

Highlights of Regional Banks' Financial Results for Fiscal Year Ended March 2018

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 2018 (FY2017) and earnings forecasts for FY2018.

1. Industry Trend

10-year JGB yield has been in general slightly above 0% since introduction of the Bank of Japan ("BOJ")'s policy of quantitative and qualitative monetary easing with yield curve control in September 2016. 20-year JGB yield has been staying at a low level of about 0.5%. U.S. 10-year government bond yield temporarily declined to near 2% due to increased geopolitical risk with respect to issues surrounding North Korea around September 2017, but the yield increased to more than 2.5% towards the end of FY2017 due to concern about effects from tax reduction and expansion of government expenditure. U.S. short-term interest rates were on an upward trend due to the Federal Reserve Board's policy rate hike and expectation of the hike. While regional banks therefore continued facing difficulty in investments in bonds both in Japan and abroad, solid moves of Japan's stock market in general worked as support for their securities investments.

2. Financial Results

Core net business income of Japanese regional banks (64 member banks of Regional Banks Association of Japan ("RBAJ")) increased for the first time in 2 years in FY2017. Their core net business income significantly decreased in FY2016. JCR considers that temporary effects from a significant worsening of earnings environment due to factors such as BOJ's introduction of negative interest rate policy were large. The number of regional banks which decreased core net business income grew to 54 in FY2016 from 33 in FY2015. The number of regional banks which increased the income was limited to only 10 in FY2016, and most of regional banks decreased the income. In FY2017, the number of regional banks which decreased core net business income was limited to only 25, while the number of them which increased the income grew to 39. There are an increasing number of regional banks which can be seen as having succeeded in putting an end to the decline of their core net business income. However, 27 banks out of 42 regional banks which published estimated core net business income for FY2018 expect the income to decline, while the number of regional banks which expect the income to increase or stay flat is limited to only 15. Conditions where it is impossible to be optimistic about regional banks' business performance will continue into the future. There might have been disparities among regional banks in their performance direction, depending on factors including trend of regional economies, differences in asset portfolio, outcome of measures that have been taken to date.

Their loans' quality has been improving, and their credit costs have been at a low level. JCR values that their capital ratio has been historically at a high level, but the ratio has been gradually declining in recent years. The increased risk assets are a major factor for the decline of capital ratio. Regional banks facing a worsening of earning environment are increasing loans to small and medium-sized enterprises ("SMEs") with relatively high yield, particularly real estate companies with high risk weight. They are increasing equity assets with high risk weight in their securities investments, because it is difficult to secure earnings through investments in JGBs and local government bonds with zero risk weight. JCR sees that this situation has an impact on the decline of their capital ratio.

3. Highlights for Rating

JCR places great value on assessment of business bases and financial bases including capital adequacy, loan quality, earnings capacity, etc. in rating regional banks. 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 their major sales territories. Although regional banks' capital ratio has been gradually declining, JCR values that the level itself historically has been at a high level in the long run. Their loans' quality has significantly improved as

compared with the past, and their credit costs therefore have been at a low level. Their earnings capacity, on the other hand, has been in general on the decline, and there remains downward pressure on their earnings.

Every regional bank is taking measures for enhancement of earnings including strengthening loans to SMEs and individuals, diversifying securities investments, reducing costs. JCR considers whether these initiatives can lead to satisfactory results will be keys to their ratings in the future. JCR will confirm degrees of their risk taking, while keeping balance with assessments on business base, capital adequacy and quality of loan assets, etc., to be reflected in ratings. In cases where earnings capacity is significantly weak as compared with rating level, however, JCR has been negatively assessing such regional banks when reviewing their ratings. JCR sees that ratings for regional banks remain in negative direction in general.

Hajime Oyama, Tsuyoshi Ohishi

(Chart) Regional Banks' Profit/Loss Situation

(JPY 100 mn)

