The Problem of "Potential Non-Performing Loans"

– Financial Services Agency Plans Special Inspections –

By Tani Sadafumi

One of the pillars of the structural reforms that Prime Minister Koizumi Jun'ichiro has promised to undertake is disposing of non-performing loans (NPLs). Financial institutions are trying to solve their problems with NPLs even before the government authorities exert pressure, according to one leading bank executive. But the prospect of solving the problem seems grim. Moreover, there have been concerns that instability in the financial system may be re-ignited. The reason for these concerns is the presence of debtors who are classified as the so-called "needing attention" category and have the potential to produce massive amounts of NPLs. In order to deal with the situation, the Financial Services Agency plans to conduct a special inspection of leading banks by March 2002 to find such potential NPLs.

The Financial Services Agency in April 2001 submitted to the Diet a report based on financial institutions' self-inspections, which stated that loans to ailing industries had reached a total of ¥150 trillion 922 billion as of the end of March 2000. Of the entire amount, loans to clients who are classified as "needing attention" account for ¥116 trillion 966 billion. Loans to clients who are in the "danger of bankruptcy" category account for ¥20 trillion 510 billion. Loans to clients who are in the "bankrupt" and "de facto bankrupt" categories account for ¥13 trillion 446 billion. But the report says that a little less than ¥70 trillion out of ¥151 trillion are actually healthy loans because there are sufficient mortgage and loan guarantees.

The key issue now is the loans to "needing attention" debtors that account for a greater part of the entire loans. Generally, loans to clients who are "in danger of bankruptcy" and those who are in the "bankrupt" and "de facto bankrupt" categories are defined as NPLs. For these two categories of NPLs, the government has decided to write off balance sheets within two years the ¥12 trillion 700 billion NPLs held by leading banks. The government has also called for banks to write off within three years newly occurring NPLs.

But according to an examination of the four major financial groups (United Financial of Japan, Mitsubishi Tokyo Financial Group, Mizuho Financial Group and Sumitomo Mitsui Banking Corp.) by the Financial Services Agency, of the clients defined as "normal" as of the end of March 2000, a year later, 6.5% turned out to be "needing attention" clients and 0.6% turned out to be those who are "in danger of bankruptcy" or in the "bankrupt" and "de facto bankrupt" categories. Considering the fact that even "normal" clients downgraded their classification, an even larger proportion of "needing attention" clients, that are "gray" from the beginning, could produce even more NPLs.

According to the Bank of Japan's Bank Examination and Surveillance Department, the operational net profit of the nation's banks, including leading banks, regional banks and second regional banks, was ¥4.7 trillion for fiscal 2000 (between April 2000 and March 2001). The cost of writing off NPLs at those banks was ¥6.1 trillion. In other words, there is not much more profit than the cost of clearing NPLs that resulted from the failures of past investments. Such circumstances have been continuing since 1994.

One of the reasons such circumstances have been continuing is that worsening company management due to the lingering economic slump generates further new NPLs. But this is not enough to explain why financial institutions have to deal with a massive amount of NPLs year after year. It is more pertinent to assess that such institutions have been delaying a resolution of the problem due to their lax inspections. Consequently, they have been in the position to pay the cost of defining clients as "needing attention" when they should have labeled them as those who are "in danger of bankruptcy."

Financial institutions normally reserve NPL allowances of 70 to 75% for clients who are "in danger of bankruptcy" and 3 to 5% for "needing attention" clients for fear that they may be unable to collect their loans due to clients' financial difficulties such as bankruptcy. Apparently, even when clients who lag behind in repayments have unrealistic reconstruction plans, Japanese financial institutions have trusted their clients in many cases and classified them as "needing attention." In this way, financial institutions only had to prepare small amounts of NPL reserves and kept postponing writing off NPLs. As a result of this practice, once their clients do fail, and the problem of NPLs appear to the surface all at once, they will have to spend huge costs to dispose of them.

An incident that symbolized this tendency was the bankruptcy of a leading supermarket chain, Mycal Corp. The firm applied to the Tokyo District Court on Sept. 14, 2001 for an application of the Civil Rehabilitation Law with ¥1,742.8 billion in debts. As a result, financial institutions that had classified Mycal as "needing attention" had no choice but to re-classify it as a client who is "bankrupt." In other words, they were required to reserve the amount which is the difference between the sum of the loans and the guaranteed mortgages.

