Japan’s banks heading for a better future

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The grim forecasts of a possible collapse of the Japanese financial system that have been made regularly for many years are rapidly losing their shock value as signs of the revitalisation of the banking sector become more and more evident. Japan’s leading banks plan to return to the black in the current fiscal year (ending 31 March 2004). Many financial holding companies have even raised their profit expectations considerably in the meantime. Encouraging progress has also been made in trimming the bad loan portfolio.

The persistence and scale of Japanese banks’ bad loans problem is probably unparalleled among the developed economies (see Die Bank 1/2002, p. 6 ff). Nevertheless, it has become increasingly clear recently that there is a good chance that the banking industry can be rescued. Hopes are based mainly on tough government measures designed to tackle the bad loans problem and revitalise the financial system as quickly as possible, even though the heavy national debt limits the action the government can take.¹

The government is likely to be helped by the economy, which picked up again in 2003 and supports the rescue measures. The Japanese economy continues to grow in the current year, and the upturn has pushed up stock prices. After hitting a low at the beginning of May, the Nikkei 225 Index had rallied by around 30 per cent by the end of 2003. According to the Daiwa Institute, this rise in Japan’s most important stock market barometer enabled the seven big banks alone to record paper profits of around €10.5 billion.²

The government has been intervening for some time to help the country’s troubled banks. It has various means at its disposal to deal with the banking crisis, ranging from financial aid to nationalisation. Between 1998 and 2000, for example, the government pumped around €70 billion into Japanese big banks and regional banks in return for preferred stock in these banks that can be converted into common stock with voting rights. Mandatory stock conversion is being considered in four cases:

- Where no dividend is paid
- Where there is a significant deterioration in profits for two years in succession
- Where banks are badly undercapitalised
- Where there is no improvement in the management situation despite corrective measures imposed by supervisors.

That the government means business was made quite clear recently by the nationalisation of Resona Bank in May and Ashikaga Bank in December 2003. The Resona banking group, created by the merger between Asahi Bank and Dawai Bank, is based in the structurally weak Kanzai region. After only starting operation on 1 March 2003, it was nationalised in mid-May. One of the main reasons for this bank’s problems was the structure of its clientele. Its client base included many SMEs that were unable to repay loans on time because of the recession. Often loans actually had to be written off completely. The result: With a capital ratio of only 2 per cent, Resona Bank fell below the 4 per cent minimum regulatory requirement, whereupon the Japanese government effectively nationalised it by acquiring voting stock. The government invested around €15 billion worth of tax revenue to prop up the bank.

Ashikaga Bank, based in the Tochigi prefecture 100 km north of Tokyo, was, on the other hand, natio-
nalised because balance sheet ratios had deteriorated dramatically. The Japanese government then intervened to bring the bank under its supervision.

Central bank activities
The protracted banking crisis, for which the central bank was seen as partly to blame, led to a change at the top of the Bank of Japan. One of the first things the new central bank governor, Toshihiko Fukui, the candidate for the post favoured by President Koizumi, did in office was to convene a special meeting at which the volume of funds available to buy commercial banks to cushion increases by ¥1 trillion to around ¥3 trillion (€23.4 billion). Instead of around €4.2 billion previously, stock to the tune of €5.9 billion may now be acquired. In addition, the upper limit on purchases of government bonds was lifted.

Policy of the Financial Services Agency
A powerful government means of exerting influence on banks is the Financial Services Agency (FSA). The FSA was set up because confidence in the Japanese financial system was rapidly dwindling both at home and abroad and was designed to centralise banking supervision for the first time. At the same time, public funds were made available to improve struggling banks’ capital adequacy.

Yet, the FSA initially failed to convince the Japanese public, as it took a long time to get the bad loans problem under control. In particular, the lax supervision of measures imposed was repeatedly criticised in the media. For example, the criteria laid down by the FSA for mandatory conversion of the preferred stock held by the government into voting stock were seen as virtually too soft to implement.

In the meantime, however, the FSA is taking a harder line with banks. The fact that ‘superminister’ Heizo Takekaka now heads this agency alongside the Economics Ministry shows just how important the FAS is. In his new function, he immediately threatened to nationalise banks should they be unable to solve their problems on their own. No less than 15 banks were warned in writing that they had to start making a profit again or face drastic measures such as the dismissal of board members or government acquisition of a major shareholding. The most recent proof of how serious this warning was is the nationalisation of Ashikaga Bank as well as the Resona banking group, where a 13-man strong FSA team is in now place to ensure effective supervision and to determine which loans are at risk or already irrecoverable.

The long recovery phase
The road to recovery for Japan’s banks is long and difficult, as the problems are deep-rooted. This is illustrated by, among other things, the chronic undercapitalisation of many banks. According to a survey by the International Monetary Fund, for example, many Japanese banks failed to comply with the international capital ratio rules. Most of the previously 21 big banks saw merging into even bigger units – often together with regional

banks – as the answer to their earnings and equity problems. The restructuring accompanying these mergers meant massive job cuts, and this process is by no means over 1).

The mergers created a total of four big banks – Mizuho, UJF, Tokyo-Mitsubishi and Sumitomo – as well as a few other important institutions 2).

Consolidated net losses for the fiscal years 03/2002 and 03/2003 were high. On the one hand, the heavy bad loan write-offs helped to produce these steep losses – on its own, the biggest financial group, Mizuho, wrote off the equivalent of €17 billion in bad loans. On the other hand, converting book values into market values put a heavy strain on balance sheets; securities write-downs averaged 30 per cent. Overall, the 15 biggest banks recorded losses of around €300 billion in March 2003.

But the turnaround is already on the horizon. During the fiscal year closing at the end of March 2004, Japan’s leading banks aim to return to profit. Thanks in no small way to the rise in share prices on the Japanese stock market, many financial holding companies – such as Mizuho, Mitsubishi Tokyo Financial, United Financial of Japan and Sumitomo Mitsui Financial – have raised their profit expectations considerably in the meantime. In addition, there are plans to trim the bad loan portfolio by over €100 billion, and in the years ahead a further marked improvement in the bad-loans-to-earnings ratio is envisaged 3).

Revitalisation – Japanese-style

The Japanese government has recognised that the bad loans problem affects not only Japanese banks but also many enterprises that are basically healthy. The damage to the economy as a whole is evident. Largely to ease the burden on banks, the Industrial Revitalization Corp. (IRC), a sort of rescue company, was set up to give enterprises with a competitive range of products a chance of survival. The IRC’s budget for 2004 and 2005 alone is €70 billion. Banks benefit as soon as the rescued enterprises can service their loans again.

The nationalisation of the Resona banking group in May 2003 and of Asahi Kagaku Bank in December 2003 can be seen as evidence that the government has now adopted a bolder approach and is committed to revitalising the financial industry. Banking industry representatives appear to have understood these signals. They have, for instance, announced plans to shed an enormous volume of bad loans. Big banks, which were still recording steep losses during fiscal year 03/2003, are now saying that they have reached the turning point. Even Mizuho Holding, which did particularly badly, hopes to make a profit again, and Mitsubishi Tokyo Bank plans to write off half of its bad loans by fiscal year 2005. The Japanese government’s commitment to revitalising the banking system by taking tougher action has been a clear success. If banking industry representatives can keep their promises – and the chances of this are not bad –, the Japanese banking crisis is likely to soon be a thing of the past.

1) According to Finance Ministry estimates, total central government debt amounted to around €6 trillion, i.e. approx. 141% of GDP at the end of fiscal year 2002. Forecasts for 2003 put it just as high. 2) Conversion was generally made at a rate of 120 yen to the euro.

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