

# INTERVIEW

*with President Hara*



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*uestion: What were the major factors that prompted you to undertake such a huge corporate reorganization?*

The prolonged business recession and subdued domestic financial markets in Japan have severely affected the profitability of Japanese securities companies. Daiwa is no exception. It was clear that only fundamental reform could rebuild the foundations required to ensure our return to prosperity. At Daiwa we have taken the most dramatic steps in our history, totally reforming our organizational structure to take advantage of long-established strengths. We are, I believe, well on our way to achieving our mid-term goal of 10 per cent return on equity.

Our reorganization is also, of course, taking place in the context of the Japanese government's "Big Bang" reforms. Recognizing that deregula-

tion is essential for the development of Japan's financial markets, the government has taken a variety of steps. In April 1999, the securities transaction tax was abolished. In October, equity brokerage commission levels will be deregulated completely. By March 2001, barriers to entry between market sectors will have been largely eliminated.

By the early twenty-first century, the Japanese securities industry will be radically different from that of the late twentieth century. The key to achieving our mid-term goal of 10 percent return on equity will be the ability to react quickly to changing opportunities at the tactical level while maintaining a strong strategic vision. Securities companies that are slow to adapt to this paradigm shift, no matter how mighty today, will eventually be humbled.

Our strategic vision includes a renewed focus on Japanese securities markets with operations in diverse sub-sectors ranging from corporations to institutional and individual investors. I concluded that to meet the specialized needs of each sector, the optimal organizational structure would involve operating subsidiaries under a holding company that provides control and direction. This structure allows each subsidiary to adopt policies and take actions best suited to its customers' specialized needs while retaining the synergistic benefits of belonging to a large group.

*Could you be more specific about the merits of moving to a holding company structure?*

First and foremost, the adoption of a holding-company structure makes it possible for each of the individual business divisions to respond flexibly to the needs of its own particular marketplace. The market may dictate that we seek external partners with complementary skills, as evidenced by our relations with The Sumitomo Bank, Limited (Sumitomo Bank), T. Rowe Price of the US and Robert Fleming of the UK. It may

also dictate that each of the divisions adopt differing policies with regard to organizational structure, human resources management, training or systems investment. It would have been impossible to implement the sort of changes that we had in mind within the confines of a traditional Japanese securities company. That is why we decided to establish separate corporate entities for the main business lines and to maintain overall control of the group from within the holding company.

In essence, we wish to allow the main subsidiaries to take a pro-active approach to the dictates of their markets. If the markets tell us that we can maximize shareholder value through selective tie-ups with other financial companies, then we will be open to forming new relationships at the operating division level. We are open to further relationships with both domestic and overseas partners. Similarly, if the market dictates adopting a flexible approach to product innovation or distribution, then we will respond accordingly.

One additional benefit of the holding company structure is that it is easier to clarify operational responsibility and to make rational choices concerning capital allocation between operations.

Ten main subsidiaries and affiliates will come under the holding company. Our plan is to promote efficient usage of capital across the group. Each company will be regarded as equal in status and will be evaluated according to consistently applied criteria. In addition, our equity exposure to affiliated companies will be adjusted in light of the earnings potential of that company and its ability to meet the appropriate financial and operational targets.

#### *How will the competitive landscape change following the Big Bang?*

Competition is increasing from all quarters. To date the most significant competition has come

from foreign securities firms with a large and growing market presence in Japan. They now account, for example, for up to 40% of the total turnover on the Tokyo Stock Exchange. Able to draw on rich parent companies with deep pockets resulting from the prolonged bull market in US financial markets and with two decades of experience of operating in deregulated markets, these companies are clearly tough competitors.

With barriers to entry crumbling, we also face increasing competition from new domestic competitors including commercial banks and insurance companies. These new entrants may be weaker in product development than the foreign securities companies, but they do boast distribution channels the foreign securities companies lack.

#### *So you think the outlook is grim for Japanese securities companies?*

On the contrary. I believe that the current period will eventually be looked on as a turning point in the history of Daiwa and other Japanese securities companies that adopt an appropriate response to the challenges of the age.

In the first place, deregulation will create significant new opportunities, particularly in asset management, investment banking, and trading. These new opportunities will offset the impact of falling commission revenues. In addition, history shows that the abolition of securities transaction taxes and the deregulation of commissions are likely to lead to an increase in trading volumes both at the agency and proprietary levels. Short-term declines in commission revenues may be unavoidable, but in the mid to long term, growth in trading volumes should be a positive factor.

