3392	5416	5416
ROA %	Citigroup	1.5	1.2	1.5	1.2	1.3
	Bank of America	1.1	1.4	1.5	1.5	1.4
	JPMorgan Chase	0.2	0.2	0.9	0.5	0.7
	HSBC Holdings PLC	0.8	0.9	1	1	1.1
	UBS AG	0.4	0.3	0.5	0.5	0.5
	Deutsche Bank AG	0	0	0.2	0.3	0.4
	ABN-AMRO Holdings NV	0.4	0.4	0.5	0.7	0.6
	Mitsubishi-UFJ	0	0	0.5	0.3	0.4
	Sumitomo Mitsui	na	0	0.3	0	0.6
	Mizuho	na	0	0.3	0.4	0.5
ROE %	Citigroup	19.7	16.2	19.5	16.6	18
	Bank of America	14.1	18.7	22	19.2	16.4
	JPMorgan Chase	4.1	4	15.4	5.9	8
	HSBC Holdings PLC	11.8	12.7	13.8	14.7	16.8
	UBS AG	10.9	8.4	16.7	21.9	24.6
	Deutsche Bank AG	1.1	1	4.1	8.7	12.5
	ABN-AMRO Holdings NV	20	22.1	27.2	29.1	24
	Mitsubishi-UFJ	0	0	16.7	7.8	13.5
	Sumitomo Mitsui	na	0	31.6	0	33.1
	Mizuho	na	0	135.2	54.3	26.3

Source: Prepared by author from Standard and Poor's industry data and annual reports.

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## 5.4 PECULIARITIES OF JAPANESE BANK MANAGEMENT

### 5.4.1 CHARACTERISTICS OF JAPANESE BANK MANAGEMENT UNTIL THE 1990s<sup>74</sup>

Peculiarities in management traditions at Japanese banks are rooted in hierarchical structures and conservative behavior that can be observed in Japanese society at large. The three points discussed below distinguish Japanese bank management traditions from those observable at banks in the US and Europe.

#### 5.4.1.1 "Yoko-narabi"

The term *yoko-narabi* suggests a neat lining up, like a row of schoolchildren toeing the schoolyard line before entering the school. From the end of WW2 until the middle of the 1970s, one would be hard pressed to find any significant difference in the management behavior from one "city bank" to the next.

A major factor contributing to such behavior had been the need by banks for frequent informal consultation with the Ministry of Finance with regard to such matters as expansion into new markets or introduction of new financial products. The Ministry's excessive constraints with regard to the introduction of new products led to a situation wherein banks were limited in their capacity to differentiate their products from those of competitors and this caused banks to focus on the maximization of volume and market share rather than profitability. Other adverse effects were that corporate cultures became almost indistinguishable from one bank to the next, and that there was no sense of urgency or responsibility among bank management. The fact that the problem of bad loans from the bubble era occurred at all major banks (albeit more at some than others) is evidence of this tendency among Japanese banks to mimic each other. Further evidence is that in this industry the most important task of strategic planners was to find out what other banks are doing, and through constant exchange of information ensure that no one breaks away from the pack.

#### 5.4.1.2 The Manager as Representative of Employees

Most of Japan's senior bankers sit atop vast corporate hierarchies that span functions and branches where the principal aim is the efficient handling of individual transactions. Their responsibilities are vague. Few have been trained deeply in a particular technical discipline. Their most important talent

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<sup>74</sup> This part of the chapter's analysis is based on Kuhara (2000a).



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has been that of a high-level relationship manager (of important clients and regulatory authorities).

For many years following World War II, sources of capital were limited and members of the financial community enjoyed a position of superiority vis-à-vis corporate borrowers. During these times such managerial talent was sufficient. Potential senior bankers were singled out on the basis on their popularity at the Ministry of Finance, and with important clients and other bankers. Working hours were spent thinking about methods to expand market share via mergers with other banks and other means, and rubber-stamping plans and transactions generated by subordinates. The formula for success was primarily sociability, e.g., golf, karaoke, an old-boy school network and so forth, rather than deep understanding of finance, creative thought, and assertiveness. The bold reforms required today, in terms of both internal and external governance, depend on these latter attributes. Unfortunately, these are in short supply. As a result, banks procrastinated with regard to their bad-asset problem.

#### **5.4.1.3 Development of Banking Generalists**

Since World War II, banks have been able to attract the crème de la crème from Japan's labor pool. Internal competition within each bank has been severe and only the most dedicated and skillful (in terms of those skills discussed above) have been able to make it to the top. A career at a bank provided high social status and credibility, relatively high salaries, stable employment, and the possibility to serve as advisor to the bank's client companies. Each year since the 1950's, approximately 10% of the graduates from the Economics Department of the prestigious University of Tokyo have selected banking careers. Beginning in the latter half of the 1960's, the proportion rose to over 20%, equaling the percentage of such elites entering the entire manufacturing sector. Although there is intense rivalry once these high-potential human resources enter the bank, the over-emphasis on relationship management and system of frequent rotation to various posts within the bank has prevented these persons from accumulating technical skills and knowledge. Instead, they developed into generalists. They were aware that any mistake would be a big black mark on their record, from which recovery would be difficult or impossible. This fostered conservatism and reluctance to take risks. Due to the lack of an external labor market and vestigial performance evaluation methods, employees learned to be socially bureaucratic. Those who were trusted by their peers were groomed as managers.

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**5.4.2 FAILURE TO SUCCESSFULLY ADOPT DIVISIONAL PROFIT CENTER CONCEPT:  
SUMITOMO BANK**

During the late 1970's and early 1980's, all major Japanese banks converted to divisional profit center structures, the so-called "comprehensive headquarters function system." However, the internal controls and internal resources allocation mechanism that are prerequisite for such conversion were inadequate, so there was little substance behind the appearance of divisional profit center structures. As a result, many conversion attempts ended in failure.

The structure of major Japanese banks until the 1970's was generally based on the centralization of power in the functional areas of lending, deposits, foreign exchange, and credit analysis. As banks grew, so did the number of departments and sub-sections within departments, but the basic principle of a functionally-delineated, centralized authority remained. Because of strict regulation, it was difficult for them to differentiate themselves in terms of products, services, target customers, or locations from their competitors. There were several problems with this management structure based on functional lines. First, it required a tremendous amount of time and energy for coordination. Second, as a result it slowed the process of decision-making on strategic issues. Third, because the bank's singular objective was expansion of volume and not cost reduction, cost control and internal quantitative management control mechanisms were surprisingly primitive.

