



Recent Japanese and Chinese Investments in U.S. and European Financial Institutions

In the last two years, Japanese and Chinese financial institutions have made a number of investments in their U.S. and European counterparts, many of which have experienced difficulties as a result of the global financial crisis. The form and timing of these investments have varied, reflective of the different stages of development in the Japanese and Chinese financial markets. Japan's recent investments, which have come primarily from its three "megabanks," represent the country's return to the international arena after Japan's financial troubles in the 1990s. China's recent investments are more experimental in nature—trial entrées into the world of international banking as the country looks to become a larger player in global finance. This *Asia Focus* report compares some of the more significant investments by Japanese and Chinese financial institutions in both the U.S. and Europe, highlighting trends and offering thoughts on the direction of future investments.

Japan

In 2008, Japan's three largest banks provided capital injections to financial institutions in the U.S. and the U.K. that were negatively impacted by subprime-related write-downs and tight liquidity markets. Although Japanese banks are only a few years removed from their own local banking crisis, the combination of weak domestic lending opportunities and overseas banks in need of capital created an opening for Japan to renew and strengthen its footprint in the global financial market. As a result, large Japanese banks became increasingly interested in expanding abroad, while aiming to remain true to their traditionally conservative approach to banking.

Mizuho Corporate Bank and Merrill Lynch

In January 2008, Merrill Lynch (Merrill) announced that it had reached agreements to issue US\$6.6 billion in private placements to long-term investors, primarily Korea Investment Corporation, Kuwait Investment Authority and Mizuho Corporate Bank (Mizuho). Mizuho's portion was US\$1.2 billion. Less than a month beforehand, Merrill had completed a private place-

ment of US\$5.6 billion with Temasek Holdings, one of Singapore's two sovereign wealth funds, and Davis Selected Advisors.

Mizuho initially said that the arrangement with Merrill was purely a "straight investment"; however, the Japanese lender has since strengthened its collaboration with Merrill in areas such as project finance, mergers and acquisitions, corporate finance, risk-sharing and financial advisory projects. As the first major investment by a Japanese bank in a Wall Street firm since the late 1980s, the Mizuho-Merrill deal marked a turning point for Japan's banking sector, whose banks have recently reemerged as important players in international financial markets. Japanese media outlets have reported that Mizuho intends to continue holding its Merrill shares after they convert to Bank of America shares in the future.ⁱ

Sumitomo Mitsui Banking Corporation and Barclays

Sumitomo Mitsui Banking Corporation (SMBC) invested approximately £500 million (US\$730 million) and entered into a collaborative agreement with Barclays PLC (Barclays) in June 2008.^{ii,iii} The agreement provided SMBC with access to Barclays's investment banking platform and its India and Pakistan footprints, while Barclays gained access to a wider Japanese and Asian network for services such as private banking. This deal was part of broader capital raising efforts that involved investments from the Qatar Investment Authority and a separate Qatari company called Challenger, as well as an increase in holdings by existing investors, including China Development Bank (CDB) and Temasek. About five months later, Barclays also received investments totaling £500 million (US\$730 million) from Qatar Holding LLC and entities representing the beneficiary interests of HH Sheikh Mansour Bin Zayed Al Nahyan of the United Arab Emirates.

In addition, SMBC's investment in Barclays relates to its April 2007 agreement to acquire the trust administration and custody operations of Barclays Global

Investors Japan Trust & Banking Co., Ltd. that was accomplished through Sumitomo Trust & Banking Co., Ltd. (STB). Through the acquisition, STB aimed to strengthen its core trust banking and custody operations business, gain a new client base, and expand its assets under custody. Going forward, SMBC and Barclays are expected to work together on private and overseas commercial banking.

Mitsubishi UFJ Financial Group and Morgan Stanley

In October 2008, Mitsubishi UFJ Financial Group (MUFG) closed a deal to invest US\$9 billion in Morgan Stanley (Morgan) for a 21% ownership stake. The two companies had previously announced plans for a strategic partnership following Morgan's conversion to a bank holding company (BHC). Morgan became a BHC on September 21, 2008, one week after Lehman Brothers (Lehman) collapsed.

