“Comments on Hoshi and Kashyap,
“Will US Bank Recapitalization Plan Succeed? Lessons from Japan”

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Memorable Quotes, US Treasury Secretary on Japanese NPL

• “Why don’t Japanese banks **foreclose NPL properties and auction them**. Once the bottom is found, real estate prices have only one way up, and the investors will be happy to purchase them”

  – US Treasury Secretary in a private meeting with economists in Tokyo, sometime during the lost decade of Japan
(1) Opening Question

• It seems that “US now” is NOT following what US told Japan (and Asia) 10 years ago—three possibilities
  – (A) American advices 10 years ago were totally wrong
  – (B) Americans are not doing right things right now
  – (C) The two crises are fundamentally, totally different in nature?
Housing (Real Estate)
Boom and burst

- Japanese housing bubble (1980s)
  - 3-fold increase in 6 years
  - All lost in the following 12 years
- Is this what will happen in US?
  - More than double in 8 years
  - Just lost 20% from the peak
Land price index for housing, Japan
Is US following Japanese footsteps? --16 years later
US housing prices may fall further

• Compare the Japanese boom and bust (Land for Housing index) with US boom and bust (Case-Schiller)
• Maybe US is only the 3rd inning of the bust process, if the parallel holds
• Maybe 700 billion may not be enough, if US starts to buying distressed assets
Crisis Mechanism

• Bubble and Burst
  – How bubble was formed and encouraged
    • Starting point, good fundamentals
  – Why did the authorities not take actions
    • No other bad signs like inflation
    • Reason to believe good fundamentals explain a boom
Root of crisis (1)

• Japan
  – Real Estate Bubble and bursting bubble
    • Both housing and commercial
    • Belief in ever-increasing land prices
    • No check on borrowers because of secure collateral
    • “Step interest rate loan” to ease income constraint
  •

• US
  – Housing Bubble and bursting bubble
    • Mostly housing
    • Belief in ever-increasing housing prices
    • No check on borrowers because of securitization ⇔ moral hazard (originate “to” distribute)
    • Teaser rate for first two years, time bomb
Root of Crisis (2)

- **Japan No securitization**
  - Banks kept loans on their balance sheet
  - Losses hid in subsidiary and creating accounting

- **US Securitization**
  - Too complex senior/mezzanine/equity, CDOs
  - Conflict of interest in credit rating
  - Hid in subsidiary: Potential losses in SIV, not on B/S of banks
Failed business models

differences

- **Japan, commercial banking**
  - Housing Loan Companies (Jusen) to fall first
  - Smaller commercial banks failed
  - Four large banks failed (1997-2003)
  - Several rescue and strategic mergers of large banks

- **US, investment banking**
  - Large investment bank fell
  - Crisis spread to Fannie and Freddie, MMF, insurance company (AIG), Big 3 auto companies, (and more?)
Crisis Management, common pattern

- Common pattern (S&L, Nordic, Japanese, and now the US)
  - Refuse to recognize ("No problem")
  - Forbearance, Recognize, but regard it to be a small problem—no action
  - Try to take action, but fail to win public support ("Why tax payer’s money?")
  - Action, but too little, too late
  - Big crisis happens and big action becomes possible
Crisis Management

• Japan
  – Forbearance
    • Jusen problem to all banking system
  – Recognize, try to act, but no public support
    • Defeat of 685 billion yen stop gap
    • Distressed asset purchase—good bank-bad-bank model
  – Act, too little too late
    • Capital injection, No. 1
  – Big crisis, big action
    • Public money injection 40 trillion yen
    • Capital injection No.2

• US
  – Denial
  – Forbearance
    • (Aug 2007->March 2008)
  – Recognize, try to act, but no public support
    • Bear Stearns rescue
    • Refusal of first TARP in Senate
    • TARP difficulty
  – Act, too little too late
  – Big crisis, big action
    • Change TARP to capital injection
    • Make investment bank to commercial bank (holding company)
### Key moments, crisis management

#### Japan

- **November 1997**
- Failures of Sanyo Securities, Hokkaido Takushoku Bank, and Yamaichi Securities
  - Sanyo default in the call market
  - Financial institutions become skeptical each other
  - Freeze of the call market
  - Japan premium
- Legal framework was not ready (supervision mistake)

#### US

- **September 2008**
- Lehman failure
  - Financial institutions become skeptical each other
  - Freeze of money markets
  - Western Premium
- Legal framework was not ready
- Failed business model of investment banks (supervision mistake)
Key Moments: deposit guarantee

Japan

• Blanket deposit guarantee, 1995-2003
• Arrange rescue mergers
  – Many regional banks
• Temporary nationalization of banks, 1998-2003
  – LTCB, 1998
  – NCB, 1998
  – Resona, 2003

