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Made (up) in Japan

"It's not easy turning the Titanic," Jeffrey Brown, CEO of Ally Financial, the former General Motors Acceptance Corp., told bemused listeners on Ally's first-quarter conference call. While the telephonic audience may or may not have taken that metaphor in the hopeful spirit in which it was intended, the Ally skipper did have a point. Big financial institutions, like big ships, are slow to answer the helm, and some of them, like the Titanic, do sink.

Banks and their buoyancy—in Japan and Italy—are the topics at hand. The scourge of modern regulatory and monetary methods is the common thread in the narrative. In preview, we judge that Japanese regional banks, collectively, are broke, and that Italian banks, collectively, are less broke. We are bearish on the Japanese, intrigued by the Italians and bullish on the homely ideal of financial truth-telling.

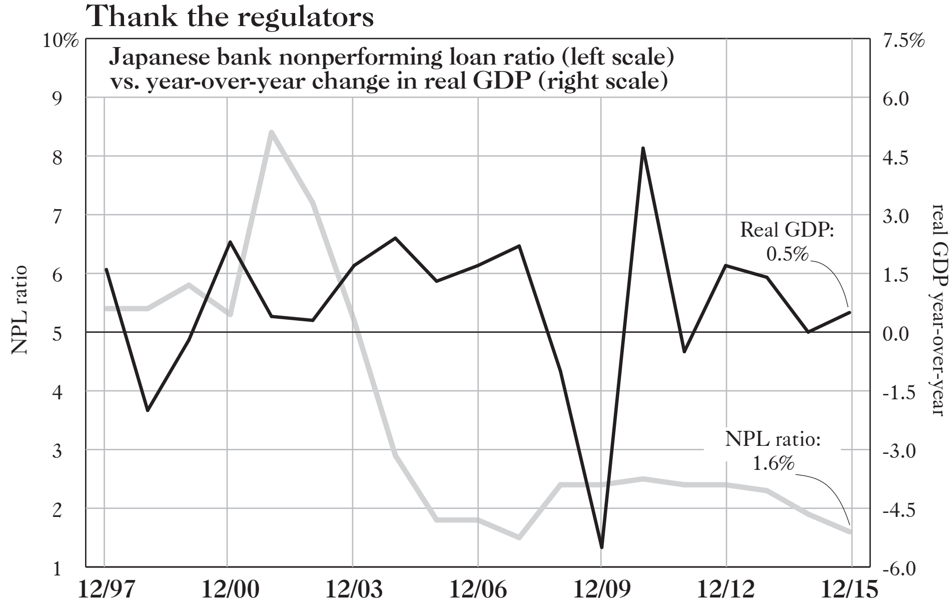
"*Sofferenze*" is the Italian word for uncollectable debt; it means "sufferings." It's the mark of sound banking that *sofferenze* do, indeed, induce suffering—and timely action to cut the pain short. The trouble with Japan is not any absence of suffering—shareholders in the likes of Tokyo-listed Shizuoka Bank (8355), Nanto Bank (8367) and Daishi Bank (8324) have been on the rack for years. What ails the world's third largest economy is rather (among other things) the officially sanctioned make-believe that masks the underlying causes of distress.

A glance at the credit record alone would prompt no suspicion that Japan bore a 6.5% loss of real output in the Great Recession and spells of little or no growth in the years following. As a percentage of total loans at Japanese banks, nonperformers peaked at only 2.5% in 2010, up from 1.5% in 2007; they stand at just 1.6% today. Compare and contrast the toll exacted by the much milder downturn of the late 1990s and early 2000s. In that millennial cycle, nonperforming loans as a percentage of overall loans topped out at 8.4%—this was in 2001—up from 5.4% in 1998.

For the cosmetically happy results of recent years, credit the Japanese politicians, central bankers and bank regulators, as opposed to the underwriting prowess of the Japanese lending officers. On Nov. 30, 2009, the newly elected Democratic Party of Japan enacted the Small to Medium-Sized Enterprise Financing Facilitation Act, a.k.a. SMEFFA or—more descriptively—the "moratorium law." "We're going to get financial institutions to provide these firms with more loans," said Financial Services Minister Shizuka Kamei at the time. "Banks won't have to treat debt on which they provide a moratorium as bad." In exchange for permission to extend and pretend—indeed, for the obligation to do so—banks received regulatory clearance to fasten the label "performing" on loans that aren't. Mere *sofferenze*, they were not; they were, and remain, zombie loans.

