Enhanced performance and robust balance sheets improve the credit profile of Japanese banks

by NUS-CRI Market Monitoring Team

- **NUS-CRI Agg PD indicates an improvement in the credit health of Japanese banks driven by an increase in lending growth and an increase in foreign loan NIMs**
- **NUS-CRI Forward PD suggests a worsening credit outlook as Japanese banks may still have to contend with an uncertain macroeconomic environment**

Growth in lending and wider interest margins in international markets may have driven an improvement in the credit profile of Japanese banks. In particular, the three Japanese megabanks[1] benefited from a widened interest margin that boosted net interest incomes on foreign loans and concurrently offset the losses on investment holdings in foreign securities with gains in domestic securities. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of Japanese banks improves over the past year, with the Agg PD for the three megabanks in particular improving to BB- as proxied by PDiR2.0[2], after their FY2022 financial results were released in May. Although the collapse of Silicon Valley Bank in Mar-2023 did impact the industry as a whole (see the fall in TOPIX bank index in Mar-2023 in Figure 1a), the Agg PD for the Japanese banks remained robust due in part to their strong balance sheets in the domestic ultra-easy financing environment. The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD)[3] for Japanese banks suggests a worsening credit risk outlook, though still well below the level at the start of the year, over the next 12 months. As such, though Japanese banks are well-capitalized, their credit profiles may still have to contend with an uncertain macroeconomic environment, both domestically and abroad.

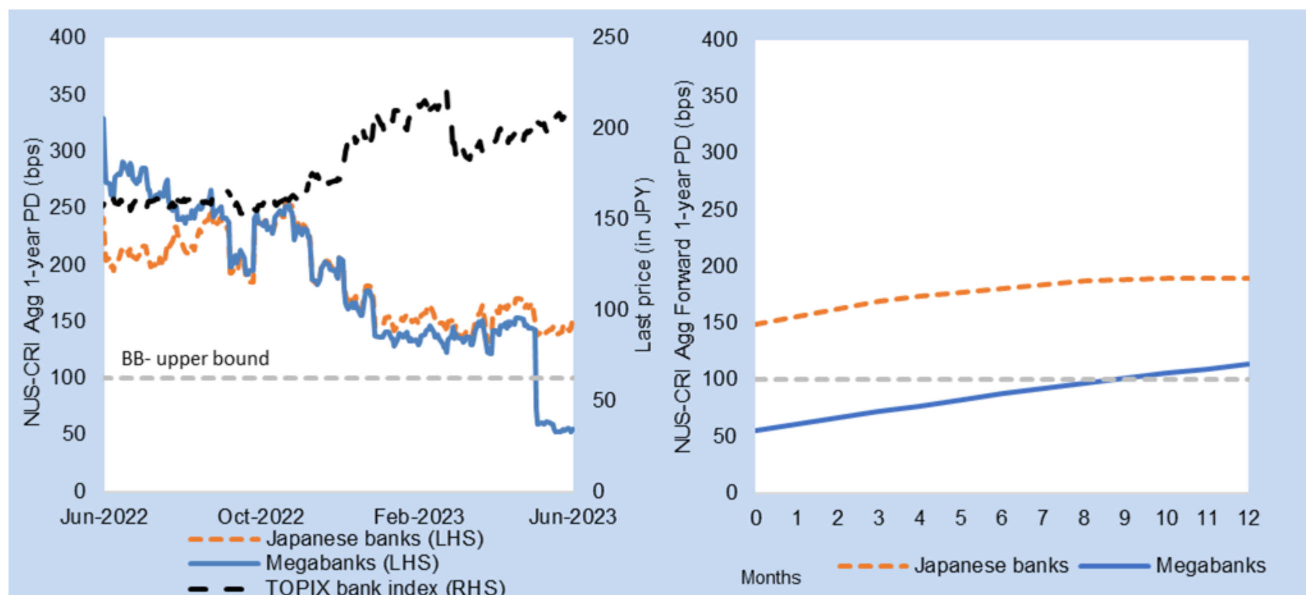

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Japanese banks and the three megabanks from Jun-2022 to Jun-2023, with reference to PDiR2.0 bounds; and Tokyo stock exchange TOPIX bank index. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Japanese banks and the three megabanks as of Jun-2023 with reference to PDiR2.0 bounds. *Source: NUS-CRI, Bloomberg*

[1] Megabanks represent the three largest banks in Japan - Mitsubishi UFJ Financial Group Inc., Sumitomo Mitsui Financial Group Inc., and Mizuho Financial Group Inc.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

The credit health of Japanese banks shows an improvement, possibly benefiting from higher credit growth (see Figure 2a) as well as higher interest income gains in international markets. Since 2022, Japanese banks have benefitted from the robust demand for credit driven by economic recovery and higher working capital needs due to higher costs of inputs. The YoY growth rate of bank loans touched 3.4% in May-2023, the fastest credit has expanded in the banking sector over the past two years. At the same time, credit growth in foreign loans has also shown a consistent expansion, especially for the region of North America. Japanese banks, with international exposure, specifically the three megabanks, may have increased loan extensions in foreign markets to take advantage of the higher interest rate margins compared to the yield they can receive domestically. Resultantly, the combined net profit of the three megabanks reached JPY 2.48tn , the highest in nine years.

