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When Will Major Banks Contribute to Tax Revenues?

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The combined consolidated current profits of Japan's three megabank groups for the March 2006 fiscal year are projected to reach the 2.82 trillion yen level. Despite such handsome income figures, however, there are few prospects of these financial institutions contributing to growth in the nation's corporate tax coffers anytime soon. The reason for this is that the big banking groups have been left with losses in terms of their tax status as a result of massive bad loan write-offs. This prompts the question of just when these financial heavyweights will return to the upper ranks of Japan's corporate income rankings.

Spurred by the economic rebound, corporate tax revenues are displaying growth above and beyond most projections. Among industries that appear set to take off, meanwhile, are the big banks – formerly perennial leaders in the corporate income rankings. For the March 2006 fiscal year, the combined consolidated current profits of Japan's three megabank groups are forecast to reach the 2.82 trillion yen level. However, even if these banks were to post profit levels worthy of mighty Toyota Motor Corporation, the prospects are slim that they will help grow Japan's corporate tax coffers anytime soon. That's because these big banking groups are carrying tax losses due to their massive bad loan write-offs. So, just when might these financial heavyweights return to the upper echelons of Japan's corporate income rankings?

Sumitomo Trust & Banking: Might Pay up in March 2008 Year

Upon demand from the Financial Service Agency, Japan's banks have been required to disclose the details of their deferred tax assets since the interim account settlements of September 2003. The figures supplied include tax-based losses carried over from the previous fiscal year. Examining the September 2005 interim settlement of Sumitomo Trust & Banking Co., Ltd., the losses carried forward for listing as deferred tax assets totaled 54.2 billion yen, or about half the amount listed 18 months previously.

As the grounds for being able to recover their deferred tax assets, major banks listing these assets are estimating pre-adjustment taxable income over the coming five years. In the case of Sumitomo Trust & Banking Co., Ltd., the five-year total is 700.1 billion yen, or an annual average of 140 billion yen. Figuring an effective tax rate of 40 percent, the tax due on these assets would be 56 billion yen. The bank's forwarded losses of 54.2 billion yen would thus be used up by the end of the March 2007 year, making it possible for Sumitomo to pay taxes by as early as the following fiscal year.

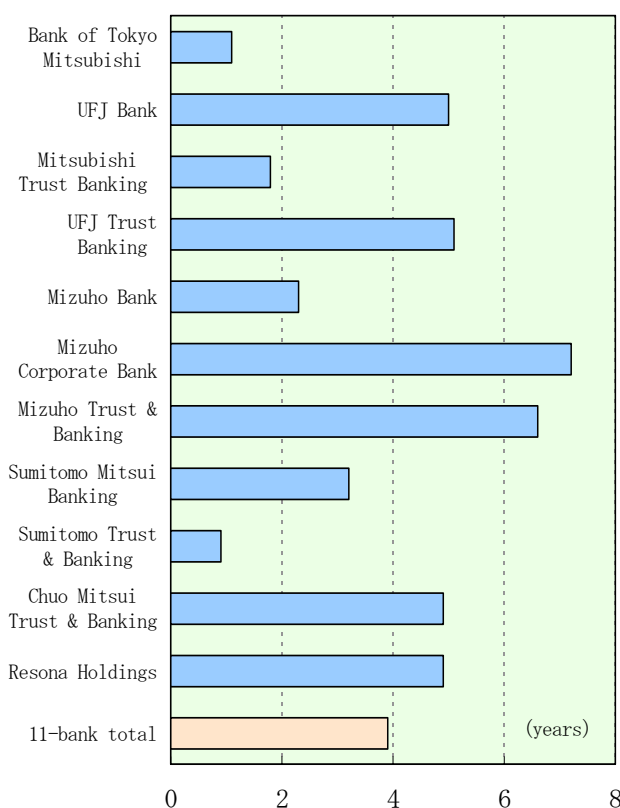
Tax-wise, deferred tax assets also contain loans, securities taxable reserves and appreciation and other assets that cannot be calculated as losses. As with the forwarded losses, they are effective in lowering future tax payments, which means that if these temporary difference factors are removed the elimination of the forwarded losses will be delayed. In the case of Sumitomo, however, even the gross value of its deferred tax assets is only 122 billion yen, with the period figured when dividing by the annual tax payment working out to be a mere 2.2 years.