We should also note how the continuing restructuring of balance sheets in the Japanese corporate sector opens many doors for our investment bankers, for example in helping to unwind cross-shareholdings. Finally, individual Japanese



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investors are likely to become more sophisticated. That change will be driven partly by a desire to achieve higher returns to fund retirement needs, partly by the reduced security of bank deposits in a deregulated world, and partly due to the imminent maturation of a large number of postal savings accounts. Investors placed these funds at fixed interest rates considerably higher than those prevailing today and are thus likely to be more return-sensitive than usual. In general, the prolonged low interest-rate environment will continue to prompt investors to seek higher returns elsewhere. There is a high probability that the vast domestic pool of private investments will shift into new asset classes where Daiwa is already a market leader.

In the second place, far from being a passive onlooker, Daiwa is aggressively developing an optimal structure to thrive in a deregulated world. As I noted above, this was the principal reason we moved to a holding company structure.

These are the reasons for my optimism. I firmly believe that the next several years will see a major

expansion in the opportunities available to companies such as ours. The difference between winners and losers will be decided by the degree to which we and our competitors can respond quickly and effectively to new market needs. Because of our radical restructuring and long-established strengths, Daiwa leads all other Japanese companies in this respect. We face the future with confidence.

*What do you think the Japanese securities market will look like (five) years from now and how do you see Daiwa Securities Group positioned within this market?*

Five years is a long time during which literally anything could happen. As I hope I have made clear, my primary concern is to ensure that Daiwa can react proactively to whatever changes the markets throw at us. However, if I were to try to predict the future, my predictions would be as follows:

First, there will be a drastic weeding out of the “me too” players in the market. By this I mean that those companies, both domestic and foreign, that have neither the critical mass to offer full line services nor the flexibility to adapt to new circumstances are unlikely to survive. Only a handful of companies, including Daiwa, will be able to survive as full line service providers. We anticipate increasing concentration of market share in these market leaders.

Companies that lack the product development capabilities, financial strength, or distribution muscle to stay in the front rank of securities markets will need to take advantage of deregulation to offer niche services. They will have to specialize in certain product lines, geographical areas, type of client, or distribution channel, for example, the Internet. In fact, the ending of the system of fixed commissions can be looked on as an opportunity for such companies to unbundle their services. I do expect to see survivors who thrive by finding profitable niches.

Finally, as noted above, I see potential for many new entrants to try to leverage existing distribu-



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tion channels, product capabilities or client relationships into new business opportunities. Their ranks will include banks, insurance companies, overseas asset management companies and trading companies. The distribution capabilities of banks and insurance companies are one potential threat. There is also no doubt that foreign asset management companies, which are now coming to Japan in droves to address the new opportunities in such areas as defined contribution pensions and investment trusts, are another source of concern.

Since few of these new entrants have all of the expertise needed to provide full-line services in-house, it seems logical to expect the recent wave of joint ventures and tie-ups between those entities with product development expertise and those with existing distribution channels to continue. Beyond this I believe it is too early to say for sure what the shape of the landscape five years hence will be. However, Daiwa is already a market leader in most of the areas in which these newcomers are just now trying to establish a presence. We hold the "home field advantage" and are aggressively augmenting our capabilities. In my opinion, these new entrants may be able to establish viable niches in selected areas but I find it difficult to believe, at present at least, that any will emerge to challenge us on a more significant scale.

Daiwa's key areas of competitive strength include depth of distribution, internal synergies and recognized brand image. Our branch network gives both the retail and wholesale companies a truly nationwide reach. Our competitors, with the exception of the other major domestic securities companies, generally target a much more restricted group of clients in the wholesale area. We by contrast are lead underwriter to over 600 listed companies and maintain close ties with successful unlisted companies that have the potential to go public. Another point of differentiation is the synergy between the retail and wholesale businesses. About

70% of last year's NTT 4th issue, for example, was placed through our retail distribution outlets. Admittedly, the true value of this synergy has been masked over the last several years by the dearth of new issue business, depressed investor sentiment, and the relatively high level of participation of foreign investors in Japanese financial markets. However, as our financial markets stabilize in the twenty-first century, the relative importance of these synergies will become more apparent.

*Could you say a few words about the role of the Holding Company in the new group?*

Daiwa Securities Group Inc., the holding company, is the publicly traded legal entity that holds stakes in subsidiaries and affiliates and thereby exercises control over the strategic direction taken by these operations. Put simply, the role of the Holding Company is to allocate both financial capital and human resources effectively so as to ensure that the group as a whole maximizes shareholder value. While we will pay attention to a range of indicators of financial performance, our primary goals are formulated in terms of return on equity.

Under our old corporate structure it was difficult to separate tactical management of the individual operations from strategic development of the company as a whole. Under the new structure we are able to separate these functions. We have pushed responsibility for day-to-day management of the individual operations much closer to individual managers in the subsidiaries, empowering them to take tactical decisions on a day to day basis. At the same time we have freed group managers to address the strategic development of the group as a whole over the medium and long terms. Ultimately, the result will be superior service for





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our clients who can now look forward to more focussed service, more innovative products, and closer liaison with sales staff. The results will also include superior returns for our shareholders.

