Bank of Japan Review

2009-E-5

Financial Statements of Japanese Banks for Fiscal 2008

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In fiscal 2008, Japanese banks registered net losses for the first time after fiscal 2003. The factors behind this are that (1) operating profits from core business declined mainly due to the decrease in non-interest income; (2) realized losses on securities increased sharply with higher write-off losses and losses on sales of stocks; and (3) credit costs rose dramatically with the deterioration in borrowers' businesses and the rise in bankruptcy. The nonperforming loan (NPL) ratio of the major banks increased for the first time in seven years, but the regional banks registered the seventh consecutive year of declining NPL ratio. Capital adequacy ratios of both the major banks and the regional banks rose for the first time in two years. A review of the banks' financial statements over the past 20 years shows that the banks have occasionally registered consecutive net losses for several years with the rise in credit costs and the deterioration in realized gains/losses on securities. From the standpoint of ensuring the stability of the financial system, it remains an important challenge for banks to strengthen their profit base through steady efforts to improve the balance of risk and return on lending and securities holdings.

I. INTRODUCTION

The Bank of Japan's *Financial System Report*, published twice a year, contains an analysis and assessment of developments in banks' profits. The report constitutes part of an effective framework for assessing the stability of the financial system from a number of viewpoints and identifying risks underlying the financial system from a macro-prudential perspective. In this paper, recent developments in profits are analyzed and assessed for the major banks and the regional banks using data from the fiscal 2008 financial statements, in advance of the September 2009 issue of the *Financial System Report*. Furthermore, the medium- to long-term developments in banks' profits are examined, while the challenge to securing banks' profitability is considered.[1]

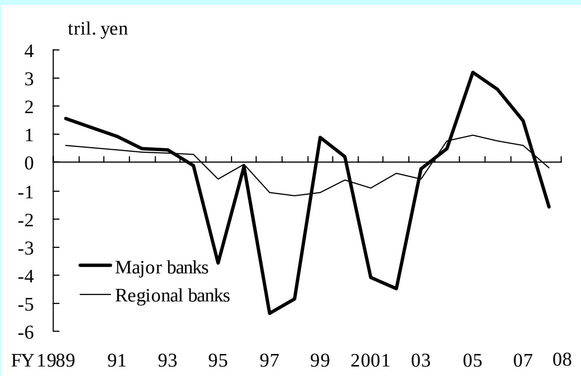
II. FEATURES OF THE BANKS' FISCAL 2008 FINANCIAL STATEMENTS

A. Net Losses Reported

The banks' fiscal 2008 financial statements show that net income of both the major banks and the regional banks posted their third consecutive declines year on year (Chart 1). The major banks reported net losses of 1.6 trillion yen, while the regional banks reported net losses of 0.2 trillion yen. Eight of the 12 major banks and 55 of the 108 regional banks reported net losses. On a year-on-year basis, all major banks and 93 regional banks reported poor results for net income/loss.

The year-on-year deterioration in net income/loss can be attributed to the following factors for both the

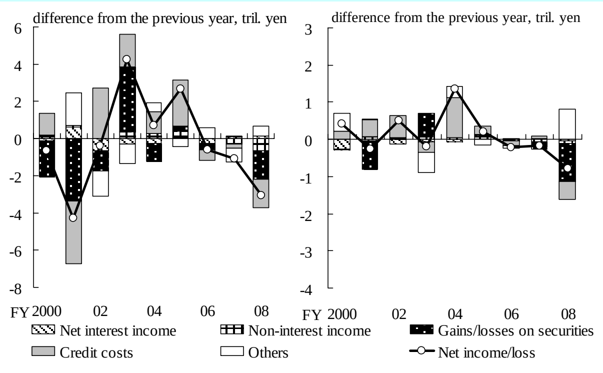
Chart 1: Net Income/Loss



major banks and the regional banks: (1) a decrease in operating profits from core business mainly due to sluggish non-interest income; (2) a sharp deterioration in realized gains/losses on securities; and (3) a sharp increase in credit costs (Chart 2).