Japan's regional banks, which have assets of ¥292.5 trillion, equal to 59% of Japanese GDP, and are heavily exposed to small and medium corporate borrowers, were principal parties in this pact with the devil. Just how much bad debt

Thank the regulators



sources: IMF, the Bloomberg

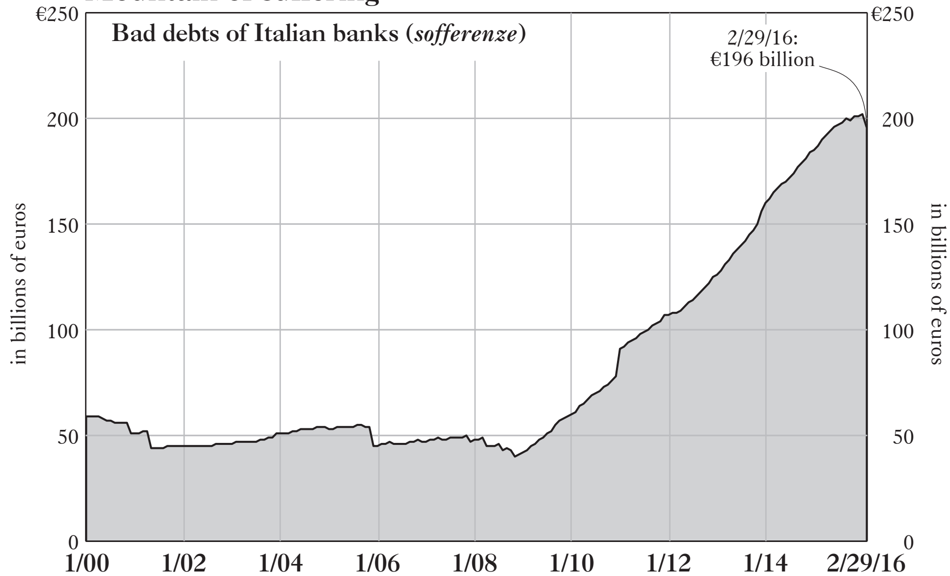
they have legally transmogrified into good debt is undisclosed, though the curtain of secrecy was briefly parted in October 2014. As of that date, according to Shannon McConaghy, a portfolio manager at Horseman Capital Management, there were likely outstanding ¥93.9 trillion of loans with modified conditions under the moratorium law, of which ¥50.3 trillion were provided by regional banks. "This is 2.73 times the total net assets [i.e., equity] at regional banks (¥18.4 trillion) on their combined balance sheets in that year," McConaghy pointed out. The survey results on which he based his observation show that slightly more than half of the small and medium businesses that received loan modifications would have hit the wall but for that dispensation. Maybe they still might fail; survey data suggest that few of the recipients of these mercy credits have returned to anything like sound commercial health.

Signs of the impact of such "performing nonperforming loans" do turn up from time to time. "There was a convertible-bond prospectus that I read recently for Shizuoka Bank," McConaghy tells colleague Evan Lorenz, "and in their prospectus they write something to the effect that the difference between our accounting for our cash flows and the actual cash flows received from interest and principal payments is ¥8 billion. That's like a third of their earnings for a year. That was a one-line throwaway."

Though the moratorium law expired in 2013, it lives on as a phantom source of regional-bank profitability. "Helped by zero-percent interest rates and the fact that bankruptcies were so low," Brian Waterhouse, the CLSA analyst who covers Japanese regional banks, tells Lorenz, "a lot of banks were tempted—and did—write back to profits a lot of their surplus loan-loss reserves, which was one of the principal features buoying net profits for some of the very small regional banks from 2009 right up through last year." For the four dozen publicly traded Japanese regional banks listed on the Japanese Bankers Association website, loan-loss provisions represented an expense of ¥333.1 billion in fiscal 2009. Reversals of those provisions generated ¥6.6 billion in operating profit in fiscal 2015 (ended March 31). So, not only have Japanese banks not recognized doubtful loans, but they've also eroded their capacity to withstand future losses.

