Asia Focus

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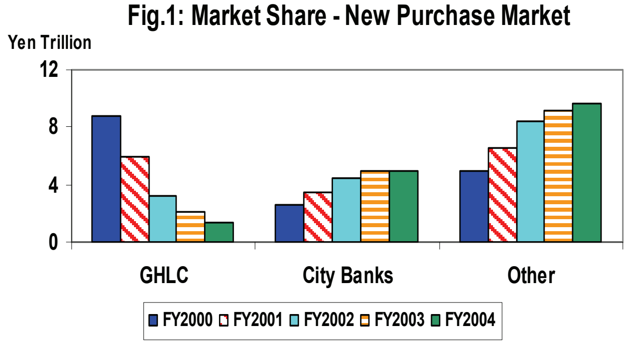
JAPANESE CITY BANKS: UNWARRANTED HOUSING LOAN EXPECTATIONS

Prime Minister Junichiro Koizumi's recent election victory has raised hopes that the big Japanese city banks will continue to recover, but in one area – housing loans – the outlook is deteriorating. While an early Koizumi reform sparked a boom in big bank housing lending the first three years of the decade, housing loan book expansion halted last year, and margins are under increasing pressure. Intense competition, little experience in managing housing loan risk and inefficiencies in the real estate market will limit growth even if the underlying housing market recovers. Big banks will likely have to look elsewhere to boost profitability in coming years.

RECENT GROWTH UNSUSTAINABLE

Recent strong growth in big bank housing lending is neither sustainable nor reflective of the underlying market. Housing loan balances at the top 7 banks rose 25 percent on a compound annual basis 2000-2003, but growth in overall Japanese housing loans stagnated over the period. The value of the housing loan market has remained at the $1.7 trillion level since 2000. Despite the dull market, large banks and other private institutions have expanded housing loan books the past several years by increasing their market share at the expense of the Government Housing Loan Corporation (GHLC) (Figure 1). As part of Prime Minister Koizumi's 2001 plan to convert GHLC from a loan originator to a mortgage-backed securities packager, GHLC has securitized most of its loan book and slashed new lending. This shift from GHLC to private players is now largely complete. GHLC had only a 9 percent market share remaining at end-2004, and it will cease originating housing loans completely in 2007.

Fig.1: Market Share - New Purchase Market



Source: BOJ, Shinsei Bank

TIGHT MARGINS

Intense competition among banks is squeezing housing loan margins. With highly liquid banks all chasing the same stagnant pool of customers, financing terms have become very attractive for borrowers. Banks now offer many customers low teaser rates or loan-to-value ratios at or above 100 percent (to finance closing costs). As a result, current margins in housing loans are not much higher than city banks can obtain from their corporate clients.

The entry of additional players, both foreign and domestic, will likely make the market even more competitive. GE Finance, the most experienced new nonbank player, plans further expansion in the Japanese market. Foreign-owned Japanese banks such as Shinsei Bank and Tokyo Star Bank have also increased their focus on housing loans. To a certain extent, smaller banks and nonbanks are targeting lower-income borrower groups the large banks choose not to assist, but the smaller players also believe they can seize market share from big banks with superior service. The smaller banks, for instance, are being innovative in linking deposit products to loan repayments. In contrast to the GHLC restructuring, Prime Minister's Koizumi's planned postal system reform could hurt the big banks' housing loan business. A privatized postal system with a huge branch network will likely make housing lending a priority market.

HIGHER RISK EXPOSURE

Risks to large banks in the housing loan market are increasing. A rise in borrowers' debt service burden combined with relaxed bank lending standards has resulted in higher credit risk on many loans, but the banks have yet to implement a risk-based pricing system. Banks continue to charge the same rate on most housing loans regardless of the borrower's creditworthiness. Japanese banks do not have use of a standardized credit score similar to the FICO score in the U.S., and the lack of credit bureaus covering consumers' total credit exposure complicates the borrower evaluation process. Housing lending could be increasing interest rate risk at the big banks. Rising long-term housing loan balances potentially increase the duration of the overall loan book and widen banks' asset-liability mismatches, but the large banks typically do not employ derivatives to adjust housing loan maturities. Japanese banks have little experience in managing this type of risk.

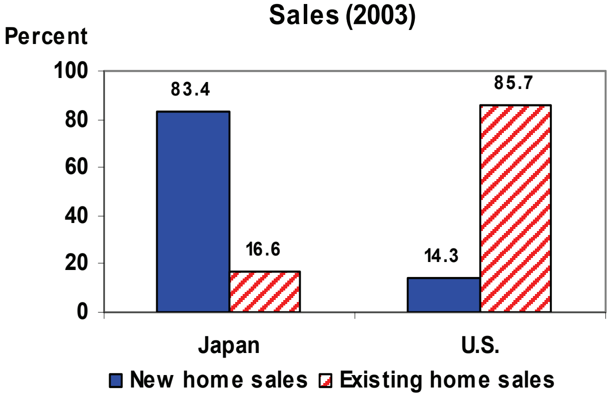
CHANGING BORROWER PROFILE

Large banks are adapting too slowly to the evolving credit needs of a more diverse work force. While the typical Japanese homebuyer in the past was a long-term salaried employee of a large corporation, more workers are now changing employers frequently or holding nontraditional jobs. While smaller banks have been able to accommodate these new types of borrowers, large banks have had trouble moving away from underwriting systems based on outdated borrower profiles.

MARKET CONSTRAINTS

The lack of an active secondary home market will constrain growth in the housing loan market for large and small banks alike. Most transactions in Japan are for the purchase of a new house. The resale market remains extremely small as compared to the U.S., where the secondary market dominates (Figure 2). The reform of GHLC, which prefers financing new homes, removes one impediment to resale market development, but the lack of adequate information about sales prices of existing homes, high capital gains taxes for short holding periods and high transaction taxes remain obstacles to market growth. There has been little government effort to support a secondary market in housing.

Fig. 2: Ratio of Existing to New Home Sales (2003)



Source: Nat'l Assoc. of Realtors

POTENTIAL GROWTH PROSPECTS

The housing market still offers some growth areas for the large banks. Home equity loans may offer a viable alternative to borrowers traditionally paying very high interest rates on unsecured consumer loans. The growing ranks of older Japanese looking for retirement funds might provide a market for reverse mortgages, and a sustained upturn in property prices would increase housing credit demand. Further expansion of the mortgage-backed securities market could stimulate growth as banks are increasingly able to sell off their existing loans and invest the proceeds in new loans. By selling loans instead of holding them, banks would also be able to increase income from servicing fees.

STEEP LEARNING CURVE

But these positive factors lack the power of the forces currently weighing on housing lending at the big banks. The property cycle is notoriously hard to forecast, and demographics present threats to housing as well as opportunities. At present, single and DINKS (double income, no kids) households are growing, but after 2015, they will shrink in number. At best, it appears that the large Japanese banks face a steep learning curve as they adjust to a tighter housing market demanding much improved expertise in consumer credit analysis, interest rate risk management and retail marketing. For at least the next several years, the big banks will likely have to look beyond housing for exciting growth opportunities.

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