Japanese Megabanks Put to Test

Their Recovery Genuine?

By Sakai Katsuhiko

A decade has passed since some large Japanese banks and securities firms failed amid the 1997-98 banking crisis. Keeping in step with economic expansion, the Japanese banking industry has come to the final phase of turnaround. Huge public funds invested in major Japanese banks, which had symbolized the crisis, have almost disappeared from their balance sheets following repayments to the government. European and US debt-rating agencies have upgraded their credit ratings for Japanese banks.

In fiscal 2006 that ended in March 2007, however, the six largest Japanese banking groups' combined consolidated net profit declined nearly 10% from the previous year to ¥2.8 trillion. In fiscal 2005, their net profit hit an all-time high of ¥3.1 trillion, breaking the record for the first time in 17 years. After shifting from net loss to profit by almost completing the disposal of nonperforming loans extended in the bubble economy period, the banking groups smoothly boosted their earnings in fiscal 2005. But their growth lost momentum in fiscal 2006. Their core banking business profit was slack, leaving their profitability to be questioned. When "Yucho Bank" emerges as the largest Japanese bank in deposits on privatization of the postal system in October 2007, the major Japanese banks' full revival will be put to the test. Yucho Bank is set to take over ¥188 trillion in postal savings.

Growing Business Flexibility

The past year saw many upbeat newspaper reports impressing readers with recovery of the megabanks. Japan's three largest financial groups have completed their repayment of the taxpayers' money that they got from the government in 1998 for recapitalization amid the banking crisis. In this way, Mitsubishi UFJ Financial Group Inc., Mizuho Financial Group Inc. and Sumitomo Mitsui Financial Group Inc. came out of government control and recovered their free hand in business management, shifting to more aggressive business approaches.

For example, they have begun to return more profit to shareholders and customers. After coming under fire for earning too much, the three largest financial groups raised their dividend payout for fiscal 2006 by between ¥3,000 and ¥4,000 per share, or 57%-133%, from the previous year. For fiscal 2007 ending in March 2008, the three megabanks plan to increase their per-share payout by another ¥3,000 on the strength of expected robust earnings. MUFG has projected its fiscal 2007 dividend will rise 27% to ¥14,000 per share, the highest among the three. Mizuho and Sumitomo Mitsui plan to increase their payout by 42% to ¥10,000 per share. For depositors, these groups have lowered automatic teller machine and money transfer fees and raised deposit interest rates in line with policy interest rate hikes by the Bank of Japan. Although deposit rates are still low, an after-tax rate of 0.28% on a one-year time deposit worth ¥1 million at the Bank of Mitsubishi-Tokyo UFJ in March would give the depositor interest earnings enough to pay for fairly good *sushi* lunch. In the zero-interest rate period before the BOJ began to raise its policy rate in July last year, after-tax interest income on the same time deposit was limited to 0.024%, failing to pay even for a Big Mac hamburger.

First Double-A Rating in 9 Years

In November 2006, Mizuho made its debut on the New York Stock Exchange. It was the first Japanese financial group to be listed on the exchange since the Bank of Mitsubishi, the predecessor to MUFG, did so in 1989. Mizuho cleared the US Securities and Exchange Commission's tough listing qualification tests, demonstrating an end to Japan's nonperforming loan problem that emerged after the burst of the economic bubble in the early 1990s.

Market ratings for Japanese banks have also risen gradually. In May this year, US credit-rating agency Moody's Investors Service upgraded deposit ratings for banks of the three largest Japanese financial groups to the third highest level of "Aa2" from the fifth rating of "A1." Main reasons for the upgrade included Japan's economic recovery and the banks' improved financial profiles. The Aa or double-A rating, just after the highest rating of Aaa or triple-A, is an indispensable pass for internationally active banks, a banking industry source says. It was the first time in nine years since 1998 for major Japanese banks to gain the double-A rating. This means that the megabanks have recovered the minimum qualification for participation in international competition.