"At the expiration of the moratorium law," Waterhouse goes on, "the banks

Mountain of suffering



source: The Bloomberg

set up investment funds to support local industry, which again was encouraged by the government. The neat thing about this is [that] setting up an investment fund is not a quoted security, and it is an investment and not a loan. You put money into the investment fund, and that fund then lends to local companies such as your struggling customer, who would have had an adverse credit rating before the debt moratorium law set in. He still can't repay, but now he has new money. With the new money he can repay the bank, and it is now a good loan. The bank has put the money into an investment fund, and it is an unquoted investment—therefore, it doesn't have to be marked to market. Even if it loses money, it doesn't affect the bank until it runs out of capital and needs more investment." Naturally, disclosure is de minimis.

With legalized credit subterfuge in the foreground and demographic decline in the background, regional banking in Japan is no one's idea of a growth industry. Only one banking line item seems to grow dependably: Between fiscal 2013 and fiscal 2015, interest and dividend income on securities rose by 13%, to ¥817.6 billion, which approximates the ¥821.1 billion in net income that regional banks reported last year.

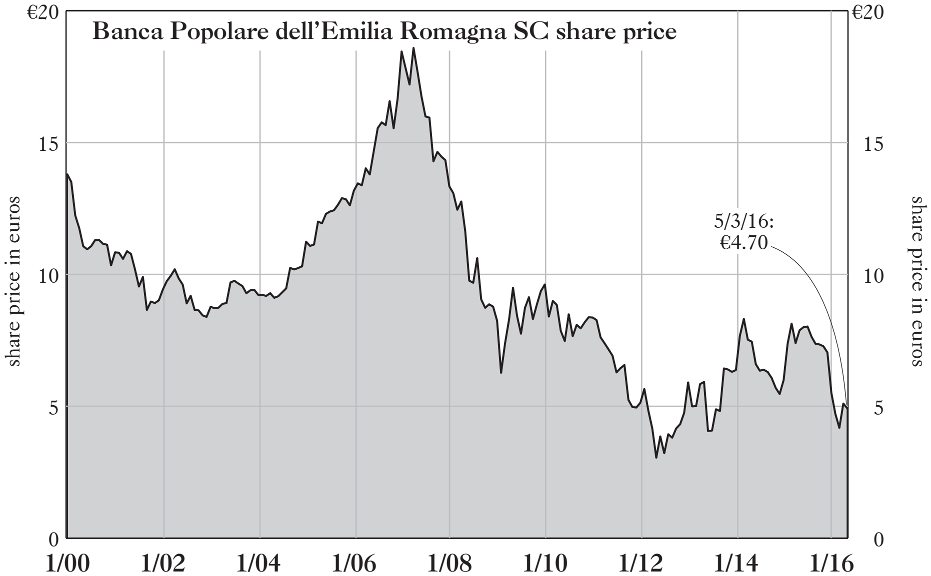
Inasmuch as positive nominal yields begin at the 15-year point on the JGB curve and that virtually yield-free bonds constitute 75% of the regional banks' securities portfolios, the results pose a bit of a mystery. Equity gains, and their treatment under Japanese GAAP, provide the answer. Suffice it to say that stocks held in private investment trusts with Japan's money-center banks are accorded special accounting treatment. Then, again, not even Japanese regulators have figured out a way to squeeze capital gains from a droopy stock market; to date this year, the Nikkei 225 index has fallen by 15.2%.

"While the banks are mum on the volume of nonperforming loans they classify as money-good," Lorenz points out, "they do disclose how much of their loan-loss reserves they've chosen to reclassify as earnings. Our friends Shizuoka Bank, Nanto Bank and Daishi Bank rank high on the list of aggressive loan-loss reclassifiers."

Shizuoka, the largest of the regional banks, commands a $4.9 billion market cap and trades at 9.1 times trailing earnings and 51% of (generously computed) book value. Nanto has a $763 million market cap and trades at 8.8 times earnings and 32% of supposed book value. Daishi, which lays claim to the title of Japan's oldest bank, has a $1.2 billion market cap and trades at 8.4 times earnings and 40% of ostensible book value.

