YOSHINARI HARA

President & CEO of Daiwa Securities Group Inc.

Could you please, in your own words, give us your analysis of major developments affecting the Daiwa Securities Group during the financial year under review?

The biggest external influence on our business during FY 2000 was the rather poor situation pertaining in Japanese securities markets. The reasons behind this include the growing sense of a slowdown in the outlook for IT-related businesses, which had performed the role of a global engine of growth, and growing anxiety in Japan about the future direction of Japan's economy, which was beginning to show signs of a recovery. As a securities group, the Daiwa Securities Group, like all of its competitors, was greatly affected by these conditions, which generally deteriorated throughout the year.

In this environment, our consolidated revenues for FY 2000 increased by 10%, to 718.1 billion yen. Ordinary income was down by 21%, to 177.7 billion yen, and net income for the year by 39%, to 64.5 billion yen. Although our profits compared to FY 1999 declined to a level that is certainly unacceptable to us, these numbers appear similar to those reported by our main competitors and, as such, might be regarded as "as-expected" given the prevailing market conditions.

Needless to say, as with any company, there were areas where we feel we made real progress and areas where we feel we need to make further efforts.

In some areas I am happy to say that the Daiwa Securities Group made a great deal of progress. This progress was manifested in operating results in several ways. Allow me to cite several specific examples. We achieved progress in equity trading, M&A, structured finance, and in the IPO markets at Daiwa Securities SMBC, our investment banking arm, and successfully implemented the three-service-package strategy in Daiwa Securities' retail securities business, where we are also steadily expanding our number of customer accounts. At other Group companies we reported higher ordinary income than in FY 1999 thanks to stronger earnings in our asset management business at Daiwa Asset Management, even as total investment trust net assets fell because of the stock market decline, and at Daiwa SB Investments as the result of solid growth in equity investment trusts. Daiwa Institute of Research, which manages our systems development and research businesses, also improved its contribution. Finally, NIF Ventures, our venture capital operation, is well placed to go public during FY 2001, and Daiwa Securities Business Center, our securities-related back office, made progress in several areas including acquisition of ISO9001 certification and Daiwa Real Estate increased efficiency.

In yet other areas we took steps that, although lacking an immediate payback, nevertheless strengthened the Group's foundations for future growth. Here I would mention the establishment of Daiwa Pension Consulting Co., Ltd. which will enable us to address opportunities that will accompany the introduction of 401(k) style defined contribution pension plans in Japan. We also took decisive steps to equip our staff, including those serving at near-board levels, with the skill sets needed to compete successfully in modern securities markets through the inauguration of the Daiwa Management Academy and other measures.

On the other hand, there were also a number of areas where there is room for improvement. At Daiwa Securities a core management objective is to increase retail client assets under custody. Unfortunately, such assets fell by approximately 2 trillion yen since individual investors became more conservative during FY 2000 as the stock market declined. This amount reflects approximately 3 trillion yen in valuation write-downs due to the fall in market prices, however, so even under this difficult environment the net asset inflow exceeded more than 1 trillion yen.

Certainly bearish sentiment in the stock market was a large factor that prevented us from achieving the asset growth we had planned in FY 2000. I believe the steep decline in the stock prices of IT-related companies made investors very risk-averse. Furthermore, at the introduction of mark-to-market accounting, due to the effect of past investment policy, we were unable to introduce competitive products with the result that returns on our medium-term government bond funds and certain bond investment trusts were less attractive than those offered by the competition. This resulted in a reduction in the balance of bond investment trusts outstanding. During the current year, as mark-to-market effects have been eliminated, we are once again starting to compete on a level playing field with the result that we are again starting to see a flow of funds into Daiwa Securities. Our equity investment trusts were affected by the decline in the stock market, and the performance of some of our flagship funds, like those of our competitors, underperformed the main equity index during FY 2000. Overall equity investment trusts were weak and the flow of funds into such instruments has slowed dramatically. Before the start of FY 2000, we had anticipated that large amounts of capital would flow into the securities markets because a substantial amount of fixed-term postal savings deposits were set to mature. Unfortunately, the majority of such funds ultimately remained in postal savings deposits, and the shift of funds into securities markets failed to materialize to the degree we had been expecting.