Chart 2: Contributions to Changes in Net Income/Loss[1,2,3,4]

Major banks Regional banks



Notes: *1.* Non-interest income = net fees and commissions + profits on specified transactions + other operating profits - net realized bond-related gains/losses.

2. Credit costs are net base, with reversals of allowances for loan losses. Figures include credit costs of subsidiary companies for corporate revitalization.

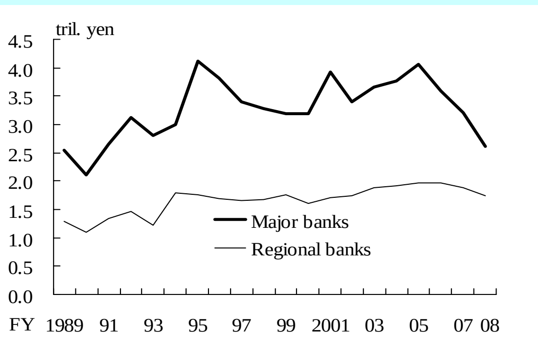
3. Gains/losses on securities = realized gains/losses on bonds + realized gains/losses on stocks.

4. For net interest income, the composition of interest expenses is calculated assuming that the ratio of each component to total expenses is the same as the ratio of interest on loans and bills discounted, interest and dividends on securities, and other interest income to total interest income.

B. Decrease in Operating Profits from Core Business

Operating profits from core business that represent banks' core profitability declined for the third consecutive year for both the major banks and the regional banks (Chart 3). As a result, operating profits from core business amounted to 2.6 trillion yen for the major banks and 1.7 trillion yen for the regional banks. These figures marked the lowest level after 1990 for the major banks and 2001 for the regional banks.

Chart 3: Operating Profits from Core Business[1]

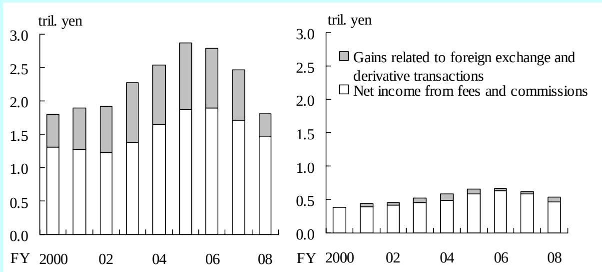


Note: *1.* Operating profits from core business = net interest income + non-interest income - general and administrative expenses.

The decline in operating profits from core business was mainly due to the sharp decline in non-interest income. Between 1998 and 2002, banks were permitted to sell a growing range of investment trust and insurance products. Fees and commissions from the sale of these products contributed significantly to improving banks' profits after fiscal 2003, as well as a rise in profits on foreign exchange and derivative transactions for the major banks. However, net income from fees and commissions declined in fiscal 2007 and registered a steep decline in fiscal 2008 as the market conditions worsened sharply (Chart 4).

Chart 4: Non-Interest Income

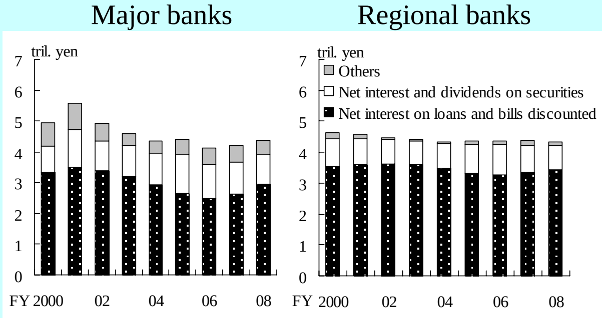
Major banks Regional banks



Net interest income increased slightly for the major banks and remained mostly unchanged for the regional banks (Chart 5). For the major banks, their lending to large firms that encountered difficulty in funding from capital markets after the bankruptcy of Lehman Brothers increased and contributed to the rise in net interest income. They also increased assets in