US

• Deposit guarantee ceiling raised from $100,000 to $250,000, proposed
• Capital injection into banks by the government
• Arrange rescue mergers
  – Bear and Stearns
• Nationalization?
  – AIG
Key moments: Capital injection

Japan

• Denial of capital injection, Feb 1995
• 685 billion yen to help resolve Jusen companies (small housing finance companies) were denied in the budget process
• Two years later, 40 trillion yen was needed to help large banks
• Capital injection to large banks, March 1998 and March 1999
• Capital injection first resisted by banks for fear of dismissal of management
  – In the end, no management responsibility pursued

US

• TARP was first voted down by the House of Representatives
• One week later, TARP was passed
• A few weeks later, an aim of TARP changed from purchasing distressed assets to injecting capital (preferred shares) to large banks
• Capital injection first resisted by banks for fear of dismissal of management
  – In the end, management pay restriction
A series of policy actions

  - Blanket deposit guarantee
  - Lax accounting standard on NPL => “evergreening”
  - No action on lack of capital shortage
  - Arrange rescue mergers
  - Blanket deposit guarantee (1995)
  - Capital injection (1998, 1999)
  - Create a legal framework to fail banks (until 1998)
  - Fail life insurance companies
  - Arrange mergers (of smaller institutions)

- **US (2008)**
  - Bail out investment banks
  - FRB buys (almost) any assets, expand B/S
  - Arrange rescue mergers
  - Loss guarantee for distressed assets taken over by rescuing institutions (Bears-JPMorgan)
  - Bail out AIG
  - Explicit guarantee for Freddie and Fannie
  - Deposit guarantee (MMMF) and raise ceiling (FDIC)
  - Stop mark-to-market accounting
Policy role: Monetary policy

**Japan**

- Was monetary policy responsible for creating a bubble?
  - Low interest rate, 1987-89
- Was monetary policy too tight for mitigating the damage from a bursting bubble?
  - Too slow cutting the interest rate, 1992-1999
  - Should BOJ have adopted the ZIRP (maybe 1995?)

**US**

- Was monetary policy responsible for creating a tech bubble, 93-99?
- FRB learned from the Japanese mistake of bursting a bubble too aggressively, so massive cut in the interest rate 2001-02
- Responsible for creating a housing bubble, 2003-07?
  - Too low interest rate to manage the tech bubble burst?
  - Too slow in increasing the interest rate to prevent the next bubble?
- FRB is again cutting the interest rate very quickly, 2007-2008
- Will FRB adopt the ZIRP (another lesson from Japan)?
Comments on Hoshi and Kashyap

• Role of Asset Purchase
  – For what?
    • Help banks (purchase price > market/fair price)
    • Loss cut. Prevent further/future losses
    • To create markets (S&L bulk sales, not this crisis)
  – Who funds it?
    • Banks’ own money (initially in Japan) → no advantage (except for tax) to banks
    • Tax payers’ money → will work but difficult to say help banks
Japanese and Asian experiences

- Easier, faster to do capital injection and/or nationalization, if banks’ capital is too small.
- Evaluation of fair price takes time
- Legal power to threaten banks is a key
- Temporary nationalization (wipe out shareholders’ equity and change of management) is faster, better solution for really distressed banks—then take time to evaluate and sell assets
- Corporate restructuring (ICRJ) has to go with bank restructuring
Comparison, summary

• Similarities
  – Rejection of using tax payer’s money, and regrets
  – Capital injection into bank
    • Reluctance on the part of banks due to string attached
    • Then, force down the throat, and across-the-board
  – Accounting, mark-to-market suspended
  – Lack of capital
  – Nationalization (faster way of restructuring)
  – Loss guarantee (for white knights)

• Differences
  – Speed, “dog year” difference (Japan’s 10 years vs. US 10 quarters)
  – Central bank purchase of assets, more aggressive in US
Any Lessons from Japan?

• (Q) Negative lesson?
  • (A) Japan was too slow in recognizing the problem and taking actions → US is doing much better

• (Q) Positive lesson?
  • (1) How to reestablish “trust” in interbank market? → recapitalization of banks; and no failures for several months; clean up balance sheets by buying distressed assets
  • (2) How to deal with failing banks? → Give power to FSA (FDIC-in US) to takeover banks (determine later whether insolvent or not—shareholders’ interest may be wiped out) and replace management and workout NPLs; depositors and counterparties protected.
  • Power to do corporate restructuring is important
  • (3) Final resolution did not come until land priced stop declining, 2003 in Japan; 201x in US.
References


• Takeo Hoshi and Anil K Kashyap, “Will the U.S. Bank Recapitalization Succeed? Lessons from Japan, NBER working paper, no. 14401 October 2008