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Credit risk of Japanese banks remains elevated amidst a weakening yen

by Elaine Uy

- **NUS-CRI Agg (median) 1-year PD for Japanese banks suggests heightening credit risk as increased exposure to the volatile global macroeconomic environment raises uncertainty regarding the financial profile of the industry**
- **Stress tests show that the impact of the continued weakening of the yen on Japanese corporates' credit health and, in turn, the asset quality of the banking industry, is conditional on the appropriateness and adequacy of government's response**

The Japanese yen (JPY) has hit a fresh three-decade low record, following which, the Bank of Japan (BOJ) might be compelled to intervene anew in the foreign exchange market to stop the further slide[1] of the currency in the wake of its decision to maintain ultra-low interest rates. Several years back, the negative interest environment prompted the Japanese banks either to expand offshore to augment their then-thinning margins or consolidate to build up capital and weather the unconducive economy. Overseas expansion had provided Japanese banks access to higher yields and initially successfully bolstered profitability. However, amidst the recent volatility in the global markets, such exposure also makes the Japanese banks' financials sensitive to idiosyncratic risks in different economies. On top of increased international exposure, the prolonged thin margins alongside the worsening of asset quality amid JPY's weakness translated to higher credit risk as seen in the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of the industry, which has hovered above the BB- upper bound since last year (See Figure 1a). Nonetheless, the prospective net positive effect of rate hikes globally on Japanese banks' margins, coupled with the expected boost in the domestic economy from the reopening of the borders, could potentially ferry in a favorable credit outlook in the next 12-36 months, as suggested by the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[2]) in Figure 1b.

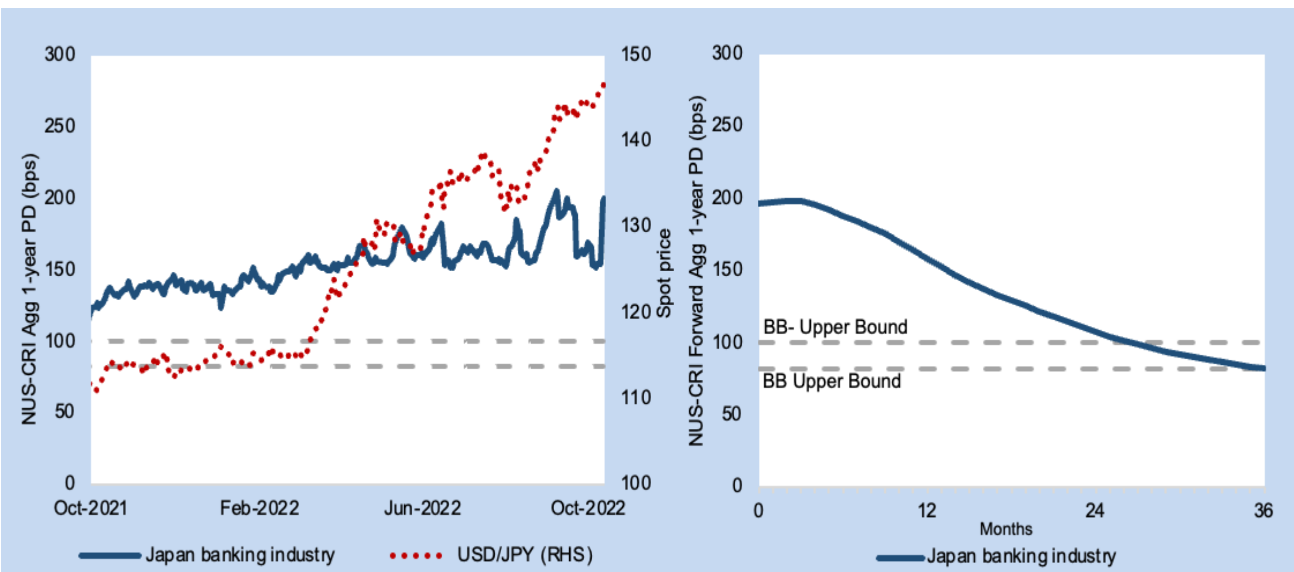

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Japan banking industry[3], with reference to PDiR2.0 bounds[4]; Daily closing spot prices for USD/JPY from Oct-2021 to Oct-2022. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Japan banking industry, as of Oct-2022, with reference to PDiR2.0 bounds. *Source: NUS-CRI, Refinitiv*

[1] To date, the JPY is the worst-performing currency among G10 countries.
[2] 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.
[3] Sample based on Japanese Bankers Association's list of full members.
[4] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through 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.

