17-D-0299
July 13, 2017

Highlights of Regional Banks' Financial Results for Fiscal Year Ended March 2017

The following are Japan Credit Rating Agency, Ltd. (JCR)'s perception of the current status and rating highlights of Japanese regional banks based on their financial results for the fiscal year ended March 2017 (FY2016) and earnings forecasts for FY2017.

1. Industry Trend

FY2016 was a year where financial market was significantly affected by overseas political events. US long-term interest rates were at a low level in the first half and its 10-year treasury yield declined to a record low at a percentage between 1.3% and 1.4%. Risk-off trend was accelerated by event that UK's national referendum in June resulted in a significant deviation from prior forecast and ended with UK's exit from EU, as well as concern over slowdown of economies of China and other emerging countries and lower prices of natural resources. After Mr. Trump won US presidential election in November, however, the yield sharply rose to 2.6% at one point due to concern over expansionary fiscal policy and hopes of an economic recovery. US short-term interest rates were on an upward trend due to the Federal Reserve Board's policy rate hike and expectation of the hike. Bond market in Japan saw a decline of 10-year JGB yield to minus 0.3% and a decline of 20-year JGB yield to a percentage in the neighborhood of 0% in July. These yields subsequently recovered to yields in the neighborhood of 0% and 0.5%, respectively, because the Bank of Japan didn't further advance its negative interest rate policy and introduced its policy of quantitative and qualitative monetary easing with yield curve control. Japan's stock market had been weak, but turned to a recovery towards the end of the fiscal year.

In the midst of intensifying earnings environment surrounding regional banks, there were ongoingly many mergers and reorganizations. In February 2017, The Mie Bank, Ltd. and The Daisan Bank , Ltd., which belong to the 2nd group in terms of market shares in deposits and loans in Mie Prefecture, announced their basic agreements on business integration. In April 2017 where FY2017 has already started, The Daishi Bank , Ltd. ranking the top and The Hokuetsu Bank , Ltd. ranking the 2nd in terms of market shares in deposits and loans in Niigata Prefecture announced their basic agreements on business integration. There is much room for creation of cost synergies through reorganization of overlapping branch networks in addition to economies of scale in these cases of integrations where integrating parties are located within the same prefectures. JCR is paying attention to whether these banks can strengthen their earnings power through mergers and reorganizations by utilizing management resources that would be generated.

In March 2017, THE MINATO BANK, LTD. and Kansai Urban Banking Corporation, both of which are under umbrella of Sumitomo Mitsui Banking Corporation, and Kinki Osaka Bank, Limited, which is under umbrella of Resona Holdings, Inc. announced their basic agreements on business integration. After the 2 banks, MINATO BANK and Kansai Urban Banking, enter into Resona Group, enhancement of earning power through utilization of Resona Group's products and know-how and cost reduction through rationalization of office locations and sharing of office work will be promoted.

Fukuoka Financial Group, Inc. and The Eighteenth Bank, Limited that is headquartered in Nagasaki Prefecture have already agreed on their business integration, and THE SHINWA BANK, LTD. of Fukuoka Financial Group that is also headquartered in Nagasaki Prefecture and Eighteenth Bank plan to merge in the future. Given that as review of business combination at Fair Trade Commission ("FTC") has not been completed, the schedule of this integration was postponed from the initially planned, JCR will pay attention to what decisions FTC can make concerning business integrations among regional banks in the same prefectures.

2. Financial Results

Core net business income of Japanese regional banks (64 member banks of Regional Banks Association of Japan ("RBAJ")) decreased for the first time in 3 years in FY2016. The decrease rate was a large 12.6% year-on-year (Source: RBAJ, The same applies to the following). An expansion of net interest income' decrease rate was a primary reason for the decrease. Intensification of competition after the Bank of Japan's introduction of negative interest rate policy accelerated a decline of yield on loans, which then led to an expansion of decline of interest on loans and discounts. Interest and dividend income on securities have been supporting regional banks' core net business income through an increase of balances of foreign securities and investment trusts, but this income turned to a slight decline in FY2016 due primarily to earnings drop of domestic accounts. Although fundraising expense was helped by reduction of deposit interest rates, contributions to net interest income was limited in scale, affected by the increased foreign currency funding costs. Net fees and commissions, a non-interest income including commission revenue, etc. in FY2016, decreased largely from this profit in FY2015. Japan's slumping stock market in the first half of FY2016 decreased sales commissions for investment trusts. Sales of insurance products also weakened due to lower yen market interest rates. It seems that disclosures of insurance agents' commissions and change to the method of receipts of such commissions that were conducted as a part of initiatives for fiduciary duty had also impact on a temporary basis. Profitability measured by average interest rate spread and ROA (on a core net business income basis) declined faster once again.

