

# Some Results in Bringing Non-Performing Loans to Light

## – Special Inspections by Financial Services Agency –

By Tani Sadafumi

On April 12 the Financial Services Agency (FSA) released the results of special inspections conducted into the major banks' problem borrowers. The additional amount of non-performing loan (NPL) accordingly identified by the FSA was ¥1.9 trillion, bringing the total amount of NPL to be written off in the year ended March 31, 2002 to ¥7.8 trillion. This is the scale of the problem since fiscal 1997 and 1998 when more than ¥10 trillion had to be written off in the face of a financial crisis.

On the plus side, despite a reduction in the value of capital accompanying the additional writing off of NPL, all the large banks cleared, with ample margins, the capital adequacy ratio of 8% required of financial institutions engaging in international transactions. Minister of Financial Services Yanagisawa Hakuo boasted at a press conference: "The NPL problem is close to being under control now." However, many of those involved in the markets say that the potential for the problem to flare up still exists.

The special inspections, started by the FSA last October, targeted 13 major banks known as "money center banks." The 13 were Dai-ichi Kangyo Bank, Fuji Bank, Bank of Tokyo-Mitsubishi, Asahi Bank, UFJ Bank, Sumitomo Mitsui Banking Corp., Daiwa Bank, Mitsubishi Trust Bank, Yasuda Trust Bank, UFJ Trust Bank, Sumitomo Trust Bank, Chuo Mitsui Trust Bank and the Industrial Bank of Japan.<sup>(1)</sup> The NPLs of a total of 98 companies (owing ¥10.5 trillion) out of 149 corporate problem borrowers (owing ¥12.9 trillion), were investigated. These were in the so-called "depressed sectors" of construction, real estate, distribution/trading and non-banking.

The inspections revealed that compared to the major banks' last November announcement of the self-assessments, which was conducted at the end of September, the debtor classification of nearly half of the 149 corpo-

rate problem borrowers (71 companies owing ¥7.5 trillion) had deteriorated. In particular, 34 companies were identified as "in danger of bankruptcy" with little possibility of paying back their debts. (These companies collectively owed ¥3.7 trillion.) No companies were classified in this category in last year's self-assessments. If we define the debts of companies classified as "special attention needed," including lower classifications, as "NPLs," a further ¥4.7 trillion in NPLs came to light through the special inspections.

For the first time, the inspections identified a deterioration in the NPLs to the above four "depressed sectors," including construction. Twenty-six of the 34 corporate debtors classified as "in danger of bankruptcy" were from the four sectors, which contributed ¥1.7 trillion of the ¥1.9 trillion additional NPL to be written off.

Based on the special inspections, the banks modified their expectations and announced new outlooks for the settlement period ending March 31, 2002. In addition to an increase in their burden of NPLs, banks posted across-the-board current shortfalls as a result of losses arising from the fall in the prices of shares and of other negotiable securities as they moved to complete the introduction of current price accounting. Although the total net operating profit, which indicates the profitability of banks' main business, was corrected upward from a predicted ¥3.8 trillion to ¥4.1 trillion, this was still considerably short of the ¥7.8 trillion in NPL to be written off. Even if all of each year's profits are plowed into offsetting the NPL overhang, they would still not compensate for banks' past mistakes in making loans. This sorry state has existed for eight years, since the year ended March 31, 1995. To liken this to the household budget of an indebted family, even if the family devoted all its disposable income to repaying its debts, its income would fall short of its

repayments for eight years. We can observe from this fact that major banks have lost significant strength over the past several years.

Along with the announcement of the special inspections, the FSA announced the following three administrative policies: (1) encouragement of disposal of NPLs, (2) stationing of resident inspectors in banks and (3) promotion of mergers among regional financial institutions.

Policy (1) aims to provide guidance to banks in removing NPLs from their balance sheets, setting a goal of 50% disposal within one year and 80% within two. This policy has given concrete interim targets to the policy already being pursued of getting NPLs off balance sheets within three years. Policy (2) is a system of stationing resident inspectors in the banks of each major banking group; private sector personnel will also be used.