The Federal Reserve issued approval on October 6, 2008 for MUFG to acquire up to 24.9% of the voting shares of Morgan. The approval cited "unusual and exigent circumstances affecting the financial markets" in order to justify expeditious action on the proposal, as well as the minority, non-controlling nature of the investment in Morgan to justify the waiver of public notice.^{iv} The decision was consistent with the Federal Reserve's September 2008 *Policy Statement on Equity Investments in Banks and Bank Holding Companies*, which provides additional guidance on minority equity investments in banks and BHCs that generally do not constitute "control" for purposes of the U.S. Bank Holding Company Act.^v In recent months prior, MUFG paid approximately US\$3.5 billion to increase its 65% share ownership to 100% control of Union-BanCal Corporation, parent of Union Bank of California.^{vi}

The announcement of MUFG's investment in Morgan came only hours after Nomura, Japan's largest broker, announced it would acquire Lehman's operations in Asia and was in talks to buy parts of its operations in Europe. In general, Japanese institutions have been interested primarily in relatively conservative, minority stakes in what were once perceived to be leaders in international finance. However, Nomura's deal to acquire Lehman's Asia operations has created some financial strain for the Japanese firm.

Since the first of these megabank investments, capital levels at Japanese banks have felt significant pressure, particularly from the banks' relatively large equity

exposures and cross-shareholding agreements. Furthermore, Japan's economy has experienced a sharp decline due to the global financial crisis. As a result, it is likely that major acquisitions by Japanese financial institutions will be on hold until not only global financial markets become less volatile, but also Japanese banks are able to strengthen capital levels and address internal structural challenges.

China

Whereas Japan's recent investments in overseas financial institutions have stemmed primarily from its banking and brokerage industries, China's recent investments have come from an even broader range of organizations, including a policy bank, an insurance group and a sovereign wealth fund. As China strives to become a bigger actor in the international financial arena, these international investments serve as a means to achieve an assortment of long-term strategic goals—to gain technical expertise, enter new markets and pursue higher rates of return on national reserves. A summary of the most significant investments is included below.

China Development Bank and Barclays

As referenced in the description of the SMBC deal, Barclays issued new ordinary shares to CDB and Temasek in August 2007. CDB purchased a 3.1% stake in Barclays for £1.5 billion (US\$2.2 billion). Founded in 1994, CDB reports directly to the State Council of China and specializes in financing infrastructure developments, core industries, and key national projects. Although CDB is one of China's three policy banks, it received a capital injection of US\$20 billion from Central Huijin in December 2007 to facilitate its transformation into a commercially operated financial institution.^{vii}

The August 2007 investment by CDB broadened the bank's relationship with Barclays to that of a strategic partnership. Barclays agreed to assist CDB in its evolution into a commercially operated bank by providing training and advice in fields such as risk management, corporate governance, customer service, and information technology. In return, CDB agreed to use Barclays Global Investors as one of its preferred asset managers. As such, the partnership offered Barclays increased access to the rapidly growing Chinese market, with a particular focus on wealth and asset management. It helped CDB to better serve Chinese corporations with international commercial activities by gaining access to Barclays's extensive global fran-

chise. The two parties also agreed to cross-refer clients and jointly develop new international business opportunities.

As a result of market stresses, Barclays's stock price has declined substantially since the initial CDB investment and the U.K. bank has gone through multiple capital raising exercises in the last year. Therefore, despite the breadth of longer-term benefits afforded by this type of strategic partnership, the sharp decrease in the value of CDB's investment in Barclays has raised concerns among Chinese policy makers regarding the appeal of such overseas investments.

Ping An Life Insurance and Fortis

In November 2007, China's Ping An Life Insurance Company (Ping An) acquired a 4.18% equity stake in Belgium's Fortis. The stake was later raised to 4.99%. Ping An is China's second largest life insurance company, and like Fortis, Ping An's parent group follows a multi-pronged business model that integrates insurance, banking and asset management. Building upon this initial investment, the two companies signed an agreement in April 2008 to establish a global asset management partnership, whereby Ping An's parent group would acquire a 50% equity stake in the global asset management arm of Fortis for €2.15 billion (US\$2.99 billion).

