Bank-held Shares Shaking Financial System

Gov't, BOJ Resume Share Purchases

By Katsuhiko SAKAI

In the first half of 2008 when the US subprime mortgage problem began to rattle the entire world, many financial industry experts predicted Japanese banks would be hurt less than their US and European rivals. Indeed, Japanese banks' direct losses on securities linked to subprime mortgages were generally limited as a whole. But a severe blow came from a different direction. That was a steep stock market decline. The problem was not bank stock prices. It was plummeting prices of shares held by banks that did harm. If Japanese banks had not had excessive shareholdings, the impact of the financial crisis on them would not have been as serious as seen now.

Six major Japanese banking groups' combined consolidated net profits for the April-December period of 2008 posted a sharp decline of 89.9% from a year earlier to ¥135 billion. The largest factor behind the profit plunge was expanded appraisal losses on their shareholdings amid the stock market tailspin. The six groups' appraisal losses on shareholdings totaled nearly ¥1 trillion in the first nine months of fiscal 2008. Mitsubishi UFJ Financial Group plunged into the red for the first time. The others reported net losses or sharp profit drops.

Regional banks also saw further deterioration of their earnings. The 87 publicly traded regional banks' published appraisal losses on securities exceeded ¥580 billion in the first three quarters of fiscal 2008. The number of regional banks with group net losses for the three quarters increased to 44 from 27 for the first half of the year. The 87 banks as a whole posted ¥68.5 billion in net loss against ¥621.1 billion in net profit a year earlier. The abrupt change for the worse came on the stock market plunge.

Japan's Unique Cross-shareholding Practice Backfires

Banks and business corporations had expanded their cross-shareholdings without being conscious of relevant risks until the 1980s. Corporations had been willing to secure banks as their stable shareholders, while banks had intended to take advantage of their closer relations with growth companies to expand business operations. The match between banks and corporations had led to Japan's unique main bank system. The Japanese stock market continued rising through the periods of postwar restoration and rapid growth to reach the zenith of the bubble economy, allowing banks to use unrealized profits on shareholdings as a buffer from management fluctuations.

In the early 1990s, the bubble burst. As banks had expanded shareholdings beyond the size of their respective capital bases, a long stock market slump brought about huge unrealized losses on bank-held shareholdings, shaking the entire financial system.

Learning lessons from the serious impact of the stock market slump on banks, Japan enacted the Banks' Shareholdings Restriction Law in 2001. Earlier, the Antimonopoly Law and the Banking Law had limited a bank's voting equity stake in a business corporation to 5%. No other restriction had been imposed on banks' shareholdings. The new law then limited banks' shareholdings to not more than their respective "Tier 1" or core capital bases. In a bid to cushion the impact of banks' massive share sales before the new restriction was implemented in September 2006, the government-created Banks' Shareholdings Purchase Corporation (BSPC) and the Bank of Japan (BOJ) began to purchase shares from banks in 2002. By April 2006, the BSPC bought ¥1.6 trillion in shares from banks. The BOJ acquired more than ¥2 trillion by September 2004.

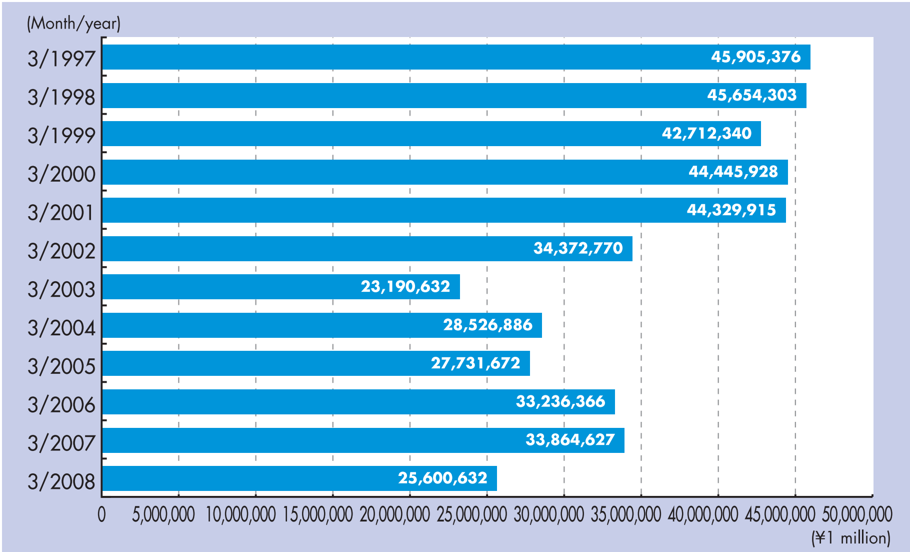
Banks' Most Vulnerable Spot Hit Again

Japanese banks' shareholdings shrank to ¥23 trillion, half their peak level, by the end of March 2003. But their shareholdings increased since around 2004 as corporations asked banks to hold shares to help ward off hostile takeover bids and as banks tried to expand business relations with their corporate customers. At the end of March 2008, banks' shareholdings exceeded ¥25 trillion.

