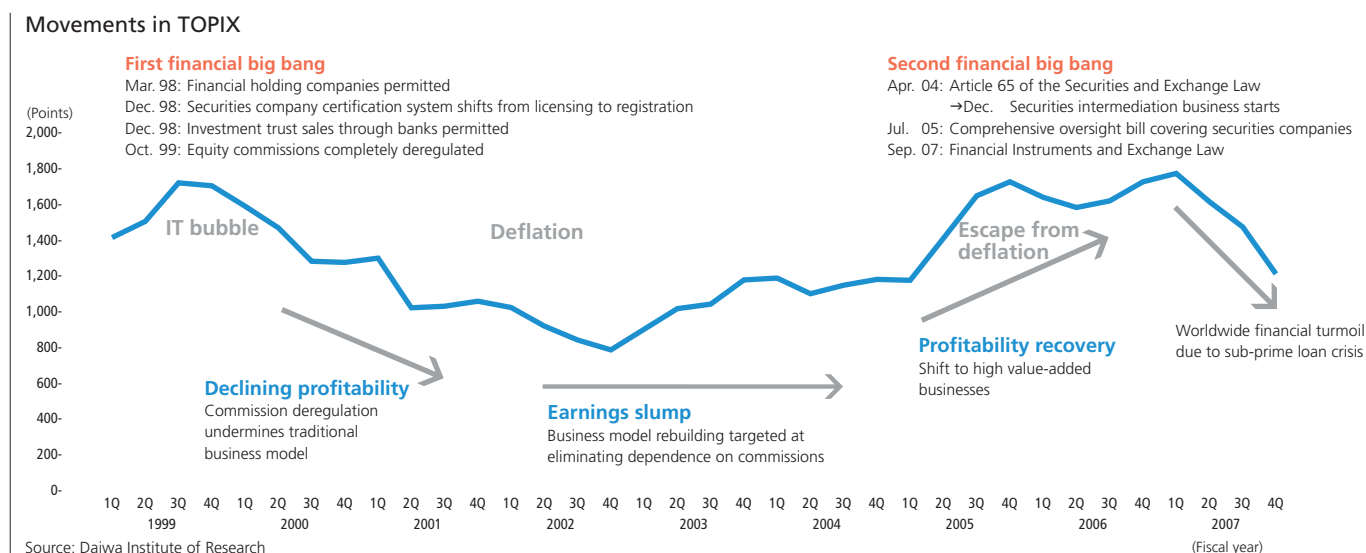


The Business Environment for the Daiwa Securities Group

In FY 2007 the global financial industry was shaken by the sub-prime loan crisis, which created turmoil in the markets and made operating conditions very difficult for securities companies. Yet the year also brought many opportunities, as individual investors continued to shift their funds from savings to investment, and as corporate M&A activity accelerated.



The Business Environment for the Daiwa Securities Group



Business Conditions

The business environment for Japanese securities companies has undergone dramatic changes over the past decade. In 1996, the government began introducing a series of reforms that dramatically deregulated many financial activities. These reforms, often referred to as “the Japanese Financial Big Bang,” aim to revolutionize Japan’s financial system, making it Free (as in “free markets” driven by market principles), Fair (transparent and unbiased) and Global.

As part of this deregulation, the basic structure of the securities industry was changed in December 1998, from a licensing system to a registration system, and the regulations which prevented banks from offering investment trust products at their branch offices were eliminated. In October 1999, brokerage commissions were fully liberalized; this not only allowed new competitors to enter the industry, but also stimulated price competition, which pushed down average securities brokerage commissions.

In December 2004 securities intermediation services were deregulated, and in October 2005 the post office’s financial services division was permitted to begin offering investment trust products. This introduced new competitors to the securities industry, but also stimulated the market and greatly increased the number of individual Japanese investors who own more “investment-oriented” products, including stocks and investment trusts.

In September 2007, the new Financial Instruments and Exchange Law went into effect. This establishes regulations to help protect investors and hopefully will further encourage the shift of individual assets from savings to investment. It also lays down clearer rules on the trading of various financial products and market operations. Another central theme of this law is that it pressures securities companies to establish infrastructure to ensure that financial and equity markets function effectively, thus accelerating the “internationalization” of Japan’s markets.

Market Conditions

In the early months of FY 2007, a relatively strong US economy, a weakening yen and buoyant overseas stock markets provided favorable conditions for domestic stocks, particularly exporters and companies with strong earnings. The yen weakened to around ¥124/US\$ in June, and stock markets both in Japan and overseas moved higher. In July, the TOPIX reached its high for the year, at 1,796.89.

