

# THE ORIENTAL ECONOMIST

A L E R T

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**HOW THIS DIFFERS FROM THE “LOST DECADE”**

## **BANK LOSS: NPLS VS. SECURITIES WRITE-DOWNS, PART 1**

### **Key points:**

- **NPLs are rising, but this does not mean a return to the banking/debt crisis of the “lost decade”**
- **In April-December, credit costs from bad debt amounted to less than 0.3% of total loans, compared to rates of 3%--10 times higher—during the late 1990s**
- **Losses from falling stock prices were greater than losses from NPLs, and this doesn’t even count losses from mark-to-market write-downs of holdings in overseas asset-backed securities**
- **While such losses are a problem for the banks, this is very different from the “lost decade” when bank losses were mainly a mirror of rot in the real economy, i.e. too many companies whose products were not worth what they cost to make**

### **Overview**

Once again, headlines are blaring about rising rates of nonperforming loans (NPLs) at Japanese banks. A recent AP-Kyodo headline read, “Bad loans at 121 Japanese banks balloon to ¥12.3 trillion” during the six month term ending Sept. 30. As it turns out, there is less here than meets the eye. The “ballooning” amounted to a 7% increase of NPLs and, as a ratio to total loans, by just 0.1% to 2.5%. This is a far cry from 2002 when official NPLs stood at 8.4% of total loans and “needs attention” loans brought the total amount of problematic loans to nearly 20% of all loans.

Other headlines point to rising net losses at some of the major banks due to rising NPLs and write-downs of securities ranging from Japanese shares to overseas derivatives, like asset-backed securities. During the April-December period, profits the six biggest banking groups

fell 90% from a year earlier, and Mizuho and Mitsubishi-UFJ each suffered a net loss. Results will surely be worse when the books close at the end of the fiscal year on March 31. Meanwhile, *Kyodo* reports that, “Some 38 of 87 listed regional banks are expected to fall into the red in the year to March due to losses from stock falls and the hefty cost of disposing of bad loans.”

So, it’s easy to put two and two together and come up with sixteen: the impression that Japan is re-entering the banking crisis from which it only recently escaped, a crisis caused by too many borrowers being unable to pay their bills.

From the data we’ve seen so far, we think this is a big exaggeration and a misreading of the evidence. Undoubtedly, NPLs will increase as Japan enters a very severe recession. And undoubtedly, bank bottom lines are going to suffer. But there is a big difference between today’s problem and that of the “lost decade.”

In the “lost decade,” the problems of the banks reflected much broader and deeper problems in the real economy. Behind each nonperforming loan was a nonperforming borrower. The total amount of NPL losses accumulated during 1993-2005 added up to nearly 20% of GDP. These bank losses were the financial mirror of hordes of companies, from corporate giants to smaller firms, whose products were not worth what it cost to make them. They were the result of overinvestment and misinvestment during the 1980s-90s. Banks were in trouble because of too many “zombie borrowers.”

Today, the situation is more mixed. Yes, there is a rise in NPLs and corporate failures and that will continue. But much of the losses at the banks stem, not from the inability of borrowers to pay, but from write-downs of securities held by the banks, from their holdings of corporate shares to overseas asset-backed securities. That reflects, not fundamental rot in the real economy, but the gyrations of financial values in a panicked market flooded with mark-to-market write-downs. Besides, bank profits were already so low that it doesn’t take much to turn profits into losses. Hence, a problem for the banks does not necessarily reflect a severe problem for the economy as a whole. It could turn into that, but it certainly has not done so yet.

### **Bank Losses**

In the first nine months of the current fiscal year (April-December) the net profits of the big six banking groups fell by 90% and two of the giants, Mizuho and Mitsubishi-UFJ suffered net losses. Importantly, the losses due to falling stock prices (still a big part of the banks’ portfolio) were greater than the losses from NPLs, and this doesn’t even count losses from overseas asset-backed securities.

Banks are required to take a write-off when the market value of their shareholdings falls by more than 50%. As a result of the plunging Japanese stock market, the big six had to take write-offs totaling ¥900 billion (\$9.6 billion). This was greater than the ¥772 billion losses

due to NPLs, including the cost of higher reserves against possible future losses (see *Figure 1* and *Figure 2*).

### **Thin Bank Profits Mean Even Small Losses Can Turn Black Ink to Red**

While we don't have figures on the loan portfolio of just the Big Six, the total loans outstanding of all nine major banks (of which the Big Six comprise the lion's share) was ¥249 trillion (about half of GDP) as of September 30. A credit cost on bad loans of ¥772 billion means a loss equal to less than 0.3% of the total loan portfolio. This compares to annual credit costs equal to nearly 3% of loans outstanding—i.e. 10 times higher—during the late 1990s.