Tokyo-Mitsubishi UFJ May “Mobilize” Merger

The Bank of Tokyo Mitsubishi was No. 12 in the declared corporate income ranking for fiscal year 2000. In the interim settlement of September 2005, for its deferred tax asset listing the bank carried over losses of 245.5 billion yen, in contrast to its annual average pre-adjustment taxable income of 574.2 billion yen. Tax assessment computations reveal that the listed losses will be cleared from the books in 1.1 years.

The situation has been changed with the merger between Tokyo Mitsubishi and UFJ Bank Limited in January of this year. Based on the deferred tax asset data for both banks in their September 2005 interim settlements, the total forwarded losses come to 1,228.6 billion yen, while the total tax assessment computed from average annual taxable income was 425.3 billion yen. For this total, it will require 2.9 years to dispose of the losses, with the merger thereby serving to defer the new bank’s tax payment schedule.

Chart 1. Years Required to Eliminate Forwarded Losses



Note: Figures are for September 2005 interim settlements.
 Years needed to eliminate = Forwarded losses/pre-adjustment average taxable income × effective tax rate. (0.4)
 Source: Disclosure materials from the individual banks.

The bank formed by the merger (Tokyo-Mitsubishi UFJ, Ltd.) has effectively inherited the 667.6 billion yen (as of the end of December 2005) in public funds injected into UFJ through the preferred share format (directly assumed by the holding company). The bank has also taken on an even greater total (983.1 billion yen) in the form of losses carried over by UFJ. Although based strictly on the underlying

assumption that the estimated taxable income can in fact be obtained, one viable interpretation is that it is now possible for the bank to put these losses to work in curbing its outbound flow of capital.

The ties between Mitsubishi Trust Banking Corporation and UFJ Trust Banking Corporation, which have also merged operations, resemble the Tokyo Mitsubishi/UFJ pattern. While the period required for clearing the forwarded losses from the books is 1.8 years for Mitsubishi Trust, it rises to 5.1 years for UFJ. With the merger, the total comes to 2.8 years. The trust bank formed through this merger last October has inherited 200 billion yen of taxpayer money injected into UFJ Trust, while the combined forwarded losses come to 238.8 billion yen.

Turning to the other major banks, for Sumitomo Mitsui Banking Corporation the period to be required to clear away these outstanding losses is 3.2 years. The losses carried over in the bank's deferred tax assets for its September 2005 interim settlement come to 1,056.1 billion yen. Within the Mizuho Financial Group, while Mizuho Bank will see these losses disappear in 2.3 years, the totals are relatively longer for Mizuho Corporate Bank (7.2 years) and Mizuho Trust & Banking (6.6 years). For Chuo Mitsui Trust & Banking, the figure calculates to 4.9 years.

Resona Holdings subscribes to a consolidated taxation system. For Resona Bank, Ltd. and the two other banks in that group, the total losses carried over and listed in the interim settlements last September came to 1,211.1 billion yen. Annual taxable income for the group's banks works out to be 242.4 billion yen, meaning that 4.9 years will be needed to take the losses off the books. Under the tax system reforms of FY2004, the carryover period for losses occurring from FY2001 and thereafter was extended from five to seven years, with the big banks taking advantage of this period to draft plans to write down those losses.

“Pre-adjustment Taxable Income” Approaching Reality

There is deep-rooted criticism of pre-adjustment taxable income as being exorbitant. All Japanese banks base these calculations on the No. 4 Example Section Provision Clause in the Administrative Guidelines of the Japanese Institute of Certified Public Accountants. Namely: “In cases when forwarded losses occur as a result of business restructuring, revisions of laws or other regulations or other unordinary and special reasons, it shall be the judgment that deferred tax assets will be recovered, with the limit being taxable income within a period of time capable of being rationally estimated in the future (generally five years), referring to the portion for which temporary differences may be scheduled during the said period of time.”