However, the US sub-prime loan crisis was already starting to affect markets. Ratings agencies began to fret about the problem, and the threat of downgrades intensified uncertainty in credit markets. In August, a plunge in stock prices in the US took other markets, including Japan’s, down as well. Stock prices worldwide fell by the largest margin since the collapse of the IT bubble, and concern about the risk of further financial market turmoil intensified. By the start of calendar 2008, major financial institutions in the US were announcing huge losses, and even the credit ratings of US “mono-line” bond insurance companies began to be downgraded. This triggered further declines in stock prices, culminating in a dramatic drop in mid-March when a leading securities company in the US announced that it was effectively insolvent. In Japan, the TOPIX fell to its lowest level in two-and-a-half years, dropping below the 1,150 level, and the yen strengthened to ¥95/US\$, its highest level in over 12 years. Although financial markets began to stabilize in the subsequent weeks and months, the TOPIX closed out FY 2007 at 1,212.96, and the yen stood at ¥99.69/US\$.

Earnings Conditions

Stock trading operations benefitted from strong volume, with average daily trading on the TSE increasing 6.6% year on year to ¥2,939.3 billion, but the sharp drop in prices caused individual investors to cut back on trading. Their share of trading volume dropped off, while trades by foreign investors increased as a percentage of total volume.

In the asset management business, individual investors continued to shift their assets from savings to investment. Customers showed a particular interest in investment trusts which targeted foreign currency-denominated bonds, or stocks in newly industrializing countries. Roughly ¥11.5 trillion in new funds flowed into publicly offered equity investment trusts in Japan over the course of the year. However, the stock market downturn and financial turmoil at the end of the fiscal year depressed asset prices, causing total net assets under management in investment trusts to actually decline by 2.8%, to ¥57,749.7 billion at the end of FY 2007.

The stock market downturn affected investment banking operations as well. Companies became increasingly concerned about the risk of a hostile takeover, and for that reason, were very reluctant to consider equity financing activities which would increase the number of floating shares. The total value of new share offerings by already listed companies fell 77.6% year on year, to ¥536.3 billion. The IPO market was also affected by falling share prices, as well as by tighter criteria for share listing. Initial public offerings in FY 2007 had a total value of ¥609.7 billion, down 55.9% year on year. The total value of deals in the M&A market declined as concern intensified throughout global financial markets, but the number of such deals increased. Meanwhile, relatively low and

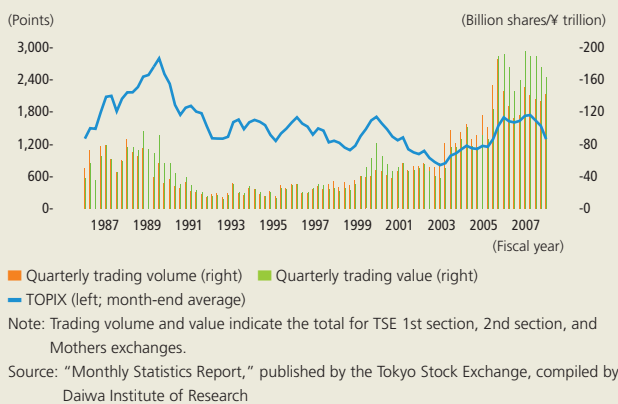
stable interest rates increased attractiveness of bond issuance. As more companies raised capital through straight corporate bond issues, the total value of bonds underwritten during the period rose 42.4% year on year, to ¥6,899.3 billion.

Future Outlook

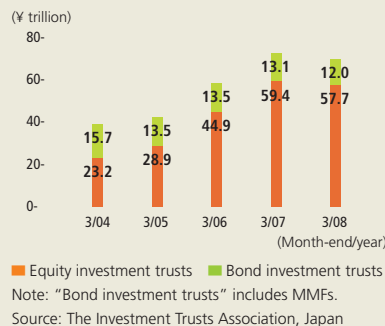
The steady flow of individual assets from savings to investment is likely to continue, even though it has slowed temporarily in response to market turmoil, both in Japan and overseas. As this wealth of individual assets continues to flow into the markets, we expect the domestic stock market to strengthen, supported by the inflow of funds from equity investment trusts and other equity investments. We also expect continued demand for bonds, particularly foreign currency-denominated products with high interest rates, and highly secure Japanese Government Bonds for individual investors.

Individual investors are expanding their horizons, and showing an increased interest in not only stocks and bonds, but also commodities and commodities indexes, currencies, real estate and credit-related products. The diversity of investment targets is likely to expand further in the future, and as individuals try to diversify their investments further, it is up to fund managers and securities firms to develop investment trusts and other products that can meet these needs.

