Financial System Reform: Recovery or Retrogression?

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INTRODUCTION

The Japanese finance system has attracted a stream of international attention in the last decade, from Krugman likening Japan to the return of the depression economics of the 1930s, to Citrin and Wolfson heralding the return of Japan to respectable growth.¹ More recently several observers draw lessons from Japan's experience for the current crisis, drawing on the parallels between Japan's 'Lost Decade' and the Great Depression of the 1930s.² This suggests that after a long period of 'Japan passing', Japan's experience is in no longer being overlooked by international commentators. But what lessons are being taken from it?

Most discussions of Japan's experience during the 1990s suggested the lessons to be learnt for the international community were largely negative. Commentary focused particularly on bad policy in the banking crisis. The policy of 'forbearance', where both regulators and bankers try to wait out problems and do not take action against underperforming banks (in the case of regulators) or borrowers (in the case of banks), prolonged problems and ultimately resulted in real, not just financial, economic distress. Attention to these lessons often concluded with 'don't do what Japan did'. Additionally, it was argued that Japan's fiscal expansion during the 1990s showed the failure of Keynesian stimulus policy both because it had no effect and because it led to a build up of government debt.

The reality, as demonstrated in the economic data was, however, more complex. By 2006 Japan had its longest period of economic expansion since the Second World War and was amongst the strongest growing OECD countries. Bank health had been restored, corporate profitability recovered and unemployment, and government deficits, were reducing. The growth was based not only on exports but

also on domestic consumption.³ Wolf, drawing on Koo, concluded that Japan demonstrated a quite different set of lessons.⁴ In the face of a potentially devastating financial crisis what is needed is immediate recapitalization of banks and really large fiscal injections of demand by the government. The mistake Japan made was to take too long to do this but the direction of the policies, when eventually implemented, was right and necessary. This was, in fact, the path followed by most countries hit by the global financial crisis of 2008–9.

This chapter will argue another element of an alternative view to the commentary on Japan's financial 'mess'. While forbearance was a mistake in Japan's circumstances, it was understandable in the initial phase and in different circumstances could have been the right policy. More importantly, the eventual policy design for 'micro prudential' management (i.e. the supervision and regulation of banks) could now be a model for the world (though macroeconomic management remains poor). This chapter first examines the financial elements of Japan's 'Lost Decade' and how the recapitalization and reform of banks shaped the slow and stumbling path to a solution. Through the change in the regulatory structure that followed, not only was a technical change seen, but the political economy of banking regulation was also changed. With the Takenaka Plan in 2002, Japan was at last seen to be 'banging heads together' and implementing steps for substantial change. Part of this process involved some far reaching reforms of the system for managing poorly performing banks, which have given Japan a leading-edge policy framework with lessons for other countries.

BACKGROUND TO CRISIS

A prominent feature of Japan's poor economic performance and banking crisis of the 1990s was the long, slow build up that preceded the worst years. During this time, from the initial drop in growth in 1990–1 to the mid-1990s, there was a belief that asset prices would recover and that banks' unrealized capital gains (that is, the value of the corporate shares they held which were valued at their initial purchase price rather than the market price) would support their balance sheet recovery. Coupled with the denial of the emerging scale of bad loans (since reliable data were not available at the time), there was an attempt to preserve the so-called 'convoy system' in which the Japanese Ministry of Finance (MOF) would keep all banks afloat and keep the whole 'convoy', the set of all banks, moving at the pace of the slowest. The method to do this involved MOF-orchestrated agreements for the rescue of weaker banks by stronger ones, which were neither public nor transparent. With the mishandling of the politics of the *jūsen* crisis, when housing loan associations backed by the banks lost money and a rescue scheme to restore the banks'

lost capital was proposed, MOF's reputation was damaged and public antipathy to rescue packages for banks rose. Both factors contributed to the slow response by the authorities to the gathering storm. Early warning signs could have been seen in the failures of Tōhō Sōgo in 1991 (absorbed by another mutual institution with assistance from the Deposit Insurance Corporation of Japan (DICJ)); of Tōyō Shinkin (absorbed by Sanwa Bank with assistance from DICJ, Industrial Bank of Japan (IBJ), and Zenshinren) in 1992; of Cosmo and Kizu credit unions in 1995, and of Hyogo Bank (reorganized as Midori Bank with assistance from city banks, the Bank of Japan (BOJ), and DICJ). The foreign financial markets certainly saw these as a warning and began to charge Japanese banks a premium over the standard rate of interest at which banks lend to each other in the international market, the so-called 'Japan premium', because they perceived Japanese banks to be in a fragile state and, therefore, not good credit risks.

