

# Financial Situation and Management of Banking Sector

## 1. Introduction

In June of 2003, the structural reform package entitled “Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2003” was passed in the Cabinet. According to these directives, the “Financial Revitalization Program” was launched and aimed to reduce the share of bad loans in fiscal 2004 to half of the levels of fiscal 2002, and to have the bad loan problem resolved by the same year. However, from fiscal 1992, banks have recorded credit costs totaling 88.2 trillion yen for bad loans, and it continues to be very difficult for banks to earn enough in profits every year to dispose of the bad loans that exist now, as well as loans that may sour in the future.

In this study, we analyze the banking sector using recent data. First we use financial data up to fiscal 2002 (at the end of March 2003) to analyze their fiscal health -- the profitability of the banks, the bad loan situation, and their capital ratios. Then we examine such issues as the recapitalization of the major banks, the business consolidation system in place for bank mergers, and the injection of public funds into the banks.

## 2. Profit Structure of Banks

First let us examine the profit structure of the Banking Sector (Table 1). The “Lending Margin” item has been hovering around 10 trillion yen since fiscal 1992, and in fiscal 2002, it fell by 400 billion yen over fiscal 2001. “Other Revenue” would be all profits/losses outside of Net Interest Income, less the gains and losses from sales of securities, and gains and losses from sales of real estate. This “Other Revenue” item had been fluctuating in the range between just over 2 trillion up to about 3.5 trillion yen and had marked over 3 trillion yen for the years from fiscal 1995 to 1997 probably because as interest rates were declining, bond dealings were temporarily quite profitable. This “Other Revenue” is rising again from fiscal 2000, and in fiscal 2002 this marked 3.6 trillion yen. We believe that this is due to an increase in profits from bond dealing again. The total of these two items, Lending Margin and Other Revenue, are the Gross Profits earned from banking activities. These profits have been steady from about fiscal 1998, and in fiscal 2002, they rose by about 600 billion yen. Operating Expenses peaked at about 8 trillion yen in fiscal 1996, and have begun declining, marking 7 trillion yen in fiscal 2002. Most of this reduction in expenses are from lower human resources expenses and suggest that expenses are falling from mainly the restructuring efforts of the banks. Another expense is the Loan Loss which is mainly composed of the loan loss reserves and amortization of bad loans. By fiscal 1995, 97 and 98, they had risen to a massive 13.4 to 14 trillion yen. Loan Loss receded temporarily to between 6 and 7 trillion yen in fiscal years 1999 and 2000, but after the Special Inspections of the Financial Services Agency in fiscal 2001, banks lowered their assessments of some of their borrowers, and the loan loss provisions once again increased to 9.4 trillion yen. In Fiscal 2002, the amount of bad loan disposals fell to 7 trillion yen. After Loan Loss Charges have been deducted from Gross Profit before Loan Loss, we are left with the profit from their core business, their Net Operating Profit. This figure has been negative from

fiscal 1993, and although Loan Loss declined in fiscal 2002, it continues to be the case that Banks are not earning enough with the profits from their core business to clear themselves of their bad loans.

From fiscal 2001, Realized Capital Gains marked a large negative figure, and the Net Profit figure also marked a large negative. This is believed to be due to two factors. One, due to the implementation of mark-to-market accounting, unrealized losses were recorded on share holdings. Two, the losses recorded when stocks were sold<sup>1)</sup> were also significant.

Thus, this shows that banks were not able to cover their Loan Loss with their Gross Profit. Generally, we see the profit picture of the banks as being very harsh.

Table 1. Profit structure of Banks (all banks basis)

trillion yen

Financial Year	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Lending Margin (A)	7.1	8.9	9.8	9.2	9.7	10.8	10.7	10.0	9.6	9.7	9.4	9.8	9.4
Other Revenue (B)	2.6	2.2	2.5	2.8	2.1	3.3	3.7	3.6	3.1	2.5	3.0	3.1	3.6
Operating Costs (C)	7.1	7.5	7.7	7.7	7.8	7.8	8.0	8.0	7.5	7.3	7.1	7.0	7.0
Salaries and Wages	3.7	3.9	4.0	4.0	4.0	4.0	4.0	4.0	3.6	3.5	3.4	3.2	2.8
Gross Profit (D)=(A)+(B)-(C)	2.6	3.5	4.5	4.3	4.0	6.3	6.4	5.6	5.2	4.9	5.3	5.9	6.0
Loan Loss (E)	0.8	1.0	2.0	4.6	6.2	13.3	7.3	13.5	13.5	6.3	6.6	9.4	7.0
Net Operating Profit (F)=(D)-(E)	1.8	2.5	2.5	-0.4	-2.2	-7.0	-1.0	-7.9	-8.3	-1.4	-1.3	-3.5	-1.0
Realized Capital Gains (G)	2.0	0.7	0.0	2.0	3.2	4.4	1.2	3.6	1.4	3.8	1.4	-2.4	-4.1
Net Profit (F)+(G)	3.8	3.3	2.5	1.7	1.0	-2.6	0.2	-4.2	-6.9	2.3	0.1	-5.9	-5.1
Asset	927.6	914.4	859.5	849.8	845.0	848.2	856.0	848.0	759.7	737.2	804.3	772.0	739.0
Outstanding loans	522.0	537.0	542.0	539.0	539.0	554.0	563.0	536.0	492.0	476.0	474.0	465.0	435.0

Notes:

1) 134 banks were included in this data: 7 city banks, 2 long-term credit banks, 8 trust banks, 64 regional banks and 53 second regional banks. Foreign banks were excluded from this analysis. Also, figures were for banks on non-consolidated bases.

