Financial Health and Earning Power

By Izumi Masaki

HOPES are rising for a revitalization of Japan's financial system. Together with the recovering economy and rebounding share prices, progress has been made in the disposal of non-performing loans (NPLs), while notable new developments toward strengthening earnings bases have begun to emerge, in which major banks have embarked on broadening investment banking operations for corporate clients and branching out into unsecured lending to individuals and small and medium-sized enterprises (SMEs) through alliances established with consumer finance companies.

In late June, the U.S. Standard & Poor's (S&P) rating agency raised its ratings of Japan's major banks for the first time since the collapse of the bubble economy in response to a fall in high risk assets, among other factors. However, despite some opinions that the road to normalization of the financial system has at long last come into view, clear developments have yet to demonstrate that Japan's financial system will be able to boost its competitive strength while steadily shedding the burden left over from its bubble-era legacy.

Major banks' account settlements in the fiscal year that ended in March show a decrease in destabilizing factors at the operating level. Among the seven banking groups' consolidated net results, with Mitsubishi Tokyo Financial Group (MTFG) leading the ranking at ¥560.8 billion, five groups swung back into the black from the deep red figures posted in the fiscal year that ended in March 2003. In addition to the stock market rally, strong effects came from the decrease in NPL disposal costs in the wake of the economic recovery. The outstanding balance of NPLs fell to ¥13.7691 trillion, compared with ¥20.4154 trillion as of March 31, 2003.

The seven banking groups referred to here are: MTFG, Sumitomo Mitsui Financial Group (SMFG), UFJ Holdings, Mizuho Financial Group, Resona Holdings, Mitsui Trust Holdings, and Sumitomo Trust & Banking. UFJ, which the Financial Services Agency had found materially short of provisions for NPLs, posted a net loss of ¥402.8 billion, and Resona, which has been proceeding with NPL disposal after an injection of public funds, reported a net loss of ¥1.6639 trillion. Both institutions suffered net losses for the third consecutive year.

The much-observed NPL disposal cost, compared with the previous fiscal year, fell by ¥1.6373 trillion to a total of ¥3.3915 trillion, thus contributing to the improved earnings. The default ratio for the outstanding loan balance of the seven groups came to an average of 5%, marking a big step toward attaining the government-prescribed goal of cutting the ratio by half to the 4% level by March of next year, from the 8% level as of March 31, 2002.

This 50% reduction target is an objective under the Program for Financial Revival formulated in the autumn of 2002 by Minister of State for Economic and Fiscal Policy Takenaka Heizo and other officials. In light of this, major banks have been working to restore their asset portfolios back to health through the collection of outstanding loans, the disposal of loans through sales to the Resolution and Collection Corporation (RCC) and other external buyers, and through the rehabilitation of borrowers.

Viewed separately by banking group, the balance of NPLs has been cut by nearly half to 5% at SMFG, as reflected in a comment by its president, Nishikawa Yoshifumi, who stated that attainment of the 50% reduction would be possible by September 2004. Mizuho has lowered its balance to 4.4%, freeing the bank from a situation of rapidly rising NPL disposal costs, as the group's president Maeda Terunobu emphasizes. MTFG has already reached the 50% reduction target with a 2.9% default ratio, which compares well even against blue-chip U.S. and European financial groups according to former Mitsubishi Tokyo president Miki Shigemitsu, who also predicts to the ratio will fall to the 1% level within two years.

Photo : Kyodo News

Former president of MTFG, Miki Shigemitsu

The cost of NPL disposal at MTFG has been such that the bank was able to post gains totaling ¥105.7 billion from the reversal of loan loss provisions built up in the past, among other items. In the process of economic recovery, support extended toward the rehabilitation of borrowers has been bearing fruit, leading to an increase in the number of companies that could be upgraded into a higher borrower category. Additionally, the incidence of loan defaults has decreased.

For the seven groups overall, the percentage of deferred tax assets as a ratio of equity capital improved to 35% from 57% a year earlier. Deferred tax assets, which are counted toward equity in anticipation of a future refund of corpo-

Table 1 FY2003 March Account Settlements

	Consolidated-net Result	Real net Business Profit	NPL Disposal Cost
Mizuho	4069	9541	2379
Sumitomo Mitsui	3304	10001	8034
Mitsubishi Tokyo	5608	6548	☆1057
UFJ	▲ 4028	7946	12577
Mitsui Trust	507	1812	583
Sumitomo Trust & Banking	796	1450	218
Resona	▲ 16639	2121	11181

Source: Cut off under 100 mill. ▲ = Deficit ☆ = Post gains

ration tax, have the effect of inflating capital, and have been criticized as symptomatic of Japanese banks' financial weakness. Incidentally, injections of public funds into both Resona Bank and Ashikaga Bank were triggered by the refusal of auditor to admit recognition of deferred tax assets for the banks' accounts.