Gains (losses) related to bonds, etc. resulted in a loss in FY2016 for the first time since FY2008 where these gains/losses were significantly affected by Lehman Shock. Reduction of volume of foreign securities, mainly US government bonds, and replacement of these securities with bonds with lower yields, after sharp increase of US long-term interest rates following US presidential election, expanded the losses. Gains (losses) related to stocks, etc., on the other hand, significantly increased in FY2016. JCR sees that this sharp increase was intended to absorb a part of losses related to bonds, etc. There was no change to conditions where the number of corporate failure is stable nationwide, and credit costs remains at an extremely low level. Ordinary income decreased for the first time in 8 years in FY2016, down 18.5% year-on-year, due to a decline of core net business income and losses related to bonds, etc. Net income decreased 15.4% year-on-year.

Average loan balance increased 3.9% year-on-year in FY2016, a relatively high growth rate following FY2015. By client (domestic fiscal year-end balance), loans to SMEs increased for 7 straight years in FY2016. The year-on-year growth rate of loan balance in FY2016, which was 5.3%, has been increasing successively from the FY2013's 2.1%, FY2014's 3.9% and then FY2015's 4.8%. While an increase of loans to real estate leasing companies significantly helped the increases, these successive increases also indicate achievements of regional banks' efforts for enhancement of earnings power in tandem with reduction of loans to large corporations with low interest rates. Yield on loans and bills discounted declined by 10 bps from a year earlier to 1.20% in FY2016. The declining pace of yield had been softening every fiscal year from a decline of 12 bps in FY2013, a decline of 9 bps in FY2014 till FY2015 where it declined 8 bps from a year earlier, but FY2016 saw an increase of the declining pace.

Average securities balance slightly decreased for 2 straight years in FY2016, down 1.0% year-on-year. Balance of yen-denominated bonds centering on JGBs significantly decreased against a background of low yen market interest rates following the Bank of Japan's introduction of negative interest rate policy. Balance of foreign securities, on the other hand, increased 7.5% year-on-year in FY2016. The increase of balance continued in FY2016 following FY2015, although growth rate slowed down from 17.6% in FY2015. Growth rate of balance of other securities including investment trusts in FY2016 remained high at 38.2%. Shift of assets with relatively higher return as compared with those of yen-denominated bonds is continuing. Yield on securities had been increasing, but it remained unchanged from a year earlier in FY2016.

Average deposit balance has been stably increasing and it increased 2.5% year-on-year in FY2016. By depositor (domestic fiscal year-end balance), deposits from general corporations and individuals remained on an uptrend, increasing 4.2% and 2.3% year-on-year, respectively. By deposit type, demand deposits increased 6.3% year-on-year, which was higher growth rate as compared with FY2015's, but time deposits decreased 3.3% year-on-year, which was higher decline rate as compared with FY2015's. Yield on deposits, etc. in FY2016 was 0.04%, 1 bps lower than that in FY2015.

Claims disclosed under the Financial Reconstruction Act continued to significantly drop in FY2016, down 7.7% year-on-year. Ratio of these claims to total claims outstanding was 1.84%, which decreased 0.23% year-on-year, thanks to curbed occurrences of new non-performing loans and well-improved creditworthiness of customers for the disclosed claims.

Consolidated capital ratio of 54 regional banks subject to domestic standards decreased 0.35% from a year earlier to 10.32%, and that of 10 regional banks subject to international standards decreased 0.20% from a year earlier to 14.38% as of March 31, 2017. Despite the increased retained earnings, increased risk assets in tandem with an increase of loan balance, etc. had an impact on the ratio. Regional banks subject to domestic standards have decreased consolidated capital ratio for 3 straight years till FY2016 since they shifted to Basel III. While some banks responded to increased demand for return of profits to shareholders in stock market by an increase of dividend payment and buybacks of their own shares, there were actions towards an increase of capital through equity finance in preparation for further increase of loan assets.