From a funding perspective, on a domestic front, a sticky deposit base that is highly concentrated in the retail segment, allows Japanese banks to obtain yen-denominated funding at relatively lower costs. On the other hand, although the growth in overseas loans drove bank profitability to record heights, moving forward, with funding costs rising in overseas markets, to maintain and attract a stable dollar deposit base, Japanese banks may have to raise deposit rates which may negatively impact profitability in the coming quarters.

In addition to improved profitability, the improvement in credit health was also driven by lower costs linked to non-performing loans and a robust capital position. Government support ensured that non-performing loans remained in check, thus enabling banks to maintain lower loan loss reserves. However, with government aid to businesses soon coming to an end, banks may see a rise in delinquency rates. Japanese banks have also maintained stable capital positions with capital ratios exceeding regulatory requirements (see Table 1). Even though their capital ratios were pressured due to accumulated losses on banks' securities holdings, these losses have since narrowed.

Capital ratios (%)	Internationally active banks	Domestically active banks
Mar-2023	14.92	11.34
Sep-2022	14.40	11.63
Mar-2022	15.72	11.56

Figure 2a (LHS): Japanese banks' YoY lending growth and the monthly YoY inflation rate in Japan. Table 1 (RHS): Capital ratios of internationally and domestically active Japanese banks *Source: Trading Economics, Financial Services Agency*

The credit quality of the Japanese banks is closely related to the domestic monetary policy. In Dec-2022, the BOJ surprised the market by raising the cap of Yield Curve Control (YCC) to 0.5% due to the impact of global central banks' tightening policies leading to a depreciating Japanese yen, which was seen as a sign of a shift from the ultra-easy monetary policy. However, the newly appointed governor of the BOJ, Governor Ueda, chose to continue the BOJ's loose policy and decided to keep the interest rate at an ultra-low level in the most recent meeting in Jun-2023. With the inflationary pressure in the United States starting to ease and the Federal Reserve pausing its rate hike cycle in Jun-2023, it is expected that the Fed's rate hike cycle is likely to finish by the end of this year, thereby diminishing the risk of subsequent yen depreciation in 2024. The inflation rate in Japan, though hitting four-decade-high, is transitory cost-push imported inflation according to the BOJ, and thus may not dictate the implementation or cessation of quantitative easing in Japan. Therefore, the BOJ may stick to the ultra-easing monetary policy in the foreseeable future, keeping the credit cheaper.

Even though increased exposure to foreign markets through investment holdings and credit extension has benefitted Japanese banks over the past year, increasing credit risk overseas in the near term could impact the loan portfolio of Japanese banks as the risk of souring assets rises. Japan's financial regulator has already raised warning signs to Japanese megabanks on the risks pertaining to their exposure to China due to the current Sino-US tensions escalating and local economic recovery faltering. Furthermore, with the global recessionary outlook worsening across major economies where Japanese banks have large exposures, banks may have to increase provisions for losses that may arise on both their loan book and investment holdings.

However, as seen by the relatively robust nature of Japanese banks to the banking crisis in Mar-2023, BOJ's ultra-loose monetary policy might be able to mitigate any potential recessionary impact on the strong balance sheets of Japanese banks. As such, though Japanese banks have fared well over the past year, continued recovery in their credit profile is likely to be under threat of a worsening global macroeconomic environment, as suggested by the Forward PD in Figure 1b.