Despite these alarm bells, the slow build up of the crisis continued as the situation deteriorated with several bank failures in 1996. By April 1997, the MOF and BOJ had to lead a rescue, with financial assistance from other banks and insurance companies, for the Nippon Credit Bank, a large, specialist institution making long-term loans to big customers for physical investments in factories, construction and infrastructure. In autumn 1997 several large credit unions received assistance from DICJ to merge. The real crisis came in November 1997 with the failures of Sanyo Securities, Hokkaido Takushoku Bank and Yamaichi Securities and, at this point, the Japan premium rose sharply so that Japanese banks were paying nearly a full one percent more than the standard lending rate to borrow in international markets.

RESCUE THEN REFORM

Against this background the government arranged a series of packages to inject capital into banks and to guarantee deposits. The Prompt Recapitalization Act (October 1998) set aside ¥25 trillion for capital injection, in addition to the ¥17 trillion for deposit protection and ¥18 trillion for nationalization. ¥7.5 trillion was directed at fifteen major banks in March 1999, with varying terms, although the first attempts at recapitalization put money into all banks whether they needed it or not in an attempt to protect the reputation of the weaker ones. A further ¥0.5 trillion was directed to twelve regional banks by March 2001 when the act expired.

These developments have been described in many other places, so the details need not be repeated here, but the consensus view on the recapitalization plans is well-represented by Hoshi and Kashyap.⁵ They argue that the recapitalization attempts in 1998 and 1999 did not have sustained impacts. Furthermore, the authorities were either uninformed or unwilling to face further public criticism so

their recapitalization attempts were muted until much later. From late 2001 to early 2002, the Financial Supervisory Agency conducted 'special inspections' but announced that all banks were well capitalized and did not need further capital injections, though, in fact, as Fukao has argued, the banks were still financially weak at that time.⁶ Hoshi and Kashyap conclude that what eventually restored the banks was the combined effect of the Takenaka plan and macro-economic recovery. The eventual effect of reform and recovery can be seen in Chart 1, showing the amount of non-performing loans which continued to rise until the end of 2001 but began to decline rapidly and significantly after that. Subsequent recapitalization plans in the 2000s were more effective because they were targeted at weak banks, rather than the blanket approach used in the earlier attempts of the 1990s, and they had stronger conditions attached. The Act for Strengthening Financial Functions (ASFF) was passed in June 2004. That law allowed the government to inject public capital into banks without justifying their systemic importance. In 2006, ¥40.5 billion was injected into two regional banks under this law. When the law expired at the end of March 2008 it was revived in December 2008 so that the government could continue to inject capital into the banking sector when deemed necessary. In March 2009, ¥121.0 billion was provided to three regional banks. The Japan premium in international markets spiked briefly in 2001–2, though at much lower levels than previously, and then settled at a level barely above the international norm, suggesting that the market regarded the whole package of support for Japanese banks to have removed counterparty risk.⁷

While attention was focused on these large sums of money, several other elements of the reform programs for banks and their regulation

Chart 1 Source: Financial Services Agency, 'Status of Non-Performing Loans', <http://www.fsa.go.jp/en/regulated/npl/index.html>.

were arguably more radical though less well known. A classification by Hoshi and Kashyap of Japan's policy response into four key elements is useful.⁸ One element, the recapitalization programme, has been described above. Another element was the Takenaka plan of 2002. Takenaka Heizō became the Minister of Financial Services and announced the 'Programme for Financial Revival' in October 2002. The key elements of the Takenaka Plan were to require banks to make a more rigorous evaluation of assets using discounted expected cash flows or market prices of non-performing loans. The plan also proposed to cross-check consistency between different banks in classifying loans to large debtors. Any discrepancy between the banks' self evaluations and the FSA's evaluations were to be made public to discourage banks from hiding problems. A key reform was to prohibit banks from declaring unrealistically large deferred tax assets (a technical element on balance sheets which many observers believed was allowing banks to appear to be in profit when they were not) and, importantly, to impose business improvement orders for banks that substantially underachieved the revitalization plans. The Takenaka plan therefore put much tougher conditions on banks both before and after they received public capital injections. The result was the turnaround in the non-performing loans ratio of the major banks, as shown above, to about half by March 2005. Crucially, Takenaka also wanted a *prior commitment* that the government would be prepared to inject public funds if necessary rather than relying on the piecemeal response to crisis of the past. This plank of the reform was directly related to other forward-looking features described below.