3. Highlights for Rating

Core earnings power of regional banks significantly declined in FY2016. Considering that downward pressure will continue to be placed on their core earnings capacity, if the negative interest rate policy lengthens, JCR will pay attention to the achievements of regional banks' measures to strengthen earnings power. While 12 regional banks plan an increase of core net business income and additional 12 regional banks plan a reduction of the income's decrease rate out of 40 regional banks for FY2017, which announced their estimates and details of core net business income for FY2017, 16 regional banks, a little less than half of the total number, plan an expansion of the decrease rate. Although regional banks in general have a grim view on net interest income, 5 regional banks out of these 40 regional banks plan to stop their decline of net interest income. There are many regional banks, which plan to lessen a reduction of net interest income by an increase of non-interest income centering on net fees and commissions.

JCR will watch closely to what extent regional banks can soften in FY2017 the accelerated lowering pace of yield on loans in FY2016. All regional banks are focusing on growth of loans to SMEs in its locality that could generate relatively high yield, and their efforts have already led to certain accomplishments. It seems that requests for reduction of interest rates from customers increased in FY2016 after the Bank of Japan's introduction of negative interest rate policy. JCR sees it will be important in the future whether they can increase the balance of loans, while ensuring a certain yield. There are also actions to increase balance of card loans, which could bring a high yield to them, and these efforts are significantly contributing to supporting yield on loans. Concerning these banks' card loans, however, there are developments of taking measures to prevent excessive lending, in particular, they are reducing criteria for loan amount that requires certificate of annual income and curbing advertisement of card loans. JCR will watch closely future trend. Interest and dividend income on securities has been supporting regional banks' earnings to date. In a situation where concern over rise of long-term interest rates mainly in US is increasing and their US dollar funding costs are increasing, however, the authorities is watching their risk taking. There is a move towards revisions to their investment policies.

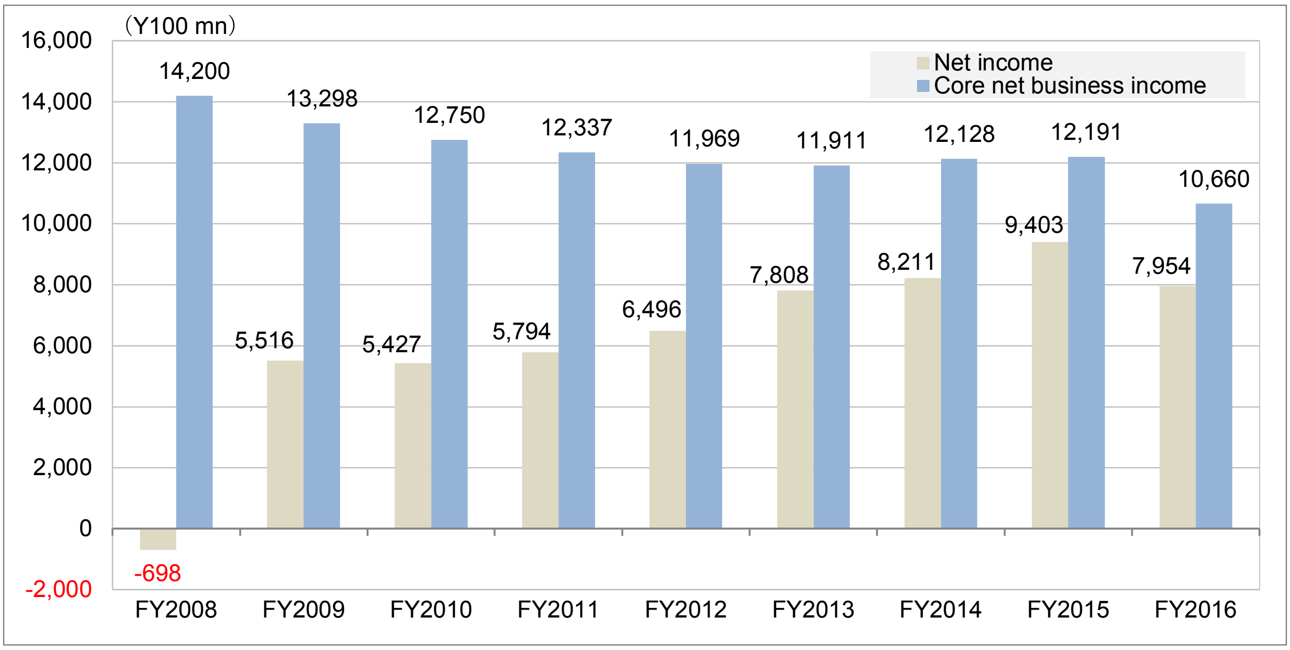
There are many regional banks that set forth an expansion plan of non-interest income, while there remains downward pressure on net interest income. They plan to expand sale of investment products, a major business of non-interest income, through an increase of sales staff, higher operational efficiency introducing new system, enhancement of their product lineups, etc. Seeing it is not easy for regional banks to sustainably expand fee business with respect to sale of investment products in light of downward pressure on commission rate in the face of increasing uncertainty over prospect for future financial market, JCR thinks it is necessary to watch closely future developments. There are also regional banks which are generating good results by strengthening fee business for corporations. JCR sees that diversification of earnings sources into businesses other than sale of investment products remains important.