Chart 5: Net Interest Income

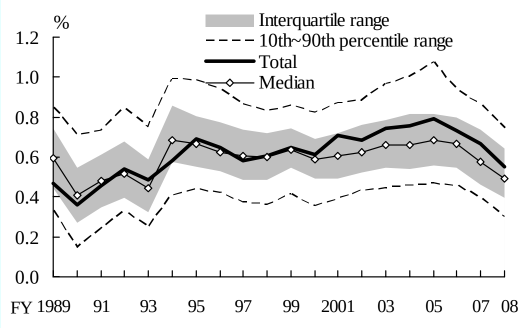
Major banks Regional banks



the international sectors during the first half of fiscal 2008. For the regional banks, total interest margin on loans narrowed mainly due to a relatively limited growth in lending to large firms and low-rate loans backed by the emergency loan guarantee system during the second half of fiscal 2008.

This decline in banks' core profitability can also be seen in its relation to total assets. "Core return on assets (core ROA)" has been on a declining trend since fiscal 2005, and core ROA for many banks declined to the same level as marked in the first half of the 1990s (Chart 6).

Chart 6: Banks' Core ROA[1]



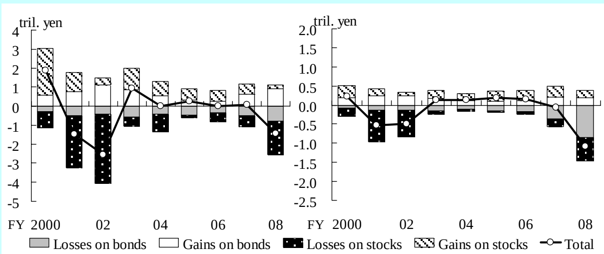
Note: *1.* Core ROA = operating profits from core business/total assets.

C. Deterioration in Realized Gains/Losses on Securities

An important feature of the banks' fiscal 2008 financial results was a dramatic deterioration in realized gains/losses on securities that was affected by the turmoil in the global financial markets. Realized losses on securities amounted to 1.4 trillion yen for the major banks, a deterioration of 1.5 trillion yen from the previous year. For the regional banks, it amounted to 1.1 trillion yen, worsening 1.0 trillion yen from the previous year (Chart 7). Declining stock prices contributed to a large increase in realized losses

Chart 7: Realized Gains/Losses on Securities[1]

Major banks Regional banks

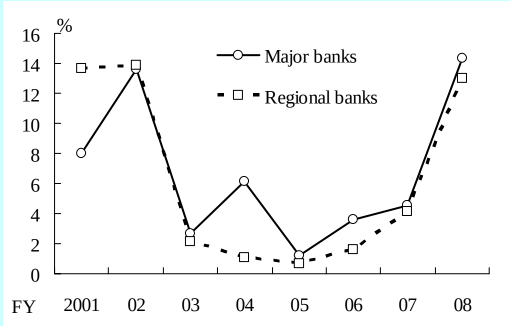


Note: *1.* Losses on bonds = losses on redemption of bonds + losses on sales of bonds + losses on devaluation of bonds.
Gains on bonds = gains on redemption of bonds + gains on sales of bonds.
Losses on stocks = losses on sales of stocks + losses on devaluation of stocks.
Gains on stocks = gains on sales of stocks.

on stocks for both the major banks and the regional banks. The regional banks also registered a significant increase in realized losses on bonds from write-off losses (losses on devaluation) and losses on sales for equity investment trusts and real estate investment trusts. For both the major banks and the regional banks, realized losses on securities amounted to about 60 percent of operating profits from core business.

The rise in realized losses on stocks pushed up the ratio of the losses on stocks to total stockholdings (i.e., write-off losses and losses on sales of stocks divided by total stockholdings). This ratio reached 14 percent for the major banks (up from 5 percent in the previous year) and 13 percent for the regional banks (up from 4 percent in the previous year), equivalent with levels previously registered in fiscal 2002 (Chart 8).