Policy (3) is designed to target regional banks, second-tier regional banks, credit associations and other institutions not covered by the special inspections. Because restrictions on payoffs<sup>(2)</sup>, including those on ordinary savings deposits, will be fully lifted in April of next year, the FSA considers it necessary to restructure financially insecure regional financial institutions that could trigger instability in the financial system. However, compared to the major banks, which have forced themselves through a process of merger or integration, the actions of these regional financial institutions have been somewhat dilatory. The FSA's bold "promotion of mergers" is an expression of its exasperation with this situation. In fact, sources associated with Fukuoka City Bank, a second-tier regional bank, and The Nishi-Nippon Bank, a Fukuoka regional bank that announced a business merger in April, admitted to "pressure" from the FSA. In the future, there is a strong probability that government-driven mergers

## Distribution of Borrower Classifications

## Total Figure

(Unit: ¥ trillion)

Year ended September 30, 2001			Year ended March 31, 2002		
Classification category	Number of debtors	Amount	Classification category	Number of debtors	Amount
Normal	50	3.2	Normal	35	2.4
			Needs Attention	35	2.6
Needs Attention	56	6.4	Special Attention	45	4.2
			In Danger of Bankruptcy or Below	34	3.7
Special Attention	43	3.2			

## Four Industries Only

(Unit: ¥ trillion)

Year ended September 30, 2001			Year ended March 31, 2002		
Classification category	Number of debtors	Amount	Classification category	Number of debtors	Amount
Normal	24	2.2	Normal	18	1.8
			Needs Attention	20	2.0
Needs Attention	39	5.5	Special Attention	34	3.4
			In Danger of Bankruptcy or Below	26	3.3
Special Attention	35	2.8			

among regional financial institutions will increase.

In addition to the announcement of the results of the special inspections, the FSA displayed "an inspection manual relating to credit to small and medium-sized enterprises." This is a highly detailed document, but to briefly summarize its contents: "banks' self-assessments for small and medium-sized enterprises need not be as rigorous as for large corporations and firms of middle standing." For example, for a company with sophisticated technological capability and an owner intending to provide his or her own assets, there is no need to downgrade the debtor classification just because the company remains in the red. The Liberal Democratic Party, whose support base comprises local business people, has for some time been opposed to small and medium-sized enterprises being treated according to the same standards as large corporations. Recognizing this, the FSA has also condoned a double standard.

These special inspections were precipitated by doubts arising in regard to the self-assessments of financial institutions when the leading supermarket chain Mycal Corp., rated as "normal" for lending purposes, went bankrupt last fall. The aim was to remove doubts about Japanese banks by implementing rigorous checks by government authorities. In that hidden NPLs came to light and their disposal was hastened as a result of the special

inspections, the stated aim of the inspections was achieved.

The FSA was singing its own praises, and the banks were recognizing that they are "fully over their mountain of NPLs" (Furusawa Kiichiro, president of Mitsui Trust Holdings, Inc.), but economists and market watchers were not easily persuaded. To be sure, banks have revealed their circumstances more accurately than in the past, but it is not possible to say that there is no concealment of NPLs, whether intentional or otherwise.

For example, recently, there have been many cases of debt-equity swaps in the provision of financial support for distribution and general construction companies. This is a method of corporate restructuring by the banks, by which a lender is given equity participation to replace a loan and to reduce companies' burden of principal and interest repayments. When there is no way for a company to repay a loan, it is more profitable for the banks to convert that loan to shares and wait for the share price to recover after the company has been restructured. This is an appropriate business judgment.

However, the problem lies in whether companies that have received assistance can be restructured. Looking at Daiei Inc.'s restructuring plan, even though Daiei received ¥520 billion in financial assistance, ¥900 billion of interest-bearing liabilities will still be outstanding in February 2005. Companies may succeed in restructur-

ing sooner than planned, but some analysts believe that additional financial support will still be needed.

It is not clear how the credit extended to Daiei was assessed, but some financial analysts point out that, as a result of financial assistance by way of a debt-equity swap, the classification of the residual credit (the loan), which should be "in danger of bankruptcy," could be eased to "needs attention." If this happens, the special inspections would have deferred losses in relation to the credit needed for increasing the reserve allowance. Depending on economic trends, it is impossible to rule out the danger that further NPLs not uncovered by the supposedly strict special inspections may come to light in the future. **JUJI**

## Notes

1) Dai-ichi Kangyo Bank, Fuji Bank and the Industrial Bank of Japan were merged to form Mizuho Bank and Mizuho Corporate Bank on April 1.

2) The end of state-backed guarantees for full repayment of deposits at failed financial institutions.

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