Although the ratio of shares in banks' securities investment portfolio has declined substantially over the past decade, their financial conditions remain unstable, still dictated by stock market trends. The recent stock market plunge amid the global financial crisis has hit home Japanese banks' weakest spot, as indicated by their earnings reports for the first three quarters of fiscal 2008.

Some think tanks have estimated that the level of the Nikkei stock average at which the six major Japanese banking groups' unrealized profits on shareholdings become nil is between 9,500 and 10,000. The widely followed stock average fell from 14,691 at the beginning of 2008 to 8,859 at the end of the year, turning banks' shareholdings into the largest risk factor that shakes the financial system again.

Balance of all banks' shareholdings



Source: Japanese Bankers Association

BSPC, BOJ Set to Buy ¥21 Tril. in Shareholdings

In October 2008 when the Nikkei average posted a record monthly decline of 23.8%, the government and the ruling parties vowed to have the BSPC resume purchasing bank-held shares. They were worried that if nothing were done, banks would see a decline in their respective capital adequacy ratios due to expanding unrealized losses on shareholdings and shy away from giving new loans to or even choose to collect outstanding loans from small and medium-sized enterprises (SMEs) with difficulties in meeting year-end fund needs amid the recession.

The Banks' Shareholdings Restriction Law was revised to boost a government loan guarantee ceiling from ¥2 trillion to ¥20 trillion for the BSPC's fund-raising to purchase shares from banks and other entities. Shares eligible to be purchased by the BSPC are those given "BBB minus" or higher ratings, as are the case with the BSPC's past share purchases. The special corporation is designed to acquire bank-held and other shares for market prices (closing prices for the previous day) over the three years to the end of March 2012. The BSPC is to hold these shares for a certain period before selling them depending on market conditions. In order to prevent its share sales from affecting the stock market, the revised law extended the deadline for the BSPC's share sales for five years to March 2022 from March 2017.

In response to the BSPC plan, the BOJ has decided to purchase up to ¥1 trillion in shareholdings from about 30 banks, including megabanks that hold equity shares close to their respective capital sizes. BOJ Governor Masaaki Shirakawa has positioned the central bank's share purchases from banks as a safety valve for the financial system, indicating that it would like to shoulder the risks of banks to mitigate the impact of depressed stock market prices on the real economy.

Significance of Bank Shareholdings Questioned

The problem is how many banks will offer to sell shareholdings to the BSPC or BOJ. They are strongly opposed to realizing massive losses on sales of shareholdings at the current levels of stock prices that have fallen sharply. The government eased bank capital adequacy regulations last November, exempting banks not engaged in international operations from an accounting rule requiring banks to deduct appraisal losses on securities holdings from their Tier 1 capital bases in calculating capital adequacy ratios. Furthermore, banks may be reluctant to terminate cross-shareholding arrangements with their close corporate customers only for reasons of economic efficiency.

The resumption of share purchases from banks by the government entity and BOJ involves the greater issue of banks' restructuring. The significance of banks' shareholdings is questioned again. As far as banks' financial bases remain vulnerable to stock market fluctuations, financial system stability or facilitation of SME loans is far from being secured. "It is extremely important for banks to reduce the risk of stock market fluctuations in stabilizing their business performances," says a senior BOJ official.

Even after the turn of the year, we see no sign of stock market recovery. Some bankers have come to voice the need for awareness that banks should not fail to take advantage of the stock market plunge, not missing out on a chance to reduce their shareholdings for the third time. "We should discuss what to do with shareholdings anew," says Mizuho Bank President/CEO Seiji Sugiyama, former chairman of the Japanese Bankers Association. "I personally feel banks should try to reduce cross-shareholdings."

About half of bank-held shares in Japan exist at the three megabank groups – Mizuho Financial Group, Mitsubishi UFJ Financial Group and Sumitomo Mitsui Financial Group. On a consolidated basis, their shareholdings exceeded ¥11 trillion at the end of September 2008. "Whether the purchases of bank-held shares will make progress all depends on these megabank groups," says a stock market official. JS

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