Conversely, at Daiwa Securities SMBC, although we recorded good results judging purely from the level of profits recorded, this was very dependent on our success in equity trading. The bond markets were affected by a reduction in profitable trading opportunities. This was aggravated by the introduction of the Real-Time Gross Settlement (RTGS) system for government bonds leading us to record disappointing earnings there. In addition, our investment banking operations were mixed. Our structured finance, mergers and acquisitions and IPO businesses reported good progress. On the other hand, our equity underwriting business turned in a disappointing performance and lagged our major competitors in the lead-management of large-scale global issues.

On the face of it, overall you would seem to have performed in line with your major competitors. In some areas the Daiwa Securities Group has done well; in others it has lagged. Would you regard this situation as satisfactory?

Frankly speaking, I am not satisfied with the current situation. As you point out, if we simply judge by the numbers, we have turned in a performance that might be described as satisfactory given the market conditions. However, as you know, over the last two years we have expended much effort in restructuring this company to address the opportunities thrown up by deregulation and structural change in Japanese securities markets. To this end, in March 2000 we implemented our new Group Medium-Term Management Plan to be achieved by March 2003. While our performance relative to our competitors has been in some sense satisfactory, relative to the Group's management objectives our progress has been decidedly unsatisfactory. In terms of our three central targets for March 2003, which are to achieve a sustainable return on equity of 15%, retail client assets under custody of 28.3 trillion yen, and a single A or better rating from the main credit rating agencies, we have suffered the greatest setback in client assets under custody, as I have mentioned before.

In which case, have you rethought your corporate strategy or changed the goals outlined in the plan?

No, we have not. As I mentioned before, the Daiwa Securities Group's corporate strategy stresses new opportunities in the securities markets for both individuals and corporations. In the retail securities market, for example, we have been expecting a wave of investors new to securities markets looking to increase returns while maintaining risk at acceptable levels through appropriate use of portfolio diversification. The logic for this shift in investment behavior is irrefutable. However, the sad fact of the matter is that it simply has not happened to the degree expected. Many Japanese continue to favor low-risk investments such as postal savings and bank accounts. Consequently, as I have mentioned, a disappointingly high proportion of the large volume of postal savings time deposits maturing during 2000 bypassed the securities markets entirely and was reinvested in postal savings deposits.

Were we to accept that such an investment style was somehow so ingrained in Japanese investors that there was no opportunity for change, then this would constitute a bona fide reason to change our corporate strategy and the measures of success that we have adopted. For my part, I would like to point out that the level of individual involvement in securities markets in Germany, which is in some ways a more appropriate comparison for Japan than the more oft-quoted U.S., rose from 23% in 1991 to 33% in 1999. It is quite possible, therefore, for a securities

investment culture to be established in a relatively short time. We should not be tempted to believe that general attitudes of Japanese individuals toward securities investment are irretrievably fixed for all time. The evidence is to the contrary. Moreover, once this sort of shift starts to happen, even in Japan the chances are that it will gain momentum relatively quickly. Consequently, thorough preparation by the Daiwa Securities Group is a necessity.

A second point I would like to make is that sustainable long-term recovery in the Japanese economy as a whole is itself contingent on those same variables on which we have staked our prosperity. It is hardly a new observation that reform of Japan’s financial markets and reform of her economic structures are intimately linked. Absent any progress in reform of the financial markets, it is difficult to see how progress in the wider economy can proceed. Although the economy clearly continues to face many problems that are separate from reform of the financial markets, we simply do not see the kind of situation that would be necessary for us to abandon our offensive posture. The formation of Mr. Koizumi’s Government has bolstered this belief further. The Government’s aggressive proposals to restart the Japanese markets are based on utilization and activation of the securities and capital markets, which is exactly what our industry needs.

This is not to say that we are simply constrained to take a wait and see attitude. On the contrary, much of the responsibility for promoting the sort of changes we anticipate rests squarely with the Daiwa Securities Group itself and with the securities industry in general. In the retail sector, our major task is to shake off the old-fashioned image of securities companies as self-serving and unreliable partners. For some time now we have addressed these issues in many ways, including a shift in our internal mind-set toward stressing asset accumulation over brokerage commissions, enhanced staff training, implementation of strict compliance procedures, and increasing use of technology. In terms of deliverables, we are well positioned. The remaining hurdle we need to surmount is the ingrained resistance to securities investment among the general public. I believe that the lesson last year has been that it is necessary but not sufficient for us to offer our customers and potential customers superior service and products. It is also necessary for us to disseminate our core value proposition in clear and unambiguous terms. This applies across the whole Group but is most relevant to the retail securities business conducted by Daiwa Securities. This is the reasoning that underlies our corporate branding project, which is destined to play a key role in our future development.

