Lessons from Japan's Banking Crisis, 1991-2005

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1. Introduction

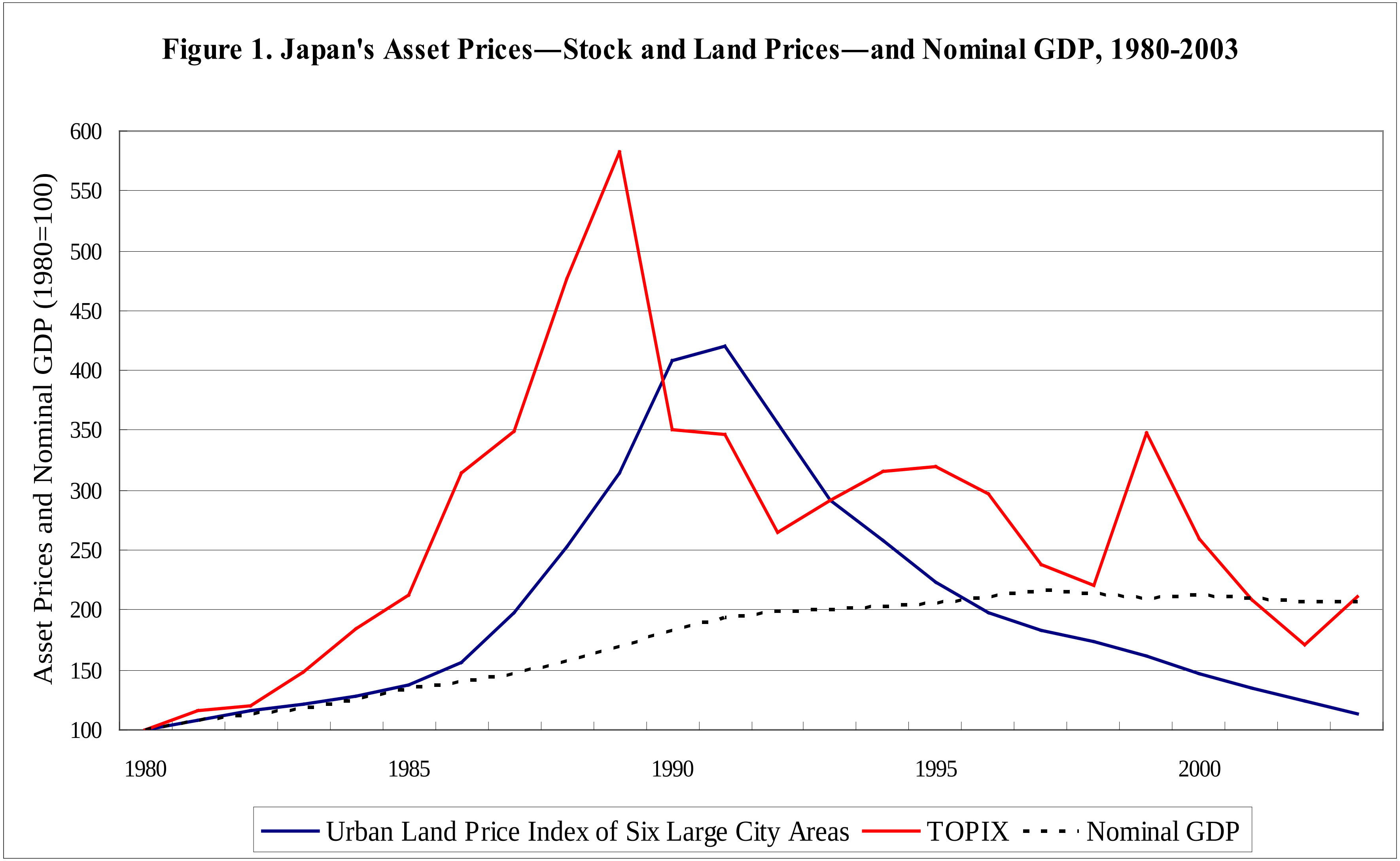
- Japan had a "lost decade" because of the failure to promptly and decisively address the banking sector problem
- But from 1998 it began to take aggressive policy to resolve the crisis
- Facing the financial crisis, the US has been implementing TARP1 (Paulson) and TARP2 (Geithner-Summers)
- Resolution of "toxic assets" is critical to the resumption of credit flows and sustained recovery of the US economy
- What lessons can be learned from Japan for resolving the financial crisis in the US (and potentially in Europe)?