2) We classified the profit/loss items from the Income Statements as follows:

?Lending Margin = Interest Income – Interest Expenses

?Other Revenue = Fees and Commission Income + Trading Income + Trust Fees + Other Business Income + Gains on Investment of Money Held in Trust + Other Operating Income – Fees and Commission Expenses – Trading Expenses – Other Business Expenses – Losses on Investment of Money Held in Trust + Extraordinary Gains (Excluding Gains on disposal of Premises and Equipment) – Extraordinary Losses (Excluding Losses on disposal of Premises and Equipment)

?Operating Costs = Operating Operating Costs (including deposit insurance premiums)

?Gross Profit = Lending Margin + Other Revenue – Operating Costs

<sup>1)</sup> The Shareholdings Restriction Law was enacted in November of 2001. This meant that banks and their subsidiaries were no longer permitted to hold stocks etc. to the same amount as their capital. (Law concerning Restriction, etc. of Banks' Shareholding etc). This is to be enforced from September 30, 2004, but if there is strong rationale with approval from the competent Minister, this can be delayed for a maximum of two years.

?Loan Loss = Provision of Allowance for Bad Debts + Loan Write-offs + Other Operating Expenses

?Net Operating Profit = Gross Profit – Loan Loss

?Realized Capital Gains = Gains on Sales of Securities + Gains on Disposal of Premises and Equipment – Losses on Sales of Securities – Losses from Sales of Premises and Equipment

?Net Profit = Net Operating Profit + Realized Capital Gains = Income Before Taxes

3) In order to remove the effects of changes in accounting standards from these figures, we removed deferred tax assets from total assets, and we also removed loan loss provisions from fiscal 2000 that are now listed in assets.

Source: “Corporate Finance Data Base” NEEDS-Financial QUEST

### 3. Bad Loans in Fiscal 2002

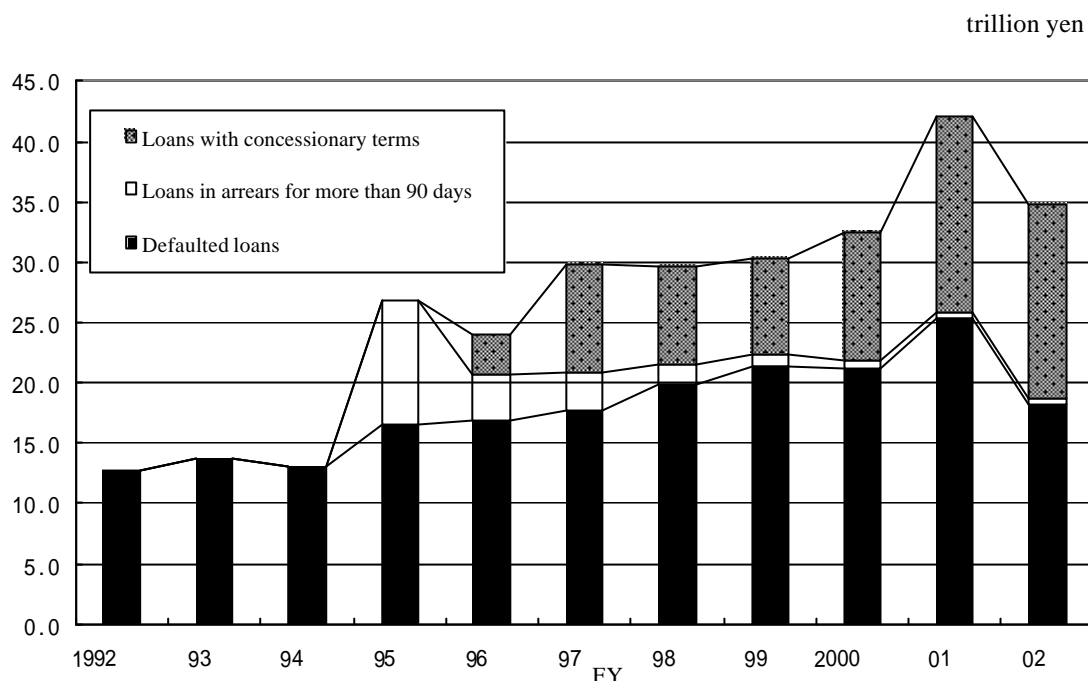
#### 3.1 Outstanding Amount of Bad Loans

We define "bad loans" here as, of the receivables such as loans held by banks etc., those with which interest or principal are past due, or those loans that are feared to become past due. In Japan, there are three definitions of bad loans: 1) Self Assessment Loans, 2) Risk Management Loans and 3) Loans based on the Financial Revitalization Act. Self Assessment Loans represent the most important standard because banks estimate their loan-loss reserves and the amount of write-offs based on this classification. Risk Management Loans and Loans based on the Financial Revitalization Act are disclosed. They are required by the Bank Act or the Financial Revitalization Act. However Self Assessment Loans are not disclosed on an individual basis.