In the wholesale securities markets, which are addressed by Daiwa Securities SMBC, our 60%-owned subsidiary formed as a joint venture with the former Sumitomo Bank (now Sumitomo Mitsui Banking Corporation), we face a somewhat different set of challenges. Here regulatory changes and market opportunities have been quicker to take root. In some areas, such as equity trading, structured finance, and principal finance, we already rank as the market leader among securities companies. In other areas, such as M&A, although still a relatively small player, we are growing rapidly and gaining in strength.

To optimize the quality of our earnings, our two biggest challenges in the investment banking business are to reduce our dependence on equity trading profits in our business mix and to improve our relative competitive positioning in other areas, then to improve our competitive position in equity origination and underwriting. Unfortunately, we were not able to make much progress toward these goals during the last year. While we remain confident that benefits from our relationship with Sumitomo Mitsui Banking Corporation, particularly in our investment banking operations, will accrue over time, to date the benefits have not been of a sufficient scale to make a dramatic change to the business mix of our investment banking operations.

So to answer your question, there is no doubt in my mind that strategically we have made the correct decisions. The move to a holding company structure and tie-up with a major city bank have greatly improved the ability of the Daiwa Securities Group to address the opportunities securities markets will offer us in the twenty-first century. Although a more distant target than seemed likely a year ago, we fully believe that under the right circumstances our medium-term targets are attainable. Of course this will not simply happen. We need to adopt a highly proactive approach. Our strategic thrust remains unaltered. But we fully recognize the need to react swiftly to changing market circumstances at the tactical level.

Could you elaborate somewhat on your branding strategy?

The reason for undertaking our corporate branding project is simple. The financial world is now a more complex place than it used to be. Whereas it used to be possible to compete on the basis of individual products and services, these days we need to promote the Group as a whole. A regulated world was one where our individual operations were not really given incentives to look beyond the confines of their individual areas of responsibility. Today, however, things are vastly different. Financial innovation we cannot even imagine today will require the different entities in the Daiwa Securities Group to collaborate in new and probably unpredictable ways. Moreover, as Japan evolves from a so-called producer economy to a consumer society, customers will demand ever higher levels of service in ever more diverse areas.

I would like to stress that defining the Daiwa Securities Group Brand is not simply a matter of advertising or promoting a consistent visual image. Certainly, these are one way in which the Daiwa Securities Group reaches out to its customers, and I do not want to belittle the importance of the external communications process. However, if the Daiwa Securities Group Brand were nothing more than this, it would amount to little more than an empty gesture. On the contrary, the sum totality of the customer experience across every interaction with every member of the Daiwa Securities Group, embracing not only external communications but individual transactions, our telephone manners, and word-of-mouth recommendation as well, is what defines the Daiwa Securities Group Brand. Experience gives rise to expectations toward the Daiwa Securities Group and fulfilled expectation gives rise to trust. It is this central position in our customers collective consciousness that we wish to occupy. Apart from the immediate benefit of breaking down barriers and establishing ourselves as the customer's partner of first resort, the fact is that a trusted brand carries real economic value for corporations across the globe.

I therefore believe that the logic for building a brand for the Daiwa Securities Group is strong. Yet when we go out into the real world and investigate how we actually are perceived the answer is relatively disappointing in the sense that our customers have no clear image of what the Daiwa Securities Group Brand is. That is, they have only a vague idea of what our core value proposition to them actually is. On the positive side, while our main competitor is mainly described in terms of over-aggressiveness, the general public most often mentions "professional," "stylish," and "gentle" when describing the Daiwa Securities Group. These are traits I am personally very proud to be associated with and have been adopted as key elements for building our "brand personality."

The most important task that faces us in promoting the Daiwa Securities Group Brand is actually to ensure that shared Group values, which have actually always been strong within this company, are given sharper focus. We have spent a lot of time and effort during the year articulating a management vision in terms that are easily understood and appreciated by every employee. Ensuring that the values expressed in that vision are reflected throughout the Group is a key goal. We will also work to ensure that these values are reflected in our advertising, corporate communications, and in fact at every point at which the Daiwa Securities Group interacts with its customers.