	FY2014	FY2015	Change	FY2016	Change	FY2017	Change	Change(%)
Net interest income	30,389	30,187	▲ 202	29,122	▲ 1,065	29,256	134	0.5%
Interest income	32,751	32,777	26	31,693	▲ 1,084	31,857	164	0.5%
Interest on loans and discounts	24,080	23,539	▲ 541	22,581	▲ 958	22,371	▲ 209	▲ 0.9%
Interest and dividends on securities	8,176	8,667	491	8,548	▲ 119	8,886	337	4.0%
Interest expenses	2,364	2,592	228	2,573	▲ 19	2,602	28	1.1%
Net fees and commissions income	4,484	4,433	▲ 51	4,056	▲ 377	4,308	252	6.2%
Income from other business transactions	725	662	▲ 63	540	▲ 122	150	▲ 390	▲ 72.2%
Core gross business income	35,599	35,284	▲ 315	33,718	▲ 1,566	33,715	▲ 3	0.0%
Gains (losses) related to bonds (v)	578	504	▲ 74	▲ 467	▲ 971	▲ 1,067	▲ 600	N.A.
Expenses	23,472	23,092	▲ 380	23,058	▲ 34	22,827	▲ 231	▲ 1.0%
Personnel expenses	11,760	11,722	▲ 38	11,638	▲ 84	11,450	▲ 188	▲ 1.6%
Non-personnel expenses	10,468	9,995	▲ 473	9,922	▲ 73	9,863	▲ 59	▲ 0.6%
Transfer to general allowance for loan losses (i)	▲ 111	▲ 6	105	▲ 154	▲ 148	355	509	N.A.
Net business income	12,817	12,702	▲ 115	10,348	▲ 2,354	9,463	▲ 885	▲ 8.6%
Core net business income	12,128	12,191	63	10,660	▲ 1,531	10,887	227	2.1%
Non-recurrent income and losses	567	1,193	626	971	▲ 222	1,553	582	59.9%
Disposal of non-performing loans (ii)	1,206	1,078	▲ 128	1,198	120	1,000	▲ 198	▲ 16.5%
Gains (losses) related to stocks, etc. (vi)	895	1,237	342	1,810	573	2,086	276	15.2%
Reversal of allowance for loan losses (iii)	396	422	26	335	▲ 87	360	25	7.5%
Recoveries of written-off claims (iv)	311	278	▲ 33	267	▲ 11	189	▲ 78	▲ 29.2%
Other non-recurrent income and losses	170	333	163	▲ 243	▲ 576	▲ 82	161	N.A.
Ordinary income	13,380	13,891	511	11,316	▲ 2,575	11,015	▲ 301	▲ 2.7%
Extraordinary income	▲ 295	▲ 141	154	▲ 299	▲ 158	▲ 45	254	N.A.
Income taxes, etc.	4,872	4,345	▲ 527	3,063	▲ 1,282	3,130	67	2.2%
Net income	8,211	9,403	1,192	7,954	▲ 1,449	7,838	▲ 116	▲ 1.5%
Net credit costs ((i)+(ii)-(iii)-(iv))	387	371	▲ 16	440	69	805	365	83.0%
Net credit cost ratio (against Core net business income)	3.2%	3.0%	▲ 0.1%	4.1%	1.1%	7.4%	3.3%	79.1%
Gains (losses) related to securities ((v)+(vi))	1,473	1,741	268	1,343	▲ 398	1,019	▲ 324	▲ 24.1%

(Source: Prepared by JCR based on RBAJ's Data)

Japan Credit Rating Agency, Ltd.

Jiji Press Building, 5-15-8 Ginza, Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026

Information herein has been obtained by JCR from the issuers and other sources believed to be accurate and reliable. However, because of the possibility of human or mechanical error as well as other factors, JCR makes no representation or warranty, express or implied, as to accuracy, results, adequacy, timeliness, completeness or merchantability, or fitness for any particular purpose, with respect to any such information, and is not responsible for any errors or omissions, or for results obtained from the use of such information. Under no circumstances will JCR be liable for any special, indirect, incidental or consequential damages of any kind caused by the use of any such information, including but not limited to, lost opportunity or lost money, whether in contract, tort, strict liability or otherwise, and whether such damages are foreseeable or unforeseeable. JCR's ratings and credit assessments are statements of JCR's current and comprehensive opinion regarding redemption possibility, etc. of financial obligations assumed by the issuers or financial products, and not statements of opinion regarding any risk other than credit risk, such as market liquidity risk or price fluctuation risk. JCR's ratings and credit assessments are statements of opinion, and not statements of fact as to credit risk decisions or recommendations regarding decisions to purchase, sell or hold any securities such as individual bonds or commercial paper. The ratings and credit assessments may be changed, suspended or withdrawn as a result of changes in or unavailability of information as well as other factors. JCR retains all rights pertaining to this document, including JCR's rating data. Any reproduction, adaptation, alteration, etc. of this document, including such rating data, is prohibited, whether or not wholly or partly, without prior consent of JCR.

JCR is registered as a "Nationally Recognized Statistical Rating Organization" with the U.S. Securities and Exchange Commission with respect to the following four classes: (1) Financial institutions, brokers and dealers, (2) Insurance Companies, (3) Corporate Issuers, (4) Issuers of government securities, municipal securities and foreign government securities.

JCR publishes its press releases regarding the rating actions both in Japanese and in English on the same day. In case that it takes time to translate rating rationale, JCR may publicize the summary version, which will be replaced by the full translated version within three business days. (Regarding Structured Finance products, JCR only publicize the summary version in English.)

Copyright © Japan Credit Rating Agency, Ltd. All rights reserved.