Chart 8: Ratio of Losses on Write-offs and Sales of Stocks[1]

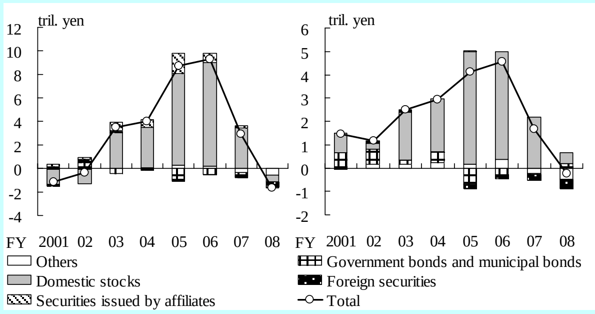


Note: *1.* The ratio of losses on write-offs and sales of stocks = (losses on devaluation of stocks + losses on sales of stocks)/ total stockholdings at the end of the previous fiscal year.

The unrealized gains/losses on securities also worsened considerably and moved into the unrealized loss territory, even though the banks recorded a large amount of realized losses. The banks reported smaller unrealized gains or larger unrealized losses for stocks, and a rise in unrealized losses related to foreign securities and other securities (Chart 9).

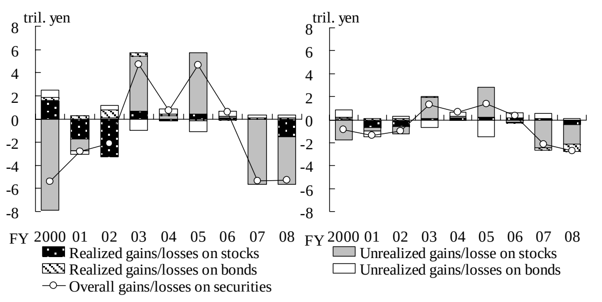
Chart 9: Unrealized Gains/Losses on Securities

Major banks Regional banks



As a result, both the major banks and the regional banks registered large overall losses on securities for the two consecutive years, measured by the sum of realized gains/losses on securities and changes in unrealized gains/losses on securities (Chart 10). The amount of such losses reached 5.3 trillion yen for the major banks and 2.7 trillion yen for the regional banks, roughly twice the amount of operating profits from core business for both groups of banks. These figures indicate that coping with market risks associated with stockholdings remains an important challenge for Japanese banks.

Chart 10: Overall Gains/Losses on Securities[1]

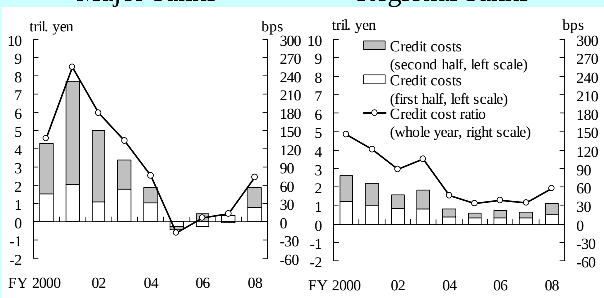


Note: *1.* The overall gains/losses on securities are the sum of realized gains/losses on securities and changes in unrealized gains/losses on securities.

D. Increased Credit Costs

Credit costs increased to 1.9 trillion yen for the major banks and 1.1 trillion yen for the regional banks in fiscal 2008, a sharp increase from the previous year reflecting a deterioration in borrowers' businesses and an increase in bankruptcy with higher loan-loss write-offs and loan-loss provisions (Chart 11). Credit costs amounted to roughly 70 percent of operating profits from core business for the major banks and more than 60 percent for the regional banks. The credit cost ratio rose to 72 bps for the major banks (up from 13 bps in the previous year) and 58 bps for the regional banks (up from 34 bps in the previous year).

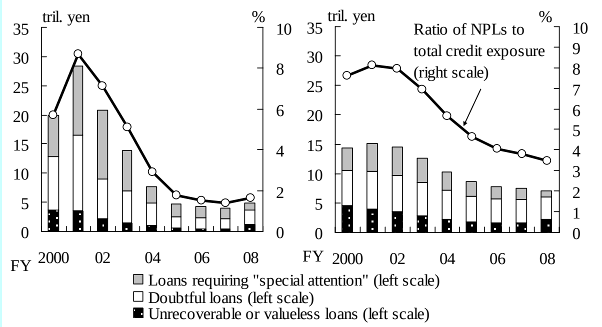
Chart 11: Credit Costs[1]



Note: *1.* Credit cost ratio = credit costs/total loans outstanding.

