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Japanese Regional Banks' Preparedness For Rising Credit Risk

—Necessity of Introduction of Forward-looking Provisions —

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<Summary>

- Although the results of regional banks in fiscal 2020 are solid, including a small increase in ordinary profit, this is considered to be temporary due to the significant impact of extraordinary factors under the Covid-19 crisis. In the future, demand for borrowing is expected to decline due to the elimination of extraordinary factors, the prolongation of the low interest rate environment and the accelerated pace of population decline.

- Amid the increasingly severe business environment, there are concerns that credit risks at regional banks will increase. In addition to the risk of bankruptcy of companies with increased debt burden due to the Cobid-19 crisis, it is also necessary to pay attention to the risks of large-lot borrowers and cross prefectural border loans.

- To prepare for future credit risk, forward-looking provisions is an important tool for calculating the allowance for possible loan losses using future forecasts. Although Megabanks have been introducing the system since its establishment in fiscal 2019, only a few regional banks have done so.

- For forward-looking provisions, it is necessary to design the measurement technique at each banks in addition to the limitations of regional statistical data and the difficulty of developing unique measurement models, regional banks also need time to ensure the transparency of their operational processes and appropriate governance arrangements to avoid arbitrary operation. Additionally, there is a possibility that regional banks with insufficient financial capacity may not be able to introduce the system due to concerns that it would increase credit costs.

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- In order to resolve these issues, financial authorities should take the following actions.
  ① Introduction Support ... Based on an analysis of precedent cases in Japan and overseas, financial authorities will provide advice to regional banks on how to resolve issues.
  ② Promote Disclosure ... For reference by regional banks considering the introduction of forward-looking provisions, financial authorities will request banks that have already introduced forward-looking provisions to disclose specific provisions and decision processes.
  ③ Gradual Introduction ... In order to mitigate the temporary financial impact of the introduction, financial authorities will allow gradual introduction.

- Regional banks are expected to make full use of the forward-looking provisions to prepare for credit risk and to focus on business model reforms to enhance profitability for sustainable growth.

- **This is a English version of "地方銀行の信用リスクへの備えを考える — 求められるフォワードルッキング引当の導入拡大—" in JRI Research Focus (The original version is available at https://www.jri.co.jp/MediaLibrary/file/report/research/pdf/12749.pdf)**

1. Introduction

Despite a significant slowdown in the Japanese economy due to the Covid-19 crisis, the financial results of regional banks in fiscal 2020 remained solid, with small increases in ordinary profit. However, from a medium- to long-term perspective, the business environment of regional banks continues to deteriorate. And in the wake of the Covid-19 crisis, some are wary of rising credit risk.

In this paper, we first examine the future performance of regional banks based on their fiscal 2020 financial results. Next, focusing on the "Forward-looking Provisions" which is allowance for possible loan losses using a forward-looking approach that employs forecasts, etc. introduced in FY 2019, we will consider the measures required of regional banks and financial authorities to strengthen regional banks' preparedness against credit risk.

2. Financial Results and Future Prospects of Regional Banks during the Covid-19 crisis

(1) Overview of Fiscal 2020 Financial Results

Despite the significant slowdown in the Japanese economy due to the Covid-19 crisis, the financial results of regional banks in fiscal 2020 remained solid, with a modest increase in ordinary profit (Table 1). Net interest income, mainly income from loans, increased due to a significant increase in outstanding loans as a result of funding support for companies provided during the Covid-19 crisis. In addition, net fees and commissions, which consist of arrangement fees in syndicated loan transactions and investment trust sales commissions, etc., also increased. As for costs, General and Administrative expenses were reduced by regional banks, and the credit cost ratio of regional banks rose only slightly due to the suppression of corporate bankruptcies to historically low levels.

