12-1-2001

Annual Report on Japan's Economy and Public Finance 2000-2001

Government of Japan: Cabinet Office

Annual Report on Japan' s Economy and Public Finance 2000-2001

- No Gains Without Reforms -

December 2001

Cabinet Office

Government of Japan

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Chapter 2

Problem of Non-Performing Loans and Strength of the Japanese Economy

Section 1 Swelling non-performing loans

The problem of non-performing loans that is plaguing Japanese banks is continuing. As the characteristics of the problem, the following three points are important:
(1) With cases of loans becoming fresh non-performing loans continuing, the balance of non-performing loans keeps increasing.
(2) With the cost for disposal of non-performing loans (direct write-off costs, provisions for credit losses, etc.) exceeding the profits from the core banking business (net business profits), it can be said that, in terms of profitability, banks are virtually in the red. The non-performing loans will continue to erode banks' profitability for some time to come.
(3) Considerable amounts of the non-performing loans are concentrated in specific industries: real estate, construction, and wholesale and retail.
In this section, these characteristics of the problem of non-performing loans will be studied in detail and factors that give rise to fresh non-performing loans will be analyzed.

1 Three Characteristics of the Problem of Non-Performing Loans

● Non-performing loans are still continuing to increase

First, we will examine the first characteristic: that is to say, non-performing loans are continuing to increase. The outstanding balance of non-performing loans held by Japanese banks, as measured by the outstanding balance of "risk-management loans" of all banks, has been increasing since the fiscal year ending in March 1993. Even after the definition of risk-management loans was revised to the present definition in the year ending in March 1998, non-performing loans have remained at the high level of around ¥30 trillion and hit an all-time high of about ¥32.5 trillion in the year ending in March 2001 (Figure 2-1-1). During this period, the proportion of non-performing loans (risk-management loans / total loans) has also been increasing and hit 6.6% in the year ending in March 2001. By comparison, the proportion of non-performing loans of U.S. commercial banks has stayed at around 1% in recent years. The total risk-management loans of "deposit-taking institutions," including shinkin banks (credit associations) and credit cooperatives, amounted to ¥43.4 trillion in the year ending in March 2001.

Why have the non-performing loans of Japanese banks been increasing for more than 10 years since the collapse of the bubble economy? Among the factors that increased non-performing loans are (1) the definition of non-performing loans (what should be included in non-performing loans) was expanded gradually until the year ending in March 1998 and (2) the pace of banks' move to clear their non-performing loans off their balance sheets by such means as legal liquidation and credit waiver was slower than the pace of the incidence of fresh non-performing loans. Incidentally, clearing non-performing loans off one' s balance sheets is also called "final disposal" or "clearing off balance sheet" of non-performing loans (See Column 2-3 "What is final disposal of non-performing loans?").

In studying why non-performing loans have increased, it is necessary to divide the time frame into two: one before the year ending in March 1998, when the definition of non-performing loans was expanded gradually, and one in and after the year ending in March 1998, when the current definition of non-performing loans was adopted.

As was described in the above, the increase in the outstanding balance of risk-management loans before the year ending in March 1998 was, first and foremost, due to the fact that the definition of risk-management loans was expanded gradually. Specifically, during the period from FY 1992 to FY 1994, risk-management loans referred to only loans to borrowers in legal bankruptcy and past due loans in arrears by six months or more, but during the period from FY 1995 to FY 1996, they also referred to interest-reduced loans, and in and after FY 1997, they referred to not only loans to borrowers in legal bankruptcy and past due loans in arrears by six months or more but also loans in arrears by three months or more and restructured loans(1). As a result, disclosure is now on a par with the SEC standard in the U.S. Meanwhile, the balance of non-performing loans continued to increase during this period due partly to an increase in risk-management loans caused by the expansion of their definition and partly to the deterioration of loans caused by a decline in asset values and prolonged stagnation of the economy.

