STRATEGIC INTENT AND SUMITOMO MITSUI BANKING CORPORATION

When SMBC comes into being next April as the result of the merger between Sumitomo Bank and Sakura Bank, it will be able to boast a huge domestic market share as well as ample resources to exploit the continuing IT banking revolution. In addition, although size per se is not one of the new bank's goals, the merged company will be able to achieve significant cost savings beyond that achievable by either bank individually, as well as address emerging global opportunities only available to the largest banking groups.

The decision to merge with Sakura was the most important development of fiscal 1999. Shareholders approved this decision at the Annual General Meeting in June 2000, with the new bank due to be launched on April 1, 2001.

The integration with Sakura Bank is highly complementary in many respects. Sakura, for example, has strength in eastern Japan, with its economic anchor in Tokyo. Sumitomo, of course, is historically an Osaka bank, based in western Japan. A marriage with Sakura, therefore, offers the possibility of a huge but regionally balanced nationwide clientele. In addition, for large corporate customers, there is minimal overlap, giving the two banks much room for cross-selling. Among those listed companies, which have business with either of the two banks, for example, only one quarter have significant relationships with both Sumitomo Bank and Sakura Bank. The decision to merge will thus yield SMBC the best customer base in Japanese banking today.

This complementary nature of the relationship is also evident in the product lines of the two companies. Sumitomo Bank brings to the table market-leading strengths in capital markets expertise and operational efficiency. In sales of investment trusts, Sakura and Sumitomo rank numbers one and two, respectively, while Sakura ranks first in housing loans, a profitable product, and also brings substantial expertise in virtual banking and other areas to strengthen Sumitomo's already substantial presence in this area.

As mentioned above, the bank is determined to make a clean break with past practices, which tended to equate the size of the balance sheet with fundamental strength. In fact, Sumitomo's goals both before and after the merger stress rationalization of the asset base. However, it remains true that size still remains a potent factor in the international banking community. Increasing scale will allow SMBC to amortize large IT investments more efficiently. It will also allow it to achieve greater economies of scale particularly in the domestic branch network.

Basic Information about the Merger

Merger Date	April 1, 2001
Corporate Name	Sumitomo Mitsui Banking Corporation
Chairman of the Board	Akishige Okada (Currently President, Sakura Bank)
President & CEO	Yoshifumi Nishikawa (Currently President & CEO, Sumitomo Bank)
Merger Ratio	1 share of Sakura Bank's Common Stock will be exchanged for 0.6 shares of Sumitomo Bank's Common Stock

Benefits

In general terms, the benefits of the merger fall into three broad categories:

Firstly, the customer bases of the two companies are highly complementary as has already been noted.

Secondly, as detailed below, the product lines of the two banks are such that each bank will bring significant strengths to the merger. The product line, which can be fielded by the merged bank, will be the strongest of any of the new banking groups.

Thirdly, SMBC will have ample room to cut its cost base, eliminate duplicate overheads and fund aggressive investment in information technology, while at the same time improving the composition of its asset base.

Goals

Firm goals have been agreed for SMBC to be achieved by fiscal 2004. The most important quantitative goal for SMBC is the achievement of ROE of at least 10% as discussed earlier. These goals are both definite and quantitatively verifiable. They have been agreed to by both banks and form the basis of the merger agreement.

In the first place, as of March 2000, Sumitomo Bank and Sakura Bank employed a total of 29,324 staff and sported a combined network of 653 domestic and 36 overseas branches. By March 2004, it is intended that SMBC employ 23,200 employees and have 484 domestic and 22 overseas branches. These figures are substantially more aggressive than the commitments made under the restructuring plans submitted to the government and should yield correspondingly greater reductions in the cost base of the new bank.