However, in the months following these two deals, Fortis's stock price experienced a substantial decline in value. Consequently, Ping An recognized a sizeable mark-to-market loss of approximately RMB 15.7 billion (US\$2.3 billion) on its investment in Fortis.^{viii} In September 2008, Fortis received capital injections totaling €1.2 billion (US\$15.6 billion) from the governments of Belgium, Luxembourg and the Netherlands in exchange for 49% of the respective Fortis bank institutions in each country. Soon after the government injections, Ping An's parent group and Fortis announced that they would not be able to complete their proposed asset management partnership, citing "the current severe market disruption and the ongoing uncertainty in the global capital markets."

Despite the losses, representatives of Ping An have said that the company considers its investment in Fortis to have been a beneficial exercise in overseas investing.^{ix} Analysts expect that Ping An's exploratory investment will provide useful lessons for itself and other Chinese companies when evaluating future international financial sector opportunities.

China Investment Corporation and Morgan Stanley (and others)

China Investment Corporation (CIC), China's first sovereign wealth fund, was established in September 2007 with US\$200 billion under management.^x About three months after its inception, CIC invested approximately US\$5 billion in Morgan. As is the case with many long-term passive investments, the provisions of the deal capped CIC's stake at 9.9%, gave CIC no special rights of ownership, and offered CIC no role in the management of Morgan. From Morgan's perspective, this equity investment enhanced the company's capital position, deepened its historic ties with China, and provided international growth opportunities. For CIC, the deal offered a chance to invest in a well-respected U.S. financial company and an expected higher rate of return on China's foreign exchange reserves.

CIC has also made investments in other U.S. financial sector firms, including, for example, US\$3 billion in the Blackstone Group in May 2007 (before CIC's official launch date). As of October 2008, CIC's initial equity stake in Blackstone had lost roughly two-thirds of its original book value. CIC's investment in Morgan has also experienced significant losses.

In general, analysts have cited various reasons for the relatively unsuccessful performance of CIC's investments to-date. One reason is CIC's date of establishment; it entered the international financial markets just before a severe downturn. A second reason is CIC's internal composition and structure. For example, CIC faces internal challenges in hiring and retaining experienced asset managers. Mainland-based *Caijing* magazine has stated that senior positions at CIC carry a salary of about US\$100,000, far below international standards.^{xi} Furthermore, CIC's staff base is still gaining experience in terms of evaluating complex, international financial investments. As an organization, CIC is operating in a learning phase—internalizing its mission, setting parameters and expectations for investments, and managing staffing challenges.

Other Attempted Investments

Two key deals with Chinese financial sector companies made headlines, but were not completed. Although widely reported, the October 2007 deal between Bear Stearns and China's CITIC Securities (CITIC) to swap stakes was never consummated. By the first quarter of 2008, CITIC said it was rethinking

its agreement to invest in the U.S. company. Following JPMorgan's acquisition of Bear Stearns in late March 2008, CITIC announced a formal termination of negotiations. Whether the deal was delayed by bureaucratic inefficiency or an awareness of market trends, the outcome proved to be beneficial to CITIC given the U.S. firm's quick sale to JPMorgan. Media outlets also reported that Citibank was in talks with CDB in January 2008 to obtain a capital injection. However, the deal did not come to fruition. Many analysts speculated that the Chinese government, mindful of recent disappointing investments in other foreign financial companies, would not approve the deal.

These recent Chinese investments in overseas financial institutions have little in common except their pragmatic nature as pilot deals. While they may not follow an obvious pattern, they do demonstrate China's step-by-step approach to familiarizing itself with global financial markets. Recent declines in the value of these investments have put pressure on Chinese leaders to scrutinize future deals so that national finances are more insulated from extreme volatility. These domestic pressures will likely impact the form and timing of Chinese investments for the foreseeable future.