The introduction of the divisional profit centers energized traditional Japanese banks by dispersing power within the organization by empowering divisions to respond to rapid changes specific to the environments within which they operated. Acting under the advice of the management-consulting firm, McKinsey & Company, Sumitomo Bank was the first to adopt such a structure. The aims were to respond quickly to customer needs and strengthen customer relationships; markets were segmented and several divisional departments were established with broad decision-making authority and responsibility. Initially, the new structure was quickly responsive to customer needs, and appeared to contribute to profitability. However, the profit-first mentality went too far. Credit analysis, which now was controlled by each divisional headquarters, became lax, and before long, large problem loans were accumulating and contributing to the formation of the bubble. Each divisional headquarters considered only the assessment of individual loan risks and improvement of their own results. This resulted in

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a portfolio management problem in that there was no over-arching authority concerned with risk to the bank as a whole, and the risk-return relationship. Headquarters functioned only to determine the allocation of funds at each division and divisional headquarters ran off without proper centralized control.

#### **5.4.3 SUMMARY OF ORGANIZATIONAL PROBLEMS OF JAPANESE BANKS**

Japan's economy after the Second World War successfully grew by utilizing close ties between subsidiary companies and banks through the "main bank" system and crossholding of shares but the system eventually became the weak point of Japanese bank organization. Because the system as a whole was sticky, it was difficult to change what needed to be changed to adjust to the changing environment during the 1980's and the system became the major reason Japanese banks lost their international competitiveness. The problem rests on their incapability to manage a modern financial institution. It is important that these basic managerial characteristics of Japanese banks are very difficult to completely change although under the influence of progress of globalization change is taking place at the Japanese banks.

#### **5.4.4 PASS DEPENDENCY AND CULTURAL DIFFERENCE**

Japan utilized its well-organized economic and financial system to concentrate scarce capital resources where they would be utilized best. The Japanese banking system was compartmentalized and relation-oriented in order to serve for this economic growth. The organization structure of banks has been functional and centralized headquarters decided on the allocation of funds and human resources within the bank. Because of the rigidity of this Japan-specific bank organization culture and system, it is very difficult for Japanese financial conglomerates to adjust strategy and organization to match change in the global market.

Different from the case of manufacturing, a sector where Japan has competitive advantages in, for example, the automobile and electronics industries, it is very difficult for Japan to develop competitive resources in the financial industry. In the financial industry, the source of competitiveness has relied on the quality of human talent and how an organization can encourage the full enhancement of such human quality. The Anglo-American environment, where the performance of professionals is well evaluated and there is a meritocracy compensation system, has a big advantage for creating a competitive financial firm. The Japanese type of organization

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where the long-term related parties contribute to the accumulation of company-specific knowledge, informal and formal integration to varying degrees, and where such knowledge becomes a source of international competitiveness is still appropriate for the likes of the automobile industry -- but not for Japan's banks.

### 5.5 STRATEGY AND STRUCTURE OF THREE MEGA-BANKS

**"Structure follows strategy."**<sup>75</sup> A firm chooses the organization structure that fits its business strategy. In the case of financial firms, which are heavily regulated, we can say **"Structure follows strategy and regulatory environment."**

As previously discussed, diversified financial institutions take on the structure of a holding company, a universal bank, or a bank subsidiary. We found that no matter what structure they take they organize their business according into several strategic business divisions and try to materialize synergy within the diversified business as well as effective risk control. The performance of financial conglomerates heavily relies on having a sharply-defined strategy and effective management to run a complicated organization.

In this section, we will present Japanese mega-bank cases to analyze their strategy and structure and discuss how they compare to Western conglomerates.

It is important to note that most of the Japanese financial conglomerates introduced an American type multi-divisional structure under a financial holding company structure. But in most cases, it is just a superficial imitation of an American bank and it is very hard to find managerial efficiency under this organizational structure. Instead of adopting and adapting, which were the way to develop Japanese institutions traditionally, Japanese banks just imitated what they saw, and this may be a big stumbling block to Japanese banks when they attempt to demonstrate their international competitive advantage in the future.

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<sup>75</sup> Chandler (1962), Chandler clarified the reasons of high performance at GM and DuPont were their adoption of a multi-divisional structure during the growing business environment in 1930's.

### 5.5.1 MIZUHO FINANCIAL GROUP

#### 5.5.1.1 History

Mizuho Group was born as an equal merger of three banks, Fuji, Daiichi-Kangyo and the Industrial Bank of Japan in 2000. Their priority was how to balance the power between these three. As a result their organization structure became inefficient from the start. The group established Mizuho Holding, led by a former Fuji Bank senior executive as a holding company. Under it they established Mizuho Corporate Bank to be in charge of large corporate customers; this was headed by a top executive from the former Industrial Bank of Japan, while Mizuho Bank was to be in charge of middle market and consumer banking, and led by a former senior executive of Daiichi-Kangyo Bank. The newly merged bank was really three separate organizations each run by a former senior executive of the former bank.

Later the group created Mizuho Financial Holding one level above Mizuho Holding in order to strengthen its capital base, and reorganized the group. As a result each subsidiary bank owns a wholesale security subsidiary and retail security subsidiary respectively (see **Figure 5-1**).

FIGURE 5-1. ORGANIZATIONAL STRUCTURE OF MIZUHO FINANCIAL GROUP (AS OF MAY 2005)				
Mizuho Holding	Mizuho Trust	UC card	Mizuho Research Institute	Other subsidiaries
Mizuho Corporate Bank	Mizuho Bank			
Mizuho Securities	Mizuho Investor Securities			

Source: [www.mizuho-fg.co.jp/company/taisei.html](http://www.mizuho-fg.co.jp/company/taisei.html).

#### 5.5.1.2 Strategy and New Structure of the Strategic Business Groups

On April 26, 2005 the group announced a strategy plan, the "Channel to Discovery Plan,"<sup>76</sup> and the group disclosed a new organization structure (see **Table 5-2**). In this new structure, the financial holding company directly controls the subsidiary banks and the group is divided into three strategic business units, a Global Corporate Group, Global Retail Group and Asset

<sup>76</sup> The title of this strategic plan was stated in English and most of the contents follow foreign financial conglomerates strategy.

Management and Wealth Management. This structure is exactly same as at many large US and European financial conglomerates.

Basically ***this new structure amounted to nothing more than giving new group names to the previous subsidiary banks and it is impossible to identify any effect the change had to enhance the synergy and operational efficiencies within the group and between the groups.*** For example, there may have been many customers from the middle market companies at Mizuho Bank that could have been identified as potential customers for wealth management services but there were no arrangements to link the silos and to pursue such customer synergy.

At the holding company they announced concentrated investor relations and brand strategies plans and stated that the two deputy presidents will be in charge of Mizuho Bank and Mizuho Corporate Bank respectively, and the auditors of the holding bank will be subsequently become auditors of each subsidiary bank. There was emphasis on a more centralized strategic direction and coordinated risk control and compliances among subsidiary banks and the holding company.