JCR places great value on assessment of business bases and financial bases including capital adequacy, loan quality, earnings capacity, etc. For business bases, JCR checks competition with other financial institutions and market shares for fund volume and loan balance, as well as industrial structure and size of financial market in the region, for each regional bank. Although regional banks' core capital ratio has been gradually declining, JCR values that the level itself is at a historically high level. For some regional banks, however, risk assets may become a constraining factor for their efforts to further increase their loan balance. Quality of loan assets has significantly improved than before against a background of the small number of corporate failures,

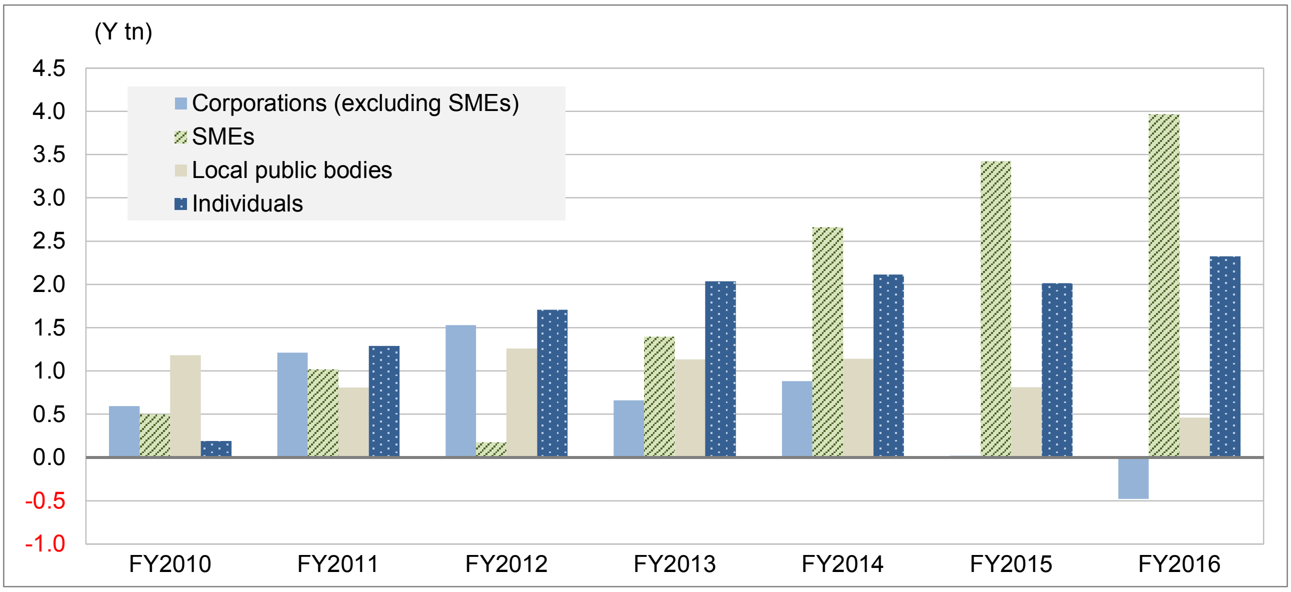
Regional banks' earnings capacity is on the decline in general, but JCR does not consider that a worsening of earnings capacity due primarily to a decline of yield on loans only becomes a structural factor for a rating downgrade. If the Bank of Japan's negative interest rate policy lengthens, its minus impact on earnings may further increase. In such cases, JCR will examine earnings power of each regional bank, while balancing with assessment of capital adequacy and quality of loan assets, to be reflected in rating. In cases where earnings capacity is weak as compared with rating level, however, JCR negatively assesses such cases in terms of rating. In particular, if JCR decided that future credit costs would not be fully absorbed by core earnings, JCR actually changed ratings or revised rating outlooks in many cases.