There has been no increase in non-performing loans caused by a change of the definition of risk-management loans since FY 1997, as there has been no change in the definition since then(2). However, the outstanding balance of non-performing loans has remained at the high level of about ¥30 trillion. The banks carried out final disposal of a considerable amount of non-performing loans, but the balance of non-performing loans has did not decrease because almost the same amount of loans became fresh non-performing loans. How much of the non-performing loans have been finally disposed of and how much have fresh non-performing loans increased so far? We have to estimate the amount of the final disposal of non-performing loans (hereinafter, the non-performing loans cleared off the balance sheets will be called final disposal amount) and the amount of fresh non-performing loans from published figures.

Final disposal amount is the total of (1) direct write-off costs that are incurred in the current term and involved in final disposal, (2) the amount of existing bad loan provisions drawn down (what is called indirect write-off costs), and (3) recovery at time of disposal, such as through sale of land put up as collateral(3). The total of direct write-offs (the (1) above) and the amount of bad loan provisions drawn down (the (2) above) amounted to ¥38 trillion in four years from FY 1997 to FY 2000. This plus the amount of recovery (the (3) above) is final disposal amount. Suppose that the recovery amount was 20% of total loans, it would mean that ¥45 trillion of non-performing loans were removed from balance sheets and finally disposed of (Figure 2-1-2)(4). Even if the recovery rate was different, say, 10% or 30%, the result of the calculation would not differ much. The balance of non-performing loans is the amount obtained by subtracting such final disposal amount from existing non-performing loans and adding the amount of fresh non-performing loans. Since the balance of non-performing loans remained almost unchanged or increased only slightly during the four years, it is believed that there occurred fresh non-performing loans in the amount equal to or slightly more than the final disposal amount. In short, the banks made final disposal of slightly more than ¥10 trillion of non-performing loans annually for the last four years, but they incurred almost the same amount of fresh non-performing loans annually, resulting in the total amount of non-performing loans staying at a high level of about ¥30 trillion.

The question is why such a huge amount of fresh non-performing loans continue to occur. Since this question is closely related to the second and third characteristics of the problem of non-performing loans, we will analyze this after studying the two characteristics.

Column2-1

What are Non-Performing Loans?

As non-performing loans, there are risk-management loans that are disclosed based on the Bank Law, and classified assets based on the Financial Reconstruction Law that are disclosed based on the Financial Reconstruction Law. Their outstanding balance stands at more than ¥30 trillion on the All Banks base and more than ¥40 trillion on the all deposit-taking financial institutions base.

(1) Risk-management loans

Risk-management loans consist of loans to borrowers in legal bankruptcy, past due loans in arrears by six months or more, loans in arrears by three months or more and less than six months, restructured loans. Their disclosure is now on a par with the SEC (Securities Exchange Commission) standard in the U.S.

(2) Classified assets based on the Financial Reconstruction Law

Classified assets based on the Financial Reconstruction Law consist of loans to borrowers in legal bankruptcy or under restructuring and their equivalents, risky loans, and monitor-requiring loans. The scope of such loans covered for disclosure is almost the same as risk-management loans, but the scope of assets covered is slightly wider than risk-management loans.

(Note) Classification of debtors for banks' self-assessment

Banks conduct self-assessment primarily to calculate the amount of write-offs and provisions required based on the credit exposure categories (I~IV) classified debtor-by-debtor by banks. With regard to the debtor classification (normal borrowers, borrowers that need attention, borrowers in danger of bankruptcy, and bankrupt and effectively bankrupt borrowers) for self-assessment, some news media classify loans to borrowers that need attention or riskier borrowers as non-performing loans. Loans to borrowers that need attention or riskier borrowers stood at about ¥110 trillion (all banks, Bank of Japan 2001) in FY 2000, far larger than the outstanding balance of risk-management loans or classified assets based on the Financial Reconstruction Law. Since payments of principal and interest on much of the loans to borrowers that need attention are being made as originally contracted, however, it is not appropriate to consider all of the loans to borrowers that need attention as non-performing loans. Moreover, among the corporations classified as borrowers that need attention, there are many corporations whose business performance, though sluggish under current business conditions, is expected to improve in the future. The amount of categories II~IV credits stands at about ¥66 trillion (all banks, Bank of Japan 2001). But again, it is not appropriate to compare this amount with that of risk-management loans or of classified assets based on the Financial Reconstruction Law, as it is different in that the amount includes loans to borrowers that need attention (excluding the portion of normal operating funds) and excludes the portions of provisions and collateral on loans to borrowers in danger of bankruptcy and to bankrupt and effectively bankrupt borrowers.

