Megabanks Boast High Capital Accumulation Strength

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Having paid back the public funds injected into their operations, Japan’s Big 3 financial groups have now entered the phase of building up their net worth. This scenario is based on predictions that the profits of the banks in their respective corporate groups will be climbing to greater heights. All of the banks have carried losses forward in their tax accounting, which has acted to curb their payment of corporate taxes. As a result, they are able to earmark the majority of the profits generated for internal accumulation. During the days of financial uncertainty, the banks were sometimes forced to raise capital at comparatively high costs. If they now use the profits to be generated from here on to reshuffle the substance of their capital, they will also be able to raise the quality of that equity.

Using Accrued Profits to Boost BIS Ratio by 3%

In this report, I estimated the total value of profits to be accrued by the banks within the Big 3 financial groups over the next five years, to compute the degrees to which the consolidated BIS (Bank of International Settlements) capital adequacy ratios for the respective holding companies will rise during that period. The results showed that the ratio for the Mitsubishi UFJ Financial Group should rise by 3.08%, the Mizuho Financial Group by 3.60% and the Sumitomo Mitsui Financial Group by 3.24% (see chart).

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<th>Potential Accrued Profits and Effects of Rise in Capital Adequacy Ratios Over the Next Five Years</th>
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<td>(100 million yen; %)</td>
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<th></th>
<th>Combined after-tax profits of group banks over 5 years</th>
<th>Consolidated base dividend total over 5 years</th>
<th>Potential accrued profits</th>
<th>Consolidated base risk assets</th>
<th>Effects of increase in capital adequacy ratio</th>
<th>BIS capital adequacy ratio</th>
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<tbody>
<tr>
<td>Mitsubishi UFJ FG</td>
<td>40,467</td>
<td>5,760</td>
<td>34,707</td>
<td>1,125,675</td>
<td>3.08</td>
<td>11.95</td>
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<tr>
<td>Mizuho FG</td>
<td>31,390</td>
<td>3,355</td>
<td>28,035</td>
<td>777,914</td>
<td>3.60</td>
<td>11.01</td>
</tr>
<tr>
<td>Sumitomo Mitsui FG</td>
<td>27,179</td>
<td>5,155</td>
<td>22,024</td>
<td>679,459</td>
<td>3.24</td>
<td>10.07</td>
</tr>
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Notes:
1. The consolidated base risk assets and BIS capital adequacy ratios are for the end of September 2006.
2. The consolidated base dividend total over 5 years was calculated from the number of shares as of December 2006 and prospective dividends for the March 2007 year.
I based my trial calculations on the estimated total value of pretax profits over a five-year period for the group banks on a non-consolidated basis. I then subtracted the corporate taxes and other payments projected to be owed during that period to compute the total value of the after-tax profits. Accompanying the bad debt write-offs from the past, all of the banks have carried forward large losses on their books. Because no corporate taxes need be paid until such retained losses are settled, after-tax profits will rise at the banks in direct proportion to the scale of the losses they have carried over.

From these after-tax profits, I subtracted the total value of dividends (for both common and preferred stock) over a five-year period, basing my estimates on the value of the dividends scheduled by the holding companies for the March 2007 year and thereby computing potential accrued profits. The effects of the rises in the consolidated BIS ratios were estimated by dividing these potential accrued profits by the risk assets at the end of September 2006. Because a new risk asset calculation method will be introduced from the March 2007 year under new BIS capital adequacy requirements, there is a possibility that these figures may change.

The chart shows the consolidated BIS ratios for the Big 3 groups at the end of September 2006. With the Sumitomo Mitsui Financial Group (FG) having completed repayment of the injected taxpayer money in October, its BIS ratio is inferior to the other two groups at 10.07%. If the potential accrued profits can be secured as calculated, the BIS ratio rises. Groups with sufficiently high BIS ratios will be able to write-off high-cost preferred shares and other stocks issued in the past, and thereby hold down the total value of their dividends.

In the case of the Mizuho FG, the target promises to be the 1 trillion yen capital increase carried out in March 2003, an event that attracted major attention for raising such a massive amount of capital. Two issues of preferred stock were offered on a widespread basis, targeting financial institutions, business companies and other buyers. The dividend yields were 2% and 3%, respectively, somewhat high in view of the conditions existing at that time. The group’s annual dividend burden is just under 20 billion yen.

For the Mizuho FG’s Eleventh Series of Type 11 preferred stock, which at 943.7 billion yen comprised the majority of the value issued, preferred stock shareholders may request that the financial group buy up the shares at the issue value from July 2008. Depending on the inclination of the shareholders, it is conceivable that buy up demands could converge all at once. In view of this, there are also forecasts that the Mizuho FG will push ahead into a new round of capital financing.

I Trillion Yen Capital Increase also viewed Absorbable

However, viewed from the potential accrued profits of 2.8 trillion yen over the next five years, it should be possible to adequately absorb this degree of capital increase. While it depends on the methods used to raise capital, even if new procurements are made the chances are good that the outstanding balance can be reduced in the near future through cancellation.

In January 2003, the Sumitomo Mitsui FG issued some 150 billion yen in preferred stock, which was allotted to Goldman Sachs. The dividend yield was high at 4.5%. The price for exercising the right to request acquisition was 318,800 yen (October 2006), or
one-third the stock price on February 1. While this amounts to financing at unfavorable conditions, with the Sumitomo Mitsui side having no other options the situation appears bound to continue for the time being.

The First Series of Type 6 preferred stock was issued at a total of 210 billion yen, targeting institutional investors and including no issue of common stock. The dividend yield is 2.95%. The Sumitomo Mitsui FG may freely acquire this stock from March 2011 at the issue price. It is believed that the group will acquire the shares while keeping a close watch on its progress in accruing profits, the cost of alternative means of raising funds and other factors.

The Mitsubishi UFJ FG, different from other companies, did not cancel all of the preferred stock injected as public funds, with one portion resold to the Norinchukin Bank, major life insurance companies and other buyers. These shares consist of the Type 8 preferred stock issued by the former Sanwa Bank and the Type 12 preferred stock issued by the former Toyo Trust Bank. Those stocks may be acquired in full by the Mitsubishi UFJ FG in August 2008 and August 2014, respectively. Figuring the stock price at 1.6 million yen, approximately 250 billion yen will be needed prior to that.

In February 2005, 250 billion yen in preferred stock was allocated to major life and non-life insurers. There was no issue of common stock, with the dividend yield set at 2.40%. Mitsubishi UFJ FG will be able to freely acquire this stock at the issue price from February 2010. Adding up these two potential acquisitions amounts a total of only around 500 billion yen, an amount that can be easily covered with the group’s accrued profits alone.

Looking for potential concerns, if the profits generated each fiscal year fail to expand at a pace corresponding to the increase in net worth, there is the fear that the return on equity (ROE; the measure of capital efficiency) could decline. Due to the move to forward-looking management, there are signs that the overhead ratios (operating costs divided by gross operating profits) of the individual banks will be above the numerical targets set at the drafting of the financial soundness plans. There is also the risk that if “strategic outlays” (as the banks like to call them) fail to bear fruit, it will prove difficult to break away from the low-earnings image typically associated with Japanese banks, causing stock prices to level off.

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