There have been many similar cases. For instance, in the Financial Services Agency's Jan. 2000 inspections into Sumitomo Bank (now merged to form Sumitomo Mitsui Banking Corp.), the

Agency considered leading general contractor Kumagai Gumi, as a client which was "in danger of bankruptcy," while the bank officials put the firm in the "needing attention" category. But in September the same year, Kumagai Gumi fell into a situation where they had to request the bank to forgive its loans. This is a typical example of how new NPLs are produced.

As mentioned above, Japanese financial institutions have for years spent more on expenses than their operational net profits in order to dispose of NPLs. This was possible because they had hidden profits from the stocks they had obtained at a low cost in the past. But as a result of allocating hidden profits to deal with NPLs, according to an estimate by the Daiwa Institute of Research, even the Bank of Tokyo-Mitsubishi, which is considered to have the strongest financial foundation, found that its level of the Nikkei Stock Average that turns hidden profits from stocks to zero has gone up to ¥11,000. As a result, with the average stock price at ¥9,774 at the end of September 2001, all the leading banks now have latent losses. While the tendency depends on changes in the stock market, financial institutions can no longer count on their hidden profits from stocks as a fund to dispose of NPLs. Furthermore, following the introduction of current value accounting, firms' stock values are now going down causing their own capital to shrink.

The policies implemented on the basis of the changing financial environment and reflections on past problems include the restrictions on financial institutions' holding stocks as well as stricter inspections. With regard to the latter, the Financial Services Agency plans to conduct special inspections between late October 2001 and the spring of 2002, and will reflect its results in the settlement of accounts for fiscal 2001 (term ending March 2002). To be more specific, the Agency will demand that financial institutions increase their NPL reserves or write off loans for clients who are classified as "needing attention" but whose business performances and stock prices have gone down or status has suddenly dropped. The undertaking aims to be in line with Prime Minister Koizumi's policy of disposing of NPLs without delay.

In relation to this, Finance Minister Shiokawa Masajuro made an interesting remark. Shiokawa criticized both industries with excessive debts and financial institutions that lend them funds. Shiokawa says, "At least listed firms are publicly recognized and have social responsibilities. It is not right for them to continue having excessive debts while not paying dividends and at the same time to have banks abandon large amounts of debts and yet be unable to draw up plans for reconstruction" and "Such firms and financial institutions have a 'cozy' relationship. Some kind of political action is necessary in order to solve the problem of NPLs."

There are three means to deal with NPLs, namely 1) legal means, 2) private means, or waiving loans, and 3) selling them. Regarding the legal means, the Civil Rehabilitation Law has been enforced. With regard to the private means, the Japanese Bankers Association (Zenginkyo) and the Japan Federation of Economic Organizations (Keidanren) drew up guidelines to admit waiving loans for a second time provided that the executives of failed firms resign, clarify stock holders' liabilities and draw up rational reconstruction plans. Concerning the selling of NPLs, the government strengthened the function of the Resolution and Collection Corporation (RCC) so that NPLs can be purchased at current prices, instead of the book values of five percent which are lower than current prices.

But whether the change in the environment will be utilized is up to the judgment of financial institutions and business owners. Finance Minister Shiokawa's remark reflects his frustration toward the reluctant attitude of both business owners and financial institutions, who will be sorely affected, because it could force them to take full responsibility.

Meanwhile, the State Minister in charge of Financial Affairs Yanagisawa Hakuo takes a rather aloof stance saying that it is not easy to resolve the problem of excessive debts, while Shiokawa has called for drawing up standards for streamlining firms with excessive debts. Yanagisawa holds the view that the administration should not intervene in civil matters and maintains that it is undesirable for the government to draw up forceful uniform standards. But he does not object to the idea of stricter screening of clients by financial institutions as a result of special examinations conducted by the Financial Services Agency and streamlining heavily indebted firms without a prospect of reconstructing their businesses.

The problem is the social and economic impact created when firms with excessive debts fail. In the lingering economic slump, public concerns about unemployment resulting from chain reaction bankruptcies could make the economy worse. Also, dealing with NPLs could weaken financial institutions, which could re-ignite the instability of the financial system that occurred in 1997 and 1998. With the April 2002 restart of the pay-off system (a form of deposit insurance system), there is a high probability that people's savings could outflow from financial institutions with weak management foundations.

Financial institutions must work to solve such problems by 1) restructuring (such as integration and closing of branch offices, cutting the number of executives, returning executive members' retirement allowances and staff pay cuts), 2) increasing their own capital, and 3) further reorganization. Furthermore, the government, though opinions are divided, will likely need to be involved in the process by re-injecting public funds and using the state-owned bridge bank system. JJTI

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