2. Japan's Banking Crisis

(1) Causes of the banking crisis: bursting of the bubble

- Overextension of bank loans in risky areas under the general environment of inadequate supervision and regulation over banks and a rise of unregulated financial institutions (*Jusen*) during the bubble period
- Severe negative impact of the bursting of the bubble and the subsequent asset price deflation, making bank loans non-performing;
- Economic slowdown in the 1990s (TFP declines?); and
- A delay in policy action to decisively contain the banking sector problem

Japan’s asset prices



2. Japan's Banking Crisis

(2) Lost years: phase 1 (1991-1997)

- The initial policy based on protection and regulatory forbearance to support ailing banks
- Deposits protected fully on an informal basis, emergency liquidity assistance for troubled banks, and financial resources to encourage healthy institutions to merge troubled institutions
- In 1995-96, the government used 680 billion yen to bail out specialized housing loan companies (*Jusen)* but encountered strong public criticism
- In 1996, blanket guarantee of deposits
- In 1997, failures of several large institutions, leading to a systemic financial crisis

2. Japan’s Banking Crisis

(3) Decisive action: phase 2 (1998-2005)

- The 1997-98 systemic crisis forced the government to take much more decisive policy action than in the earlier years
- Public money injected for capitalization of banks in March 1998 (1.8 trillion yen) and March 1999 (7.5 trillion yen)
- Temporary nationalization of 2 failed large banks (Oct & Dec. 1998)
- FSA’s special inspection of bank loans in March 2002, leading to tighter loan classification for 142 borrowers, and another one in March 2003 focusing on 167 borrowers

2. Japan’s Banking Crisis

In October 2002, the FSA introduced the Program for Financial Revival, a decisive three-pronged strategy to accelerate bank restructuring:

- Bank shareholding to be reduced to 100% of tier-1 capital by September 2006.
- Loan classification and loan loss provisioning to be strengthened, starting in FY2003, with measures to improve the classification of loans to small businesses.
- Banks to remove 50% of new NPLs within one year and 80% within two years, with a target of reducing major banks’ NPLs by half by March 2005 from its level of 8.6% in March 2002.

Total losses on NPLs disposal of all banks, March 1993 – March 1994

(Billion yen)

	March-93	March-94	March-95	March-96	March-97	March-98	March-99	March-00	March-01	March-02	March-03	March-04	March-05
Total Losses on Disposal of NPLs	1,640	3,872	5,232	13,369	7,763	13,258	13,631	6,944	6,108	9,722	6,658	5,374	2,848
Net Transfer to Provisions for Loan Losses	945	1,146	1,402	7,087	3,447	8,403	8,118	2,531	2,732	5,196	3,101	1,616	94
Direct Write-offs	424	2,090	2,809	5,980	4,316	3,993	4,709	3,865	3,072	3,975	3,520	3,734	2,754
Cumulative Total since end-March 1993	1,640	5,512	10,744	24,113	31,877	45,135	58,766	65,710	71,818	81,540	88,198	93,572	96,420
Risk Management Loans	12,775	13,576	12,546	28,504	21,789	29,758	29,627	30,366	32,515	42,028	34,849	26,204	17,539

2. Japan’s Banking Crisis

(4) Asset management companies

- The Resolution and Collection Corporation (RCC) and the Industrial Revitalization Corporation of Japan (IRCJ) were established, to promote corporate restructuring and to accelerate the disposal of bank NPLs
- The RCC purchased, from failed institutions and mortgage lenders (*Jusen*), collateralized NPLs, focusing on small, non-viable firms.
- The IRCJ focused on higher quality NPLs for larger firms to promote restructuring of relatively large, troubled but viable firms by purchasing their loans from secondary banks, leaving the main bank and the IRCJ as the only major creditors