Table 1. Financial Results of Listed Regional Banks (Consolidated)

(0.1 billions of yen)

	2017 Fiscal Year	2018 Fiscal Year	2019 Fiscal Year	2020 Fiscal Year	Year-on-Year
Ordinary Profit	13,055	10,985	9,764	10,036	2.8%
Net Interest Income	34,914	33,767	32,998	33,287	0.9%
Net Fees and Commissions	6,610	6,554	6,562	6,772	3.2%
Operating Expenses	-30,254	-29,350	-29,275	-28,978	-1.0%
Income before Income Taxes	8,963	7,963	7,638	6,772	-11.3%
Credit Cost Ratio	0.07%	0.14%	0.13%	0.15%	—
Loans and Bills Discounted	2,382,079	2,461,131	2,540,158	2,668,772	5.1%

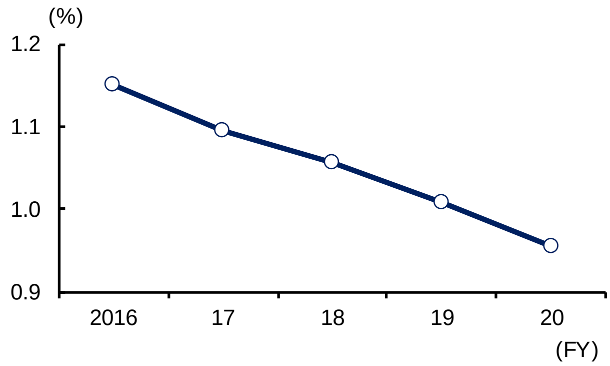
Source: Prepared by JRI based on financial results, etc.

Note 1: Partially non-consolidated. Credit cost ratio = credit cost/loans. Credit costs are disclosed on a non-consolidated basis (holding company is the total of the banks). Above, some definitions may differ.

Note 2: The decrease in net income in fiscal 2020 was caused by a decrease in negative goodwill in fiscal 2019 (1,174 100 million yen).

However, the solid fiscal 2020 results, which were affected by extraordinary factors during the Covid-19 crisis, should be seen as temporary. The outstanding amount of loans extended by regional banks, which had increased due to the Covid-19 crisis, may be sluggish in the future due to a decline in firms' ability to borrow money and repayment of their excess cash reserves in response to the Covid-19 crisis. In addition, lending margins have been on a declining trend against the backdrop of a decline in interest rates as a result of the Bank of Japan's monetary easing policy (Figure 1). Arrangement fees in syndicated loan transactions and investment trust sales commissions, which have boosted earnings from net fees and commissions, are unlikely to continue to grow at a high rate given the decline in fundraising in response to the Covid-19 crisis and the leveling off of Japanese stock prices. In addition, there is a strong possibility that the reduction in general and administrative expenses will reverse and increase again if regional banks resume their operations after the Covid-19 crisis ends.

Figure 1. Changes in lending Margins



Source: Prepared by JRI based on financial results, etc.
Note: Non-consolidated (Partially Consolidated) Interest Lending margins = Interest on Loans/Outstanding of Loans (Fiscal Year) - Interest on Deposits/Negotiable Certificates of Deposit/Outstanding of Deposits/Negotiable Certificates of Deposit (Fiscal year-End).

From a medium- to long-term perspective, the business environment for regional banks is expected to become even more severe, as demand for borrowing is expected to decline due to the prolonged low interest rates and accelerated population decline.

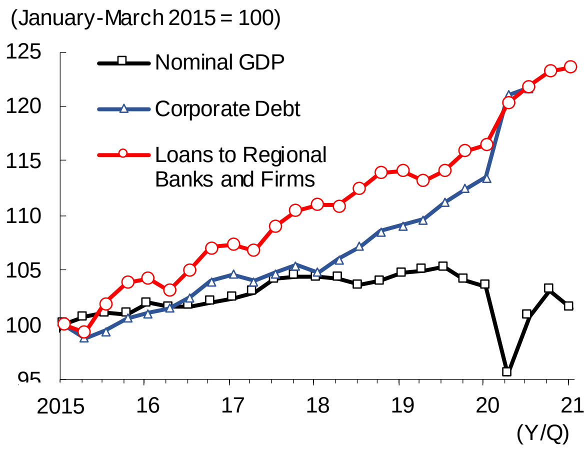
3. Increased concern of credit risk

As the business environment becomes increasingly severe, regional banks are also facing heightened credit risk. In particular, attention should be paid to the following three points.