From this we can easily imagine how difficult it was to efficiently unite such three banks when there was an equal merger in Japan compared to the quick restructuring of U.S. banks by terminating redundant officers and staff and by streamlining the management under strong leadership. C-level executives at Japanese banks should prioritize the consideration of all the related parties with their history previous human relation etc.

### **Current Organization**

The current organization is as shown below. The three strategic business groups as described by the company are also introduced **Table 5-2** below.

Strategic Group	Subsidiary	Grand Subsidiary
Global Corporate Group	● Mizuho Corporate Bank Ltd.	● Mizuho Securities Co., Ltd.
Global Retail Group	● Mizuho Bank Ltd.	● Mizuho Investors Security Co., Ltd. ● UC Card Co., Ltd ● Mizuho Capital Co., Ltd
Global Asset and Wealth Management Group	● Mizuho Trust Bank Ltd. ● Mizuho Private Wealth	

	Management Co., Ltd.	
Group Strategy Affiliates	<ul style="list-style-type: none"> <li>● Mizuho Financial Strategy Co., Ltd.</li> <li>● Mizuho Research Institute Ltd.</li> <li>● Mizuho Information and Research Institute Inc.</li> </ul>	

Source:<http://www.mizuho-fg.co.jp/english/company/group.html> .

### **Three Strategic Business Groups**

- ❖ The **Global Corporate Group** provides highly specialized and cutting-edge products and services by leveraging our comprehensive financial capability, with close cooperation between the global corporate banking sector and the wholesale securities sector in response to the needs of large, global corporations.
- ❖ The **Global Retail Group** provides top-level products and services on a global scale, with close cooperation with leading domestic and international companies in response to the diversified and globalized needs of individuals as well as small and medium-sized enterprises and middle-market corporations in Japan.
- ❖ The **Global Asset & Wealth Management Group** provides top-level products and services on a global scale in response to the diversified and advanced customers' needs in the business areas of trust and custody, and private banking.

### **Four Major Subsidiaries**

- ❖ **Mizuho Bank** serves primarily individuals, SMEs and middle market corporations, and local governments in Japan.
- ❖ **Mizuho Corporate Bank** focuses its efforts on corporate finance, primarily serving large corporations (such as those listed on the first sections of domestic stock exchanges), financial institutions and their group companies, public sector entities, and overseas corporations including subsidiaries of Japanese companies.

- ❖ *Mizuho Securities* is a wholesale securities company whose customers are institutional investors, corporations, financial institutions and public corporations.
- ❖ *Mizuho Trust and Banking* is a trust bank that possesses strengths in both the corporate and individual markets.

#### 5.5.1.3 Organizational Problems

There are several problems in this organization structure. First of all, the senior posts are equally divided among the former three firms because it was an equal merger and Mizuho Corporate Bank is heavily influenced by former Industrial Bank of Japan not only as to the management but location, culture and business traditions; the same can be said of Mizuho Bank, being influenced by former Daiichi-Kangyo Bank. There is a big risk that the whole organization will not be united because of this structure of emphasizing the equality of former firms. Especially the subsidiary banks, Mizuho Corporate Bank and Mizuho Bank, were to be run independently and this is likely to cause difficulty for the holding company to control the group. In addition to the daily control of risks, compliance and internal control were to be made at each subsidiary bank respectively and it is difficult for a holding company to influence and secure the control on these matters.

The location of the financial holding company and two subsidiary banks were different and each of them has multiple of three executive members distributed by three former banks originally emphasized the balance of three merged banks.

As of April 1<sup>st</sup>, 2005 there were eight board members at the holding company; two of them were outside board members. Among the six internal board members, the president is from the former Fuji Bank, deputy president and CIO is from the former Daiichi-Kangyo Bank, of the two managing directors one in charge of strategy and compliance is from the former Industrial Bank of Japan and another, the CFO, is from Fuji Bank, while the remaining two directors are the president of Mizuho Bank (Daiichi-Kangyo) and Mizuho Corporate Bank (Industrial Bank of Japan). This structure shows that the balance among three banks is very important for the management membership of holding company.

Because only the holding company has to be responsible to the shareholders and subsidiary banks are 100% owned by the holding company, the high degree of independence at subsidiary banks



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makes it difficult for shareholders to grasp the total picture of bank performance. Immediately after the merger, because of the necessity for increasing bank capital, Mizuho as a group concentrated on raising funds through their customers and this benefited the group by strengthening the unity as a group, but as time passed there emerged a big risk of a collapse of the balance between centralization and decentralization and the power of subsidiary banks increased.<sup>77</sup>

The investment banking subsidiary Mizuho Securities belongs to the Mizuho Corporate Bank as a wholly owned subsidiary. As mentioned above, in Japanese organizations a subsidiary is assumed to be subordinate to the parent company and parent company sends executives to the subsidiary. Under this structure of group hierarchy, an investment banking business which requires talented human resources will have difficulty in attracting such talented people and will have difficulty to enhance its creative corporate culture.

## **5.5.2 SUMITOMO MITSUI FINANCIAL GROUP (SMFG)**

### **5.5.2.1 History**

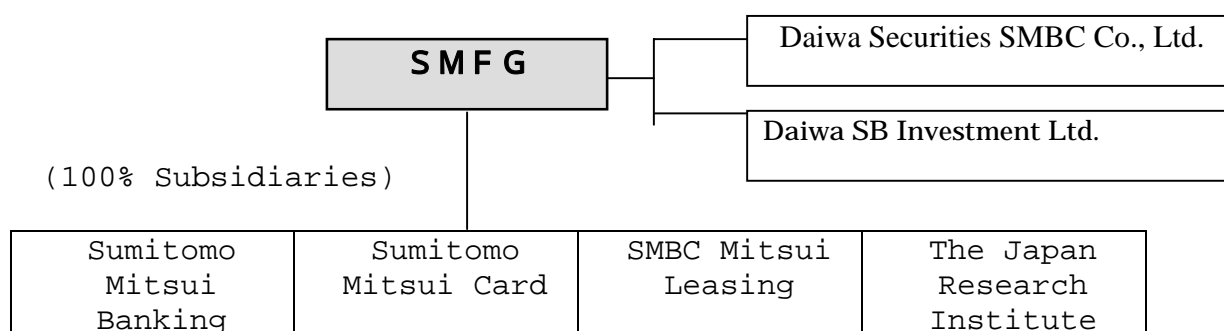
Sumitomo Mitsui Banking Corporation (SMBC) started in April 2001 by the merger of the former Sakura Bank and Sumitomo Bank. In December 2002 Sumitomo Mitsui Financial Group, Inc. (SMFG) was established through a share transfer from Sumitomo Mitsui Banking Corporation. SMBC group was transformed into a holding company structure believed to be suitable as a management infrastructure that would bind several companies with different businesses. Then the group tried to strengthen functions such as the governance of the group companies, the development and execution of the group's strategy. In February 2003 Sumitomo Mitsui Card Company, Limited, SMBC Leasing Company, Limited, and The Japan Research Institute became wholly-owned subsidiaries of SMFG.