Two other elements of the reform plan, largely unnoticed outside Japan but in fact quite remarkable by international standards, were the creation and use of asset management companies and the resolution mechanisms for failed banks introduced by the Financial Revitalization Act of 1998. These two features heralded the shift away from the old 'convoy system' and the use of what might be called a 'modern' approach to banking reform. What the change achieved was a public commitment to the idea that banks could be closed or nationalized and that even big banks could fail. Together with the Takenaka conditions, these created a near comprehensive set of conditions that spell out what will happen to individual banks in distress and what the government will do in the event of a systemic crisis.

The process involved several elements. Responsibility for bank supervision was removed in stages from the MOF and eventually the Financial Supervisory Agency (FSA) replaced the MOF role entirely, using a rules-based regulatory approach. The rules-based approach was designed to remove the problem of discretion and forbearance by regulators, so that if inspection revealed any problems, rules dictated the 'prompt corrective action' to be taken. While this was originally an American idea, backed by the IMF as best-practice, its use in Japan

coincided with its abandonment in the UK and, to some extent, in the US itself, in favour of the so-called 'principles-based' approach which handed responsibility for compliance to the banks themselves and which has been blamed for some of the conditions that led to the global financial crisis at the end of the first decade of the twenty-first century.

This process of establishing a new supervisory agency began with the Financial Revitalization Act of 1998 that established the Financial Reconstruction Commission (FRC). A key power of the FRC was the authority to decide whether a failed bank should be nationalized or put under receivership. Weak banks were allowed to apply for nationalization and the most prominent example was the Long-Term Credit Bank (LTCB) which applied to be nationalized in October 1998. The FRC also forced the nationalization of Nippon Credit Bank in December 1998 while several other failed regional banks were put under receivership between 1999 and 2001. The FRC was aggressive under its first chair, Yanagisawa Hakuo, but less so after he was replaced in October 1999. When the Prompt Recapitalization Act expired, the FRC was subsumed into the FSA in January 2001. Though initially there was concern about the resources and expertise of the new regulatory body,⁹ it is now large and well-resourced.

At the same time, various methods for removing bad assets from banks' balance sheets were tried. This process of experimentation with asset management mechanisms (as the methods for taking toxic assets off banks' balance sheets are known) was part of the eventual development of a well-developed process for handling failing banks. Despite the initial disorder surrounding the change in regulatory structure of this period, key decisions were made that led to a largely unheralded 'micro prudential' reform. Though the formulation process took some time, Japan's structures are now quite remarkable.

Japan's response to the growth of bad loans in the banking system at the beginning of the 1990s began with allowing banks to set up their own asset management companies, many of which simply turned into warehouses of non-performing loans. The result was rather similar to the problem of the structured investment vehicles (SIVs) used by US banks to remove bad assets from the regulated institution (the bank itself) to an unregulated institution, without addressing the problem loans themselves. However, the intended purpose of removing bad assets from banks' balance sheets from the policy maker's viewpoint, is to enable banks to make new loans, unconstrained by the need to provision or to hold capital against loans that will never be repaid.

There is no agreement on the best way to manage banks' bad loans in a crisis. An influential study at the World Bank notes:

The two alternatives for asset management strategies include setting up a government agency with the full responsibility for

acquiring, restructuring, and selling of the assets (the centralized approach) or letting banks and other creditors manage their own non-performing assets (the decentralized approach).¹⁰

However, in practice the distinction between centralized and decentralized is not completely straightforward. Decentralized methods of restructuring debtors have been located both inside banks (keeping the loans on the books, with the bank taking an active role in reorganizing the defaulter) or outside the bank via an off-balance-sheet vehicle or 'bad bank' which takes all the non-performing assets and works exclusively on those. The advantage of the 'bad bank' approach, as Klingebiel points out, is to 'maximize the recovery rate through active restructuring reducing drains on managerial capacity and improving overall incentives'.¹¹ Lindgren and Balino et al. show that within Asia, the private solutions (i.e. not centralized) frequently included the creation of private asset management companies (i.e. 'bad banks') and, in the best examples, resulted in the development of a private asset management industry where one had not existed previously.¹²

