YOSHINARI HARA

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DAIWA SECURITIES GROUP INC.

Discussion &

STRATEGY

Presumably, you would count the year to March 2000 as a successful one for the Daiwa Securities Group Inc. After all, revenues rose 84% to 654.6 billion yen, ordinary income was 224.1 billion yen, and net profit rose to 105.3 billion yen. Meanwhile, return on equity, one of your key corporate indicators, rose to 16%, exceeding your declared goal of 10% by a wide margin.

Certainly, we regard all of the things you mention as extremely positive for our company. They have allowed us to strengthen our balance sheet, raise our credit standing, and generally rebuild our business.

In short, our last financial year was a banner one for the Daiwa Securities Group, with earnings returning to levels last seen at the end of the bubble era (in fiscal 1989, ordinary income was 339.1 billion yen). I will not dwell on the numbers, which are covered elsewhere. However, as you note, the Group recorded a return on equity of 16% during the year, which is well in excess of the mid-term target of 10% we had sought. Consequently, in our second Medium-Term Management Plan announced in March 2000, we raised our target return on equity to 15% on a sustainable basis.

We strongly believe that a large measure of the success we have enjoyed can be attributed to the wide-ranging reforms we have undertaken. At the same time, it goes without saying that the very buoyant market conditions evident during the year were extremely helpful. This was particularly noticeable in the New Daiwa Securities Co. Ltd., our retail securities arm, which benefited from increased interest in equity investment by the household sector. Retail customer assets under custody rose to 14.7 trillion yen from 10.5 trillion yen in the previous year, in line with our basic policy of promoting assets under custody as a key corporate goal in this segment. By year-end we were sufficiently encouraged to be able to adjust our target for this key indicator to achieving 28.3 trillion yen in retail customer assets by FY 2002.

The wholesale securities company, Daiwa Securities SB Capital Markets Co. Ltd., also turned in a very strong performance in its first year of operation, with pretax profit of 73.0 billion yen which exceeded the three-year goal we had initially set ourselves. But perhaps even more important was the progress we made in the continuing reorientation of the business to address opportunities presented by deregulation and corporate restructuring in Japan. As a result, we finished the year better positioned to address these opportunities. Our equity trading and sales operations have forged a strong position following the last phase of deregulation, while such new businesses as derivatives and structured finance have moved quickly to stake strong claims to market leadership.

Our restructuring efforts have also embraced our cost base. In spite of the 84% increase in Group revenues, SG&A costs rose only 6%. In fact, SG&A expenses actually fell 10% after adjustment for expenses associated with the expansion in the consolidation base, the increase in market activity, and the added cost of restructuring associated with the move to a holding company structure. This is mainly attributable to the tight grip we have kept on personnel expenses as a result of our personnel policy which focuses on linking remuneration with performance. Reduction in our head count has been achieved through natural attrition, not forced layoffs. This left us in good condition once the financial markets turned around and hiring conditions became very tight. Indeed, some of our retirees have returned to work for this company on a contract basis.

However, I would also like to mention that, in addition to the headline figures, which all refer to the scale of earnings we produced in FY 1999, we are proud of the steps we have taken to improve the stability of those earnings. Right across the Group, we have put in place measures to reduce risk and improve the stability of our earnings stream. In other words, we have made great efforts to improve the quality of our earnings every bit as much as their quantity.

Could you elaborate a little on this point, please?

In the first instance, as I mentioned earlier, we have maintained firm control of our cost base and have worked very hard to increase the proportion of variable costs in our cost structure. This has been most evident in the area of personnel costs, where we have worked to link remuneration more closely to personal achievement and the profitability of the relevant Group company, and where we are attempting to hire certain types of employees, for example staff for the new call centers in the retail company on more flexible terms while maintaining a cap on the number of new full-time employees we hire. It should be noted that the market for qualified securities staff is now very tight. We believe we made the correct decision over a year ago to cut our domestic staff levels only to the degree achievable through natural attrition and voluntary retirement plans. Consequently, we are now able to concentrate on our longer-term goals.