#### • Risk Management Loans

The total amount of risk management loans for all banks in Japan was 34.8 trillion yen in fiscal 2002, and this was 7.2 trillion less than that in fiscal 2001. However, if we compare this amount with that in fiscal 2000 and fiscal 1999, it still remains very high (Fig.1).

Figure 1. Risk Management Loans



Source: Financial Services Agency

• Assets Classified by Self-Assessment

Table 2 shows that the total Self Assessment Loans amount to 71.1 trillion yen at the end of March 2002. This fiscal year, the Japanese FSA terminated the publication of this data, so we estimated the amount of classified loan data for March 2003 based on the disclosed bad loan data. According to this estimation, the classified loan has declined to 64.8 trillion yen which still remains very high (Table 2).

Table 2. Asset Classified by Self-assessment

Financial year	trillion yen				
	Mar-99	Mar-00	Mar-01	Mar-02	Mar-03
All credit exposure	551.8	535.8	536.3	511.6	472.6
Non classified loans (category I)	487.5	472.4	470.7	440.5	407.8
Classified loans	64.3	63.4	65.7	71.1	64.8
Substandard (category II)	61.0	60.5	63.1	67.8	62.9
Doubtful (category III)	3.2	2.8	2.6	3.3	1.9
Estimated Loss (category IV)	0.1	0.0	0.0	0.0	0.0

Source: Finance Services Agency

Estimated by JCER(2003)

In fiscal 2002, Estimated classified loans amount to 64.8 trillion yen and Risk Management Loans were 34.8 trillion yen. Since the classified loans are more broadly defined than disclosed bad-loans, the amount of classified loans is about twice as much as the disclose loan figure.

For example, borrowers which are deficit or have problems in financial condition although

scheduled payment is carried out, have possibilities to be categorized classified loans. But they are not Risk Management Loans.

However, there is a problem about laxness of standard “superior guarantee”. For example if the guarantee is from a non-dividend paying company which is listed on a stock market or an over-the-counter traded company, the asset guaranteed by this company may be considered non-classified according to the Bank Examination Manual of the FSA.

### 3.2 Bad Loans Disposal of Bad Loans

Losses incurred from the disposal of bad loans for all banks in fiscal 2002 were 6.7 trillion yen and 3.0 trillion less than fiscal 2001. However, the accumulated amount of the losses from fiscal 1992 amount to 88.2 trillion yen (Table 3).

Table 3. Disclosed Loan Losses of Japanese Banks (All Commercial Banks)

trillion yen

Financial year	Mar-93	Mar-94	Mar-95	Mar-96	Mar-97	Mar-98	Mar-99	Mar-00	Mar-01	Mar-02	Mar-03
	Only for major banks										
Loss from bad loans (A)	1.6	3.9	5.2	13.4	7.8	13.3	13.6	6.9	6.1	9.7	6.7
specific reserves	0.9	1.1	1.4	7.1	3.4	8.4	8.1	2.5	2.7	5.2	3.1
write-off and loan sales losses	0.4	2.1	2.8	6.0	4.3	4.0	4.7	3.9	3.1	4.0	3.5
Cumulative amount of (A)	1.6	5.5	10.7	24.1	31.9	45.1	58.8	65.7	71.8	81.5	88.2
Bad loans outstanding (B)	12.8	13.6	12.5	28.5	21.8	29.8	29.6	30.4	32.5	42.0	34.8
Definition of B	defaulted loans and loans with arrears			defaulted loans. loans with arrears for more than 6 months and loans with concessional interest rates below ODR.			defaulted loans. loans with arrears for more than 90 days and loans with concessional terms (similar to SEC rule)				

Source: Financial Services Agency and Bank of Japan

The depth of the problem is not necessarily defined by the amount of the bad loans being held. We find it difficult to imagine no new bad loans occurring in the next year. Therefore, the true issue with bad loans is not the scale of bad loans, but whether the banks can generate enough profits every year to charge off the existing ones and deal with the losses. In fiscal 2002, 6.7 trillion yen of bad loans were disposed of, as we showed Table 1, where the gross profit was 6.0 trillion yen. In other words, the credit losses incurred from disposing of the bad loans cannot be covered by the profits of the bank. Furthermore, this trend has continued for the past decade since fiscal 1993. If the banks hold enough shareholders' equity, and they can secure spreads large enough to cover defaults, and then the amount of the bad loans per se does not become a major issue.

### 4. Recapitalization of Major Banking Groups

The Financial Revival Program was launched in October 2002. Its objective is to construct a strong financial system in order to resolve the bad loans problem of the major banks. It consists of establishing a joint support system of the government and the Bank of Japan together to promote banks' taking loans off the balance sheet, make the asset assessment more stringent, and strengthen the capital base of the banks. Table 6 shows the BIS ratios of The Major Banking Groups at March 2003. Here, Major Banking Groups are the Japanese biggest Holding Companies, with the asset of more than 80 trillion yen. They are called the “four Mega Bank Groups”. At the end of March 2003,

the BIS ratios for the large banking groups were all similar and hovered around the 10% mark (Table 4). These are all above the required ratio of 8%, but there is a possibility that Recapitalization in 2002 helped boost their BIS ratios.