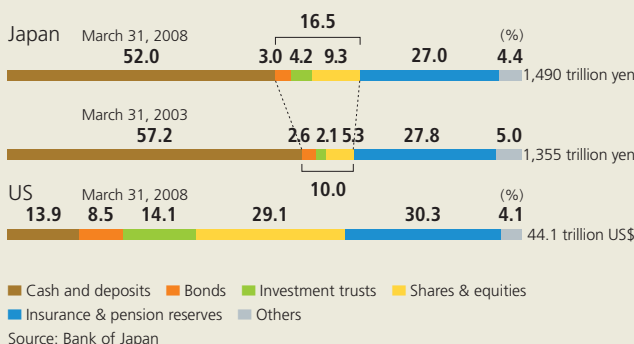
Average Trading Volume and Value on Tokyo Stock Exchange, and Movements in TOPIX (Quarterly Basis)



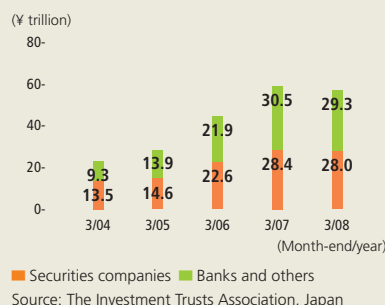
Trends in Investment Trust Assets in Japan



Trends in Household Financial Assets



Breakdown of Assets in Publicly Offered Equity Investment Trusts, Based on Sales Channel



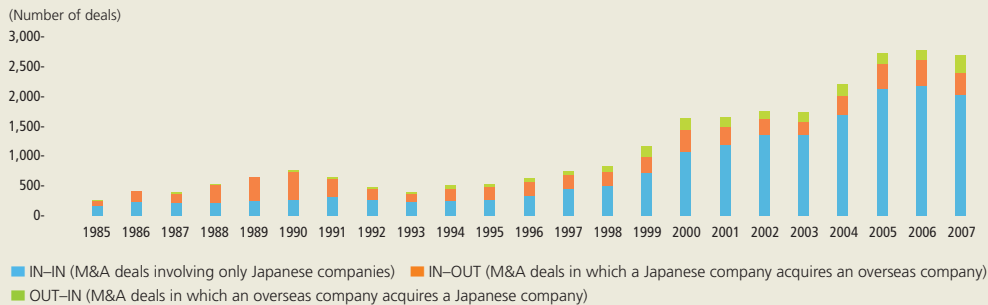
In recent years, securities companies that specialize in online trading have lowered commissions in order to expand their share of trading volume. But while this strategy has had some success, there is a limit to how far they can cut commission fees. Even the online securities brokerages seem to understand the need for direct customer service, and some have begun opening brick-and-mortar offices, selling investment trusts and other products, and seeking other ways to provide more added value.

Efforts to improve Japan's stock market infrastructure will take a stride forward in January 2009, when all stock certificates for listed companies will become electronic. Securities companies and other financial institutions will maintain and manage all electronic records of customer accounts, including name, address, number of shares held, and so on. The Tokyo Stock Exchange will also receive a systems upgrade which is expected to greatly improve order processing capabilities, and advance the effort to make Japan's financial markets fully global.

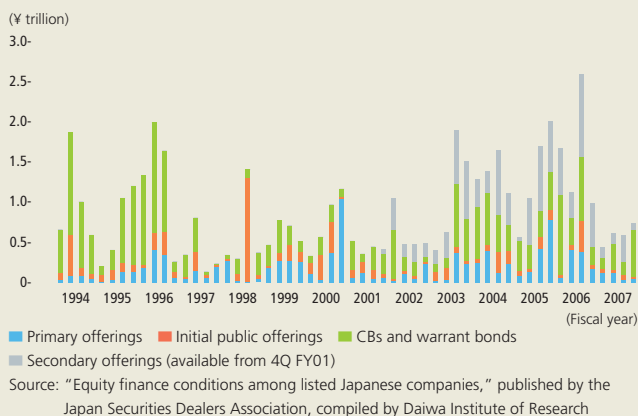
Business sentiment at Japanese corporations has weakened recently, and it seems likely that they will maintain a cautious stance towards new capital investment. However, in order to maintain international competitiveness, it is becoming increasingly important for corporations to invest in restructuring and growth, pursuing mergers and acquisitions which make them more responsive and efficient, or which allow them to acquire valuable core operations, without the time and toil necessary to build them from scratch.

The business environment in which securities companies operate will likely continue to experience dramatic change. However, the sub-prime loan crisis has hit overseas financial institutions very hard, and this will surely slow their efforts to expand, or even force them to scale down their operations. This creates a very important business opportunity for Japanese financial institutions, which have been relatively unaffected by the sub-prime loan crisis. In the near future, domestic financial institutions are likely to make increasingly aggressive efforts to expand their overseas operations, to take capital stakes in foreign financial institutions, and to build global alliances.

Trends in M&A Activity Involving Japanese Companies



Public Offerings in Japan



Bond Issuance in Japan by Listed Companies