Performance of RCC

Former RCB (established in July 1996)

	‘96	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Cumulative amount of acquired assets (book value)	384	597	2,017	3,140	3,795	4,128	4,918	4,982	5,043	5,071	5,060	5,073
Cumulative amount collected	34	86	348	953	1,893	2,729	3,483	4,256	4,962	5,492	5,816	6,011
Collection ration (%)	8.9	14.4	17.2	30.4	49.9	66.1	70.8	85.4	97.9	108.3	114.9	118.5

Former HALC (established in July 1996)

*Total loans acquired from 7 mortgage lenders (Jusen) -- JPY 4,655.8 billion (book value) (a)

	‘96	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Amount Collected	245	655	651	426	322	251	170	139	118	100	87	70
Cumulative amount collected	245	900	1,550	1,976	2,298	2,459	2,719	2,858	2,976	3,076	3,163	3,233
Collection ration (%)	5.3	19.3	33.3	42.5	49.4	54.7	58.4	61.4	63.9	66.1	67.9	69.4

2. Japan’s Banking Crisis

End of the crisis

- It was after 2003 that Japanese banks’ capital strengthened and profitability bottomed out, and the stability and functioning of the financial system began to improve
- Japan’s economy returned to a full-fledged recovery path supported by export-led growth due to global economic expansion
- Japanese banks incurred cumulative losses of some 110 trillion yen, equivalent to 20% of Japan’s GDP

3. Lessons from Japan's Banking Crisis

(1) Decisive action should be taken early on

- The authorities underestimated the nature and severity of the banking problem, delaying early recognition of losses with lingering fears about bank solvency
- Forbearance in initial accounting and disclosure standards delayed proper identification of the incurred losses of banks. This did not give sufficient incentive to banks to promptly address the NPL problem
- The authorities could not resolve troubled financial institutions in a timely manner, due to the delay in establishing a resolution framework. The legal framework of resolution, regulatory procedure for NPL disposal, and public funds to cover a capital shortage are vital for crisis resolution

3. Lessons from Japan's Banking Crisis

(2) Reasons for the delay in decisive action

- The initial approach was based on the expectation that a resumption of economic growth would restore financial health of banks and their clients
- Keynesian fiscal policy supported minimum aggregate demand and helped insolvent corporations survive, particularly in the construction sector
- There was no domestic pressure (high savings, no inflation, low unemployment, and no social unrest) nor external constraint (large foreign exchange reserves, no capital flight, no balance of payments difficulties, no currency crisis)

3. Lessons from Japan's Banking Crisis

(3) Decisive action after 1998 helped resolve the banking crisis

- The policy action taken after 1998 was aggressive and decisive
- The FSA's "special inspection" of bank loans in 2002-03 forced financial institutions to classify loans more stringently than before. Until then, banks' self-assessment of NPLs had been used, and doubt remained as to whether the figures would represent the reality
- The Program for Financial Revival in October 2002 was a decisive strategy to force banks to remove NPLs within a certain period of time

4. The US Financial Crisis

(1) Similarities and differences of crisis between Japan and the US

- There are several similarities (bubble driven, unregulated financial activities, no currency crisis)
- But the US seems hesitant in recognizing the problem as in the early years of Japan

Differences

- The Japanese crisis originated from bank loans to real estate and its problem deepened slowly. The US crisis originated from securitized instruments, which quickly affected the capital market
- The Japanese crisis was purely a domestic problem, while the US crisis spread rapidly to the global markets

Crisis Calendar

	Japan	US
Bubble peak-out	From end -1989 (stock prices) to 1991 (real estate price)	Summer 2006
Initial policy response	(Private) Asset purchase	Liquidity provision
Crisis event	Nov. ‘97: Yamaichi and Sanyo failures Fall ‘98: 2 long-term credit banks failures	Sep. ’08: 2 GSEs, AIG bailed out and Lehman failed
Policy response to crisis	･Capital injection (Mar.’98,99) ･Temporary full coverage of deposit insurance ･Asset purchase from solvent banks ･prompt corrective measures	･Capital injection (Oct. Nov.) under TARP1 ･Comprehensive stress testing under TARP2 ･Asset purchase of legacy loan/securities
Final stage	･2002~ Program of Financial Revitalization/Strict inspection	
Duration	1991-2005 (1998 – 2005)	2007 - 2014?