Table 4. BIS ratio of the Major Banking Groups (March 2003)

billion yen

	Mizuho Financial Group	Sumitomo Mitsui Financial Group	Mitsubishi Tokyo Financial Group	UFJ Holdings
Tier1 capital (A)	3,495	3,256	3,129	2,560
Tier2 capital (B)	4,681	3,396	2,966	2,129
Tier3 capital (C)	0	0	30	0
Subtraction Item (D)	143	239	38	72
Total risk-based capital (E)=(A)+(B)+(C)-(D)	6,847	5,979	5,968	4,617
Risk asset (F)	71,824	59,167	55,050	46,328
Total risk-based capital ratio (E)/(F)×100	<b>9.53%</b>	<b>10.10%</b>	<b>10.84%</b>	<b>9.96%</b>

Source: Disclosure Material

The major banking groups then hammered out some plans to strengthen their capital base by the end of March 2003. Then on August 1 2003, a business improvement administrative order was issued from the FSA to some banks that had received public fund injections. The reason cited was that these banks were not able to attain their earnings targets for fiscal year ending March 2003, and the banks given the order were requested to submit a business improvement plan that includes measures for profitability improvement. Although the content of the profitability improvement that the FSA had requested to each banking group has not been disclosed, each group has since then put forth a management revitalization plan that details their measures for improving profits and their dividend policies.

At the end of March 2003, the BIS ratios for the large banking groups were all similar and around the 10% mark. These are all above the required ratio of 8%, but this in large part is thanks to their recapitalization. Table 5 shows the various recapitalization measures taken by the large banking groups and summarized how each of them has helped boost their BIS ratios. According to BIS regulations, the sum of Tier II and Tier III capital can be included as regulatory capital up to the same amount as Tier I capital. In this estimation, we assumed that Tier II and Tier III capital together was the same amount as Tier I capital, and calculated how these recapitalization measures helped boost the capital ratios on a consolidated basis.

Table 5. Recapitalization of the Major Banking Groups, and Estimated Increases in BIS ratios (March 2003)

billion yen

Banking Group	Mizuho Financial		Sumitomo Mitsui Financial		Mitsubishi Tokyo Financial	UFJ Holdings	
Amount of Additional Capital	1081.9	118.5	150.3	345.0	293.7	120.0	111.0
Increase in BIS Tier I Capital Ratio(percentage)	1.7		0.8		0.5	0.5	
Increase in BIS Capital Ratio on Consolidated Basis(percentage points)	<b>3.3</b>		<b>1.7</b>		<b>1.1</b>	<b>1.0</b>	
Method	Issuance of Preferred Shares Alloted to Third Parties	Issuance of Preference Shares in form of Private Placement	Issuance of Preferred Shares Alloted to Third Parties	Issuance of Preferred Shares Public Offering	Issuance of Common Stock Public Offering	Issuance of Preferred Shares Alloted to Third Parties	Issuance of Preference Shares in form of Private Placement
Investors	Domestic Business Partner Companies etc.	Domestic Business Partner Companies etc.	Goldman Sachs	Foreign Institutional Investors	Domestic and Foreign Investing Public	Merril Lynch	Domestic Business Partner Companies etc.
Dividend Rates	<b>0.25% - 3.0%</b>	n.a	<b>4.50%</b>	<b>2.25%</b>	<b>0.88%</b>	<b>2.38%</b>	n.a
Increase in Dividends due to Recapitalization(Expected) <sup>(1)</sup>	20.2	n.a	14.5		2(Common Stock)	2.9	n.a
Dividends for Existing Preferred Shares <sup>(2)</sup>	22.1	n.a	14.5		4.2	7.0	n.a
Total Dividends(Expected for fiscal year ending end-March 2004) <sup>(1)+(2)</sup>	42.3	n.a	29.0		4.2	9.9	n.a

## Notes:

- 1) Expected dividend amounts for fiscal 2003 are from Management Revitalization Plans
- 2) Increase in dividends of Mitsubishi-Tokyo Financial Group are for 1) common stock. We assumed them to be the same as dividends in fiscal 2002 (4,000 yen per share). Dividend rates of UFJ Holdings are according to the Nihon Keizai Shinbun (February 26, 2003)
- 3) Amount of additional capital from Preferred Share issuance of Mizuho Financial Group is paid up amount as of March 28, 2003
- 4) Increase in BIS Tier I Capital Ratio = Increase in Tier I capital after recapitalization / risk-weighted assets  
Increase in BIS Capital Ratio on Consolidated Basis = (Increase in Tier I capital \* 2) / risk-weighted assets

Source: Disclosure Material and Management Revitalization Plans of the banking groups

The increases in capital for Mizuho Financial Group, Sumitomo Mitsui Financial Group, Mitsubishi-Tokyo Financial Group and UFJ Holdings in fiscal 2002 were respectively, 1,200.4 billion yen, 495.3 billion yen, 293.7 billion yen and 231.0 billion yen. In addition, the effect that this recapitalization has had to improve the banking groups' BIS ratios were estimated as 3.3, 1.7, 1.1 and 1.0 percentage points, and enhanced their ratios to a large extent in all cases for fiscal 2002.