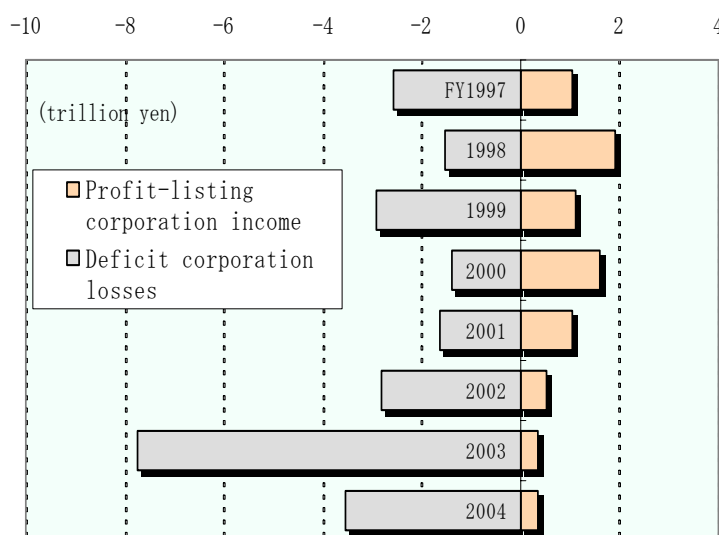
Deferred tax assets may be calculated in the basic provisions of net worth (Tier 1). In FY2002 and FY2003, when the listing of massive deficits from bad loan write-offs caused banks to fall into capital inadequacy, it cannot be denied that, in

keeping with the so-called “period of time capable of being rationally estimated in the future,” there were in fact aspects in which net worth was effectively supported by estimating the five-year total of pre-adjustment taxable income to the utmost limit.

However, from the aspect of the quality of net worth, changes can be seen in each bank hand in hand with the problematic view that has come to be taken of the high percentage of deferred tax assets. Compared to 18 months ago, nine of the 11 banks listed above have lowered the levels of their pre-adjustment taxable income. There was one bank, in fact, that lowered this income by some 40 percent. During this time, meanwhile, due to the fact that rebounds have occurred in pretax current profits (the standard used to compute taxable income), the situation appears to have drawn closer to the realities. Although record-breaking profits were posted in September 2005 half-year settlements, there is a need to discount this from the calculations. Nevertheless, the annually adjusted pretax profits for three banks were below their average annual taxable income figures.

Chart 2. Trends in Bank and Trust Bank Corporate

In the case of certain banks that have made comparatively strong progress in promoting financial soundness, wide gaps have emerged between tax payments (which are computed from a maximum of five years of taxable income) and the net deferred tax assets actually being listed. While the situation has already reached the point at which shortening the period for estimating taxable income should cause no problems, viewed from the perspective of accounting continuity, difficulties are believed to exist in changing the application of the administrative guidelines provision clause solely on the basis of improved business conditions.



Source: Number of Ordinary Companies by Industry, National Tax Agency.

Examining the figures by industry-specific corporate taxes statistics compiled by the National Tax Agency, we find that the corporate income (black ink) for “Banks and Trust Banks” has rapidly declined since FY2000 (Chart 2). On the other hand, the value of losses is expanding, with a particularly high total of 7,758.9 billion yen in losses recorded in FY2003. Although this figure declined in FY2004, the level remains high. In this way, therefore, the cumulative losses have led to the current massive losses being

carried over by the banks.

Figured by a simple average, it will require 3.9 years for Japan's 11 leading banks to clear their forwarded losses from their books, with that process expected to be wrapped up in FY2009 or FY2010. Considering loans, securities taxable appreciation and reserves and other temporary difference factors, there is also a probability that even more time will be required.

With regard to the preferred shares injected into these banks by the government, the simultaneous conversion dates to common stock, which comprise the effective deadlines for repayment, are concentrated during FY2009-10. For the banks, there are major benefits to be gained by curbing cash outflows generated by tax payments up until the time that they get over the main hump of their repayment of injected public funds. From the government's perspective, meanwhile, much like the case of that injected taxpayer money, the payment of the costs generated during the financial recession will drag on long term.

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