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## Toward a new era of regional banking conducive to regional economic revitalization

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Amid the current economic crisis, regional banks should tailor their business models to their local markets in anticipation of government decentralization.

## Grim outlook for regional banks' FY08 earnings

Japanese regional banks' earnings performance deteriorated in FY08. At Q3-end, 44 of 87 publicly traded regional banks (including second-tier regional banks) had incurred consolidated net losses in FY08 to date[1], mainly due to increased credit costs, decreased fee income, and growth in losses on securities holdings. Given the continued adverse economic environment, many regional banks are expected to report net losses for FY08 as a whole.

Regional banks' collective balance sheet at end-December 2008 showed a ¥6.8 trillion (4.6%) increase in loans and ¥1.4 trillion (2.4%) decrease in securities holdings relative to a year earlier (see table below). Holdings of foreign securities and other securities[2] fell particularly sharply, respectively down 21.1% (¥1.6 trillion) and 15.0% (¥400 billion) from a year earlier.

We surmise that loan growth was largely attributable to not only demand for funds from local companies and households but also non-local factors, including growth in syndicated lending and one-off demand for funds from large corporations no longer able to access funding from bond and commercial paper markets.

Exhibit. Regional banks' major asset holdings at 31 December 2008

(¥trn)

| Asset | As of 31 December 2008 | | |
|---|---|---|---|
| | Balance | Year-on-year change | |
| Loans | 154.0 | 6.8 | 4.6% |
| Securities | 55.5 | -1.4 | -2.4% |
| Of which, foreign securities | 6.1 | -1.6 | -21.1% |
| Of which, other securities[2] | 2.1 | -0.4 | -15.0% |
| Of which, equities | 4.2 | 0.0 | 0.6% |
| Other assets | 18.9 | -0.9 | -4.7% |
| Total | 228.4 | 4.5 | 2.0% |

Source: NRI, based on Regional Banks Association of Japan's Principal Accounts of Regional Banks

The large decreases in foreign and other securities holdings suggest that regional banks substantially sold off, wrote down and/or, in the case of fund products, redeemed holdings in response to large declines in prices of securitized products, credit investment products, REITs, and other such assets. Regional banks' equity holdings, another source of incremental securities-related losses, were roughly unchanged from a year earlier, partly reflecting the prevalence of cross-shareholdings. Regional banks' P/L statements remain highly sensitive to equity price movements.

## Importance of building localized business models

Regional banks' IR materials reveal that many banks have similar business models, with medium-term business plans focused on the same three priorities: expanding their loan books, strengthening securities investment capabilities, and increasing fee income through investment trust sales and investment banking (e.g., M&A, derivatives). These plans exhibit little strategic differentiation, conveying an overall impression of monotone uniformity.

As noted in the opening paragraph, all three of the areas that regional banks are targeting as priorities are currently weighing on profitability, albeit not solely because of deterioration in economic environment. Another contributing factor is that top-down earnings targets derived from an overarching strategy exert performance pressure on individual organizational units. This pressure tends to have unintended consequences such as lax risk management or hasty business expansion unsupported by the requisite human resources. Such deficiencies were presumably a major factor behind the recent deterioration in regional banks' operating performance. In short, we surmise that regional banks' recent difficulties stem largely from commitments to domestic and overseas institutional investors and a herd mentality that sanctioned the strategic planning described above.

With regional banks likely to remain beset by an adverse earnings environment and at substantial risk of capital erosion for a while, they can no longer afford to pursue an all-encompassing business model. Going forward, regional banks must allocate their resources in accord with the needs and circumstances of their local customers, the foundation of their operations. Doing so should partly entail formulating targets through a bottom-up approach and realigning relationships with stakeholders. Amid the current "once-in-a-century" economic crisis, conditions are ripe for such a change in mindset to be accepted by not only customers but shareholders, creditors, and other stakeholders

First, investors' expectations have changed both at home and overseas. From a global perspective, the public-utility model of banking is gaining credence in the wake of huge injections of public funds into the financial sector. Additionally, investors are likely to moderate their growth expectations vis-à-vis banks in recognition that unreasonable earnings expectations are partly to blame for the current financial crisis. Meanwhile, regional banks seeking to shore up their weakened capital bases will find retail investors or public funds to be a more accommodating funding source than the usual institutional investors. In the latter half of 2008, megabanks issued nearly ¥800 billion in subordinated bonds to retail investors to compensate for diminished access to funding from capital markets[3]. Another key point is that regional banks can strengthen their capital bases in the aim of expanding their capacity to lend to local companies by accessing public funding pursuant to the amended Act on Special Measures for Strengthening Financial Functions enacted in December 2008. Strategic utilization of this public funding is a major option for regional banks, given that it will contribute to meeting local companies' needs by expanding lending capacity. In light of such, shareholder composition is likely to change together with shareholder expectations.

Regional banks' operations are likely to also be significantly affected by changes in the external environment, including demographic trends (societal aging, low birthrate, population shrinkage), government decentralization, and consolidation of prefectures into regional administrative units. As a result of these trends, distinctions among regions will likely become more pronounced. More specifically, distinct differences are likely to emerge in terms of the composition of regional labor forces, evolution of regional industrial structures, and regional banks' customer needs arising from these factors.

## Looking for a new era of regional banking from FY09

For example, if a regional bank is based in a major city with an industrial base and slow rate of projected population decline, it should allocate its management resources in a manner that contributes to vitalizing local industries by meeting their demand for funds through various means and providing management advisory and business matching services. If a bank is located in a region with an aging population and no core industries, it should place priority on improving its portfolio management performance and offering high-quality investment products to help its customers achieve high returns on their financial assets. A number of regional banks are in fact stepping up efforts to implement such an approach.

Regional banks play an extremely influential role in regional economies. It is crucial that they make the upcoming era of decentralized government a new era of regional banking by refocusing on their local markets.

Hopefully, FY09 will be a major transitional year in which regional banks take stock of their individual circumstances, local markets' distinguishing characteristics, management resources, and capabilities and abandon their herd mentality in favor of utilizing their own independent judgment.

## Note

1) *Nikkei Shimbun,* 14 February 2009

2) Securities other than JGBs, municipal bonds, corporate bonds (including short-term corporate debt instruments), equities, and foreign securities

3) Including Nomura Holdings' ¥300 billion in issuance, over ¥1 trillion in subordinated bonds were issued to retail investors.

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