4. The US Financial Crisis

(2) Performance of the US banking system

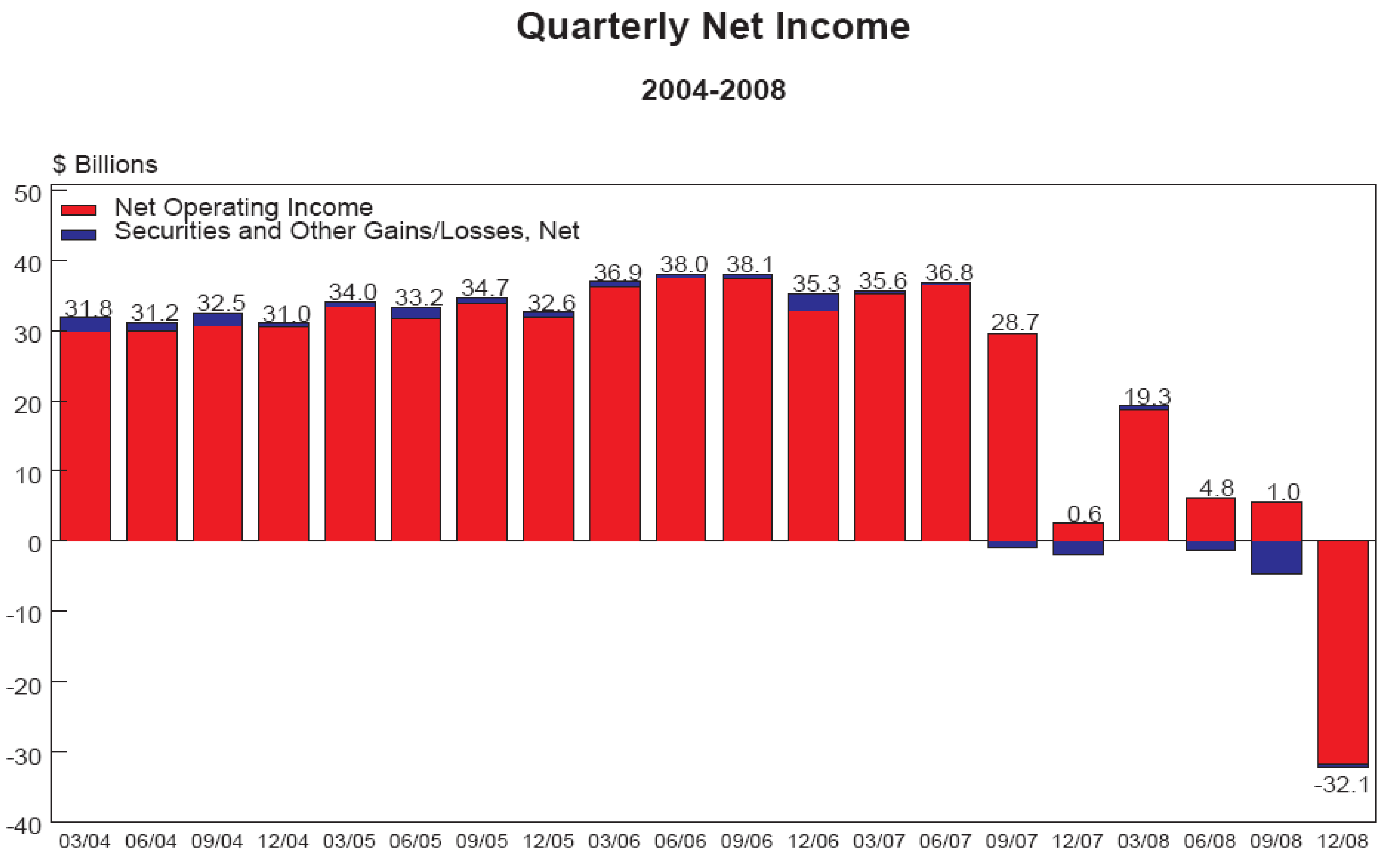
- The FDIC Quarterly Banking Profile shows that as of 31 December 31 2008, Tier-1 capital is $1,296 billion, of which $1 trillion is tangible equity while the rest is goodwill and other intangibles. The loans outstanding are $7,873 billion.
- The reserve coverage ratio (noncurrent loans covered by loan loss reserves) has declined from over 220% in 2005 to slightly under 80% in 2008.
- The US banking system has over $753 billion of capital shortfall, based on a very generous “stress test” scenario assuming NPLs peak at 8% of loans and a 100% coverage ratio (see table by Pomerleano)