(1) High level of corporate debt

Corporate debt in Japan, which has been increasing at a pace faster than economic growth in recent years, further increased in the wake of the Covid-19 crisis (Figure 2). Regional banks in particular have been increasing their lending since before the Covid-19 crisis in order to compensate for the decline in profits caused by the narrowing of lending margins, and their outstanding corporate loans have recently increased by about 20% from five years ago.

Figure 2. Nominal GDP, Corporate Debt, Loans to Regional Banks



Source: Cabinet Office, Bank of Japan, BIS
Note: Nominal GDP is seasonally adjusted. Corporate debt is non-financial corporate debt.

As the debt burden has become even heavier, the number of companies that are unable to repay debts may increase. Although many of the loans during the Covid-19 crisis come with public credit guarantees, the ratio of loans with public credit guarantees to outstanding corporate loans by banks is only about 10%. If corporate bankruptcies increase, non-performing loans will also increase at private financial institutions such as regional banks.

(2) Risk of large-lot borrowers

In the wake of the Covid-19 crisis, the risks associated with large-lot borrowers at regional banks were reaffirmed, with credit costs at some regional banks rising significantly due to the poor performance of large-lot borrowers. Specifically, banks such as Gunma Bank and Towa Bank have seen their credit costs rise sharply in connection with Sanden Holdings Corporation, and Higashi-Nippon Bank has seen its credit costs rise sharply in connection with UNIZO Holdings Company.

Although it is difficult to grasp regional banks' risks associated with large-lot borrowers only from public information, it is possible that regional banks, which have been actively increasing their outstanding loans, are becoming more dependent on specific companies with demand for borrowing. Since the upper limit on the large exposure rules is 25% of the capital adequacy ratio, if an enterprise that has extended loans up to the upper limit fails, losses equivalent to up to 1/4 of the capital may be incurred.

(3) Risk of cross-prefectural border loans

As for the case of UNIZO Holdings Company, risks associated with cross-prefectural border loans have also been revealed. According to media reports, more than 60 regional banks have extended loans to UNIZO Holdings Company, and many regional banks hold its corporate bonds. According to the Financial Services Agency and the Bank of Japan, in recent years, regional banks have been increasing loans in neighboring prefectures and the Tokyo metropolitan area to increase their outstanding loans. According to a survey by the Bank of Japan, more than 30% of outstanding loans are believed to be cross-prefectural border loans. As for the cross-prefectural border loans, regional banks cannot make use of their strong relationships with local companies and deep knowledge about regional economies, which are the strengths of regional banks, therefore they are likely to fall into competition with other banks in terms of loans (interest rates, etc.) and may not be able to detect early signs of deterioration in the performance of borrowers. In addition, since they are not familiar with the market, they tend to extend loans to large and mid-sized companies which are well-known. Therefore, regional banks also tend to face risks associated with large-lot borrowers.

4. Outline of forward-looking provisions and status of implementation

Below, we focus on the forward-looking provisions, which was introduced in fiscal 2019, and examine how regional banks are preparing for credit risk.