Three out of the four banking groups elected to issue preferred shares, but the underwriters varied; some were domestic companies that the banks did business with and some were foreign financial institutions. We do observe that the foreign financial institutions that bought the preferred shares will be enjoying high dividend rates. The dividend payment amount for the new preferred shares that were issued in fiscal 2002 is as large as for the existing preferred shares for some banking groups.

Although each of the banking groups is earning enough profit to make dividend payments, dividends by nature are to be taken from profits earned, and so it is the most important matter that they continue to be profitable in the future.

## 5. Capital Position of all Banks

To find the net capital account, we focus on the liquidation value of the banks and take the Shareholder’s equity portion of the balance sheet and adjust the figure for 1) Estimated under-reserving -- the difference between Estimated required loan loss reserves and total loan loss reserves outstanding, 2) deferred tax assets that need to be removed and 3) other items that require adjustment. Here, we also deduct the preferred shares for public funds injection to find the net capital account. The reason that we do this is that if these preferred shares are converted to common stock and cannot be sold in the market, then they must be bought back. Thus, this lacks in the “permanence” that is required in the definition of the capital.

Table 6 shows the weak capital structure of Japanese banks. On the surface, the capital account of all commercial banks was 24.8 trillion yen at the end of March 2003. However, this figure includes 10.6 trillion yen deferred tax assets that have no liquidation value. In addition, there is sizable under-reserving for bad loans in our estimation. If we subtract 5.4 trillion yen of under reserving for March 2003 and 10.6 trillion yen of deferred tax assets and 1.3 trillion yen of other items from the capital account, the Japanese banks would have only 7.5 trillion yen of capital. The government provides 7.3 trillion yen of this capital. Thus, the net capital account is only 0.2 trillion yen.

Table 6. Capital Position of all Banks (134 banks as of 2003)

trillion yen						
End of fiscal years	Capital Account	Estimated Under-reserving	Deferred Tax Asset	Other	Public Capital Injections	Net Capital Account
	A	B	C	D	E	F=A-B-C+D-E
March 31, 1998	24.3	4.9	0.0	2.1	0.3	21.3
March 31, 1999	33.7	4.0	8.9	0.4	6.3	14.8
March 31, 2000	35.6	5.8	8.2	4.1	6.9	18.9
March 31, 2001	37.6	7.5	7.3	-3.5	7.1	12.2
March 31, 2002	30.2	6.8	10.7	-2.0	7.2	3.6
March 31, 2003	24.8	5.4	10.6	-1.3	7.3	0.2

Notes:

Estimated under-reserving = Estimated required loan loss reserves – Total loan loss reserves outstanding

Estimated required loan loss reserves = 1% \* Category I loans + 20% \* Category II loans  
 + 70% \* Category III loans + 100% \* Category IV loans

Other = (Unrealized gains on available-for-sale securities – Equivalent of Deferred Tax Liabilities) +  
 Unrealized gains on derivatives – Revaluation Reserve for Land

Source: “Corporate Finance Database” NEEDS-Financial QUEST

Table 7 is the same table as Table 6 except the figures represents major banks only. The net capital

account follows the same trends as for all banks in Table 6. However, the net capital account from end-March 2002 becomes negative figures. For this last fiscal year, they were in the red. When we take into account the fact that the major banking groups increased their capital by almost 2 trillion yen by end of March 2003, their net capital must have deteriorated by even more. It is critical that banks improve their profitability to get out of the red, and strengthen their capital.

Table 7. Capital Position of major Banks (17 banks as of 2003)

End of fiscal years	Capital Account	Estimated Under-reserving	Deferred Tax Asset	Other	Public Capital Injections	Net Capital Account
	A	B	C	D	E	F=A-B-C+D-E
March 31, 1998	14.7	2.4	0.0	4.7	0.3	12.7
March 31, 1999	22.8	3.0	6.6	2.8	6.2	6.8
March 31, 2000	23.9	3.8	5.7	8.8	6.5	10.6
March 31, 2001	24.2	5.3	5.3	-2.0	6.6	4.5
March 31, 2002	18.0	4.7	8.0	-1.2	6.6	-2.4
March 31, 2003	13.1	2.9	7.9	-0.5	6.6	-4.8