The problem is that the banks' profit margins are so thin that even a small loss can turn black ink into red. Credit costs of ¥772 billion eats up half of all core business profits (see again *Figure 2*). According to S&P calculations for mid-2008, "the ratio of core operating income to average risk assets for European and U.S. banks falls between 2.4%-4.5%, whereas that of the three major Japanese banking groups ranges between 0.8%-1.9%." (see *Figure 3*)

(to be continued)

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**Figure 1: Bank Losses From Stock Market Decline**

**Troubled giants**  
Earnings at six major banking groups in April-December period of 2008; in billions of yen

	Group net profit/loss	Stock impairment loss
<b>Mitsubishi UFJ Financial Group</b>	-42.0 ( - )	470.7
<b>Mizuho Financial Group</b>	-50.5 ( - )	300.5
<b>Sumitomo Mitsui Financial Group</b>	83.4 (-73)	109.0
<b>Resona Holdings</b>	114.6 (-41)	25.2
<b>Sumitomo Trust &amp; Banking</b>	20.4 (-62)	29.5
<b>Chuo Mitsui Trust Holdings</b>	9.1 (-85)	56.4

*Year-on-year changes in parentheses; in percent* *Sources: Companies*

Note: Total stock impairment loss: ¥900 billion

**Figure 2: NPLs Greatly Reduce Already Low Profits**

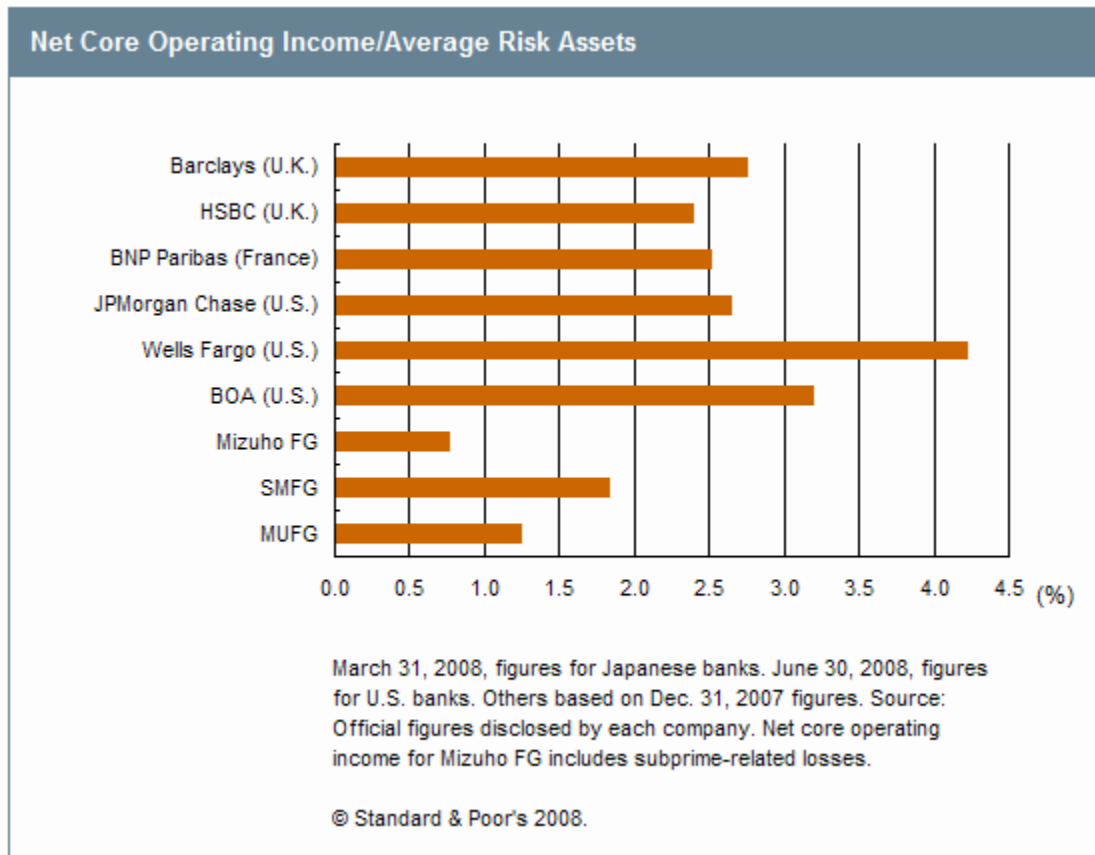
**Going down**  
Six major banking groups' earnings for six-month period ended Sept. 30; in billions of yen

	Net profit	Core business profit*	Bad-loan disposal loss*
<b>Mitsubishi UFJ Financial Group</b>	92.0 (-64)	438.1 (-13)	242.2 (54)
<b>Mizuho Financial Group</b>	94.5 (-71)	309.0 (-25)	130.4 (142)
<b>Sumitomo Mitsui Financial Group</b>	83.2 (-51)	378.4 (-3)	224.1 (96)
<b>Resona Holdings</b>	86.3 (-28)	163.2 (-1)	126.5 (810)
<b>Sumitomo Trust &amp; Banking</b>	28.3 (-24)	72.7 (-9)	3.4 (-90)
<b>Chuo Mitsui Trust Holdings</b>	13.7 (-61)	62.4 (-23)	0.3 (-98)
<b>Total</b>	<b>398.3 (-57)</b>	<b>1,424.1 (-13)</b>	<b>727.1 (86)</b>

*Year-on-year changes in parentheses; in percent*  
*\*Aggregate sum at group banks* *Sources: Banks*

Source: Nikkei

**Figure 3: Thin Profits At Japanese Banks**



**Source:** Standard & Poor's