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<sup>77</sup> *Weekly Toyo Keizai*, October, 2004 "Great competition of financial Groups"

### 5.5.2.2 Formation of the Holding Company Structure

Figure 5-2. SMFG Organizational Chart (October 2006)



Source: [http://www.mfmg.co.jp/finance/disclosure/pdf/g\\_003.pdf](http://www.mfmg.co.jp/finance/disclosure/pdf/g_003.pdf).

The holding company Sumitomo Mitsui Financial Group was established for the purpose of strengthening the capital base of Sumitomo Mitsui Bank. Most of the assets of Sumitomo Mitsui Financial group are from Sumitomo Mitsui Bank.

The organization structure of Sumitomo Mitsui group is rather simple (Figure 5-2). The holding company and bank operating company are managed together at same location with duplicated managements.

### 5.5.2.3 Organization Challenge

The challenge for this group is how to coordinate with Daiwa Securities and Daiwa SMBC in which the group has minority interests.<sup>78</sup> Another challenge is how to enter the trust business as the group does not have a subsidiary capable of this and there are separate former keiretsu group trust companies, Sumitomo Trust and Mitsui Chuo Trust.

In Japanese banking history, Sumitomo Bank used to have the most aggressive culture and had long been most profitable bank in

<sup>78</sup> 40% owned by Sumitomo Mitsui and 60% owned by Daiwa Security group. Many bankers from Sumitomo are dispatched to this investment bank.

Japan. It seems that after the merger it tried hard to establish efficient operation through cutting costs and restructuring. Now the bank is behind the other two both in size and scope of business. It is an organizational challenge for Sumitomo, with its aggressive culture, to reorient its priorities towards profit and meritocracy given its new organization.

### 5.5.3 MITSUBISHI UFJ FINANCIAL GROUP

Mitsubishi UFJ Financial Group (MUFG) is a fully-fledged comprehensive financial group comprising top-class credit card, consumer finance, investment trust and leasing companies, and a U.S. bank (UBOC), as well as a commercial bank, trust bank and a securities company. The recent chronology of group developments is shown below (see **Table 5-3**).

MUFG has the aspiration of becoming one of the world's top five financial institutions in market capitalization by the fiscal year ending March 2009 and is pursuing the appropriate business strategy to achieve this goal.

TABLE 5-3. TIMELINE OF MITSUBISHI UFJ FINANCIAL GROUP	
July 2004	Announced commencement of discussions on the integration of Mitsubishi Tokyo Financial Group ('MTFG') and UFJ Group.
April 2005	Integration agreement signed. Announced new company name, merger ratio, management philosophy, corporate identity, etc.
October 2005	Creation of Mitsubishi UFJ Financial Group ('MUFG'). Listing of MUFG on the Tokyo, Osaka, Nagoya, New York and London stock exchanges. Creation of Mitsubishi UFJ Trust and Banking, Mitsubishi UFJ Securities (and merger of group companies such as Mitsubishi UFJ Asset Management). UFJ Nicos created and became a consolidated subsidiary.  Merger agreement signed.
January 2006	Creation of Bank of Tokyo-Mitsubishi UFJ.
Source: Condensed from the company website.	

#### 5.5.3.1 Core Business

MUFG has defined Retail, Corporate and Trust Assets as its three core businesses and has established integrated business groups in the holding company for each core business. In this way MUFG aims to transcend the boundaries between business types and fully meet customer needs in a timely manner. The retail banking business aims to achieve the highest level of customer satisfaction by providing world-class products and services in diverse areas such as sales of investment products, mortgages,

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consumer finance, trusts and real estate while enhancing product development through global strategic alliances.

The corporate banking business aims to provide top-quality services and innovative products through a broad-ranging and global operational network comprising banking, trust banking and securities business and aims to secure a clear lead as the No.1 financial services provider to Japanese companies in Japan and overseas.

The trust assets business will seek to enhance its product lineup in both asset management and asset administration, and provide full-line services to meet all types of customer needs based on an efficient system that leverages economies of scale.

#### **5.5.3.2 Integration Synergies**

In sales of investment products such as annuities and investment trusts, the group aims to steadily achieve results by providing leading-edge products and services that appropriately meet customer needs. The group also aims to achieve steady progress in investment banking and the settlement business by combining the accumulated expertise of each group.

In the growth area of consumer finance, UFJ Nicos, which was created from the merger of UFJ Card and Nippon Shinpan in October 2005, will merge with DC Card in April 2007. Through that merger and other means, we intend to steadily strengthen our capabilities as a comprehensive financial group.

As a result of measures to enhance systems integration, lower cost synergies from the reduction of personnel and systems expenses are expected in fiscal 2008.

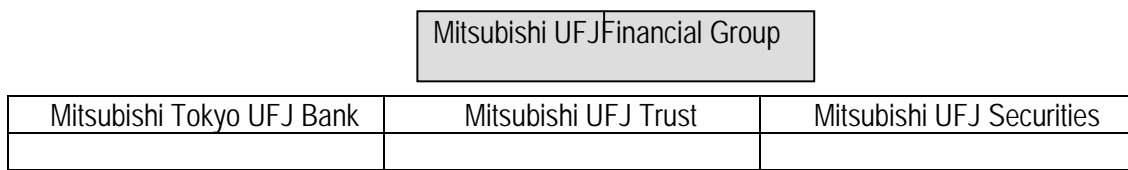
The legal structure of Mitsubishi UFJ Financial adopts the form of three subsidiary firms under the holding company, one each in commercial banking, trust banking and securities business. This organization is very simple compare to the Mizuho group and suggests that Mitsubishi Bank as the lead bank in arranging these mergers has stronger capability to manage a complex organization (**Chart 5-1**).

As for the corporate governance the new organization has adopted the "committee structure" as is becoming more common in Japan, with three independent committees, auditing, top assignment and compensation committee, each led by an outside board member.

There are three business divisions in the group, Consolidated Retail, Consolidated Wholesale, and Asset Management. These business divisions vertically cross the three legal organizations as described in **Figure 5-3**.