Credit News

US companies scramble to cuts costs, pay down debt as interest rates surge

Jun 14. Corporate treasurers are facing challenges as the Federal Reserve signals its intention to tighten the money supply. US companies experienced a 22% increase in interest costs in the first quarter, resulting in significant financial burdens for firms such as Apple and Verizon. Rising interest expenses, coupled with increased costs in various areas, are prompting companies to cut costs and reduce debt. The potential for additional rate hikes by the Federal Reserve exacerbates the situation, as it would lead to even higher interest spending. These conditions are particularly concerning for companies with weaker credit ratings. Executives are now searching for ways to improve profitability and reduce expenses to adapt to the higher cost of capital. (Bloomberg)

China's small businesses are hit hard as economic recovery falters

Jun 18. China's small businesses are in dire straits, cutting staff, grappling with debt, and facing an uncertain future, underscoring the country's sluggish recovery. These enterprises, which employed about 233 mn people in 2018, are suffering, as revealed by official data, lender disclosures, and interviews with business owners. Manufacturing purchasing managers' indexes indicate ongoing contraction, and small enterprises are either reducing staff or not filling vacant positions. Weakness in the property market and reduced consumer demand add to their woes. The struggles of small businesses have wider implications, affecting employment and income for low- and middle-income families and posing challenges to the overall economy. (WSJ)

Carving up the bond market swells into USD 39bn ETF business

Jun 16. Money managers are increasingly turning to precise fixed-income ETFs due to a hawkish central bank and economic uncertainty impacting the bond market. BlackRock and Invesco's maturity-focused bond ETFs touched record-high this year. These ETFs have gained popularity in recent years amid inflation concerns and the Federal Reserve's efforts to control it. Managing interest-rate risk, particularly duration risk, has become a top priority for money managers and financial advisers, as yields have significantly increased over the past year. Currently, the 10-year Treasury yields stand around 3.7%, compared to 1.7% in Mar 2022. (Bloomberg)

'Transition bonds' are new favorite for Japanese investors

Jun 19. Investor demand for Japan Airlines' "transition bonds," aimed at financing the purchase of fuel-efficient aircraft as part of the company's commitment to achieving net zero emissions by 2050, was remarkably high. The 10-year bonds, offering a 1.2% interest rate, were issued for a total of JPY 20 bn and were oversubscribed six times, highlighting their popularity. These bonds fall under the category of ESG bonds, which have witnessed significant growth in Japan. ESG bond issuances in the country doubled between 2020 and 2022, while overall corporate bond issuances declined by 24% during the same period. In the first five months of 2023, ESG bonds accounted for 26.5% of non-sovereign bonds issued in Japan, according to SMBC Nikko Securities. (Nikkei Asia)

An unexpected recovery sweeps world's riskiest sovereign bonds

Jun 18. High-risk sovereign bonds from countries such as El Salvador, Nigeria, and Turkey are experiencing a surge in performance as Wall Street investors seek higher yields in countries demonstrating market-friendly shifts. Despite concerns about inflation, money managers are taking on riskier investments in search of returns. However, the sustainability of this trend remains uncertain as major central banks reaffirm their commitment to combat inflation. (Bloomberg)

Argentina faces crunch IMF talks to defuse looming debt bomb (Reuters)

Polish banks suffer EU court blow over swiss franc mortgages (Bloomberg)

Indian infra lender NaBFID's debut bond issue oversubscribed five-fold (Reuters)

Regulatory Updates

Federal Reserve skips rate rise but signals two more increases on the way

Jun 15. Even though the Federal Reserve skipped hiking rates for the first time in more than a year, the US central bank has signaled support for two more rate hikes in the remainder of 2023 in the hopes of potentially quelling lagging inflation. Most members of the FOMC have agreed that further rate hikes are necessary, with the resumption of the tightening cycle expected to come as early as Jul-2023. Forecasts suggest that the Fed plans on two additional quarter-point rate hikes in 2023, increasing the benchmark rate between 5.5% and 5.75%. Many market participants believe that the Fed may have difficulty communicating its intentions, suggesting that a combination of relatively robust inflation and the recent banking crisis might have motivated the initial pause. On this announcement, the yields on the two-year treasury rose due to higher interest rate expectations. (FT)

China cuts a key policy rate for first time in 10 months as economic rebound cools

Jun 14. China's central bank, the PBOC, lowered its key medium-term lending rate on 15 Jun 2023, to stimulate the economy that has not gained momentum post-pandemic. The PBOC reduced the rate on its one-year medium-term lending facility (MLF) loans for the first time since Aug-2022, to some financial institutions by 10bps to 2.65%. Close to CNY 237bn worth of this facility is subject to this change. The move follows a week after the central bank cut its seven-day reverse repurchase rate by 10bps to 1.9%. The move by the PBOC left the CNY weaker against the USD, as the latter gained 20bps against the Chinese yuan to 7.1744, its lowest level since Nov-2022. Market participants have heralded the Chinese authorities as those that respond to market and economic signals, and are willing to prioritize growth in the post-COVID recovery phase. (CNBC)

ECB increases interest rates to highest level since 2001 (FT)

Philippine central bank to push firms to reveal foreign debt (Bloomberg)

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