Outstanding overseas loan balances of Japanese banks have reached an aggregate of approximately USD 800bn as of Jul-2022, growing close to 6% YoY. The change constitutes an increase of close to USD 40bn in exposure to the North American market, while the industry has also increased its exposure, though at a relatively lower level, to the EMEA and wider Asia Pacific region. The accelerating growth of loan exposure to the international markets since the beginning of this year has also drawn regulatory scrutiny, especially to the country's megabanks[5]. Although overseas operations for these megabanks were intensified in pursuit of higher returns and better profitability, the growing fear of global recession translated to market volatility and dampened the megabanks' performance[6]. Furthermore, successive interest rate hikes across the majority of the Japanese banks' counterparty countries caused the value of their foreign bond holdings to decline, and considering that most of these holdings are marked to market, they may potentially result in substantial unrealized losses that could hamper Japanese banks asset quality.

As of Jun-2022, Japanese banks' foreign securities holdings account for approximately JPY 770bn, increasing 6.4% QoQ. However, foreign securities comprise only a smaller portion of their current portfolio, with the exposure to overseas assets largely constituting foreign loans extended mostly to investment-grade companies. However, the aftermath of the pandemic along with the economic shocks precipitated by geopolitical tensions currently affect corporates by inflating operating costs while reducing demand, which might hamper revenue generation, and in turn, could weaken the industry's asset quality. Similarly, the industry's capital adequacy remains well above minimum requirements, with capital ratios (common equity tier 1 capital for internationally active banks and core capital for the rest of the industry) averaging above 10.0%, but as the risk appetites of the industry's key players shift towards riskier borrowers, additional provisions might be needed to further strengthen their capitals' loss absorption capabilities. At the same time, the aggressive loan portfolio expansion strategies test the industry's, especially megabanks'. ability to generate adequate foreign currency deposits from a limited deposit base (mostly institutional depositors). As of Mar-2022, outstanding foreign currency loans already exceed the amount of the megabanks' foreign currency deposits, and should they elect to narrow their loan-to-deposit gap and reinforce funding through borrowings, they will be faced with higher financing costs in line with the Fed's successive interest rate hikes.