*... and about the retail company (Daiwa Securities Co. Ltd.)?*

As I have said, the retail securities business in Japan has changed and will continue to change significantly in the future. The graying of Japan and pressure on public and other pension funds will stimulate growing interest in securities by individual investors concerned about their retirement. Addressing their needs offers major potential for growth, one that we must address and one that we are better prepared to address than any major competitor.

The most immediate challenge securities companies face in the post Big Bang world is the necessity to hone services to fit the needs of each individual client. This marks a major shift from the regulated pre-Big Bang world, which generally operated on a "one-size-fits-all" basis.

There are three basic elements to our strategy for the retail company.

The first is a major shift in emphasis from the commission-based brokerage business to providing higher value-added financial planning services. For the majority of our customers, the strategic product in this division is the Cash Management Program. Through this, we offer a range of accounts combining securities investment with much of the convenience of a regular bank account. For high net-worth individuals, we are introducing sophisticated private banking services. This, to answer the obvious question, has involved a great deal of staff retraining. Fortunately, we started this process several years ago and are now well prepared. Branches have also been equipped with sophisticated systems allowing staff to analyze client portfolio needs and make recommendations accordingly. Organizationally, our product development operations in equities, fixed income and investment trusts have been integrated with a view to more effectively serving the needs of our clients in a more comprehensive fashion.

The second is to reorganize our operational structure and devolve responsibility for day to day operations much closer to the customer. Taking this step allows us to respond more proactively to individual client needs. On a different level, reorganizing our operations along regional lines allows us to tailor our services to each of the localities we serve, taking into account the local population profile and the special needs of local industry.

Finally, we are actively seeking to exploit new means of distribution including the introduction of small branches equipped with automated consulting machines (ACM), call centers, and Internet brokerage services. The aim here is both to offer existing customers new and more convenient ways to manage their financial assets and to allow new classes of investors access to brokerage services, thereby expanding the total market available to us.

*... and the wholesale securities company (Daiwa Securities SB Capital Markets Co. Ltd.)?*

A full-fledged investment bank is an indispensable ingredient in the structural transformation of Japan's financial system. Creation of a real investment bank able to compete on a global scale has, from the very beginning, been a basic goal of our new holding company structure. Without investment banks able to compete on an equal footing with global competitors, the structural reforms at which the Big Bang is aiming cannot be realized. As a major securities company, Daiwa has for many years played a central role in investment banking. Our tie-up with Sumitomo Bank creates a solid foundation for expanding this role. Frankly speaking, to date there have been no full-fledged investment banks in Japan. Daiwa Securities SB Capital Markets Co. Ltd. is the first of its kind and, given our scale and experience, starting from a very strong position.

When you compare our current sources of earnings with those of our closest international competitors, in the United States and elsewhere, you will find that we have far less trading and investment banking business relative to our total size. That is because the regulated nature of the Japanese market has greatly limited our ability to participate in these sectors. Deregulation will allow us to offer our corporate clients a far wider range of services than heretofore, while advanced systems expertise, a wealth of skilled manpower, and a wide client list will allow us to expand our trading revenues without incurring excessive risk. Deregulation will also create considerable opportunities for Daiwa SBCM as our clients seek to reorganize their own operations by unraveling cross shareholdings, spinning off non-core operations or engaging in M&A activities. Asset securitization is another area in which we have staked an early claim and plan to move aggressively. The key issues here are product development capabilities, where we start from a

strong position, and in-depth understanding of client needs, where long-standing relationships give us a powerful edge.

The relationship with Sumitomo Bank strengthens our market positioning. A relationship of trust has existed between the two institutions for some time. As our discussions proceeded, it quickly became apparent that combining our operations in the investment banking arena was a case of one plus one equals three. The effectiveness and value of our merged operations exceeds the value of either taken separately. Looked at from Daiwa's side, we add access to a large corporate client base to our own existing relationships. We have also acquired a number of staff with important skills in the areas of M&A, fixed income, structured finance, and derivatives together with a capital injection to strengthen the financial resources available to the new company. Sumitomo Bank benefits by being able to offer its corporate clients access to sophisticated investment banking services and the synergies available to a leading securities company.

*It now sounds as if you are pretty optimistic about the future?*

I'm very optimistic. I see high potential for growth in both the retail and wholesale securities markets. Let me repeat what I said at the start. The combination of deregulation and our own radical restructuring puts us in a strong position to take full advantage of new opportunities. We are, I believe, well on our way to achieving our mid-term goal of 10 per cent return on equity.

I concluded that  
to meet the  
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