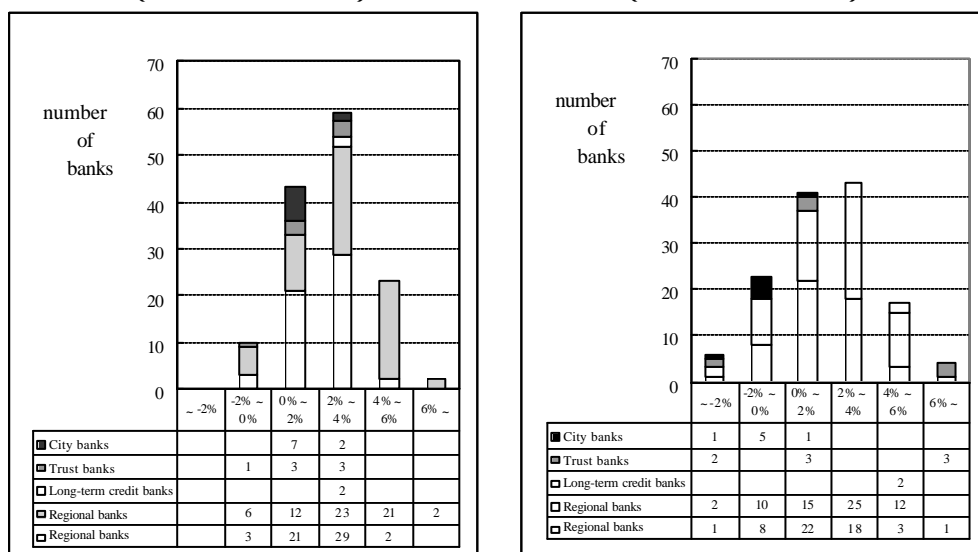
trillion of yen

Notes: Major Banks are City Banks, Long-term Credit Banks and Trust Banks.

Source: Same as Table 6

We now look at the distribution of the capital ratios by bank. The number of banks that are in negative equity have risen from 10 banks at end-March 2000 to almost three times their number to 29 at the end of March 2003. Thus, more than one fifth of all banks (134 in total) are in negative equity. The result of estimation, The Net capital of banks in Japan has continued to deteriorate by March 2003. And many banks had negative capital in our estimation.

Figure 2. Distribution of Net Capital/Asset Ratio  
 ( End March 2000 ) ( End March 2003 )



Source: Same as Table 6

## 6. Accounting for Business Combinations in Japan and Dealing with Bank Mergers

### 6.1 Trends in Accounting for Business Combinations

After the year 2000, many banks – mostly among the major banks – in Japan merged. They have secured resources for dividends and disposed of their unrealized losses on stock holdings by using the gains from mergers. Currently in Japan there is no clear standard to be applied to business combinations, and so they have taken advantage of the fact that they have flexibility in the accounting so long as it is within the guidelines of the Commercial Code<sup>2)</sup>. Using the example of the “reverse” merger (where the smaller company in a merger is the surviving entity) of Sumitomo Mitsui Banking Corporation (SMBC) and Wakashio Bank, we make a comprehensive examination below of the process of business combinations and the problems inherent in the accounting system.

### 6.2 SMBC-Wakashio Bank Reverse Merger

In March 2003, Sumitomo Mitsui Banking Corporation (the now defunct SMBC, capitalized at 1.58 trillion yen) and its wholly owned subsidiary Wakashio Bank (with 80.8 billion yen of capital) merged. With this merger, Wakashio Bank became the surviving entity, and the name of the new Bank became Sumitomo Mitsui Banking Corporation (capitalized at 560 billion yen). In this manner, with SMBC’s subsidiary becoming the surviving legal entity and the parent company becoming the defunct entity, we call this a “reverse” merger. The two points to this scheme are as follows:

- (1) There is a capital-reduction (on paper) through the merger.
- (2) There are merger profits that have occurred which are used to dispose of unrealized losses on stock, and increase profits available for dividend payments.

With the merger, SMBC reduced their capital stock by 578.8 billion yen and their capital surplus by 826.7 billion yen (both figures are as at March 16, 2003, the day prior to their merger) (Table 8). This was used to dispose of unrealized losses on securities (672.8 billion yen) and appropriated to capital surplus 658.4 billion yen.

Table 8. Composition of Shareholder’s of SMBC (now defunct)

	billion yen		
Sumitomo Mitsui Banking Corp. (now defunct, unconsolidated)	March 16 2003 (one day prior to merger)	Merger Carry Over	Net Assets Carried Over
Capital Stock	1,058	-579	479
Capital Surplus	2,004	-827	1,177
Capital Reserve	1,646	-827	820
Other Capital Surplus	358	-	358
Retained Earnings	-437	658	222
Revaluation Reserve for Land	97	-	97
Unrealized Gains or Losses on Available for Sales Securities	-673	673	-
Total Shareholder's Equity	2,050	-74	1,976

Source: Sumitomo Mitsui Financial Group Disclose Material

We consider three alternative routes for SMBC to have taken and conduct simulations: 1) They

<sup>2)</sup> After the “Exposure Drafts – Opinion of Establishing Accounting Standards for Business Combination” in August 2003, it was determined to apply Purchase accounting methods to business combinations.

take a conventional route to reduce their capital (on paper), and use their Legal Reserve to cover their unrealized losses and to generate a source to pay dividends, 2) Sumitomo Mitsui Banking Corp remains as the surviving entity and they undergo a merger, and 3) Undergo their merger using the Purchase accounting methods to be applicable from April 2006. Our results show that the merger method taken by SMBC this time was the most effective for them.

The Sumitomo Mitsui Financial Group, the parent company to SMBC, is expected to mark net profits for the fiscal year ending March 2004 of 50 billion yen, and then the dividends for all shares including preferred shares would amount to 46.4 billion yen. Therefore, we can see that the Sumitomo Mitsui Financial Group needed an effective framework to make these large dividend payments possible. However, this series of manipulations for this merger is not expected to fundamentally strengthen their financial foundation.