● Disposal of non-performing loans eroding banks' profitability

Next, in order to see the second characteristic, that is to say, the problem of non-performing loans eroding banks' profitability, we will examine the relationship between the amount of disposal of non-performing loans and banks' profitability. A bank' s "net profits" (before adjustment for tax, etc.) is obtained by subtracting "the amount of disposal of non-performing loans" from "net business profits" (profits from core banking business, that is to say, profits from lending and bond transactions minus fund procurement costs and other expenses), adding "stock-related profits/losses" (realization of stock profits, etc.) and "other profits/losses." According to Bank of Japan (2001), banks' net profits had been sluggish after the collapse of the bubble economy. Banks suffered a net loss in FY 1995, 1997 and 1998. A comparison of net business profits and the amount of disposal of non-performing loans shows that banks were unable to cover the costs for the amount of disposal of non-performing loans with net business profits for seven consecutive years from FY 1994. That is to say, banks had to dispose of a large amount of non-performing loans after the collapse of the bubble economy due to an increase in fresh non-performing loans and a decline in the value of collateral caused by falling land prices. As a result, it can be said that, in terms of profitability, banks are virtually in the red (Figure 2-1-3). "Virtually in the red" means that the amount of disposal of non-performing loans are larger than banks' net business profits. With the incidence of fresh non-performing loans expected for some time to come, loss on disposal of non-performing loans will continue to put downward pressures on banks' profitability.

Incidentally, the banks treat loss on disposal of non-performing loans not only by recording provisions (what is called indirect write-offs) but also by making direct write-offs for a large proportion of the losses.

The amount of disposal of non-performing loans and fresh non-performing loans exceeded banks' initial estimates. A study of major banks' plans for loss on disposal of non-performing loans and actual results in FY 1999 and 2000 shows that the loss on disposal of non-performing loans planned at the start of a fiscal year were revised upward in the plans at mid-term book closing and they were further revised upward to meet the actual results at the end of the fiscal year (Figure 2-1-4). It is true that behind the far larger amount of loss on disposal of non-performing loans than initially planned lies the fact that the economy remained stagnant longer than expected. But it may have something to do with the facts that corporate borrowers' business confidence and the business environment surrounding them have changed drastically and banks' understanding of the financial conditions of corporate borrowers may not be necessarily adequate. According to an estimate, a considerable number of bankrupt corporations had been assessed as normal borrowers or borrowers that need attention six months or one year before they went bankrupt and the loans extended to them were not non-performing loans (Figure 2-1-5). However, we have to take note that an overwhelming proportion of total loans are accounted for by loans to normal borrowers and borrowers that need attention.

It is a big problem that the amount of disposal of non-performing loans continues to exceed banks' net business profits. Banks must dispose of non-performing loans as early as possible and dispel market concerns about a sharp increase in non-performing loans and a delay in the disposal of such loans. To that end, banks should speed up the final disposal of non-performing loans to corporate borrowers whose business performance is not expected to improve and ascertain losses by utilizing private/legal liquidation or selling the non-performing loans to the Resolution and Collection Corporation (RCC) as set forth in the Basic Policies and the Front-Loaded Reform Program. It is also important to promote measures focused on restructuring/rehabilitation of borrowers from the standpoint of turning non-performing loans into sound loans and preventing the incidence of fresh non-performing loans. At the same time, the banks should strive to increase profits while assuming a greater risk.

