

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

Takatoshi Ito
University of Tokyo
AEA January 5, 2009
San Francisco

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

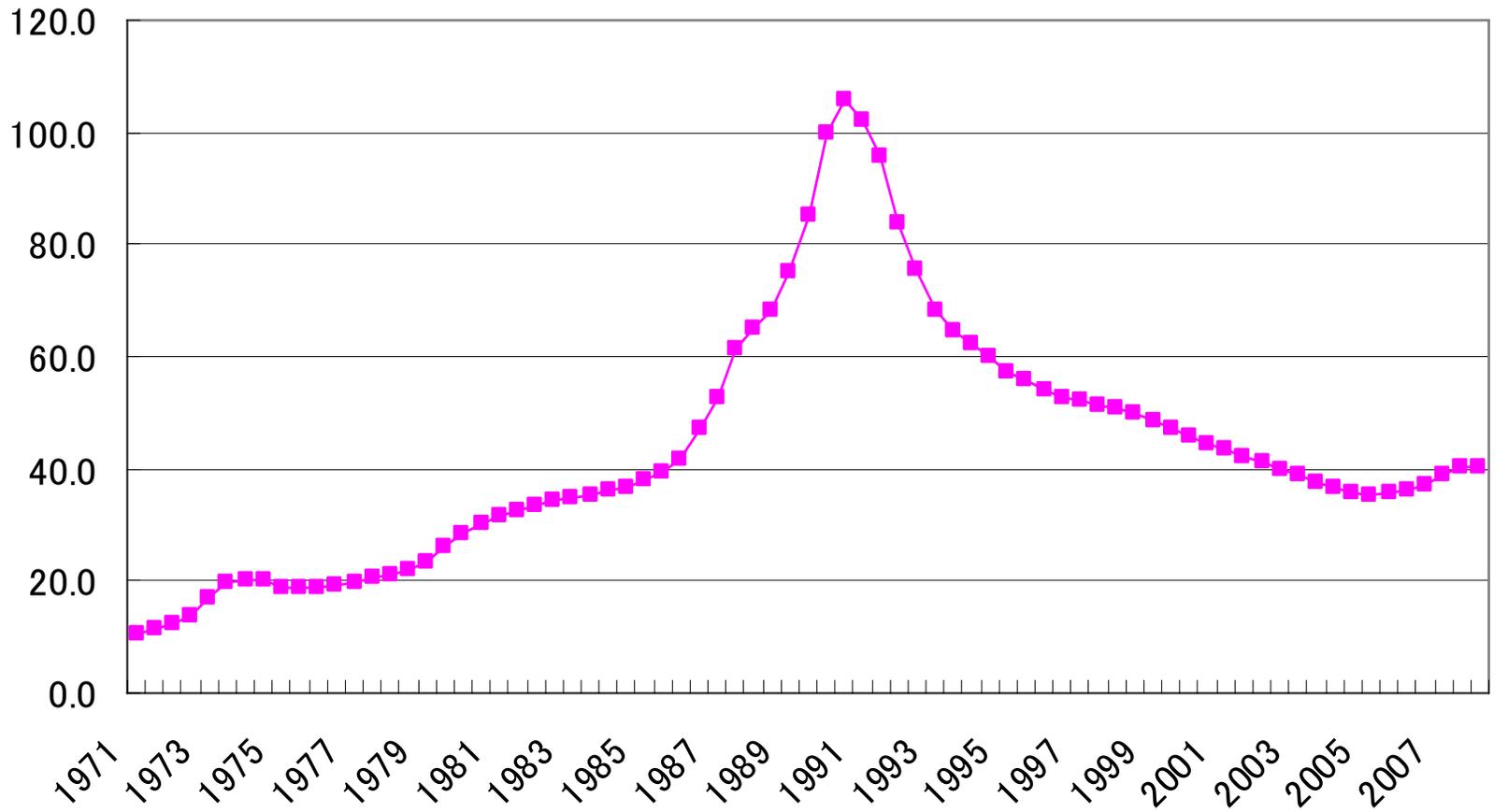
(1) Opening Question

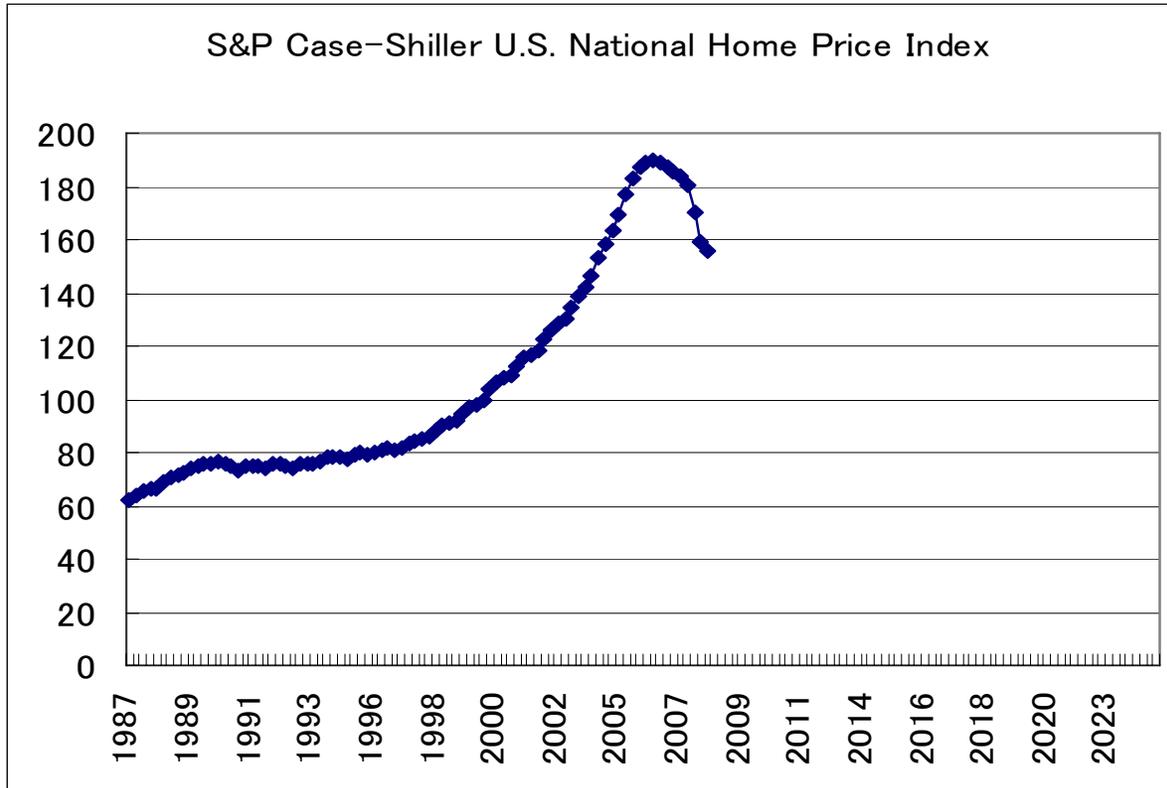
- It seems that “US now” is NOT following what US told Japan (and Asia) 10 years ago—three possibilities
 - (A) American advices 10 years ago were totally wrong
 - (B) Americans are not doing right things right now
 - (C) The two crises are fundamentally, totally different in nature?