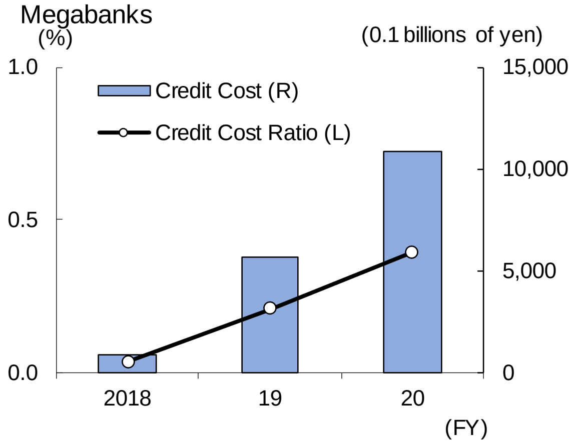
(1) Forward-looking provisions—allowance for possible loan losses for future credit risk[1]

To prepare for future credit risk, the "forward-looking provisions" were introduced in Japan in fiscal 2019. Because the traditional allowance for possible loan losses is calculated based on expected loss according to the historical loan-loss result ratios, no allowance for possible loan losses is provided unless there is an event in which an uncollectible loan is objectively expected. Therefore, it is difficult to increase the allowance for possible loan losses if firms' funding conditions are maintained through large-scale financial support, as is currently the case.

On the other hand, “forward-looking provisions” is a method of calculating the allowance for possible loan losses against future credit risk using future forecasts, etc. In 2019, when the Financial Services Agency abrogated the JFSA's Inspection Manuals, which previously included provisions based on criteria, forward-looking provisions was introduced by taking into account a wide range of information concerning future provisions, including current conditions and future forecasts, in addition to past performance, and by encouraging banks to conduct risk assessments at their own discretion, taking into account each bank's strategies.

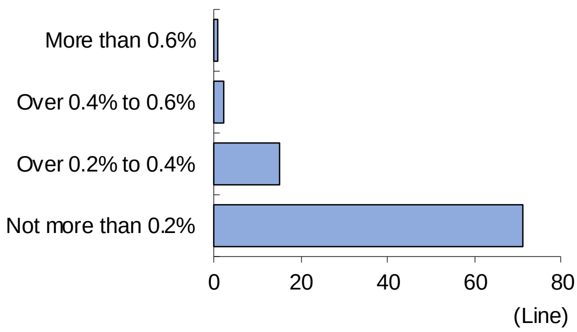
Three Japanese Megabanks introduced forward-looking provisions in fiscal 2019, and the credit costs of the megabanks increased significantly during the Covid-19 crisis (Figure 3). Regional banks, on the other hand, do not appear to be making progress in introducing forward-looking provisions. Only the Fukuoka Financial Group in fiscal 2019 and the Bank of the Ryukyus in fiscal 2020 announced the introduction of forward-looking provisions. In fiscal 2020, the credit cost ratio of most regional banks was 0.2% or less, and there was little movement to significantly increase the amount of allowance for possible loan losses (Figure 4). Therefore, regional banks have limited moves to strengthen their preparedness against the current increase in credit risk.

Figure 3. Credit Costs of Three Japanese Megabanks



Source: Prepared by JRI based on financial results, etc.
Note: Consolidation. Credit cost ratio
= credit cost/outstanding of loans (fiscal year-end).

Figure 4. Distribution of Credit Cost Ratios (Regional banks, FY 2020)



Source: Prepared by JRI based on financial results, etc.
Note: Non-consolidated (holding companies are based on subsidiaries). One of the banks, which accounts for more than 0.6% of the total, extended large loans. Reserve for possible loan losses is provided to the borrower.

According to the Financial Services Agency, banks do not need to review their credit loss accounting standards immediately after the Financial Inspection Manual was abolished. According to a survey by the Bank

[1] In general, banks are required to provide for credit risk through appropriate risk management, loan loss reserves for assumed risks, and capital (soundness) for unexpected risks. In this paper, we focus on the provision for loan losses as preparedness for assumed credit risks.

of Japan in 2020, more than 15 regional banks said they were considering introducing forward-looking provisions.