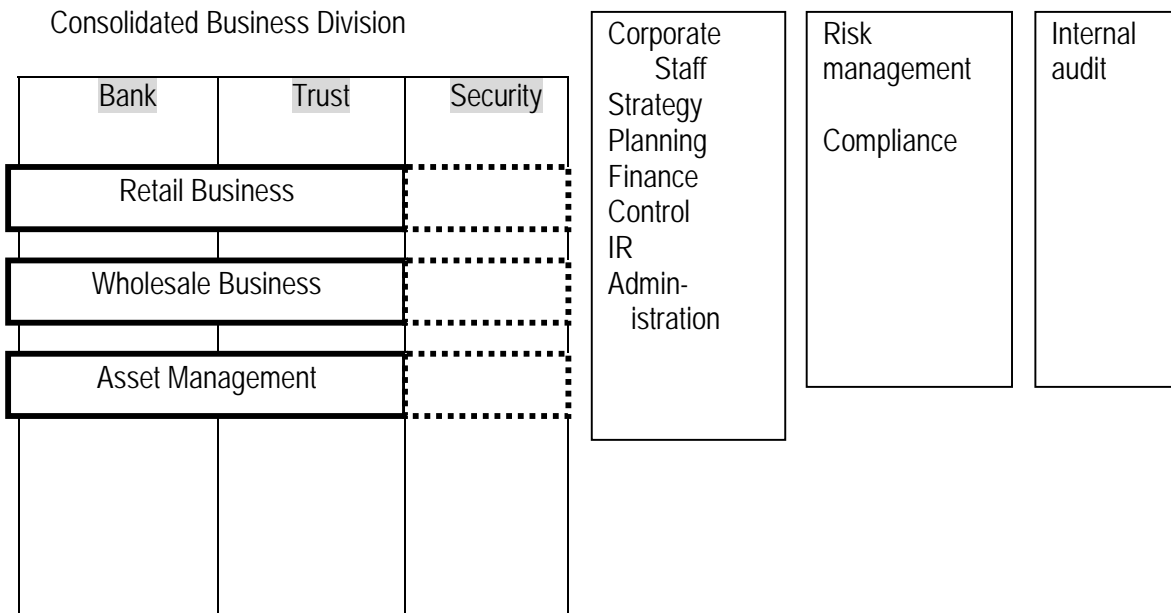
Because the holding company is listed on the New York Stock Exchange the group is oriented toward American style corporate governance and a matrix organization crossing legal entity and business divisions.

**Figure 5-3. Mitsubishi UFJ Financial Holdings Organizational Structure**



Source : [http://www.mtfq.co.jp/finance/disclosure/pdf/g\\_003.pdf](http://www.mtfq.co.jp/finance/disclosure/pdf/g_003.pdf).

**Chart 5-1. Business Division and Matrix Structure**



Source : [http://www.mtfq.co.jp/finance/disclosure/pdf/g\\_003.pdf](http://www.mtfq.co.jp/finance/disclosure/pdf/g_003.pdf).

In this group Mitsubishi Bank has been powerful in managing a traditionally conservative and control-oriented culture with

a strong group customer base. Because Sanwa Bank, the major part of UFJ group, was characterized by a very aggressive and innovative culture with middle market strength<sup>79</sup> it will be a challenge to combine the two and create a new corporate culture.

### 5.5.3.3 Structure of Management

It is instructive to observe the structure of management of Mitsubishi-UFJ because this can enable us to understand how they try to balance the composition of board members of new group by making a selection from the old organizations (see **Table 5-4**).

Among 12 internal board members, former UFJ group members are 4. Former UFJ are the products of merger between Sanwa Bank, Tokai Bank and Toyo Trust Bank. Accordingly all of those former firms represent at least one of board members.

TABLE 5-4. STRUCTURE OF MANAGEMENT OF MITSUBISHI-UFJ  
(AS OF OCTOBER 2006)

Title	Former employer	Year hired by former employer
Chairman	Sanwa Bank (UFJ)	1970
Deputy Chairman	Mitsubishi Trust	1969
President & CEO	Mitsubishi Bank	1965
Deputy President	Mitsubishi Bank	1970
Senior Managing Director	Mitsubishi Trust	1969
Senior Managing Director	Bank of Tokyo	1970
Senior Managing Director	Sanwa Bank (UFJ)	1973
Director	Toyo Trust (UFJ)	1970
Director	Tokai Bank (UFJ)	1972
Director	Mitsubishi Bank	1972
Director	Mitsubishi Trust	1974
Director	Mitsubishi Bank	1974
Outside Directors	Toyota, IBM, Prosecutor	

Source: Prepared by author using data from the bank's website.

The former Mitsubishi Tokyo was the product of a merger between Mitsubishi Bank, the Bank of Tokyo and Mitsubishi Trust. The board was made up of four from Mitsubishi, one from the Bank of Tokyo and three from Mitsubishi Trust. Seniority is very important so the composition of the board was carefully arranged by taking into account seniority. There exists some discrepancy

<sup>79</sup> See Kuhara [2005] for cultural differences of Japanese banks.

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but actual power resides in the president and CEO not the chairman. Board membership at Mitsubishi-UFJ was allocated on the basis of seniority and the importance of maintaining a balance of the former banks to which they belonged; managerial capability of the person and the idea of fitting the right person to the right post was a secondary consideration.

The way that they have tried to realize early synergy effects was to integrate branches and decrease redundant personnel.

#### **5.5.3.4 Organizational Challenges**

As the largest financial conglomerate in Japan with the combination of Mitsubishi's and Sanwa's complementary culture and customer base (Bank of Tokyo had originated as a bank dedicated to foreign exchange transactions, and had a limited branch network and retail base.), MUFG has the potential to become a global player.

However, MUFG also has many organizational challenges. First there are very many banks that have been combined to make the group. Former Mitsubishi, Sanwa, Tokai, Bank of Tokyo and Mitsubishi Trust were among the 20 largest banks in Japan. It is great challenge for the new management to merge those different cultures of those formerly sizable institutions. As the management structure of the new group shows, considerable consideration was given to balancing the former bank's senior management in creating the new bank's management structure. Not only at the management level but also the operations level there are various cultural conflicts especially between the very conservative keiretsu group customer-based Mitsubishi and very aggressive Osaka middle-market based Sanwa.

Second, the strategic subsidiary Mitsubishi UFJ Securities is assumed to be a subsidiary of a subsidiary bank and the securities firm itself was the product of combining various security subsidiaries of the previous banks. It is very difficult to become first class security broker as well as an investment bank if it is just a subsidiary of commercial bank.

Third, it might take more time to restructure the whole organization to become a more competitive organization because of the difficulty of realigning human resources in Japanese organizations.

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## 5.6 SIGNIFICANT DIFFERENCES BETWEEN JAPANESE and WESTERN FINANCIAL CONGLOMERATES

Management style and incentive structure – these two factors account for the major differences between Japanese financial conglomerates and their US and European counterparts. Western (US and European) financial conglomerates are led by relatively profit-oriented executives who are motivated to turn in a good performance. On the other hand, Japanese executives of financial conglomerates are more influenced by the other stakeholders including regulators, customers especially large corporations, and employees.