We have taken a great deal of care to position ourselves to **TAKE MAXIMUM ADVANTAGE** of the dominant trends expected in the Japanese capital markets

Secondly, whether you look at our retail or our wholesale securities business, you will notice that we have taken a great deal of care to position ourselves so that we can take maximum advantage of the dominant trends expected in the Japanese capital markets over the next several years, while minimizing the risks we take in so doing. These trends stem from the need for the corporate sector in Japan to rationalize its balance sheet, and for the household sector to change its savings patterns. In order to take maximum advantage of these trends, a securities company must be able to boast strength in its dealings with the retail, corporate, and institutional sectors, which is something that has been made easier by separating the retail and wholesale securities operations. Moreover, by focusing our efforts on the facilitation of these natural financial flows, we have been able to reduce the risk inherent in our operations. Thus, for example, in the retail company, we see a steady stream of low-risk income from customers who have come to understand and trust the Daiwa brand. In the wholesale company, meanwhile, our trading operations concentrate mainly on client facilitation following strict risk management guidelines, while our investment banking operations are generally oriented to the facilitation of low-risk and repeat client business. This is what I mean by increasing the quality of earnings.

You have raised your target return on equity to 15%. Could you possibly comment on this?

I will, if I may, answer that question in several parts.

First, return on equity is a measure that we regard as very important in any assessment of corporate success or failure. It has many positive features, including widespread acceptance among investors. Moreover, it is a concept that can be easily understood and accepted by each of our employees. We believe that corporate goals need to be pursued at many levels, not just at the board level, if they are to have a real chance of success. Consequently, we have placed return on equity targets at the very center of our corporate strategic thinking. However, this does not mean that we focus on this measure to the exclusion of all else. In particular, return on equity — a measure of returns earned — does not make any allowance for risks incurred in the process. As I mentioned above, we are not a little proud of having achieved the returns we have while keeping the risks to the minimum, consistent with our broader corporate goals. Our commitment to raising our return on equity should be understood in this context.

Secondly, as a securities company operating in the capital markets, our business will continue to reflect the natural cycles that occur there. However, I would very much like to stress that my colleagues and I have been involved in financial markets for long enough to know not to stake our company's future on any particular view of the way they will move. Our primary goal is to position Daiwa so that it can produce superior returns whatever the market environment. Our 15% target return on equity should be regarded as a base line which we feel we can meet on a consistent basis.

Finally, I would like to point out that our corporate goals also include targets for the credit standing of the retail and wholesale securities companies where we wish to achieve a rating of A or better by FY 2002, and for our brand image and domestic reach, where we have adopted retail customer assets under custody as the primary numerical indicator of customer trust in the Daiwa brand. Our targets thus encompass unambiguous and measurable indicators of the quality of our earnings, not simply their quantity. We believe that we can best enhance shareholder value by adopting such a balanced approach.

You have recently started to talk about the Daiwa brand and mentioned it in this discussion as a key goal. Would you elaborate?

If you look at recent developments in the markets we serve, you will notice an explosion in the choices available to our customers as markets deregulate, new products are introduced, and new distribution routes are explored. As Japanese financial markets mature and expand, this proliferation will continue. Under these circumstances, we and our competitors will start to interact with our customers and partners, whether retail, institutional, or corporate, in a far wider variety of ways than in the past. Along with the increased choices available to the customer will come a blizzard of information which, because of its sheer volume, will soon come to resemble background noise with the customer screening out all but that information immediately relevant to his or her needs.

In such a world, it is necessary but not sufficient to offer the best advice, best execution, best product development, and so on. More than that, we must establish a system whereby every interaction between the Daiwa Securities Group and our clients reflects a superior level of customer service and professionalism across the board. In a market where information overload is a real issue, we believe that customers will increasingly rely on a limited number of securities houses with which they have established bonds of trust. Those bonds, built on a solid foundation of satisfied expectations, are what we term the Daiwa brand.

Association with a trusted brand can add value not only to the consumer, but also to the brand owner. For example, in the retail securities market, Daiwa Securities has chosen to price its Internet distribution rationally, rather than attempt to buy market share by pricing services at unsustainably low levels. Nevertheless, Daiwa Direct remains one of the leading online brokerages. Customers would rather deal with a trusted brand than seek the absolute lowest price available. The value of that trust is also becoming increasingly visible in our wholesale activities where we have established leadership positions in several market segments from a standing start.

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Turning to more concrete matters, what do you believe have been the most significant market trends over the last year as far as Daiwa Securities Group Inc. is concerned?