The NPL ratio of the major banks rose for the first time in seven years, reaching 1.7 percent at the end of fiscal 2008, an increase of 0.3 percentage point from the previous year. Meanwhile, the NPL ratio of the regional banks declined for the seventh consecutive year, reaching 3.5 percent (Chart 12). Among factors contributing to changes in NPL levels, increased cases of upgrades (transition from NPL to normal borrowers or borrowers that "need attention"), particularly among the regional banks, contributed to restraining the NPL ratio. This is partly due to the relaxation of the requirement for restructured loans of small and medium-sized firms[2] introduced in the second half of fiscal 2008 (see below).

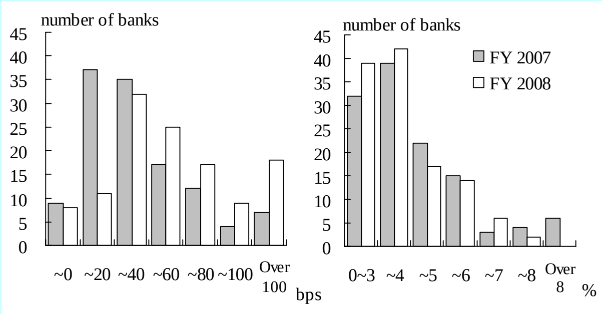
Chart 12: NPL Ratios and the Amount of NPLs[1,2]



Notes: *1.* NPLs disclosed under the Financial Reconstruction Law.
2. Figures include NPLs which are transferred to subsidiary companies for corporate revitalization.

The credit cost ratios of individual banks indicated that dispersion across banks widened. The number of banks with credit cost ratios exceeding 100 bps increased, but other banks reported credit cost ratios below 0 bps with reversal of allowances for loan losses. Significant dispersion also remained in NPL ratios, although many banks reported lower NPL ratios (Chart 13).

Chart 13: Dispersion across Banks



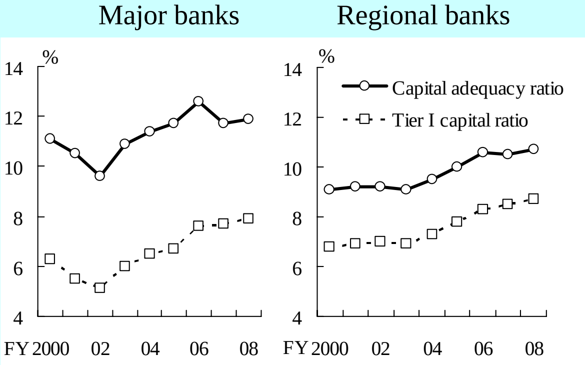
As shown above, credit costs increased sharply reflecting deterioration in borrowers' businesses, but the rise in credit costs may have been relatively restrained in spite of a sharp economic downturn. A factor behind this may be that firms, including small and medium-sized firms, have strengthened their financial bases and become more resilient to worsening economic conditions. Another factor may be the enhancement of banks' risk management.

E. Developments in Capital Adequacy Ratios

As of the end of fiscal 2008, capital adequacy ratios for the major banks and the regional banks reached

11.9 percent and 10.7 percent, respectively. Both figures represent an improvement of 0.2 percentage point from the end of fiscal 2007 (Chart 14). Tier I capital ratios reached 7.9 percent and 8.7 percent for the major banks and the regional banks, respectively, showing an improvement of 0.2 percentage point for both groups of banks.

Chart 14: Capital Adequacy Ratios and Tier I Capital Ratios[1]



Note: *1*. On a consolidated basis.