"In each case," Lorenz relates, "acknowledged problem loans represent a niggling percentage of overall loans (1.7%, 2.4% and 2%, respectively, for Shizuoka, Nanto and Daishi), yet reserves cover a low proportion of even that understated exposure (43%, 30% and 28%, respectively). Shizuoka is the best capitalized of the three banks with an equity-to-assets ratio of 8.5%; Nanto and Daishi show 4.5% and

Bank for sale



source: The Bloomberg

6%. For reference, the average equity-to-asset ratio for the component companies in the KBW Regional Banking Index of American regional banks is 11.6%.

"You wonder," Lorenz goes on, "what kind of hothouse creatures are the Japanese regionals. They're vulnerable if the economy weakens and the stock market slumps. They're at risk if—for some now unimaginable reason—interest rates rise and JGB prices plunge. In other words, the regional banks are perfectly adapted to one niche economic environment, which is today's. And they're not exactly thriving in that one."

Curtis R. Freeze, chief investment officer of Prospect Asset Management, listened patiently the other day as we spun our bearish thesis. He expressed broad sympathy with the analysis, but not much optimism for the chance of a short-seller of Japanese regional bank stocks to get paid by implementing it. "Regional banks are the most politically charged sector in Japan," Freeze said. "There is going to be a lot of things that don't make sense just based on the numbers. The danger is, you try to short it or try to predict what the intrinsic value is, and that doesn't play a part in the decision making. The most frustrating thing is—I've been in Japan for 30 years—is why does it have to take so long? Why does it have to be dragged out for so long? That is just how they do things in Japan."

So far, at least, the price movements of Japanese regional banks do seem to validate the thought patterns of a Japanese bear. When, on April 28, the Bank of Japan sent the Nikkei 225 reeling 3.6%—investors had been hoping for a lifeline that the bank declined to throw—our trio of banks fell by an average of 7%. On Monday, the Nikkei slipped by 3.1% and our three regionals pulled back by 4.6%. It would seem that the market is treating the regional banks like the credit disasters they are.

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The stereotype of the profit-deprived, bond-burdened and politicized bank is every bit as familiar in Italy as it is in Japan. Then, too, Italy has its own peculiar demons. The country is over-banked, it labors under the "bail-in" strictures of the European Union (equity owners and junior creditors must henceforth bear a loss in the failure of the bank in which they hold an interest) and it's been painfully slow to confront its bad debts. A large segment of the banking industry is, for the time being, governed by the one-stockholder/one-vote rule. What this means is that a unionized bank clerk holding one share of stock commands the same voting power as a private-equity fund holding one million shares in the same institution. It's a mercy, from the point of view of American ideals of corporate governance, that rule by shares will displace rule by stockholders next year. It would be grand, informed observers say, if Italy's too-numerous banks could be consolidated through mergers, lifting returns on equity by capturing economies of scale. And it would likewise be desirable, the same informed observers agree, if things were in such a state of good order that a prospective acquirer could trust the financial representations of a prospective acquiree. Alas, they are not, Johan de Mulder, who covers Italian banking for Sanford C. Bernstein & Co., tells Lorenz: "The fact is that the banks don't trust each other, so you never really know what you are buying into."

All this is proverbial. New and different is the announcement last week of creditor-friendly reforms to expedite the realization of collateral in future bankruptcy proceedings. Under the regime that's slated for eventual extinction, a bank has had to wait an average of seven years before it could lay hands on a defaulting borrower's assets. To a stockholder with even a three-year investing horizon, the collateral might as well not exist. Under the announced reforms, the wait could be cut in half (of which more in a moment).

How much action might follow this hopeful decree, and when it might begin, no one seems to know. Certainly, there's room for improvement. Nonperforming loans on the balance sheets of Italian banks foot to €360 billion, or 22% of Italian GDP. Of this mountain of doubtful claims, the worst of the worst, the *sofferenze*, come to €196.1 billion. Net of loan-loss reserves, these sufferings amount to €83 billion, or 19% of reported bank capital of €443 billion.

The European Central Bank judges that more than a few Italian banks are in need of capital replenishment. No more may governments simply bail out their problem children; to fashion a cosmetically private substitute for the public exchequer, the government of Prime Minister Matteo Renzi has cajoled Italy's big banks, insurers and asset managers into seeding the Atlante Fund (named after the Atlas who holds up the sky). It's a €4.25 billion pool to douse that €83 billion fire.