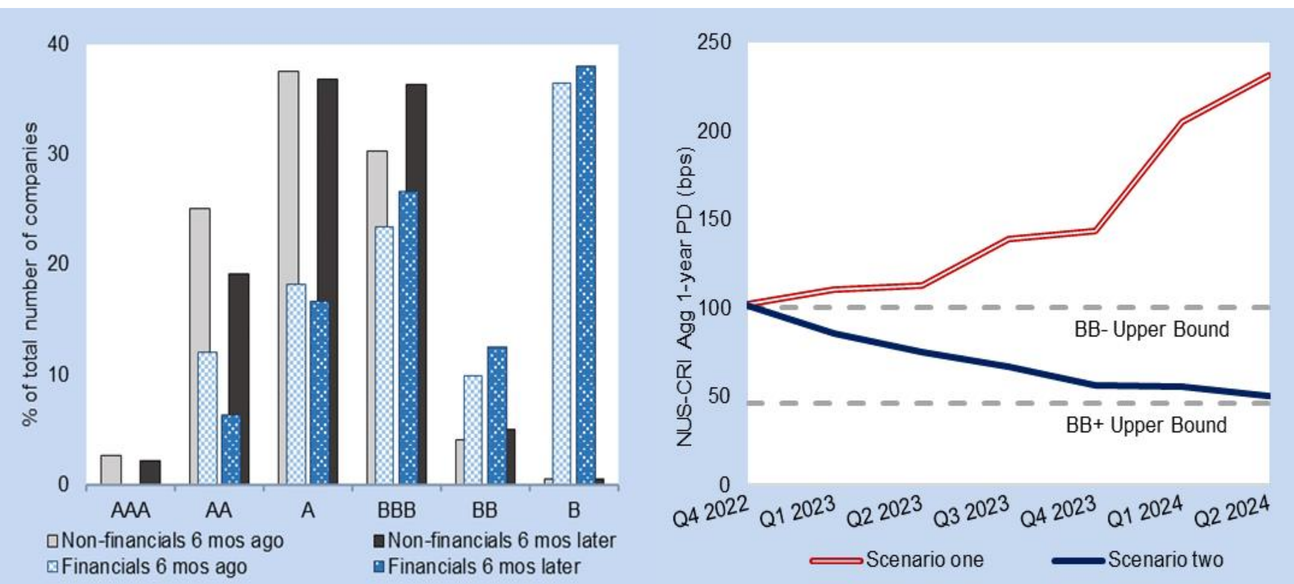

Figure 2a (LHS): Historical (6 months ago) and forecasted (6 months later) distribution of credit quality for Japanese corporates, classified broadly as Financials and Non-financials, as of Oct-2022, with reference to PDiR2.0 bounds. Figure 2b (RHS): Stressed NUS-CRI Agg (median) 1-year PD of Japanese banking industry based on Scenario one where USD/JPY exchange rate increases at a monthly sustained rate of 5% and interest rates decrease by 50bps monthly; and on Scenario two where the growth rate of USD/JPY accelerates every 6 months from 3% initially to 10%, while the decline in interest rates taper every 6 months from 50bps to 0bps, with reference to PDiR2.0 bounds. *Source: CriAT, BuDA v3.5.1*

Considering the negative yields, domestic assets are currently subjected to diminishing returns, especially government bond holdings and even reserve deposits. Moreover, credit demand has picked up to a 2.3% YoY increase in Sep-2022 as corporates require liquidity to finance the effects of the economic reopening amidst rising costs. Hence, such loan growth could be accompanied by an increase in corporate credit risk signified by the gradual increase in Agg PD for the Japanese banking industry in Figure 1a. The deterioration in the credit

[5] Based on loan portfolio distribution as to region, aggregate exposure to the US and Europe of MFG is 57.8%, while SMFG and MUFG have 65.4% and 36.6%, respectively, as of Jun-2022.
[6] Among the three, only SMFG reported a YoY increase in its bottom line (24.2%) for Q2 2022, while that of MFG and MUFG declined by 36.4% and 70.3%, respectively.

health of Japanese corporates in the near term as shown in Figure 2a, in tandem with the realization of the potential adverse effects of the JPY depreciation adds upward pressure to Japanese prices, adding further pressure on inflation and potentially worsening the asset quality of retail loans. Overall, export-oriented corporates, such as the Japanese industrials sector[7], could realize the benefits of the weakness of the JPY as Japanese exports become more competitive abroad. However, the same would also increase prices of imported food, energy, and other basic commodities, pushing up costs for households and domestic businesses, and could potentially stall domestic economic recovery, leading to an expected worsening in asset quality. The impact of the persistent weakness of the JPY and the monetary policy action on the Japanese banking industry's PD can be simulated using the NUS-CRI Bottom-Up Default Analysis toolkit (BuDA[8]). As seen in Figure 2b, the effect of currency depreciation on wider inflation levels could likely result in a deterioration of the credit health of Japanese banks as higher costs impair the debt service capacity of households and firms, especially those that are heavily import-dependent in a low interest rate environment (scenario one). On the other hand, should the BOJ respond to lower economic activity because of higher imported inflation by further monetary loosening, stress tests show that the effective impact on Japanese banks' credit quality may improve, ceteris paribus (scenario two). Notwithstanding the likelihood that the reduction of interest rates could consequently further weaken the yen, inverse response in the form of hiking interest rates, expectations of which are rising by the market, might be more detrimental to the still recuperating Japanese economy.

Prospectively, the Japanese banks' repositioning of offshore operations to focus on the lending business could potentially lift operating margins considering the foreign central banks' commitment to hike interest rates. On the other hand, the weakening of the JPY could further fuel inflation and translate to a considerable deterioration in their domestic portfolio's asset quality. The related downside, however, could be limited considering the BOJ's likely continued intervention in supporting the JPY. Nonetheless, as inflation overseas, especially in the US, approaches its peak, the reversal of its negative spillover effect on the Japanese economy could potentially be underway. In such a positive scenario, the credit profile of the Japanese banking industry, though still remaining above the BB- upper bound in the short term, could be expected to improve (See Figure 1b).

[7] The Japanese industrial sector, which contributes to the key exports for the country, may also benefit from sufficient liquidity buffers and relatively low leverage, amidst outsourcing of cost-intensive processes. Based on Refinitv data, median debt-to-capital and quick ratios are 21.7% and 1.56 as of Jun-2022, while historical averages are 22.7% and 1.60, respectively.

[8] The Bottom-up Default Analysis (BuDA v3.5.1) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of National University of Singapore (NUS) and the International Monetary Fund (IMF).