Capital adequacy ratios improved while figures for net income/loss turned negative. This phenomenon was attributed to a significant reduction of the risk assets (denominator) for the major banks, and both a reduction of the risk assets (denominator) and an increase in total capital (numerator) for the regional banks. For the major banks, total capital decreased by 3.5 trillion yen from the previous year mainly due to a decline in retained earnings and an increase in unrealized losses on securities. However, this was more than offset by the 35.4 trillion yen decrease in risk assets, mainly due to the adoption of AIRB[3] by some of the major banks. For the regional banks, risk assets decreased by 1.1 trillion yen partly due to increased credit guarantees provided by the credit guarantee corporation. Total capital increased by 0.2 trillion yen from the previous year, under the circumstance that the partial relaxation of capital adequacy requirements reduced unrealized losses on securities deducted from total capital.

F. Underpinning by the Policy Measures on the Financial System

Banks' financial statements for fiscal 2008 show that capital adequacy ratios increased and the NPL ratio of the regional banks improved despite worsening profits. Although performance of flow data deteriorated significantly, the downturn in stock-based data was relatively small. This can mainly be attributed to changes made in the financial system during the second half of fiscal 2008.

In the second half of fiscal 2008, major policy changes have been introduced, including (1) revision of the accounting standards with respect to fair value calculation and the reclassification of holding bonds; (2) relaxation of the requirements for restructured loans of small and medium-sized firms; and (3) partial relaxation of capital adequacy requirements. The effect of these policy measures for the banks' financial results in fiscal 2008 was estimated, based on surveys conducted by the Bank of Japan's Financial Systems and Bank Examination Department. For flow data, the impact of these policy measures on income before taxes in fiscal 2008 is estimated to be about 210 billion yen for the major banks and about 180 billion yen for the regional banks. The impact of reduction on credit cost ratios is estimated to be about 4 bps for the major banks and 8 bps for the regional banks. For stock-based data, unrealized gains/losses on securities in net assets are estimated to increase by about 380 billion yen for the major banks and by about 250 billion yen for the regional banks. The effects of reducing the NPL ratios are 0.2 percentage point for the major banks and 0.6 percentage point for the regional banks. The overall improvements of capital adequacy ratios amounted to about 0.3 percentage point for the major banks and about 0.5 percentage point for the regional banks.[4]

III. CONCLUDING REMARKS

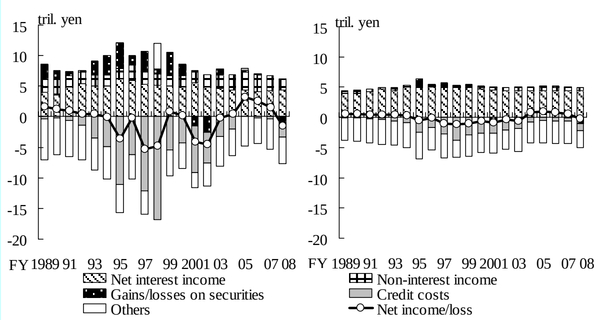
The banks reported net losses in fiscal 2008. Among factors driving net losses, the increase in credit costs and the deterioration in realized gains/losses on securities had a significant impact.

The relation between changes in net income and changes in both credit costs and realized gains/losses on securities can be analyzed over a longer term. The time-series data for net income and its main components over the past 20 years (fiscal 1989 to fiscal 2008) show that the average of net income has been slightly negative (Chart 15).

Year-on-year fluctuations in net income have been large. Operating profits from core business have remained relatively stable throughout the period, but fluctuations in credit costs and realized gains/losses on securities have been large. In addition, the ratio of the average value of credit costs to the average value of operating profits from core business has been considerably large for the major banks (about 1.4 times larger). The ratio for the regional banks is about 80 percent.