Among Japanese financial conglomerates, the top person of the holding company does not have absolute leadership capability regarding the subsidiary banks, as is clearly evident in the Mizuho case. If the top management is identical between holding company and subsidiary bank as in the Mitsubishi UFJ case, strategic and operating decisions are susceptible to confusion, and it is in this aspect that Japanese financial conglomerates are at a relative managerial disadvantage compared to their Western counterparts.

A further problem exists in the incentive structure of the professional bankers in the organization. In Western banks it is easy to adjust the incentive structure to both the outside, liquid, labor market and to internal strategic directions. As a result it is not so difficult for the manager to move to a new business and new market immediately following the environmental change. At Japanese banks, it is most difficult to adjust the incentive structure because the incentive structure is seniority-based with a small adjustment for performance but also the underlying assumption of lifetime employment. Of course, some changes are taking place in the investment banking field but most of the investment banking businesses are structured as a bank subsidiary, where clear hierarchical relationship between the parent bank and its subsidiary exists.

Because the banking business is highly reliant on human capital which has a professional capability, banks should move toward a more incentive-designed model. The nature of the business is very different from that of Japanese manufacturers which have a great competitive advantage relative to foreign competitors because of their company-specific knowledge and resources accumulated by incentive design to stimulate such.



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## **5.7 THE IMPLICATIONS OF JAPANESE AND WESTERN CONGLOMERATION EXPERIENCE TO ASIAN FINANCIAL MARKETS**

### **5.7.1. IMPLICATIONS FROM US AND EUROPEAN FINANCIAL CONGLOMERATES**

Previous discussions indicated that conglomerates with good performance have various managerial advantages—good leadership, well-designed incentives, cultural and historical experiences in managing multinational operations, a liquid pool of talented workers and well-fitted strategy and structure. However, a number of difficulties are encountered and remain part of the challenges facing these financial behemoths. In particular, US financial conglomerates experience difficulties related, largely, to management—the difficulty of managing the complexity of a huge organization, the difficulty of realizing and managing synergy, conflict of interest issues and the importance of tapping and maintaining human resources of top-caliber capabilities. All of these difficulties and challenges also apply to Japanese financial conglomerates.

Of particular concern to Asia and Japan is the conflict of interest issue in the consumer area. For example, if many banks are suddenly allowed to go into the securities brokerage business, and they sell both deposit services and risky investment products in the same branch office, even if there are firewalls and various safeguards and disclosure requirements, retail customers who are not well-informed in these matters and who are accustomed to the guaranteed bank deposit may buy investment product without having full knowledge of the risk difference and are likely to incur losses. In the area of the difficulty of managing investment banking, the lack of a well established evaluation system for financial professionals and the illiquid professional market may render the compensation system inadequately structured in coping with the newly created investment banking business in Asian financial conglomerates.

### **5.7.2 IMPLICATIONS FROM THE JAPANESE EXPERIENCE**

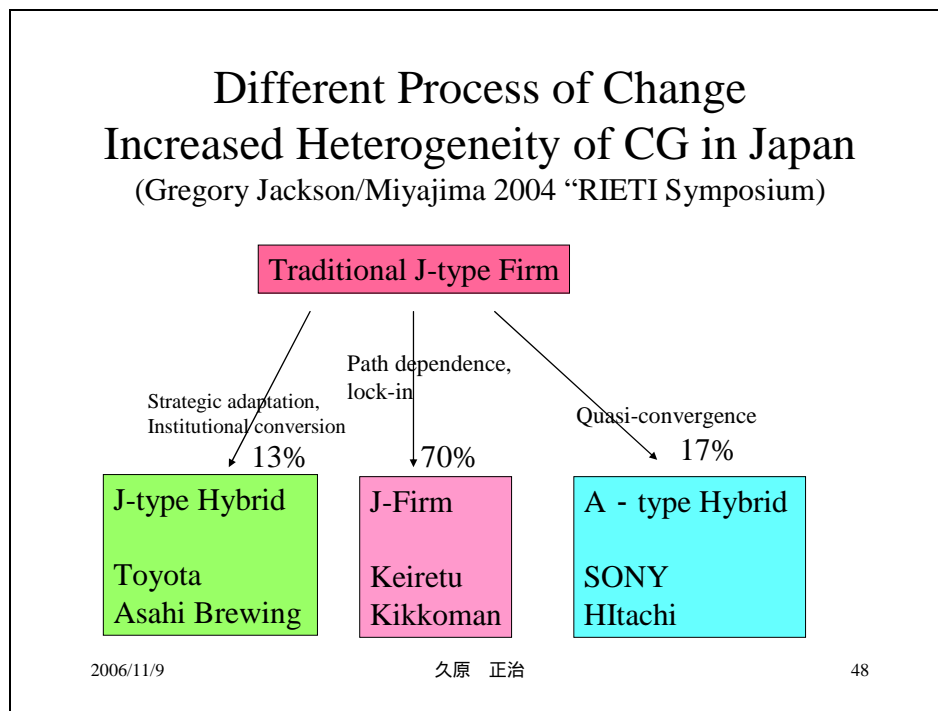
#### **5.7.2.1 Institutions and Institutional Change**

Japan is still experiencing major structural change of its economic institutions after the decade of post-bubble economic stagnation. The direction of change shows some signs of resembling an Americanized, transparency-seeking business and market environment, despite the long-standing traditions of relationship-based economic transactions and structures. However, if closely observed, the change in Japan is based on

a hybridization of the traditional Japanese and the American type model, mutually reinforcing the strength of each system and increasing the option of Japanese companies.

The Japanese financial system had been developed with the *sub rosa* objective of decreasing the various uncertainties of the corporations and depositors and directing the scarce resource of deposit funds to economic growth areas. This development is related to the path dependency of institutions. The main bank system and lifetime employment became major pillars of development because it was important to build up major industrial companies through the efforts of loyal workers who could contribute on the basis of long-term commitments to build up company-specific competitive advantages so as to grow the company (and main bank) through long-term relations. This helped to attain such growth without worry on the part of shareholders or other stakeholders. Every aspect of Japanese economic institutions is mutually complementary and point towards attainment of the high economic growth.

Figure 5-4. Different Process of Change – Increased Heterogeneity of Corporate Governance in Japan



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Japan seems to be changing its economic and other institutions so as to come closer to American style institutions. However, in reality, Japanese institutional reform, as it is now taking place, has the underlying objective of widening the options of the actors in the system by preserving some part of traditional system, and interchanging American and Japanese system components so as to make a new type of institution [Vogel 2006]<sup>80</sup>. This process of reform is progressing rather a little too slowly for changes to be noticeable.

In the area of corporate governance, Jackson and Miyajima [2006] observed that in Japan, it has become more heterogeneous as described in Figure 5-4. This manner of expanding options to Japanese companies might help adopt and adapt to the global developments in financial conglomerates' competition.