### **6.3 Motives for Sumitomo Mitsui Banking Group to Create Local Subsidiary in March 2003**

On March 5, 2003, SMBC created a wholly owned subsidiary, Sumitomo Mitsui Banking Corporation Europe Limited (with capital stock of US\$ 1.7 billion). According to their press release of February 10, 2003, the Bank created the subsidiary to become the platform for their European expansion and to raise the presence of the SMBC group in Europe. Also, according to their announcement of August 28, 2003, they state that if this is recognized by the UK banking authorities, then they are permitted to open branches freely in the European Union, and that this was a decision made from this perspective.

However, it is generally the case that banks expanding abroad establish branches rather than subsidiaries. This is because if they choose subsidiaries rather than branches, then they need to build a large capital base for the subsidiary, and that subsidiary's credit rating will often be one notch lower than the parent company causing their funding costs to increase. We have heard that the UK banking authorities viewed this new Sumitomo Mitsui Banking Corporation (established through the “inverted” merger of SMBC and Wakashio Bank) as not merely a change in name, but considered this a “consolidation” and applied the stricter standards to it and directed SMBC to establish the local subsidiary. By this “subsidiarization” of the branch, the amount of lending that may be done by this new entity will now be determined as a share of the capital stock not of the parent company SMBC, but the UK subsidiary. This may result in limiting the business that the Bank can do in the UK. Moreover, this can also be interpreted as an attempt by the UK authorities, by requesting the subsidiary to build its own capital, to separate the subsidiary from the operational risk of the parent.

## **7. The Injection of Public Funds into Resona Bank, and the Price Book-Value Ratios of the Major Banking Groups**

### **7.1 Injection of Public Funds**

After 1997, with the instability in the financial system, there have been many laws created to deal with the injection of public funds. These are called the Bank Recapitalization Act, and the Financial Revitalization Act. The injection of Public Funds under the Bank Recapitalization Act and the Financial Revitalization Act was completed by March 2001.

The Deposit Insurance Law established the Deposit Insurance Corporation in 1971. The role was to protect depositors of failed financial institutions. The Deposit Insurance Law was amended to

provide for the prevention of systemic risk in the financial system from April 2001. Type 1 measure of Article 102 was applied for the first time to Resona Bank in May 2003. Resona Bank is the biggest bank under Resona Holdings. Resona Holdings is fifth largest group just after so-called four Mega Bank groups.

We observed a few problems with the application of Clause 102 of the Deposit Insurance Law. The five major issues were 1) The implementation of the early correction measures and the decision to inject public funds under Article 102 of the Deposit Insurance Law were done on the same day, 2) The public funds were injected before a stringent assessment of assets was conducted, 3) There was an exchange of shares between the holding company, Resona Holdings and Resona Bank, 4) There is the issue of shareholder responsibility, and finally, 5) The issue of how the injected amount was determined. Going forward, should there be a second and third case when this act will have to be applied, then the authorities should use their experience with this case to make improvements to the application of Article 102 of the Deposit Insurance Law.

The amount of deferred tax assets (DTA) was a major point of contention during deliberations about the infusion of public funds. Deferred tax assets are assets that require that the future taxable income to be reduced and the tax burden to be reduced to be recognized by the auditors. Since this is an entry whose amount depends on the future taxable income, the expected future profits become a very crucial factor. Furthermore, this is an “asset” that holds no asset-like qualities in the context of liquidation value. The auditing firm for Resona Bank did not allow Resona to claim five years of profits, but only three. As a result of this, Resona could not claim 260 billion yen of deferred tax assets, and this resulted in their capital ratio falling below the 4% required by domestic standards. Thus, the injection of public funds was required.

Banks have kept large amount of deferred tax asset in spite of the fact that most of them have been losing money for the past 10 years. Table 9 shows the share of DTA in the core capital of major Japanese financial groups. The DTA of other banking groups is also very large compared with its core capital. If we apply US capital requirement rule that set the limit of DTA up to 10 percent of core capital, most major Japanese banks cannot comply with BIS capital requirements.

Table 9. Ratio of Deferred Tax Asset in Core Capital of Major Japanese Banks  
 ( Mar 2003)

	Core Capital (A) Billion yen	Net DTA (B) Billion Yen	Ratio (B/A) Percent
Mitsubishi Tokyo Financial Group	3,338	1,303	39.0
UFJ Holdings	2,665	1,522	57.1
Resona Holdings	635	522	82.2
Resona Bank	366	401	109.6
Saitama Resona Bank	155	44	28.4
Sumitomo Mitsui Financial Group	3,168	1,842	58.1
Mizuho Financial Group	4,322	2,105	48.7
Mitsui Trust Holdings	341	346	101.5

Notes: Net DTA = deferred tax assets - deferred tax liabilities.