Looking Ahead

Foreign financial institutions have employed various strategies to try to protect their recent investments. For example, many deals ensure that the investor is given some form of representation on the target bank's board of directors. However, board representation is often limited to a position with non-voting status. In its deal with Fortis, Ping An was entitled to propose the appointment of one non-executive director to the Fortis Board. CDB was likewise entitled to nominate a non-executive director to the Barclays Board.

Particularly when substantial stakes are involved, the issue of "control" can complicate potential investments. In the case of the U.S., the Federal Reserve's *Policy Statement on Equity Investments in Banks and Bank Holding Companies* has created more leeway than in the past, enabling, for instance, the expedited approval of MUFG's 21% investment in Morgan. Under the terms of the deal, MUFG agreed to be a passive investor in Morgan, explicitly committing not to exercise a controlling influence over Morgan's management. MUFG agreed not to have more than one representative serve on the board of directors of Mor-

gan or its subsidiaries.

Public relations concerns can also complicate potential investments. For example, a number of foreign financial institutions have recently sold their shares in Chinese banks to raise capital, which could make China reluctant to invest in those firms in the near term.

Rather than looking overseas for possible investments, Asian financial institutions are likely to focus more on domestic issues in the coming months. While global financial markets remain volatile and strained, many Asian banks are expected to face both declining asset quality and pressure from domestic leaders to support local economies through increased lending. In addition, Asian institutions may be wary of investing in U.S. and European banks given the dilution that possible further public equity stakes would create. Looking forward, cross-border financial sector investments by Japan and China will likely return to a more traditional model of banking, namely attractive targets at reasonable prices.

APPENDIX

Key Recent Japanese Investments in U.S. and European Financial Institutions

Target Institution	Date	Investor	Deal Value	Approximate Stake
Merrill Lynch	Jan-08	Mizuho Corporate Bank	US\$1.2 billion	2%
Barclays	Jun-08	Sumitomo Mitsui Banking Corporation	US\$730 million	2%
Morgan Stanley	Oct-08	Mitsubishi UFJ Financial Group	US\$9 billion	21%

Sources: Various investor relations websites and media reports

Key Recent Chinese Investments in U.S. and European Financial Institutions

Target Institution	Date	Investor	Deal Value	Approximate Stake
Blackstone Group	May-07	China Investment Corp.	US\$3 billion	10%
Barclays	Aug-07	China Development Bank	US\$2.2 billion	3.1%
Fortis	Nov-07	Ping An Life Insurance	US\$2.5 billion	4.18%*
Morgan Stanley	Dec-07	China Investment Corp.	US\$5 billion	9.9%

* = Stake was later increased to 4.99%

Sources: Various investor relations websites and media reports

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- i Bank of America completed its acquisition of Merrill Lynch in January 2009. "Mizuho to Enhance Ties with BOA, Merrill Lynch." Japan Corporate News Network, 9/19/08.
- ii SMFG/SMBC President's Message, July 2008 at <http://www.smfg.co.jp/english/aboutus/message.html>
- iii Exchange Rates: £0.68=US\$1; €0.72=US\$1; and RMB6.82=US\$1.
- iv <http://www.federalreserve.gov/newsevents/press/orders/orders20081006a1.pdf>
- v Federal Reserve Board Policy Statement on Equity Investments in Banks and Bank Holding Companies: <http://www.federalreserve.gov/newsevents/press/bcreg/20080922c.htm>
- vi Nakamoto, Michiyo. "MUFG to buy up to 20% of Morgan Stanley." Financial Times, 9/22/08.
- vii Central Huijin Investment Ltd. (Central Huijin) is a wholly-owned subsidiary of China Investment Corporation (CIC), China's sovereign wealth fund.
- viii Ping An Investor Presentation: "Ping An of China: Impairment of the Investment in Fortis Group Shares." 10/6/08.
- ix *Ibid.*
- x CIC was established with the issuance of special bonds worth RMB 1.55 trillion by China's Ministry of Finance. These were, in turn, used to acquire approximately US\$200 billion of China's foreign exchange reserves, which formed the foundation of CIC's registered capital.
- xi "CIC's 200 Billion Question." *Caijing* magazine, 3/5/08. Also, "Sovereign Fund: Reputation at Stake." *Caijing* magazine, 2/1/09.