●Real estate, construction, and wholesale and retail account for more than 50% of non-performing loans

As the third characteristic of the current problem of non-performing loans, it is pointed out that non-performing loans are concentrated in specific industries. According to Bank of Japan (2001), a total of 54% of the outstanding balance of risk-management loans (by 15 major and 54 regional banks that disclose industry-by-industry lending) as of the end of March 2001 were accounted for by three industries: real estate, construction, and wholesale and retail. In view of the fact that loans to the three industries account for about 33% of banks' total loans outstanding, this shows how concentrated the problem of non-performing is in specific industries.

Incidentally, of the risk-management loans outstanding as of the end of March 2001, those to manufacturers accounted for only 9%. But, the figure represented an increase of about 30% over a year earlier, indicating that non-performing loans have begun to expand to other industries. Corporate failures of manufacturers and in other industries other than the three industries have increased since around 1997~1998. Since loans to bankrupt companies ("loans to borrowers in legal bankruptcy") are part of non-performing loans, the increase in the number of bankrupt companies in the industries other than the three industries above suggests that banks' non-performing loans have been expanding to other industries (Figure 2-1-6).

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2 Background of Prolonged Problem of Non-Performing Loans

● Why do fresh non-performing loans continue to occur?

We have just seen the three characteristics of the problem of non-performing loans. Next, we will study why the problem of non-performing loans, which is that a large amount of fresh non-performing loans continue to occur and non-performing loans erode banks' profitability, remains unsolved, despite disposal of a large amount of non-performing loans by banks. Against the background of the prolonged economic recession, the following three points are important as factors that are prolonging the problem of non-performing loans;

(1) Corporations, mainly those in the three industries of real estate, construction, and wholesale and retail, that made excessive investment in land, etc. and borrowed heavily during the bubble economy saw their balance sheets damaged due to the continued decline in land prices after the collapse of the bubble economy (a decline in the value of their land assets). Some of the loans to these corporations have become non-performing due to intensifying competition caused by the prolonged economic stagnation and distribution revolution.

(2) Even loans to corporations that were less influenced by the collapse of the bubble economy, those to "losers" , have become non-performing due to expanded disparity in industry-by-industry or corporation-by-corporation business performance amid the prolonged economic stagnation and intensifying industrial structural adjustment pressures.

(3) Financial institutions have implemented stricter classification of borrowers and assessments of their loans.

We will study these points.

First, we will study the point that loans to the companies in the three industries of real estate, construction, and wholesale and retail have become non-performing. The three industries were hard hit by the asset price deflation (declines in land prices and stock prices) after the collapse of the bubble economy. Land prices, mainly commercial land prices, have been declining for about 10 years since the collapse of the bubble economy. As a result, the balance sheets of the real estate and retail industries, whose land accounts for a large proportion of their total assets, have deteriorated. The land assets held by the three industries account for 54% (real estate 27%, construction 7%, and wholesale and retail 20%) of land assets held by all industries (on the Financial Statements Statistics of Corporation by Industry, Quarterly base). Incidentally, the value added by the three industries account for 34% of the total values added by all industries. Many corporations made heavy investments in land during the bubble economy, when land prices soared. Since the amount of land purchases by corporations in the three industries accounted for more than 50% of total land purchases by all industries (1987~1992, on the Financial Statements Statistics of Corporations by Industry, Quarterly base), it is believed that they are still suffering from the aftereffects of the collapse of the bubble economy.

Moreover, profits of the three industries have remained low since the collapse of the bubble economy (Figure 2-1-7). In the wholesale and retail industry, in particular, the disparity of corporation-by-corporation business performance has expanded due partly to the impact of distribution revolution and partly to the emergence of start-up companies. A study of retail sales by listed companies shows that the disparity between companies that increased sales and companies that decreased sales has been expanding and that most of the increased sales are contributed by start-up companies listed in or after FY 1991 (Figure 2-1-8).