Other targets applicable to SMBC include the achievement of core banking profit of 1,150 billion yen (a 46% increase from that achieved in fiscal 1999), a reduction in the expense ratio from 51% to 42%, a BIS capital ratio of at least 11%, a Tier 1 ratio of at least 7% and a reduction by one half of the outstanding public fund holdings. Moreover, the bank is committed to achieving these goals without excessive use of the balance sheet. Indeed, over the period in question, it is the bank's intention to reduce its risk-weighted assets by a full 2 trillion yen, replacing less strategic and less profitable assets with more strategic and more profitable ones.

Methods

The bulk of the above improvements is slated to be realized in consumer banking and middle market activities, although all of the marketing groups should realize healthy increases in profits. A return to a more normal interest rate environment in the domestic market will, on balance, be positive for the bank as better deposit margins and loan spreads in the marketing groups are partially offset by continued pressure on returns available to the treasury operations.

In consumer banking operations, SMBC will benefit not only from an improvement in deposit margins and a sweeping reduction in the cost base, but also from new income streams both at the parent company level and from affiliates. Foremost among these will be greater income related to investment trust sales and related initiatives for customers, expansion in housing loans and income from such new ventures as virtual banking and the bank's entry into the consumer loan market.

It should be noted that the existing product strengths of Sakura Bank and Sumitomo Bank reinforce each other in this respect. For example, SMBC will start life with as the leading "mega-bank" in both of the key areas of distribution of investment products to the retail market and of housing loans.

New initiatives being undertaken to improve profitability at the consolidated level include rapid expansion in the area of on-line financial service provision in Japan where the two banks already command market-leading positions in telephone and on-line banking. Further advances will build on innovations currently in progress including the Japan Net Bank (JNB), a “virtual bank” with no physical presence except for the main head office, which will exploit the potential of the Internet to offer low-cost and highly convenient on-line services to customers. In addition, SMBC will actively promote the “@Loan” service, which marks the bank’s entry into the unsecured consumer loan market. This latter innovation is aimed squarely at the medium-risk, medium-return segment of the consumer loan market, which nonetheless enjoys highly attractive margins and risk-adjusted returns. More generally, the bank will promote the “@Bank,” offering a 24-hour-a-day service drawing on a network of 1,000 ATMs strategically located in convenience stores.

Given the size of the deposit and loan books, the bulk of the improvement expected in middle market operations, serving small and medium-sized corporations, is slated to come from improvements in loan spreads where a small improvement can have a major impact on income. Keys to improving loan spreads will include a superior level of service provided, a factor which has already yielded tangible benefits for Sumitomo Bank as discussed in the Divisional Review. However, expansion of fee income from such sources as loan syndication arrangement and electronic banking as well as investment banking income drawing on the strong capital markets capability of the merged bank will also provide added momentum to the bank’s improvement in profits from this segment.

In its corporate finance and capital markets activities, the new bank will continue to operate according to a strategy of “market-based intermediation” drawing on the capital markets strengths that Sumitomo Bank brings to the merger. This will allow SMBC to actively exploit the trend to capital market and structured financing among large corporations in Japan. The bank will also actively promote loan syndication and the emergence of a Japanese “loan trading market.” This will allow it to build on its market presence to generate a stable stream of arrangement fee income, while minimizing use of the balance sheet.

The performance and capabilities of Daiwa SBCM will continue to be important to the capital markets activities of the merged bank. During fiscal 1999, this company took a one-time charge for amortization of goodwill of 208 billion yen. Consequently, in spite of an outstanding year, the company recorded a deficit at the net profit level of 85 billion yen. This equated to a negative contribution of 34 billion yen to Sumitomo Bank. In future years, the bank’s 40% holding in Daiwa SBCM can be expected to generate a significant contribution given its already strong performance and the scale of the opportunities available in the wholesale securities markets.

In the international markets, SMBC will give increased attention to overseas opportunities once it has established a solid foundation in its own home market. However, in the meantime, a modest improvement in profitability can be achieved through rationalization of the overseas branch network of the merged bank, an increase in overseas assets held, and an increase in fee income from areas such as loan syndication.