I realize that many people, especially in Japan, may not understand the relevance of branding issues to the Daiwa Securities Group. Certainly, the potential benefits from creating a brand are less easily quantifiable than the financial information provided in an annual report. However, an inability to quantify an immediate benefit does not imply that the issues are peripheral or unimportant. On the contrary, we believe that, ultimately, the value of our brand equity will form a large component of shareholder value and justify attention by all of our stakeholders.

Now, after two years, how do you feel the relationship with Sumitomo Mitsui Banking Corporation has worked out? What do you feel about the outlook following the merger of the former Sumitomo Bank and the former Sakura Bank?

The most significant benefit of this partnership for the Daiwa Securities Group was the increased exposure to clients that might be garnered by drawing on the former Sumitomo Bank's extensive customer base. In our mergers and acquisitions business, for example, or in the IPO business, referrals from customers of the former Sumitomo Bank are increasing and the profitability of such transactions is also steadily growing. In other areas, such as structured finance and derivatives, where we already rank at the top of the market, we have certainly benefited from the relationship, although quantifying that benefit is more difficult. However, in a few areas, such as equity underwriting, I think it is fair to say that significant benefits have yet to be seen.

As for the benefits we expect from the formation of Sumitomo Mitsui Banking Corporation in April 2001, of course it is far too early to make firm predictions. Nevertheless, we are expecting tremendous benefits in various fields.

The most important will be that in contrast to the customer bases of the former Sumitomo Bank and the Daiwa Securities Group, which do exhibit a large measure of commonality, we have traditionally had only a fairly distant relationship with the customers of the former Sakura Bank. For example, of 721 (as of April 1, 2001) companies to which we are lead underwriter, only 68 have the former Sakura Bank as their main bank. This compares with 140 lead underwriter relationships with companies having the former Sumitomo Bank as their main bank. Clearly, the new client base that the former Sakura Bank brings to us represents virgin territory in many ways. In addition, Sakura Securities, the securities subsidiary of that bank, has now been merged into Daiwa Securities SMBC. The infusion of approximately 100 qualified staff has been immediately beneficial in several areas. So going forward we expect to see substantially greater benefits than we've enjoyed to date.

Looking ahead, this means we can expect some repetition of our experience with the alliance with the former Sumitomo Bank, although on a grander scale. In some areas it would be reasonable to expect concrete results fairly quickly. Nonetheless, it would be naïve to assume that we can establish strong relationships in all areas with these companies simply because we now have a closer relationship with their main bank. On the other hand, we should not dismiss these opportunities just because it will take effort to exploit them. I believe that Sumitomo Mitsui Banking Corporation has opened the door to forming closer relations with their corporate clients. How successful we are in establishing close business relationships with these new customers will depend on how hard we push on that door.

Looking forward, could you please give us some idea of what you believe is in store for the Daiwa Securities Group during fy 2001 and beyond?

Looking first at our retail securities operation, I believe that we will see a continuance of the trend to concentration of market share in the existing major companies, including this company. We may see one or more new foreign brokerages entering the Japanese retail securities market during FY 2001, but I feel it will be very hard for them to establish a significant toehold. By contrast, second-tier brokerages are increasingly being forced to focus on areas where they can squeeze out some competitive advantage, to date almost entirely concentrated in the online segment of the marketplace. This trend to specialization will only grow stronger. In my opinion, it may be difficult for such brokerages to retain clients, especially into a market upturn, if their service continues to be driven by price alone. While bank participation in retail securities markets remains muted, I believe that the real competition will continue to be between the three major Japanese securities houses.

As I mentioned above, I am not happy with the results we produced at Daiwa Securities during FY 2000. On the other hand, we took a number of steps that should bear fruit during FY 2001 and beyond. To start with, Daiwa Securities continues to boast the strongest presence of all three of the major securities companies in the online channel. The lead we have enjoyed in this channel has been reinforced by the successful introduction of the call center channel, where we have established a first mover advantage. Our three-service-package strategy enables customers to choose freely from among Daiwa Consulting at our branch offices, Daiwa Call at our call center, and Daiwa Net Internet accounts to best meet their needs, while allowing seamless migration between packages. We firmly believe these services are superior to the general approach taken by our competitors.