#### **5.7.2.2 Benefits and Disadvantages of Scale and Scope**

There are both advantages and disadvantages in becoming a larger and diversified institution. In Japan, mega-banks have less benefit from the advantage of economy of scale as do their Western counterparts because of the difficulty of integrating multiple firms. On the other hand the biggest disadvantage of scale, the millstone of bureaucracy, will become a major problem of Japanese financial conglomerates. As we described, the typical employee of a Japanese bank is an elite generalist who has more capability to control than to innovate and create. If the organization became bigger and more complicated, the bureaucracy may become prevalent culture of large organization.

#### **5.7.2.3 Promoting Trust Among People and Good Organizational Culture**

The Japanese experience has shown that any effort at imitating Western financial conglomerates is destined to give disappointing results but it is very important to know which banks are successful, which banks are unsuccessful and why so.

Banking is the foundation of economic growth of the country and if a mistake is made in structuring that industry, there will be no economic growth. Clear strategies and structures suitable to support the development of financial conglomerates must accompany general economic development objectives. Other Asian countries have an advantage in that they can learn not only

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<sup>80</sup> Vogel 2006:213-216.

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from Western experiences but also from Japan's struggle to establish a globally competitive financial sector.

## **6. CONCLUSION**

The structure of a holding company will not bring any managerial advances by itself. In banking in the U.S., because of regulations, the holding company structure has been developed as a way to bypass regulations. The large financial conglomerates have adopted the financial service holding company structure; however their group businesses are being operated on the basis of three to six separated business units.

In Japan, the financial holding company system was introduced and utilized to facilitate the merger of large banks. There are pros and cons to the holding company structure. It might be worthwhile now to summarize the findings obtained through this research which can be used as a working hypothesis for further looking into the management efficiency of large diversified financial institutions.

### **6.1 INTERIM FINDINGS AS OPERATIONAL HYPOTHESIS FOR FURTHER RESEARCH**

By looking into the organizational structure and strategies of U.S., Europe and Japanese financial conglomerates we have obtained the following findings.

In the U.S. and Europe, many of the financial conglomerates adopted a holding company legal structure. Separately all of them have multi-division type business group structures for the conduct of daily business, segmented by customer and/or markets. It seems that the latter business group organization is more important than the legal structure because the decentralized allocation of resources and performance measurements are made according to the business group. The legal structure had been adopted because of regulatory, tax and many other reasons other than the operational management reason.

All of these financial conglomerates are going into new businesses and new market by means of M&As instead of organic growth. This is because they can buy the time and they have the assurance of business track records.

- ❖ The success of these M&A activities depends on how they can integrate the business after merger. It is very obvious that management skill in integrating and operating these diversified large firms is the important factor for success.
- ❖ In many cases when commercial banks are acquiring investment banks, many managerial problems have occurred because of the differences of culture, compensation systems and the volatility of returns on the large risk taking at the investment bank business. Only a handful of firms which have highly talented managerial resources to successfully run these investment banking subsidiaries have succeeded at integration.
- ❖ Another important point related to integration after M&A is that there is more success and better performance when the stronger group with the stronger culture dominates the management of the integrated firm and those weaker left the firm.

It seems that most of the high-performance firms have talented top leaders to manage and lead these very large and diversified firms. The role of leadership is to provide clear and focused strategy, strong will to restructure after the M&A, and strong commitment to risk control.

There seems to be some kind of path dependency when a country has succeeded in managing globally active financial conglomerates. It is shown by the facts of the relative success attained by Swiss, Dutch and British banks. In the case of British banks, traditional clearing banks were not successful whereas HSBC and RBS, which are not traditional British clearing banks succeeded. Most of the former large British clearing banks failed because of the cultural differences between traditional banking and investment banking, a field that they entered later on. Continental banks from Germany, France and Italy have not been successful in global banking..

Japanese banks need to overcome major challenges to become successful financial conglomerates. As described in the previous chapters, large Japanese banks have adhered to the traditional cultural value of "yoko-narabi" (keeping up with the Joneses) strategies, have emphasized the generalist rather than the specialist, have preferred seniority based wage rather than meritocracy, and long-term employment commitments matched by loyalty to the organization. All of these factors hinder the success of globally operated financial conglomerates.

- ❖ All of the Japanese mega-banks adopted a holding company legal structure for the group management. They also adopted a business group structure similar to that already in use at U.S. and European financial conglomerates. However, they gave special attention to the legal structure and the business group structure because in Japanese organizations the loyalty to the legal organization they belong is very strong.
- ❖ Further, in Japanese companies there is a tendency to value the parent company and regard subsidiaries as second-rate places to work. This attitude is based not on which company is strategically important but on which company has a long tradition and history and which owns which. In most cases, newly developed businesses like investment banking, venture capital and leasing belong to subsidiaries of banks and the employees there are assumed to be second class compared to parent bank employees.
- ❖ These kinds of cultural and historical customs are very difficult to change and most of the profitable investment banking businesses in the Tokyo market are those of foreign-owned investment banks not by the subsidiary investment banks of these financial conglomerates.
- ❖ Even if a foreign investment bank is active in the Tokyo market, it is typically only active in a niche business where there are very high profit margins and no Japanese financial institutions will take those risks. It is very difficult for the Tokyo market to become a Wimbledon style market such as found in London. Language, culture, regulations, professional infrastructure and other features of Tokyo are diametrically opposed to those of London; Japan cannot undertake the same kind of strategy.

At least Japanese banks should recognize that the legal structure of a holding company itself has no structural advantage for the management of large and diversified financial institutions. In order to run an efficient, large and diversified financial organization it is very important to look at the managerial side of organization not the structure of the organization. Such managerial factors are leadership, methods of monitoring the performance of businesses, method of allocation of resources, good risk control system and good incentive system to encourage performance and synergy of business as a group.

The basics of group management should be reliance on the balance between centralization and decentralization. The top leader

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should have good leadership capability enabling the organization of centralized activity by delegating daily business decisions to well organized business divisions. The management needs various organizational means to make good organizational performance materialize. Japanese financial conglomerates need the following managerial devices to at least prepare for the better management of their organization.

- ❖ Working out the integration of group organization and culture crossing the boundaries of structure of organization;
- ❖ Establishment of divisional financial control and distribution of resources, including training of professional managers;
- ❖ Establishment of group risk control and internal control systems;
- ❖ The balance between centralization and decentralization depending on the nature of the group business;
- ❖ Establishment of firewalls to prevent conflict on interest problems between the business divisions; and
- ❖ Removal of sectionalism among the business divisions.

## **6.2 FUTURE RESEARCH SUBJECTS**

The foregoing study has resulted in several findings about the strategy and structure of financial conglomerates, through a critical survey of previous research in the U.S. and Europe, as well as case studies of several global financial conglomerates.