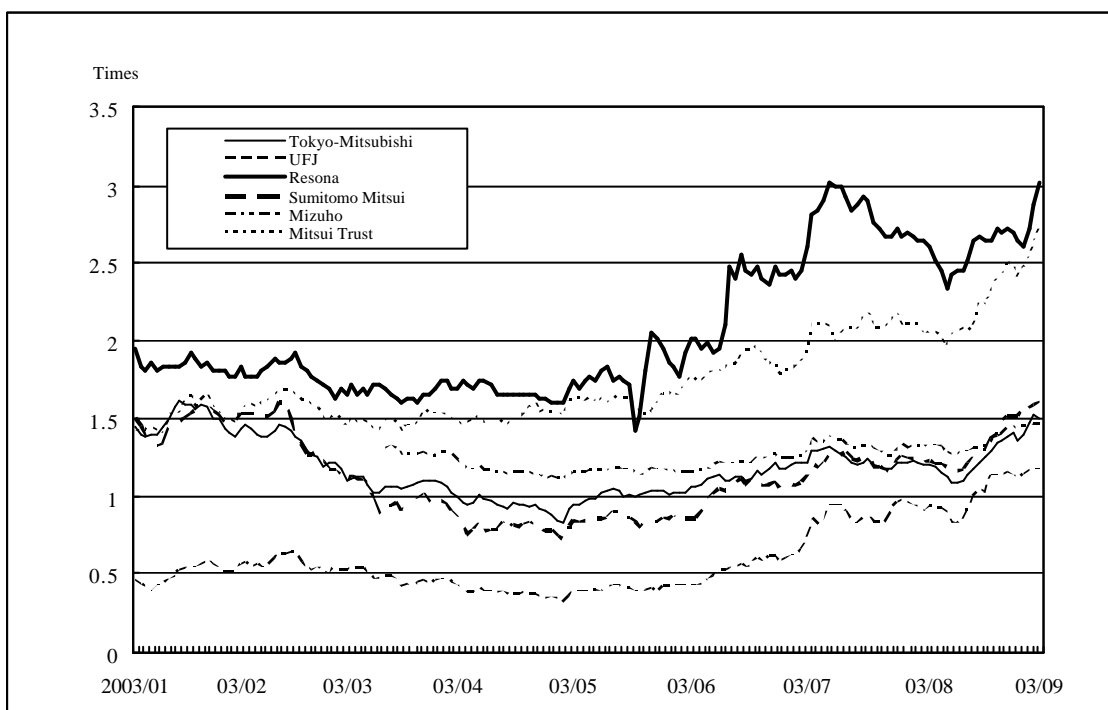
Source: Disclosure materials of individual banks.

## 7.2 Price Book-Value Ratios (PBRs)

While the capital ratios of the bank continue to deteriorate, the stock prices of the major banks are rising. Here, we estimated some PBRs adjusted for dilutions due to the issuance of preferred shares.

We show these adjusted PBRs in fig 3. The adjusted PBRs have exceeded 1 for all banking groups, and the average for all banks rose from 1.1 times at the end of March to 1.9 times at the end of August. After the decision was made to inject public funds into Resona Bank on May 17<sup>th</sup>, the adjusted PBR has shown a clear rise. For one of the major banking groups, the PBR is close to 3 times. Of course, the stock price is not determined by net assets per share alone. However, in the background of the adjusted PBRs, we sense a kind of moral hazard coming into play where the government support to Resona Bank has caused calm among investors and the stock market has become somewhat complacent.

Figure 3. Adjusted PBRs (2003)



Notes:

- 1) Adjusted PBR = { stock price  $\times$  (Number of common stock at end of March 2003 + Adjusted number of preferred shares) + Total amount of non - convertible preferred shares } / Total capital at end-March 2003.
- 2) Since we used the end-March 2003 total capital figures, we did not include the increase in capital after March 2003.
- 3) To find Adjusted Preferred stocks, we took the book value of the preferred shares, divided them by the initial convertible amount, and assumed they were converted.

Sources: “Stock Market Database” NEEDS-Financial QUEST. Disclosure material of banks

## 8. In Conclusion

In this report, we used the financial statements for fiscal 2002 of all Japanese banks to analyze their profitability, their bad loans, their capital ratios and their efforts to strengthen their capital bases. We also pointed out some of the systems in banking as we looked at the Japanese merger accounting principles.

In this analysis, there are five major issues as pointed out below that we find with the banks and the systems related to banking.

First, banks are still not in good enough health to make adequate profits. These results in the situation whereby the costs of writing off bad loans cannot be covered by the profits gained from their core businesses.

Second is the declining capital ratio. If the banks are not able to make adequate profits, then capital should decline. When we calculate the real capital using banks' financial data, we find that many banks are in excess of debt.

Third is the bad loan issue. The resolution of the bad debt problem requires banks to be able to write-off any bad loans incurred every year by their profit every year. However, the amounts of bad loans to be written off continues to be at a very high level, and cannot be written off with the profits made every year. Bad loans are not a major issue if the banks' capital is plentiful and if they can make up in sufficient margins the losses from the bad loans. However, for banks that are not able to make large margins and are weakly capitalized, then bad loans are a very pressing issue. Moreover, we do not see clear evidence that bad loans have shrunk over the past few years. Furthermore, there is also the possibility that bad loans have been shifted to subsidiaries and to the public sector.

Fourth, regarding recapitalization moves and bank mergers, bank management needs to have a clear vision and be able to convince the public that the strategy taken is one that is truly necessary at this point in time. We see a risk that the major banking groups' may have taken future costs too lightly in their recapitalization efforts and merger strategies.

Fifth, there were issues with the public funds injected into Resona Bank. Rather than implementing the Early Correction Measures, capital was injected into the Bank by applying the Deposit Insurance Law. The authorities need to have more transparency in their procedures, and be able to justify their actions to the country.