Centralized asset management mechanisms also come in different varieties, with centralized, publicly-funded AMC's set up either to help corporate restructuring or merely to acquire bad loans from banks and to dispose of the assets. Klingebiel's study of seven cases indicates that most did neither job very well and concludes '[centralized] AMC's are rarely good tools to expedite corporate restructuring'.¹³

As it struggled to build a policy framework to cope with the growing bad debts of the 1990s, Japan established first the privately-financed Cooperative Credit Purchase Company (1993) to allow banks to transfer loans off their books and claim tax deductions, then, with a major amendment to the Deposit Insurance Law in 1996, the Housing Loan Administration Corporation (HLAC) to resolve the *jūsen* housing loan crisis and the Resolution Collection Bank (RCB) to receive the assets of failed credit cooperatives (both nominally under the control of the DICJ). As more financial institutions failed during 1997 and 1998, there were further amendments to the DICJ Law, and the HLAC and RCB were merged to form the Resolution and Collection Corporation (RCC) and the Bridge Bank of Japan in April 1999 and March 2002, respectively. The RCC had the combined functions of recovering loans from the former *jūsen* companies, the purchase and collection of non-performing loans from failed financial institutions, the purchase and collection of non-performing loans from sound financial institutions and subscribing shares to enhance capital adequacy of financial institutions. It was also charged with the pursuit of civil and criminal liabilities of former executives and debtors of failed financial institutions. Thus the DICJ, through its subsidiaries, acquired multiple functions relating to deposit insurance, to the disposal of non-performing loans and to the management and recapitalization of ailing financial institutions. What the

DICJ was not required to do was to take on the restructuring or 'revitalizing' of ailing corporate borrowers which was left to the private banks to achieve.

Despite these multiple institutional developments, criticism of slow reform in the financial sector grew. As a result, the countermeasures deflation package of February 2002 called on existing institutions (FSA, DIC and RCC) to become more aggressive in their purchase of NPLs. The responsibility for corporate restructuring still lay with the banks which were encouraged to set up corporate reconstruction funds ('deleveraging funds') with help from the Development Bank of Japan.¹⁴ Even under the Takenaka plan there was no shifting of responsibility for corporate restructuring away from the banks to a central or government organization. But as the view that the private sector was making unacceptably slow progress on corporate restructuring grew, the government established a new public institution to take the lead. A Strategic Headquarters for Industrial Revival and Employment, headed by the Prime Minister, was put in place late in 2002, and subsequent bills established the Industrial Revitalization Corporation of Japan (IRCJ) to purchase loans of companies that could be rehabilitated and to supervise the restructuring. The IRCJ thus took on the role of buying bad loans from borrowers that could be expected to be rehabilitated within three years of the purchase of the loan. The structure is illustrated in Figure 1.

This moved Japan from a model of an asset-disposal type AMC to a restructuring one with an active role in corporate workouts. The IRCJ was successful in winding up a small number of large borrower

Figure 1: Industrial Revitalization Process by IRCJ. Source: *Nihon Keizai Shimbun*, 20 December 2002.

companies where banks had been unable to do the task themselves but, more importantly, its role was in due course superseded by the development of an active private market in corporate restructuring.

The other element of the new approach was the significant strengthening of the DICJ, giving it a clear mandate to close failed banks in addition to its role in managing impaired assets. The legislation of October 1998 made this clear by creating the mechanism to close down large banks, resulting in the nationalization of the LTCB and NCB (Nov 1998). Established in 1971, DIC Japan had been small, underfunded and known to have inadequate capital to cover insured deposits even when these were limited to the 10 million yen per deposit limit that applied before the blanket insurance. With the introduction of a blanket, hundred percent protection for all time and demand deposits, there was a big increase in the funding for DICJ, which rose steadily to 2003 when the model finally changed to stable, long-term funding. The DICJ is now supervised by MOF and FSA but the Governor and Deputy are appointed by the Prime Minister so that it has a significant degree of independence. The main function of the DICJ is now the winding up of failed and failing banks.

The process now in place is illustrated in Figure 2.

LEARNING LESSONS FROM JAPAN

With these reforms, Japan's system moved from a haphazard and non-transparent process of MOF-orchestrated, private workouts for failing banks to a system with clear intervention procedures. The failures of 1997–99 demonstrated how procedures would operate for both large and small banks and, significantly, showed that banks could be closed. Although the 2003 rescue of Resona Bank when it was known to be failing and was not obviously systemically important, set back the credibility of the system, Japan's system is arguably, now, a state-of-the-art procedure for dealing with failing banks. Surprisingly this cannot be said about many other countries including the UK and Australia.