Credit News

Global junk-bond sales drop most ever with no signs of recovery

Oct 24. Global junk bond issuances have fallen dramatically adding pressure on riskier corporates that are looking to refinance in the near term. According to data from Bloomberg, as of October, issuance of HY debt saw a 73% YoY drop, a sharper decline even compared to the 2008 financial crisis. The decline showcases investors' reluctance to invest in riskier companies as they face soaring inflation and a looming economic downturn. (Bloomberg)

Credit strains prompt Korea to revive USD 1.1 bn bond fund

Oct 20. As yields register record highs, South Korea has stepped up efforts to stabilize the domestic credit market. The Financial Services Commission has decided to revive a pandemic-era USD 1.1 bn bond fund to support credit markets. The commission will begin purchase of corporate debt via the fund and has also shown willingness to increase fund size through capital raised from banks, brokerages and insurers. Korean credit markets have had a rough year, with yield premium on corporate bonds higher than double of the previous year as compared to an approximate 40% increase in Asia dollar bond yields. (Bloomberg)

Profit warnings soar as UK companies struggle with costs

Oct 24. Rising inflation and falling demand have prompted 86 FTSE-listed companies to issue profit warnings in Q3 2022, the highest in a quarter since 2008. Firms in sectors dependent on consumer demand such as retail and hospitality account for more than half of the profit warnings in Q3 2022. As consumer confidence wanes and soaring inflation leads to changes in buying behavior, consumer sector companies have found it increasingly difficult to pass on cost increases to customers. The concurrent increase in the cost of debt adds to the pressure faced by companies. (FT)

Bond market sees no end to worst turbulence since credit crash

Oct 23. Global bond markets are witnessing the longest sustained volatility since the global financial crisis in 2007. Though high inflation and increasing interest rates have been relatively easier to predict, the short-term market volatility brings uncertainty regarding the impact on the wider economy. The market is expecting that the volatility could continue well into 2023, with policy moves from the FED expected to continue if the US economy continues to overheat. A leading concern is the lack of liquidity in the market, with the treasury-market liquidity deteriorating to levels last seen during the "Covid Crash" in Mar-2020. Bond market movements are primarily determined by the expectations of further rate hikes by the FED. The pain of this volatility is hurting leveraged instruments, which thrive during periods of low volatility, low interest rates and low inflation. It is unlikely that the volatility is going to retreat to pre-pandemic levels any time soon. (Bloomberg)

Era of negative-yielding debt close to end as Japan yields rise

Oct 25. Short-dated yield broke above zero for the 1st time since 2015 as there are growing bets that the Bank of Japan (BOJ) may be forced to follow global peers and tighten monetary policy amid soaring inflation and weakening yen. Currently, the total market value of negative yield issuance worldwide has dropped to just over USD 1tn. The universe currently wholly consists of short dated Japanese securities. The BOJ is due to convene later this week with economists seeing no change to policy following Governor Haruhiko Kuroda's statement that he has no intent to alter the current policy. (Bloomberg)

Outperformance at risk in USD 4tn US muni bond market (FT)

Data centers face higher costs, weaker demand for debt that fueled sector's rise (WSJ)

Carnival borrows USD 2bn as investors clamour for cruise ship-backed bond (FT)

Regulatory Updates

UK banks warn that debt rules jeopardise GBP 62bn of lending

Oct 20. Institutional lenders in the UK are raising concerns about the minimum requirement for own funds and eligible liabilities regulation (MREL). This regulation was set to ensure the wind down of a failed bank without the need for taxpayer support. The appeal against MREL was raised on the grounds that the regulation could prevent UK banks from lending up to GBP 62bn over the coming 5 years. The lenders noted that the interest cost burden of MREL debt reduces the capital a bank can hold to help support growth, given that there is a competitive funding disadvantage faced by entities subjected to the MREL requirement. (FT)

ECB and Spain set for potential clash over bank windfall tax

Oct 20. Spain has proposed a windfall tax on banks, drawing the ire of lenders in the country as they believe that it is an attempt to prevent lenders from passing on the cost of the tax to customers. The tax is incompatible with EU regulation which requires banks to reflect in loan pricing all relevant costs including tax considerations. While the rate hikes have been favourable for the banks, extraordinary profits are unlikely as the banks are still recovering from a prolonged period of low returns. As such, the tax can be deemed to be seemingly counterproductive amidst an economic slowdown where a strong banking sector would be essential to back the economy. (FT)

China makes it easier for firms to borrow from overseas as yuan drops (Reuters)

EU financial services chief calls on US to create new crypto rules (FT)

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