Hajime Oyama, Tsuyoshi Ohishi

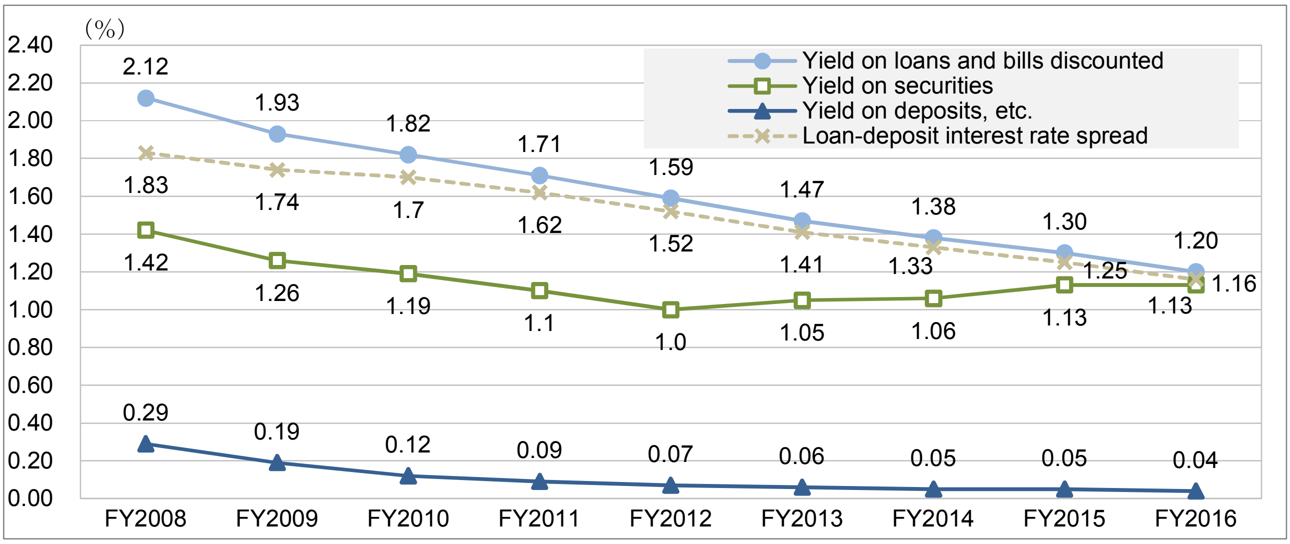
(Chart 1) Profits



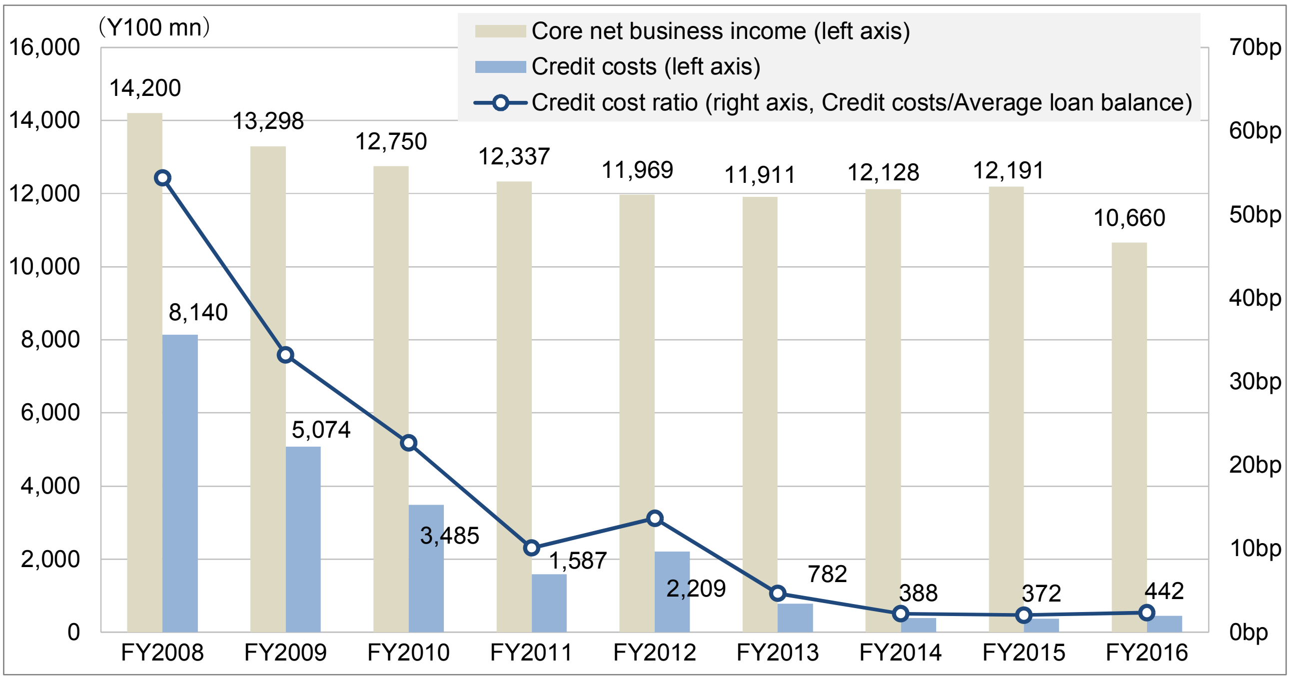
(Chart 2) Loan Balance by Client (fiscal year-end)



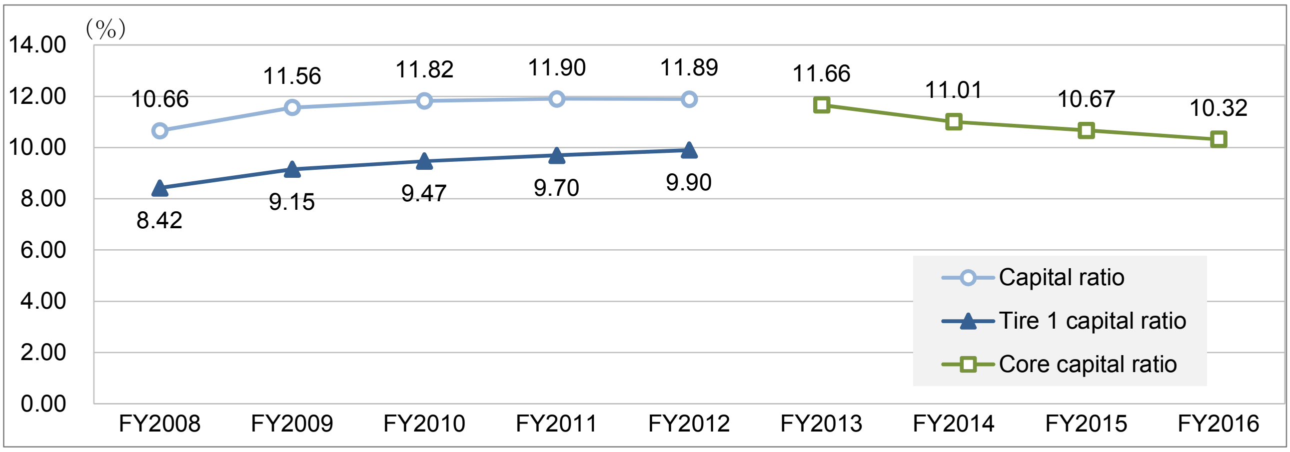
(Chart 3) Yield



(Chart 4) Credit Costs/Credit Cost Ratio and Core Net Business Income



(Chart 5) Capital Ratio (Consolidated, regional banks subject to domestic standards)



(Source: JCR based on data by RBAJ)

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