Chart 15: Net Income/Loss and Components

Major banks　　　　Regional banks



Statistics between fiscal 1989 and 2008

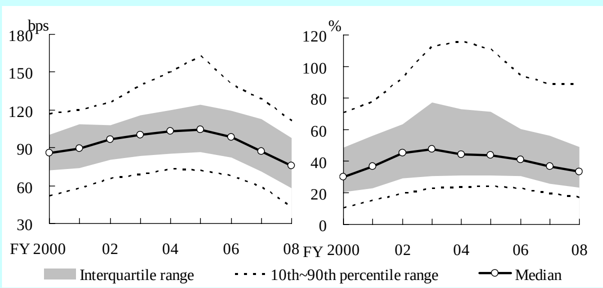
tril. yen

	Major banks		Regional banks	
	Average	Standard deviation	Average	Standard deviation
Net income/loss	-0.5	2.49	-0.0	0.69
Operating profits from core business	3.2	0.54	1.7	0.24
Net interest income	4.9	0.64	4.5	0.32
Non-interest income	2.1	0.36	0.4	0.13
Gains/losses on securities	1.1	1.75	0.0	0.40
Credit costs	-4.4	4.50	-1.4	1.07

These observations show that the banks' profitability has been heavily influenced by credit costs and realized gains/losses on securities. This feature is clearly evident in fiscal 2008. Another important feature of the banks' financial results in fiscal 2008 is a decline in core profitability. As previously stated, operating profits from core business for many banks declined in fiscal 2008 to a level similar to that marked in the first half of the 1990s (Chart 6). A decline in operating profits from core business increases a possibility of banks registering net losses for a rise in credit costs and a deterioration in realized gains/losses on securities (Chart 16).

Chart 16: Impacts of Credit Costs and Losses on Stocks[1,2,3]

Breakeven credit cost ratios　　　　Breakeven ratios of losses on write-offs and sales of stocks



Notes: *1.* Breakeven credit cost ratio = operating profits from core business/ loans outstanding.
2. Breakeven ratio of losses on write-offs and sales of stocks = operating profits from core business/ total stockholdings at the end of the previous fiscal year.
3. Breakeven ratios of each bank are sorted in ascending order.

As outlined above, the fiscal 2008 financial results reaffirmed medium- to long-term challenges in the areas of profitability and risk management for many banks. There may remain concern over the level of banks' profits. From the standpoint of ensuring the stability of the financial system, it remains an important challenge for banks to strengthen their profit base through steady efforts to improve the balance of risk and return on lending and securities holdings.

[1] This report covers 12 major banks and 108 regional banks.

[2] The requirement for restructured loans of small and medium-sized firms was revised in November 2008. Specifically, loans to firms with sufficient revitalization plans are more likely to be treated as normal loans instead of NPLs even if financial institutions relax their lending conditions such as by reducing the loan interest rate.

[3] In the Advanced Internal Ratings-Based approach (AIRB), banks estimate the probability of default, the loss given default, and the exposure at default by themselves. These estimates are then used to calculate required capital. Compared to other approaches (the standardized approach, the foundation internal ratings-based approach), AIRB is a framework that allows advanced banks to refine the calculation of credit risk and utilize advances in risk management system.

[4] Impacts were estimated for the following individual policy measures in the financial systems.

(1) Clarification of financial instruments accounting standards: Based on Practical Issue Task Force No. 25 and No. 26 of the Accounting Standards Board of Japan, revisions were made in the methods of calculating fair value and the reclassification of debt securities (excluding credit products included in monetary claims bought). These changes have a positive impact on income before taxes, net unrealized gains/losses on securities, and capital adequacy ratios.

(2) Relaxation of the requirements for restructured loans: Pursuant to the relaxation of the requirements for restructured loans of small and medium-sized firms, loans requiring "special attention" declined, which in turn had a positive impact on NPL ratios. Furthermore, this relaxation also reduced credit costs, where the reduction in loan-loss provisions was estimated using the reduction in amount of loans requiring "special attention" and loan-loss provision ratio for each bank. Thus, this measure had a positive impact on income before taxes and capital adequacy ratios.

(3) Partial relaxation of capital adequacy requirements: This measure had a positive impact on Tier I capital by

excluding the impact of unrealized losses on securities on total capital. If a bank is under international standards and chooses to adopt this measure, it has a positive impact on Tier I capital because unrealized losses for government bonds and securities without credit risk are not reflected in total capital. The measure may change values permitted to count in regulatory capital calculation, and have a positive impact on Tier I and Tier II capital for some banks affected by these values.

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