We are also taking a number of steps at Daiwa Securities to bolster our ability to provide superior service to customers and enhance consulting service sales as our "Next Century Innovation Project." In addition to our company-wide infrastructure activities, we have invested heavily in Siebel System's CRM (Customer Relationship Management) and data-mining tools that will enable us to more rapidly analyze and disseminate best-practice across the company. We have also spent a lot of effort over the last year refining our strategy for the consulting channel centered on our branch network. Although the online channel now accounts for fully 40% of the unit trades handled by Daiwa Securities, the branches continue to be central to our future development and competitive advantage in this segment. In this respect, we have also made much progress in defining plans to revitalize the branches over the coming years. In many ways the design and function of securities companies' traditional branches, both our own and those of our competitors, is now quite dated and may account for some of the resistance we have seen among individual investors to dealing with securities companies. Having devoted much time and effort over the last two years to equipping Daiwa Securities SMBC with cutting-edge systems, our attention is now turning to Daiwa Securities. The next several years will see significant investment in this area in systems and branch remodeling.

Also looking forward, we now believe that offering a broader product range to the retail market will contribute to our growth in profitability. To date, we have been rather conservative in our product development strategy for fear of oversegmenting the market before it had fully matured. However, looking back at the last year, we would probably have benefited from adopting a more adventurous approach in which the full strength of the Daiwa Securities Group's product development capability could have been brought to bear.

In the investment banking business, the primary competitors of Daiwa Securities SMBC are the other Japanese securities houses and, in certain areas, foreign investment banks. Bank subsidiaries, unsupported by a solid retail securities base, have not yet proved to be a significant force outside of their historic areas of expertise such as bond underwriting and asset securitization. Certainly, the foreign houses can bring superior product development expertise and human resources to bear as well as privileged access to an overseas client base. On the other hand, they lack the domestic reach that we and the other Japanese companies can apply, including access to the crucially important retail securities market. By comparison with our direct competitors, having operated by dint of necessity over many years according to almost identical business models, we are now following very different paths. One of us has remained an unreformed monolith, and one has chosen to partner with a major foreign financial group; we have chosen as our partner one of Japan's leading city banks. While we might have obtained better access to advanced product development skills and greater global placing power for equity offerings by tying up with a foreign company, we believed that the greater domestic reach and access to capital offered by a major city bank were more attractive. In this respect, as I have mentioned above, we regard the merger between the former Sakura Bank and the former Sumitomo Bank to form Sumitomo Mitsui Banking Corporation as an added bonus unforeseen at the time we did the original deal.

I think that it is fair to say that in the investment banking market, in those areas such as structured finance, initial public offerings, bond underwriting, and equities trading, we have managed to establish ourselves very quickly at the forefront of the industry. Where we lag our major Japanese competitor is in areas such as equity underwriting where a strong track record and established relationships are important. For example, compared to the market leader, Daiwa Securities SMBC is lead underwriter to only around one-half the number of companies. The value of the alliance with Sumitomo Mitsui Banking Corporation to us is the ability to leverage their client networks. Looking forward to FY 2001, therefore, I think that our efforts will be directed toward better exploitation of those new client networks combined with continuing reinforcement of our traditional areas of relative strength.

Outside of the two main securities companies, I think that the major event of potential interest will be the listing of NIF Ventures. In addition, we are giving careful thought to how best to structure Daiwa Institute of Research, which currently operates simultaneously as the think-tank for the Group and as our main systems development arm.

Development of our intellectual asset base is also a priority. We aim to do this drawing both on our own resources and those of external parties where appropriate. An example is our comprehensive alliance with the Hitotsubashi University Graduate School of International Corporate Strategy. Finally, we are considering entry into the broadcasting business since this complements our information distribution capabilities.

So to wrap up, how would you summarize the current situation for the Daiwa Securities Group?

FY 2000 was not a great year for the Daiwa Securities Group. We had thought that the thorough restructuring we had implemented in earlier years would have allowed us to not just match the market, but also to steal a march on our competitors. That did not happen for the reasons I have outlined above. Our goals are sufficiently ambitious that average performance is not for us analogous to satisfactory performance. Therefore our internal assessment of our own performance is harsh.

Conversely, our faith in the underpinnings of our corporate strategy is unshaken. We have identified many issues that need to be addressed both by the Daiwa Securities Group as a corporation and on a wider level as an influential economic player with a role to play in promoting the healthy development of securities markets for reasons that are simultaneously selfish and for the common good. How well we address these issues will determine our future success or failure as a corporation. I am personally confident of success and a bright future for the Daiwa Securities Group.