Actually, as the fund has already committed €1.75 billion to Popolare di Vicenza, perhaps the neediest bank, it's a €2.5 billion pool. How to stretch those scant billions to cover the needful €83 billion? Financial engineering is the proposed solution. The fund will earmark the remaining €2 billion or so as equity investments in forthcoming bad-debt securitizations. On this equity will be piled various levels of debt, and with this borrowed money the funds will buy the banks' *sofferenze*. How much of this detritus can be absorbed depends, of course, on the leverage employed and the prices paid.

"Private-market investors are expected

to buy the mezzanine and senior tranches of these bad-asset securitizations," Lorenz relates. "How much leverage will private investors tolerate? The government would prefer more to less, to mop up as much bad debt as possible. Mezzanine investors would prefer less to more, the better to limit potential loss. Let us only say that there are many unknowns with the Atlante."

Who is rescuing whom is another such unknown. UniCredit SpA, Italy's largest bank by assets, is tapped for a major contribution to the Atlante Fund. Given that UniCredit's shares trade at just 38% of book value, one can as easily imagine that bank as a supplicant to the Atlante Fund as an investor in it.

In comparing Italian banks to Japanese banks, we harken to the precept of Arjun Divecha, head of GMO's emerging-markets equity team, who says that the progress from horrible to bad is more bullish than the progress from good to great. In Italy, if even a little goes right, the banking situation is poised to move from horrible to something even better than bad (we underscore "if").

The case for optimism rests, first, on the reason why the stock of *sofferenze* continues to grow. It's confounding that it does keep growing, even in those rare years, like 2015, when the Italian GDP bestirs itself to increase (last year, by 80 basis points). Net inflows of nonperforming loans peaked in 2009. The trouble lies with the outflows. They're dammed up by Italy's slow-mo bankruptcy system.

"In normal countries," says de Mulder, "the inflow in bad debt is more or less offset by the outflows through sales or recoveries. In Italy, it takes so long before you can get rid of bad debt through recoveries because bankruptcies take seven years, and that is an average. In the south, it takes 15 years. . . . So when you go through a recession, like we had in the past three to four years, you just have that inflow at a higher pace, without an outflow to match." In consequence, the sufferings keep accumulating.

Which facts frame the news of the Renzi government's announced bankruptcy reforms. News reports quoted the prime minister as saying, "We are trying to shake the economy." Well, Shinzo Abe, the prime minister of Japan, is trying to shake the Japanese economy, too. The Japanese still slumber. Will Italy awaken?

Most loans to small and medium businesses are collateralized by real estate. "But, for the moment," says de Mulder, "a lot of investors view that collateral as worth nothing because it takes you ages before you can recover it. If that starts to be worth something because it goes from seven to three years, then you may actually have a big upside. I still believe that Italy is the biggest leveraged trade at the moment. If they only follow through on half of their promises, there is a big upside."

Banca Popolare dell'Emilia Romagna SC (BPE on the Italian Bourse), the seventh largest Italian bank by assets, stands as representative of the highly speculative value on offer in Italy. Widows, orphans and perhaps most fiduciaries should now avert their eyes. BPER has manifest credit troubles, and latent interest-rate troubles (government securities on the balance sheet represent 122.7% of tangible equity). Nor is capital super-abundant; with an equity-to-assets ratio of 8.2%, BPER seems only as well capitalized as Shizuoka Bank. The redeeming difference is that BPER has acknowledged its problem loans and has reserved against possible losses.

Nonperformers at BPER foot to €6.4 billion, or 14.5% of the loan book and 127% of book. *Sofferenze* make up €3 billion of the total; watch-list/restructured loans add another €3.1 billion, and past-due loans another €256 million. Reserves against losses amount to 64.4% of the value of the *sofferenze*, 21.9% of the watch-list items and 10% of the past-due items.

There are some early signs that BPER's loan book is on the mend. Gross problem-loan inflows fell by 28.2% last year to €1.7 billion. In the fourth quarter, the loan book (before reserves) grew by 1%, reversing two consecutive years of declining balances.

The stock market appears mindful of the risks; in the year to date, the BPER share price has fallen by 33.2%. At last look, the stock was quoted at 10.5 times trailing net income and 45% of book. Is this the bottom? We have no way to form a judgment just now; we mean to keep investigating. At this writing, our sole conviction is that the Italians are less broke than the Japanese.

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