(2) International moves to incorporate "future projections" into loan loss reserves

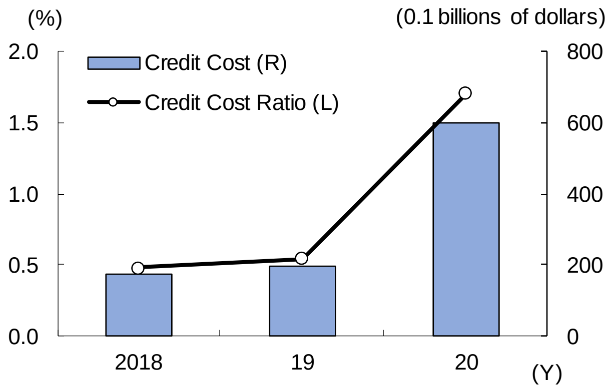
Internationally, there is a growing trend to incorporate future forecasts into allowance for possible loan losses. Conventionally, allowance based on historical loan-loss result ratios, etc., is called the "incurred loss model," and is easy to clarify in terms of rules. On the other hand, such allowance for possible loan losses tends to be "too little, too late"; for example, during the global financial crisis in 2008, a growing number of countries adopted the "Expected Credit Loss (ECL) model," which provides for early allowance for possible loan losses by utilizing a wide range of information such as future forecasts, and it has been said that the provision standards for incurred losses was a factor in exacerbating the situation[2].

Specifically, the International Financial Reporting Standards (IFRS) introduced the ECL model provision standards (IFRS 9) in 2018, while U.S. GAAP also introduced its own ECL model standards, Current Expected Credit Loss (CECL), in 2020.

Major U.S. financial institutions significantly increased their allowance for possible loan losses during the Covid-19 crisis. The credit costs of the 4 major U.S. banks increased by about $40 billion, and the credit cost ratio also increased by more than 1% (Figure 5).

Although Japan does not currently have ECL model provision standards, in order to ensure consistency with international accounting standards, the Accounting Standards Board of Japan (ASBJ) has started to develop an accounting standard for the impairment of financial assets based on the expected credit loss model.

Figure 5. Credit Costs of the Four Major U.S. Banks



Source: Prepared by JRI based on financial results, etc.
Note: JPMorgan Chase, Citigroup, Wells Fargo, and Bank of America Four lines. Credit cost ratio = credit cost/outstanding loans (end of period).

5. Challenges and measures to increase the introduction of forward-looking provisions

In the following sections, we will examine the bottlenecks faced by regional banks with regard to the introduction of forward-looking provisions, and then consider the measures required by financial authorities.

(1) Bottlenecks

① Measurement model development

The Financial Services Agency does not specify a specific measurement method for forward-looking

[2] There is a view that the slow recording of loan loss reserves caused the following: (1) a draw-down of financial institutions' capital due to the rapid increase in loan loss reserves after the crisis outbreak; (2) financial institutions became unable to recapitalize during the crisis and took steps to restrain loans; and (3) the financial crisis was further exacerbated by the effect of the economic slowdown (procyclicality).

provisions, and each bank must build a measurement model. In fact, the measurement methods of the three Japanese megabanks are not unified. However, many regional banks lack the know-how to analyze macroeconomic and financial indicators and semi-macro indicators such as industrial statistics, and it is considered difficult to develop models to predict the financial impact on business partners from the predicted values of each indicator. In addition, regional banks operating in specific regions must take into account regional characteristics, but there are also large data constraints, such as limited statistical information on a prefectural basis.

② Development of the System - Transparency of the Operation Process and Appropriate Governance System

Forward-looking provisions is a framework that provides discretion to each bank, and since management decisions are involved in each calculation, it is necessary to develop highly transparent management processes and establish appropriate governance systems to avoid arbitrary direction by management. While some regional banks are considering the introduction of forward-looking provisions, it may take time to establish a highly transparent operation process and an appropriate governance system that can be explained to financial authorities and audit firms.