Obviously, the greater buoyancy in Japanese financial markets, particularly the equity market, has been a major factor. Of particular note has been the greater participation in the market by long-dormant classes of investors, particularly retail investors. In the corporate sector, the financial and operational logic for restructuring has finally been accepted and the momentum cannot be reined in. This has also expanded the available market. The end result of this broader participation has been increased opportunities for major domestic securities companies, not just Daiwa, to exploit their greater reach and customer base.

Of course, deregulation and market strength have also led to an increase in competition. In addition to the competition we face from foreign investment banks who bring many competitive advantages stemming from long experience in operating in deregulated markets and the other major domestic securities companies, we also compete against online brokerages, banks, and other non-financial sector companies entering the securities business.

While the foreign securities companies continue to exhibit strength in the segments they serve, I believe it is fair to say that the market reach of major Japanese securities companies, including Daiwa, has allowed us to benefit to a far greater degree from the more buoyant conditions. While we continue to have the utmost respect for these tough competitors, and while they, too, are probably celebrating a good year in the Japanese financial markets, their focus on large accounts and their deal-oriented nature has restricted their ability to address the opportunities thrown up by a market in which there is broad participation.

From a standing start, online equity trading has grown to account for over 30% of all unit trades in the retail company. Competition in this segment has increased enormously, with participation not only by established US online brokerages bringing their expertise to the Japanese market, but also by startups and new market entrants from outside of the securities industry. Most of these companies have been operating according to a business model in which the primary goal is to amass a customer base as fast as possible, with achievement of profitability deferred to some indeterminate point in the future. This has led to the emergence of deep discounting in online trading as myriad competitors scramble to attract the same customers. We at Daiwa, by contrast, view the Internet as one of a continuum of choices available to our customers. We believe it essential to offer Internet-based trading opportunities only as part of an integrated distribution strategy. Therefore, while we are guiding prices lower as scale and experience allow, we have not followed the herd in discounting to uneconomic levels. This marks us as different from the majority of companies in this area.

As for other potential competitors such as banks, the retail networks of which might be thought to pose a serious competitive threat to traditional securities companies, our experience has actually been rather benign. While these distribution routes do pose a potential threat over the longer term, to date the opening up of these channels to securities products has served mainly to stimulate consumer acceptance of higher return vehicles, such as equity investment trusts, and to publicize the benefits of diversification as a means of achieving higher returns at an acceptable risk level. On the whole, although it is impossible to accurately quantify the effect, we believe that promotion of the benefits of securities investment provided by banks and other newcomers has actually served to increase the amount of business available to us.

Could you comment on the retail arm of the group, Daiwa Securities Co. Ltd.? Since we will be covering the company in more detail elsewhere in this report, perhaps you could concentrate on matters of strategic importance.

Our approach is premised on the belief that Japanese households will increasingly look to diversify their financial holdings. In order to facilitate this trend and to benefit as a company, we have promoted a general shift in our corporate stance to stress the accumulation and increase of assets, and de-emphasize commission income.

I would say that there are two major strands to our strategy in this respect. The first involves offering our clients a choice of multiple channels to access our services. The second involves the provision of an appropriate range of products to the retail market.

Regarding the first point, we have taken the view that we wish to present just one face to our clients under the Daiwa brand. Consequently, all of our channels, including our traditional branch office network as well as newer channels such as our mini-branches (sales offices), online and call center operations, will operate within the retail company in accordance with a common corporate strategy. For this reason, we decided not to separate Daiwa Direct as a distinct, semi-autonomous corporate entity. We do not intend to rigidly segment our client base into discount clients, full-service clients, and so on. Rather, we regard each of our clients simply as a Daiwa client who will choose the most appropriate channel according to his or her own personal circumstances and preferences. It is entirely possible that a single individual will wish to make use of multiple channels. Moreover, during the course of a lifetime's relationship with Daiwa Securities, an individual's financial needs and preferences may change. We aim to tailor our distribution strategy so that such customers can migrate between channels with minimum effort.

For example, we expect many new investors to appear in securities markets over the next several years. Their initial experience may be through the Internet, perhaps trading so-called "mini-kabu" stocks, where Daiwa Securities maintains a leadership position. On the other hand, it might be via our Money Market Fund (MMF) product lines, where Daiwa Securities also leads the industry, especially if the investors are shifting funds out of low-return vehicles such as postal deposits and bank accounts. As individuals' needs, experience, and financial responsibilities grow over time, so will their need for additional services. By offering a seamless continuum of channels, we aim to provide customers with an appropriate response to each of their needs at a price that reflects the level of service provided. The crucial point is, however, that no matter which channel is used, the promise of superior service implicit in the Daiwa brand will be honored.