Japanese banks have a very different history and organizational culture compared to others in Western countries. These peculiarities have influenced, in no small measure, the bad performance of Japanese bank management during the bubble period from the late 1980's and after bubble burst in the early 1990's.

Now most of those problems have been overcome and the newly created mega-banks can go ahead and develop new strategies in the global market. The organizational and managerial options for Japanese mega-banks have been widened by the deregulation, competition and the changing organizational culture environments. Japanese banks can learn from successful Western banks for the augmentation of their own strategy and structure for the future development. However, it is more important that

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they look at their historical culture, traditional strength and the way of running organizations.

The future of the management of Japanese mega-bank organizations relies more on how successfully they could integrate influences from abroad with the internal resources they have for competition. Imitating the strategy and structure of Western banks alone is not a solution.

We need more research on why some banks in the U.S. and Europe are so successful and other banks are not. We need to know the background reasons of these so that we can understand which part of them we can introduce to Japanese financial conglomerates and which we should not.



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**PART 6. CONCLUSION AND RECOMMENDATIONS**

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The following five parts surveyed standard theory and empirical studies, and reviewed the various features of financial conglomeration in the United States, Europe and Japan, comparing their features. In conclusion with this report, we illustrate the development of conglomeration with a focus on the provision of a wider range of risks and customers protection, in order to develop the policy recommendations for the East Asia.

**Three Actors in the Financial Market**

In considering the issues of financial conglomeration, it is useful to assume a theoretical framework that the financial markets consist of three actors: namely, (i) suppliers or financial institutions, (ii) users or consumers, and (iii) markets that interlink the suppliers and uses. The first actors, the financial institutions, consist of commercial banks, investment banks, insurance companies, and security companies. The conglomeration means that the suppliers are merged to cover a wider range of financial services. The second actors are the users or consumers, who enter into the markets. Some of them are equipped with good knowledge on the nature of the financial services and risks involved with the services. But the other may have less experienced with insufficient knowledge on the risks. The third actors are markets. In the past, the markets are segmented. The conglomeration implies that the markets are also integrated.

In Japan, financial conglomerates took a form of financial holding companies. The companies hold commercial banks, mutual funds, security companies and insurance companies. To the customers / consumers, the commercial banks offer a deposit with lower risks but lower returns to the customers. They extend lending with secured loans. The mutual funds provide medium risks and medium returns, and the security, high risks and high returns. The insurance provide their service to the longer-term customers. As such, a conglomerate supplies various services with variety of risks and returns.

**Merits and Benefits of Conglomeration: Financing SMEs**

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Reviewing the survey in the text of this report, rather differently, financial conglomeration has the following merits. First, the conglomeration will facilitate the exchange of information within a same organization / company. As the financial industry is in principle an information processing sector, this provides a great merit to the financial institutions. Second, the conglomeration stimulates innovation of various financial products, including securitization and credit guarantee schemes. Third, the financial conglomeration will bring about economies of scale and scope to the financial sectors.

In the East Asia, in particular, financing the Small- and Medium-sized Enterprises (SMEs) has a special importance. Because of the financial conglomeration, one financial company can supply various financial services to SMEs with appropriate risks and returns. For instance, the SMEs with stable returns may borrow loans from the banks. As the starting-up process of SMEs involves higher risks, mutual funds and trust funds may supply appropriate financial services. Insurance services may provide a longer-term lending. This diversified provision of financial services to the SMEs is made possible, because information on the specific SMEs is pooled and shared in a company.

Part 5 of this report reviewed several concrete examples of the experience in Japan. Historically, Japanese financial conglomeration started with family-owned conglomerates. The SMEs financing was supported through credit cooperatives in regional communities. At the same time, the state-owned banks functioned as a safety net.

#### **Gradual Process of Financial Liberalization in Japan**

The government of Japan followed a prudent and gradual process of financial liberalization. This characterized the Japanese financial system. In 1965, the government issued government bonds, first since the end of World War II. Foreign exchange markets are liberalized in 1980 under the Foreign Exchange Act. In 1985, the forward exchange transaction of corporate bond was permitted and in 1990, so was the future option of corporate bond. In 1996, the issue of corporate bonds was partly liberalized. The Tokyo Big Bang Program under the Hashimoto Administration led to allowing free capital mobility in 1998. In 2000, SPC Law was enacted. Finally, in 2006, the Financial Product and Financial Transaction Law was enforced to establish

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a reformed financial framework, as well as the protection of customers.

The gradual process of liberalization may have contributed to the stability of financial markets. However, the slow reform process is recently criticized, and the government tends to expedite the liberalization. The enactment of the Financial Product and Financial Transaction (FPFT) Law evidences it.

### **Three Main Perspectives of FPFT Law**

The new FPFT law is featured with three main perspectives. First, customers / consumer protection is intensified. The financial institution is obliged to provide detailed and accurate explanation on the financial services to the consumers. Second, the transformation from the bank intermediary financial system to capital market finance is supported with deregulation and liberalization. Third, regulation and supervision is upgraded in accordance with the international standards.

Especially, the consumer protection includes the provision of various financial products, the obligation to the suppliers to explain each financial product in detail, and claim and consultation procedures of the consumers. The financial liberalization enabled the financial institutions to supply the complex services to the consumers / customers, and their protection becomes a critical issue.

### **Financial Conglomeration in the East Asia as a Region**

The financial systems in the East Asia are characterized with great diversification. However, financial conglomeration appears to be the common trend. The conglomeration involves the needs for the development of capital markets, as well as stimulates them. Therefore, the capital market development together with addressing conglomeration is a common challenge for the region.

Such challenges include ensuring the fair competition among the conglomerates, maintain the stability of financial markets, as well as enforce supervision and monitoring effectively. For the competition aspect, the conglomeration results in oligopoly markets, ensuring the contestable markets is important.

### **Emerging Recommendations**

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The financial conglomeration becomes the common feature throughout the world. This is a common challenge in the region to ensure the competition and financial stability, facing the phenomenon. The survey and review indicate the following policy recommendations.

1. Ensure the Competition among the Conglomerates: Ensuring the contestability in the financial markets is important.
2. Strengthen Consumers / Customers Protection: The FPFT Law provides a good reference. The conglomeration implies that one company supplies a wide range of financial services. The obligation of explaining should be intensified and claims / consultation mechanism should be established. In addition, intra-group information exchange should be properly regulated.
3. Exchange Information on the Regulation / Supervision of Financial Conglomeration in the East Asia Region: The conglomerates extend the worldwide and region-wide business. The information on the regulation / supervision should be exchanged by the authorities to ensure the financial stability as well as ensure the competition and protection of the customers. ASEAN plus three financial group mechanism will suitably function in this regard.