③ Financial capacity for provision - increase in allowance for possible loan losses at the time of introduction and increase in the fluctuation range of allowance for possible loan losses

In addition to the increase in the allowance for possible loan losses due to the inclusion of future forecasts, etc., the introduction of forward-looking provisions is likely to increase the range of changes in the allowance for possible loan losses due to changes in future forecasts, etc. In fact, in the Mizuho Financial Group, credit costs increased by 50 – 90% in FY 2019 and FY 2020 as a result of the introduction of the forward-looking provisions. In the United States, it was pointed out that the CECL is causing large fluctuations in profit and loss[3]. At a question-and-answer session on its earnings, Mitsubishi UFJ Financial Group, which applied the CECL in its overseas operations, stated, "As the application of the CECL will increase the fluctuation in credit costs, it is necessary to take this effect into account when making future forecasts.

Regional banks with low profitability have little financial capacity to accumulate allowance for possible loan losses and may be wary of a major review of provision standards. In particular, in the face of the high degree of uncertainty surrounding the Covid-19 crisis, it may be necessary to significantly increase the amount of allowance for possible loan losses.

(2) Measures to be taken in the future

Given these bottlenecks, in order to expand the introduction of the forward-looking provisions at regional banks, the following measures should be taken by financial authorities.

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3 The effects and issues regarding the CECL are being discussed in the United States. While some argue that disclosure should be flexible due to differences in the business environment of each bank, and that the existing framework could not cope with the Covid-19 crisis, others argue that the CECL has become a variable factor in earnings, and that comparability between each bank is lacking (May 20, 2021, Financial Accounting Standards Board (FASB)).

① Deployment Support

Because forward-looking provisions is a framework that emphasizes the discretion of each bank, intervention by the financial authorities should be minimized. However, in order to promote the introduction of forward-looking provisions in a wide range of regional banks, including small regional banks, it will be necessary for the authorities to provide a certain level of support in developing measurement models and operational processes.

Specifically, financial authorities may analyze precedent cases in Japan and overseas and, if necessary, return the results of the analysis and provide advice for regional banks.

② Promotion of disclosure

Currently, the disclosure of forward-looking provisions is insufficient. Consequently, it is not even possible to grasp the status of the introduction of such provisions at each bank. Therefore, financial authorities should encourage banks that have introduced forward-looking provisions in advance to disclose specific provision standards, decision processes, assumed scenarios, etc. Such specific information can be used as a reference for the development of measurement models and frameworks at other regional banks. In addition, the measurement model and the operation process have already been verified by financial authorities and accounting audits, but specific disclosure will also be subject to external checks by investors, etc., leading to increased transparency of the operation process. Additionally, the promotion of disclosure will make it easier for stakeholders such as investors to understand the credit risk status of each regional bank.[4]

③ Gradual introduction

The introduction of forward-looking provisions in the face of high uncertainty about the future may require a significant increase in the degree of allowance for possible loan losses, and regional banks with limited financial capacity may fall into deficit. The purpose of forward-looking provisions is to strengthen preparedness for future risks; it is not made to have a serious impact on current soundness. Therefore, in order to reduce financial impact, gradual introduction should be an option in light of the business environment of each bank. Specifically, it is conceivable to expand the loan portfolio in stages. However, the specific implementation process needs to be disclosed in order to avoid arbitrary management practices.

6. Conclusion

As the business environment of Japanese regional banks becomes increasingly severe, the banks need to reform their business models to enhance profitability. However, a sound financial foundation that can cope with future credit risk is necessary for such business model reform. In this regard, forward-looking provisions is an important tool to prepare for future credit risk. From the viewpoint of regional financial stability, forward-looking provisions should be introduced in a wide range of regional banks, and financial authorities should support its introduction in regional banks using the measures described in this paper. Regional banks are expected to focus on business model reforms while fully preparing for credit risk.

[4] With the introduction of forward-looking provisions, which is highly discretionary at each bank, the comparability between banks will decrease and there will be a mixture of performance-based and forecast-based allowance. Therefore, it will be difficult to assess each bank's status and preparedness for credit risk from allowance for possible loan losses and non-performing loan details.