Housing (Real Estate) Boom and burst

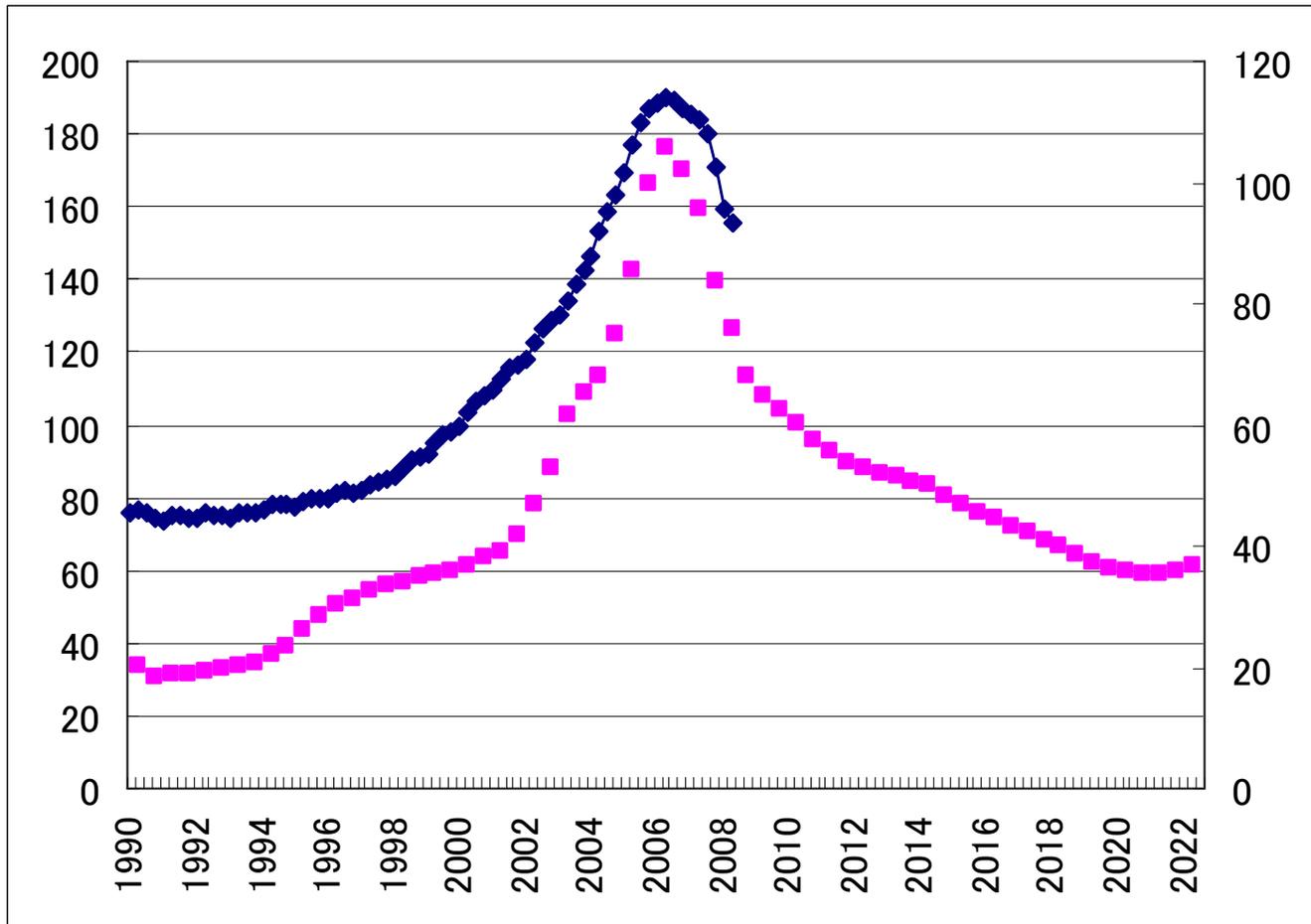
- Japanese housing bubble (1980s)
 - 3-fold increase in 6 years
 - All lost in the following 12 years
- Is this what will happen in US?
 - More than double in 8 years
 - Just lost 20% from the peak

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
 - Denial (1992 – 1995)
 - 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 N0.2
- 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

US

- 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)
- 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

US

- Blanket **deposit guarantee**, 1995-2003
 - **Capital injection** into banks by the government, 1998, 1999, 2003
 - Arrange rescue mergers
 - Many regional banks
 - Temporary nationalization of banks, 1998-2003
 - LTCB, 1998
 - NCB, 1998
 - Resona, 2003
- **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

US

- 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
- 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

- Japan (1995 – 1997)
 - 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)
 - Nationalization (1998-2003)
 - 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

US

- 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?)
- 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) \rightarrow no advantage (except for tax) to banks
 - Tax payers' money \rightarrow 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

- Cargill, Thomas F.; and Michael M. Hutchison; and Takatoshi Ito, *Financial policy and Central Banking in Japan*, MIT Press, 273 pages, January 2001.
- Ito, Takatoshi and Frederic S. Mishkin. “Two Decades of Japanese Monetary Policy and the Deflation Problem,” in T. Ito and A. Rose, (eds.) *Monetary Policy with Very Low Inflation in the Pacific Rim*, NBER-University of Chicago Press, 2006: 131-193.
- Takeo Hoshi and Anil K Kashyap, “Will the U.S. Bank Recapitalization Succeed? Lessons from Japan, NBER working paper, no. 14401 October 2008