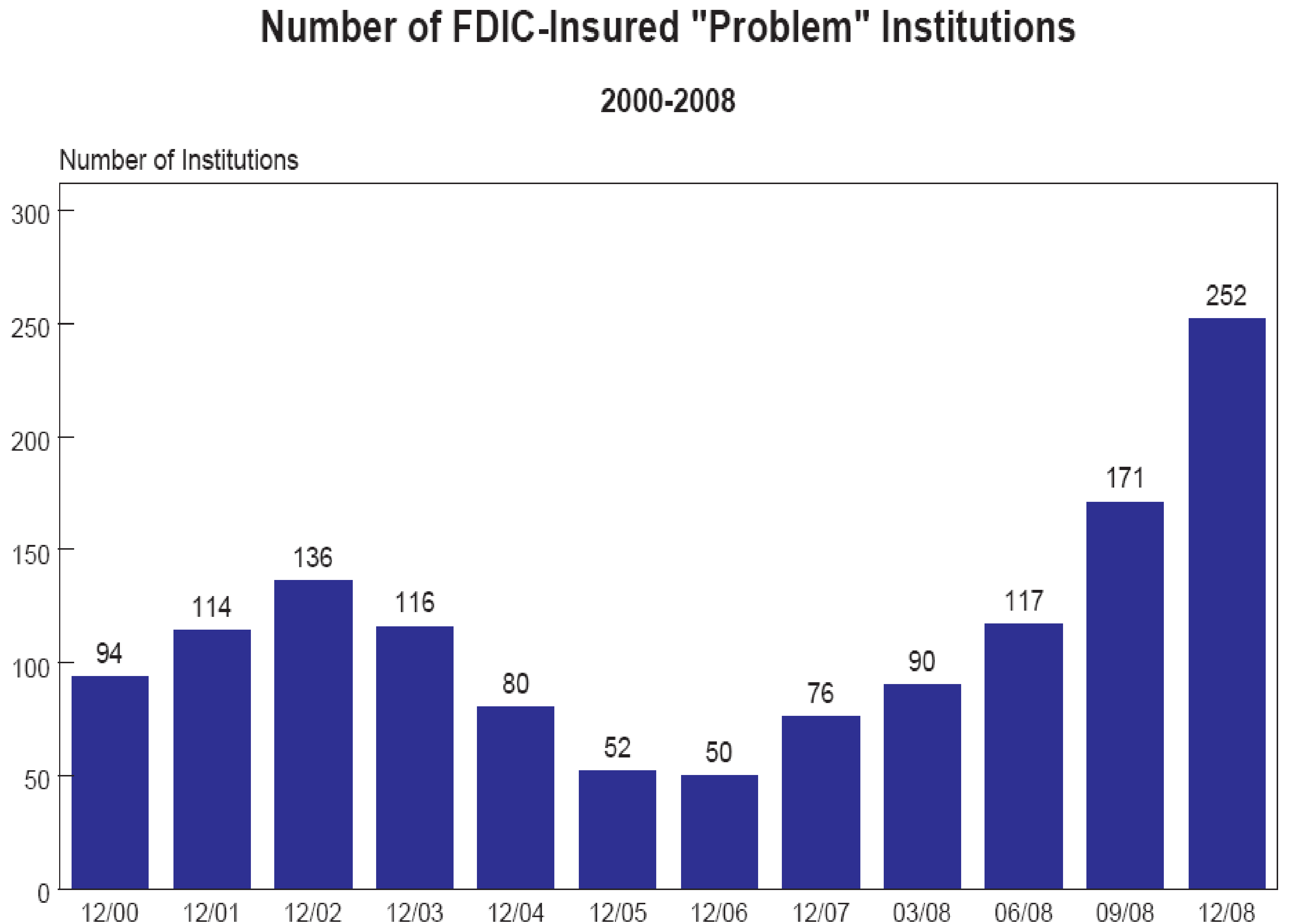
“Stress test” shows that under the most generous assumptions 750 billion is needed for bank capital