Shy of Top Global Players

But even the largest Japanese banks are still weaker than top global players. In market capitalization at the end of March this year, MUFG was ranked first among the three largest Japanese financial groups, but 10th in the world. Its market capitalization then came to ¥14.4 trillion. Mizuho was ranked 23rd and Sumitomo Mitsui 24th, both failing to reach ¥10 trillion in market capitalization. Market capitalization was limited to a ¥1 trillion-¥2 trillion range for Sumitomo Trust & Banking Co. and Mitsui Trust Holdings Inc., which are among the six largest Japanese banking groups. Concerned about the Japanese banks' weaker profitability than major European and US banks, Financial

Services Minister Yamamoto Yuji said, "Profitability gaps may emerge as market capitalization gaps." He warned even the large Japanese banks could be acquired by foreign firms "in five or 10 years."

Such concern has emerged since May, when Japan introduced the so-called triangular merger system that allows a Japanese subsidiary of a foreign company to use shares in its parent for acquiring a Japanese firm. The banking industry is not free from the system. "It would not be strange for foreign players at any time to bite into the Japanese market where household financial assets have zoomed to ¥1,500 trillion," said a senior official at the Financial Services Agency. In fact, leading European and US financial groups have been promoting cross-border mergers and acquisitions in a bid to achieve a new target of ¥20 trillion in market capitalization, a figure deemed necessary to qualify as a grand champion in the financial industry. "Japanese banks that are relatively smaller in market capitalization even after improvements in their financial profiles seem to be very attractive takeover targets," said an official at the Tokyo branch of a European investment bank.

Demonstrating the Japanese megabanks' gap with top global players was US financial giant Citigroup Inc.'s recent acquisition of Nikko Cordial Corp., one of the three largest Japanese brokerage groups. Mizuho and MUFG had been interested in rescuing Nikko Cordial, which had lost credibility due to an accounting fraud scandal. But they failed to compete with Citigroup, which has a vast pool of funds available for a public tender offer and is quicker in making decisions. The Japanese financial groups had no choice but to leave a foreign player to bargain-hunt a long-established brokerage that is sufficiently solvent.

Photo: PANA

Mizuho Financial Group President Maeda Terunobu (center) listens to a reporter's question after announcing a fiscal 2006 earnings report during a press conference at the Bank of Japan.

Enhancing Profitability

Leaders of the largest Japanese financial groups vowed to increase corporate values to defend their groups from takeover bids when they announced their fiscal 2006 earnings. They also pledged to step up their business management while remaining alert to cross-border M&A. In reality, however, problematic actions are seen at these groups.

Sumitomo Trust eliminated losses from nonperforming loan disposal carried over from prior years and resumed tax payments in fiscal 2006 for the first time in 13 years. Even with huge profits, the other Japanese megabanks have carried over huge losses on the past disposal of nonperforming loans to offset annual profits and avoid tax payments. It is expected to take them several more years to resume corporate tax payments. "Large banks failing to resume tax payments may be called half-baked," said Oku Masayuki, chairman of the Japanese Bankers Association. Some large banks have begun to pay huge retirement benefits to their former executives that had been frozen for their responsibilities for their slack performances. The banking industry has some excessive complacency with the completion of public fund repayments.

The Japanese megabanks are now required to enhance their international competitiveness. "We would like to pay attention to strategic investment contributing to enhancing profitability," said a senior official at the Bank of Japan. But these banks must give priority to accumulating internal reserves to strengthen their capital bases just after completing public fund repayments. The megabanks have been busy coping with problems popping up one after another over compliance with law when it is time for them to develop new business models meeting Japan's declining population and economic globalization. As noted by a senior official at one of the megabanks, they may remain "convalescent" for the immediate future. JS

Sakai Katsuhiko is a senior staff writer and deputy editor at the Economic News Division, Jiji Press Ltd.