Starting this July 3, we have filled the distribution gap between the self-service Internet channel and the full-line branches by introducing a full-fledged call center staffed by individuals qualified to provide intermediate-level investment advice. In addition to its function as a help desk for Daiwa Direct, the call center will be able to provide general advice on securities investments. Unusually for a call center, operations will be located in central Tokyo for the simple reason that we need to attract suitably qualified staff to provide these services.

Another distribution innovation we shall be promoting over the next several years is the mini-branch or sales office. These are smaller branches, staffed by around three to five people rather than the thirty to fifty in our traditional branches. Our experience to date in three sales offices shows that, on a per-branch basis, the new branches are as effective as the older ones in attracting new accounts and new client assets. Consequently, we have taken a decision to aggressively expand the number of such branches by twenty-five to thirty over the next three years.

It should be emphasized that our distribution strategy and our plans for wider promotion of the Daiwa brand, revolve around the concepts of trust, flexibility and superior service. In addition, while we do believe that we must be price competitive, we see it as ultimately self-defeating to try to build market share on the basis of price alone. Consequently, following total deregulation of commissions in October 1999, we have set our prices at what we regard as appropriate levels for the services provided and have left it to the others to deal with the quicksand of uneconomic pricing practices.

On the product side, we continue to stress our cash management program (CMP) and investment trusts. As noted above, our balance of retail customer assets under custody rose 4.2 trillion or 40% to 14.7 trillion yen in FY 1999. We remain the leading securities company in terms of customer assets under custody, while the scale of the increase was significantly in excess of that originally expected.

Specifically within our investment trust operations, we have successfully launched two new flagship vehicles during the past two years, “Musashi” and “0101”, both over 200 billion yen in size. Two years ago, the successful launch of funds of this size would have been inconceivable. We can address the bulk of current market needs through our various investment trusts . While we remain one of the leaders in the investment trust business in Japan, we have attempted not to oversaturate the market with unnecessarily complex or highly specialized products. The dominant trend in Japan today is increasing individual participation in higher-return markets such as equities, and a discovery of the benefits of diversification in wealth management. These trends will surely gain momentum with the imminent maturity of 106 trillion yen in postal savings deposits placed at interest rates far higher than those available today, and the gradual shifting of responsibility for retirement planning from the corporate sector to the individual. Our view is that, in such an environment, over-segmentation of our product base might actually be counterproductive. This is especially so since much of our corporate planning revolves around attracting a new wave of first-time investors. The introduction of the “beginners counter” a special program dedicated to beginners was designed to make us more accessible to potential customers who have never

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set foot in a securities company. Rather than provide our customers with an inappropriate array of complex products, we have concentrated on continuing the superior performance we have recorded with our flagship funds, and have more aggressively started promoting both this performance and the fund managers achieving it. Nevertheless, we carry a full range of products from low-risk MMFs to equity investment trusts and higher return vehicles which can cater to all investment needs. In particular, our product line includes a number of attractive alternatives to bank and postal savings deposits, for example via our CMP, which combine the convenience and safety of a deposit account with a measure of the higher returns available through securities market investment. We thus hope to offer new investors a continuum of choices from the familiar to the new and, thereby, help them to make the transition to securities market investment in a structured way.

Could you also say a few words about the wholesale securities company, Daiwa Securities SB Capital Markets Co. Ltd.? Again, this company will be reviewed in detail later in this report, so it would be a great help if you could concentrate on the strategic aspects.

Clearly, this area of our operations has been the focal point of our restructuring efforts over the last several years, culminating in the formation, in 1999, of Daiwa Securities SB Capital Markets Co. Ltd. (Daiwa SBCM) as a joint venture with Sumitomo Bank.

At the strategic level, the first phase of our restructuring is almost complete. We have improved our risk management and credit management systems to the degree that our trading operations now make acceptable returns within strict risk guidelines and without excessive use of the balance sheet. Meanwhile, our investment banking operations have already staked strong claims in newer businesses, such as derivatives, structured products, and mergers and acquisitions.

