Yet another megabank is about to be born in Japan. The UFJ Group and the Mitsubishi-Tokyo Financial Group (MTFG), two of the four biggest financial groups in Japan, have announced their intention to merge. The assets of the combined bank would make it the largest in the world. The share prices of both banks rose substantially on the news.

The optimism is puzzling in light of the long-standing problems that Japanese banks face. The four main ones - as I have argued in a recent paper with Takeo Hoshi - are insufficient capitalisation, low core profitability, backward business models and continued lending to insolvent companies*. All are clearly present at UFJ.

The merger was triggered by UFJ's need to find more capital. MTFG, the healthiest of the large Japanese banks, can certainly provide it - but it is not clear how the merger will overcome UFJ's other problems. For one thing, UFJ's lending practices need to change, so that its "zombie" clients - businesses such as Daiei, the retailer, that would go bankrupt but for repeated bank loans and debt forgiveness - do not keep receiving credit. MTFG has been better about avoiding such lending but it has just led a bail-out of Mitsubishi Motors, another zombie.

In assessing the merger, one should also bear in mind that the most successful large banking mergers are those that create value through attempting to reduce costs rather than through trying to enhance revenue. This is not surprising, given that whenever two large organisations are combined, cost savings are easy to identify and straightforward to achieve. It is much harder to figure out how to cross-sell products.

These facts imply four conclusions about the proposed UFJ-MTFG merger. First, there is no particular reason to believe that simply creating a larger organisation will solve UFJ's long-standing structural problems. UFJ needs to cut loans to non-viable borrowers and its balance sheet should be thoroughly cleaned up, with bad credits offloaded to the government's asset management companies. Presumably UFJ could take these steps unilaterally, although it may lack the capital to absorb the losses on the dud loans. MTFG's better capital position could help - but only if its management is willing to take on these problems.

Second, if it wants to compete with other global banks, the new giant will need to upgrade its business model to compensate for the declining demand for traditional banking business. The
managements reportedly believe the combined bank makes sense because the branch networks are centred in different parts of Japan. This ignores the fact that these branches are not particularly profitable and that in many areas there is overlap. The largest bank in the world is not going to succeed if all it aspires to is taking deposits and recycling them as low-margin consumer loans.

Third, for the merger to make sense, there will have to be big cost-savings. Especially around Tokyo, there is a lot of overlap between UFJ and MTFG, so this is possible.

Unfortunately, the final conclusion is that past experience gives little hope that cost-savings will be realised. When UFJ was formed three years ago there were similar opportunities to cut costs. Yet since then UFJ has trimmed only Y50bn (Pounds 25m) in expenses, less than 20 per cent of the expense base of Tokai bank (the smaller of the merging partners). In comparable US deals, savings of 30 per cent a year are common.

One might hope that MTFG could provide leadership in trimming costs but it has little experience in this regard. The 1995 merger that created Bank of Tokyo Mitsubishi, the core of MTFG, was brilliant precisely because the two merging banks had amazingly little overlap. As a result the merger did not pose especially challenging integration issues.

A simple merger with MTFG does not seem to be the way to address the serious structural problems at UFJ. If it is to succeed, the management will have to focus on implementing massive cost-cuts, making better lending decisions and developing new revenue sources. It will also have to carry out tasks - integrating computer systems and bridging the pre-merger culture gap - that other large Japanese banks have struggled to achieve. Japan’s new giant will not have an easy birth.

* 'Solutions to Japan's Banking Problems', http://gsb.uchicago.edu/fac/anil.kashyap

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