Companies in the three industries are suffering from excessive debts as a result of their excessive investment in land and poor profitability. Although all of the excessive debts are not non-performing loans, they are closely related to banks' non-performing loans. An estimate of the extent of the excessiveness of the three industries' debts as measured by "financial debts (net) / values added" ratio shows that the ratio of the three industries (real estate, construction, and wholesale and retail) combined rose sharply during the bubble economy. Although the ratio is now lower than its peak, it is still considerably higher than the level in the first half of the 1980s, or before the bubble economy, when the ratio was stable (Figure 2-1-9). In order to lower the "financial debts (net) / values added" ratio to the level in the first half of the 1980s, or before the bubble economy, it is necessary to reduce the net financial debts of the three industries combined, which now stand at ¥196 trillion, by about ¥67 trillion, assuming that the present values added remain constant(5). In view of the fact that a similar estimate puts the amount of financial debts that has to be reduced by all industries is about ¥70 trillion, this shows that most of the excessive debts are concentrated in the three industries. (The net financial debts of all industries as of the end of FY 2000 stood at ¥403 trillion.) A comparison of the "financial debts / values added" ratios by size of enterprises with those before the bubble economy shows that, although the ratios for both large enterprises and small and medium-sized enterprises in the wholesale industry are not excessive, those for both large enterprises and small and medium-sized enterprises in the construction, real estate, and retail industries are excessive (Appended Note 2-1). However, the ratio for large enterprises is higher than that for small and medium-sized enterprises in the construction industry and the ratio for small and medium-sized enterprises is higher than that for large enterprises in the retail industry. The debts of both large enterprises and small and medium-sized enterprises in the three industries are believed to be excessive relative to their profitability due to the aftereffects of the bubble economy and worsening business performance caused by intensifying competition.

Secondly, we will study the point that non-performing loans have increased even in the manufacturing and other industries on which the impact of the collapse of the bubble economy was relatively small. Some of the loans to "losers" in these industries are believed to have become non-performing due to expanded disparity in industry-by-industry amid (1) the prolonged economic stagnation and (2) intensifying industrial structural adjustment pressures. The excessive debts of non-manufacturers, excluding the three industries, and manufacturers are, on the whole, not large. The "financial debts / value added" ratio of manufacturers as a whole is almost at the same level as before the bubble economy (Figure 2-1-9).

As for corporate profitability, although the ratio of ordinary profit to sales improved significantly in FY 1999~2000, the ratio of net profit to sales that includes extraordinary profit/loss did not improve much (Figure 2-1-7). A study of the ratio of net profit to sales by type of industries and by size before and after the collapse of the bubble economy shows that the ratio, especially of non-manufacturers and small and medium-sized enterprises, has remained low amid the prolonged economic stagnation. Moreover, as was described earlier, liabilities of bankrupt companies in the manufacturing and other industries other than the three industries have been increasing since around FY 1997~1998. Amid the ongoing industrial structural adjustment, the disparity of company-by-company business performance has expanded as in the case of the retail industry, suggesting that some of the loans to "losers" in industries other than the three industries have become non-performing.

Lastly, as one of the factors that have increased fresh non-performing loans, we will study the point that loans assessed as non-performing have increased as a result of stricter classification of borrowers and assessments of loans by banks. Following the implementation of intensive inspections of banks by the Financial Supervisory Agency, Local Finance Bureaus of the Ministry of Finance, and the Bank of Japan in and after July 1998 and the preparation of the Financial Inspection Manual by the Financial Supervisory Agency in July 1999, the accuracy of banks' assessment of their assets has increased. In FY 2000, all banks, in response to the inspections, adopted stricter standards for restructured loans(6). It is believed that this, coupled with sluggish business performance of corporate borrowers, has increased fresh non-performing loans.

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