As one of the big three Japanese securities companies, Daiwa SBCM ranks at or near the top of most segments in the Japanese wholesale securities markets. In many segments, including equity trading and bond underwriting, we rank first or a close second. Unfortunately, in the IPO and equity underwriting segment we rank second or third. In the former areas we are working to build on our front-runner status to establish ourselves as the clear number one. In the latter, we aim to close and eventually entirely eliminate the gap with the market leader. We have expended considerable energy on defining quantitative measures of success for each of the divisions within Daiwa SBCM, such as industry rankings, reputable surveys of customer satisfaction, and so on. In addition, we have adopted a realistic timetable for achieving our goals. This timetable stretches out according to the strength of the competition we face, although we believe we have a realistic chance of reaching market-leader status in most of the segments in which we operate over a three year time frame.

The principal competitive strengths we will bring to bear to achieve the above are, firstly, the flexibility that comes from separating our wholesale securities business under the Daiwa Securities Group structure. We believe our financial and organizational structure is now superior to that of other Japanese securities companies in terms of being able to react to market trends, as well as providing a work environment conducive to attracting the sort of highly qualified staff we need to employ. This is already evident in certain areas such as, for example, our Asset Backed Securities (ABS) efforts, where we have scored a succession of industry firsts and established a so-called first-mover advantage. In addition, this corporate structure has made it easier for us to form alliances with partners with complementary skills exemplified, in FY 1999, by the formation of alliances with Lazard in the field of mergers and acquisitions, GE Capital in the field of private equity and Mori Trust in the field of real estate-related investment trusts. We remain open to the formation of additional relationships as and when necessary.

Secondly, many of our investment banking activities are relationship driven. Not only does this lead me to remind you of the importance of establishing the Daiwa brand and relationships of trust, as I mentioned earlier, but also to point out that access to Sumitomo Bank's client base is a decided advantage for this company. Many of these businesses are long-term in nature. For example, in certain circumstances, it can take up to ten years to bring an IPO candidate successfully to market. Consequently, the full benefits of the relationship with Sumitomo Bank and the greater market reach that it has brought us may not be immediately apparent. However, there are strong indications that, over time, this relationship will bring increasingly greater benefits.

Finally, we have poured great effort into improving our credit and risk management systems. At the same time, we have shrunk our balance sheet considerably compared with a couple of years ago. Our profitability is also on the rise. Taking these considerations into account, it would be reasonable to expect some improvement in our credit standing. Indeed, this is one of our three corporate goals in the Medium-Term Management Plan. In turn, these developments will open up for us new opportunities, such as the ability to deal in longer-maturity derivatives and to eliminate the intermediary in certain swap transactions. More generally, an improved financial structure and increased ability to manage risk should allow us to address new, and more profitable, opportunities.

As we know, Sumitomo Bank and Sakura Bank have announced plans to merge. Is it possible to quantify how much this will affect the Daiwa Securities Group?

Actually, very little of a concrete nature can be said, since the details of the merger are still being worked out. However, I believe that it can safely be said that the benefits of having a larger bank with greater reach as a partner for the wholesale securities business will be positive for the Daiwa Securities Group. Certainly, we expect to receive the same support from the merged bank as we have to date received from Sumitomo Bank.

At present, the Daiwa Securities Group and, I believe, Sumitomo Bank share the common goal of creating a competitive investment bank. We expect the significant results seen in this business to continue.

The outlook seems bright. On the face of it, the Daiwa Securities Group would seem to have few problems.

That is only partly true. A company that feels it does not face challenges is either complacent or out of touch. I sincerely hope we are neither.

However, I do feel that we are nearing both the end of the first phase of our reorganization and our emergence as Japan's strongest securities group. That is to say, the wrenching structural changes we have implemented over the last several years, culminating in the formation of the Daiwa Securities Group one year ago, are now largely complete. We believe the current corporate structures are adequate, with some adjustments, to address the opportunities presented by financial markets in the early twenty first century. Structurally, we are now pretty much where we want to be.

The emphasis has now moved to the implementation of corporate goals at the operating company level. Of course, as with any business, we face challenges here and will continue to do so. Reducing the pressure on our branch network is one such problem, attacking entrenched competition in certain sectors of the wholesale company is another, and reinforcing the common group functions is a third. However, I believe that it would be fair to say that my personal stress level is substantially lower than it has been.

Put another way, I believe we have now shifted from a pattern of revolutionary corporate change to one of evolutionary change. It is to be hoped that the fruits of actions taken to date will become increasingly apparent over the next several years.