Capital Shortfall		753
Stress test assuming NPLs peak @ 8%		
Assumptions: 8% NPL, 100% Coverage Ratio		
in $bn		4th Qt 2008
Tier 1 Equity Capital		1,296
Tangible Equity		1,000
Not Tangible Tier 1 Capital		296
Loans		7,873
Noncurrent Loans ($ Billions)		231
Loan-Loss Reserves ($ Billions)		173
Coverage Ratio (%)		75%
Loss Allowance to Loans and Leases(%)		2.2%
Annual		
Profit	Conservative estimates	10
NPLs	8%	630
Required Loan-Loss Reserves ($ Billions)	100%	630
Additional LLR		457
Tier 1Equity Capital		839
Tier 1 Shortfall to have Tier 1 Tangible at least		753

Source: Calculations by Michael Pomerleano, using FDIC data

Earnings of commercial banks and savings institutions




Number of FDIC-Insured "Problem" Institutions
2000-2008
Number of Institutions
300
250
200
150
100
50
0
94
114
136
116
80
52
50
76
90
117
171
252
12/00
12/01
12/02
12/03
12/04
12/05
12/06
12/07
03/08
06/08
09/08
12/08

4. The US Financial Crisis

(3) TARP2 (Geithner-Summers)

- The PPIP (public private investment program) for legacy assets provides a guarantee to potential investors, and by so doing, it boosts their bid prices thus facilitating the removal of troubled assets from banks' balance sheets.
- By removing the uncertainty associated with these assets from banks' books, they will be willing to take more new risks through lending
- "Stress test" is based on stringent assumptions to identify losses and capital needs.
- With insufficient capital, a bank needs to raise capital from the market or, if necessary, will be capitalized with public funds

4. The US Financial Crisis

Problems with PPIP (Geithner-Summers)

- One of the problems of PPIP is that banks with troubled assets may not have sufficient incentives to sell them to investors. The banks do not have to accept the bid, and they will do so only when the bid is higher than they want
- The CDOs and other securities are probably reserved and marked to market and available for sale. But CDOs are very hard to dispose of (due to aggregation problems)
- The real problem is in the banking book that is much higher (60%) and is not marked to market, and not adequately provisioned
- Another criticism is that PPIP will create massive transfer from the taxpayer to the private investors

5. Conclusion

- The Japanese government failed to tackle the problem early and quickly because of: the slow development of the crisis; underestimation of the seriousness; optimistic expectations of growth; sustained fiscal spending; and lack of domestic and external constraints.
- A comprehensive framework for bank resolution put in place after the 1997-98 crisis was decisive: temporary nationalization of non-viable banks; public capitalization of weak banks; tighter loan classification through stringent "special inspection"; aggressive NPL reduction through a regulatory program; and new institutions for corporate debt restructuring

5. Conclusion

- The US has set up TARP1 and TARP2, although the private-public investment program (PPIP) under TARP2 has been criticized by experts
- Recognition of the severity of the problem (potential losses) is the first step towards crisis resolution. The ongoing “stress test” of the US largest banks is a good starting point
- Sufficient (excessive?) incentives are now given to investors to purchase bad assets from banks under PPIP, but banks may not have sufficient incentives to sell them and realize losses
- The US government may have to adopt tight regulatory measures to force banks to reduce NPLs, or may have to nationalize many banks

Thank you
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