Moreover, equity portfolios, up until now a major reason for ballooning losses, have been shrinking under the banks' efforts at reduction, with a commensurate increase in each group's resilience against shifts in external factors such as the economic cycle and share prices. Even if the economy were to turn down now, signs of major banks being at risk of sudden default are unlikely to emerge. Nor does it seem probable that major banks could fall into a vicious cycle in which concern over the financial system near the end of the fiscal year causes a sudden collapse of banks' share prices, pulling down equity prices overall, thus further aggravating the operating conditions of major banks.

While financial health is therefore coming back, from the viewpoint of earning power, a host of problem issues remain. Actual net operating profit, which measures banks' core earnings, has been deteriorating at four groups due to weaker earnings from bonds, centering on Japanese government bonds (JGBs), in the wake of rising yields. Outstanding loan balances, the basis of banking income, have been declining across the board, with most of the net interest income from lending down to levels below those of a year earlier.

Amid unvaried conditions of overbanking, and with substantial corporations increasingly turning away from banks for financing, interest rate increases remain elusive given that "there are few demands for funds and all banks seek to increase lending to financially healthy corporations," according to Miki. Banks are also caught in a dilemma because, as a result of NPL disposal, high-interest borrowers are diminishing in number while lending margins do not improve.

Top government officials are said to have posited that "two mega-banks are enough for Japan." Whether convergence toward a literal two-mega-bank system will proceed is unclear, but if it does, MTFG and SMFG are likely to be the two groups that will form the core. Ironically enough, however, the actual net operating profit of MTFG, which tops the ranking in financial health, trails that of SMFG and even falls short of Mizuho and UFJ. It is not hard to imagine that MTFG is feeling an acute sense of danger in the face of its earnings situation, which contrasts with the emphasis it places on how quickly it repaid public funds to the national treasury and reached the final stage of its financial restructuring objectives.

MTFG moved to create a fully-fledged operating tie-up with a consumer finance company, to which SMFG reacted by following suit. The motive behind this step is to earn somewhat reasonable spreads by using the know-how of these consumer finance companies – although the perception is that in former times the banks would have drawn a line between consumer finance companies and themselves – and by venturing into the business of unsecured lending to individuals and SMEs, an uncharted world for major banks used to real estate collateral. Another common theme for each group is to increase fee income by expanding investment banking and comprehensive financial services for retail customers across the range of commercial banking, trust banking, insurance and securities.

Resona's uphill struggle continues. Under the leadership of its chairman Hosoya Eiji, who joined Resona from East Japan Railway, the bank has been hammering out a succession of new lines intended to propel its transition from banking to financial service operations. Adoption of a zero-waiting-time operating mode at branch counters, and standup operations, i.e. standing teller counters, have to an extent brought results, but at a level that still belongs to the realm of changing staff consciousness and improving systems.

Rebuilding the lending business to SMEs is a major cornerstone of Resona's reconstruction. Group executives' words of providing financial know-how unavailable at regional banks, and finely-tuned services distinct from those of mega-banks, conversely speak of a position potentially threatened by a two-sided attack from mega-banks and regional financial institutions. "The service business is a repetition of trial and error," is the cherished opinion of Hosoya, but a vision will need to be drafted for simultaneously fostering financial health and earning power, while repaying public funds in huge amounts. The shape of Resona's "New Business Model," to be announced in mid-November, will be a focus of attention. JS

Editorial Note: The merger movements among mega-banks to expand their financial bases have intensified since this article was written in early July. On July 14th, UFJ Holdings announced that it had proposed a merger with the Mitsubishi Tokyo Financial Group, and had canceled its planned integration with Sumitomo Trust & Banking. The Sumitomo Mitsui Financial Group announced a merger proposal to UFJ on July 30th.

Izumi Masaki is an editor in the Economic Division of Jiji Press Co., Ltd. His work focuses on economic policy. At the New York branch of Jiji Press, he specialized in matters of finance and industry.