Despite an active academic literature on the need for, and best design of, procedures to close banks when they fail, the 1998 comment by Aghion et al. remains distressingly applicable:

In most recent banking crises bank regulators have been caught off their guard and have been forced to respond to the crisis in a hurry without the support of an institutional or legal framework designed to deal with bank failures. Unfortunately most bank regulations ... are concerned with the ex-ante problem of how to avoid bank failures and few rules have been devised on how to deal with bank failures when they occur.¹⁵

Figure 2: The Winding-up process. Source: Deposit Insurance Corporation of Japan, Annual Report, 2007.

Recent studies of those countries that do have resolution procedures show that, while there is variation in the institutional structure of bank failure resolution policies in different countries, those 'where the deposit insurer has the responsibility of intervening in failed banks and the power to revoke membership in the deposit insurance scheme are more stable and less likely to become insolvent'.¹⁶ Thus, while Japan

Table 1 Policy Frameworks for Bank Failure Resolution

	Separate Bank Insolvency Law	Temporary Government control	Special Resolution Regime	Toxic Assets	Specific body for winding up banks?
Australia	No	Not clear	Not clear	Not clear	No
US	No	Bridge bank option. FDIC has control as receiver. Only occasionally used.	FDICA for deposit banks. System risk exemption. Compulsory receivership when below 2% leverage ratio within 90 days.	No prior arrangement existed. Troubled Asset Relief Program (TARP) introduced in response to 2008 crisis.	Yes, Federal Deposit Insurance Corporation (FDIC) under FDICIA. ¹
UK	Yes	Bridge bank and nationalization options. BoE has control as administrator or through exercise of stabilization powers. Nationalization used twice, bridge bank once, but government now major share owner in several banks after 2008.	Banking Act 2009 for banks and building societies. Stabilization powers.	No previous arrangement. Asset Protection Scheme now introduced.	Yes, BoE may wind up bank with green light from the FSA, under the Banking Act 2009. ²

¹ Mayes, p 10.

² Mayes, p 20.

(continued)

	Separate Bank Insolvency Law		Temporary Government control	Special Resolution Regime		Toxic Assets	Specific body for winding up banks?
	Yes	No					
NZ			Use of public funds avoided through liquidation or Bank Creditor Recapitalization. Some public guarantee of a resolved bank. RBNZ has control through process of statutory management.	Statutory management.		None	No, statutory manager appointed. ³
Japan		No	Bridge bank, nationalization and capital injection options. FSA appoints administrator (generally the DICJ). Three banks nationalized, capital injection totalling JPY 12 trillion.	Financial Crisis Management Council decides if 'systemic risk' exception applies. If so, blanket guarantee of deposits by DICJ is applied. Nationalization and capital injection options become available.	Collected and disposed of by the RCC, financed by the DICJ.		Yes, DICJ. ⁴

Source: Adapted from Mayes, D. 2009, "Banking Crisis Resolution Policy – Lessons from Recent Experience". CESifo Working Paper 2823 with additional information from World Bank. 2007. "Bank Regulation and Supervision", database of banking regulation, <http://econ.worldbank.org/>.

³ Mayes, p 28.

⁴ DICJ, 2008, Overview of Japan Deposit System, mimeo, p14.

may have taken some time to arrive at a best-practice design for bank bailout policy, it now has one, while several OECD countries still do not. As Table 1 shows, in comparison with US, UK, NZ and Australia, Japan has more of the pillars of a transparent crisis response policy.

Hoshi and Kashyap draw parallels between the crisis in Japan's financial system in the 1990s and the 2008 crisis in the US.¹⁷ They set out eight lessons that can be learnt from Japan, all concerning what *not* to do. In the list are comments about Japan's approach to managing troubled assets based on the system as it was at the beginning of its crisis. There is no comment on how far Japan has travelled in the design of its system for handling a crisis should one arise now. Mayes reinforces the message of Aghion et al. a decade earlier, in lamenting how few countries had put in place the structures needed even when they could see a looming crisis, as in the example of Iceland.¹⁸ Against that background it may now be time to start looking to Japan for some positive lessons, chief amongst them being not to wait until a bank crisis sets in before designing a strategy for managing it. Mayes also notes how few have a bankruptcy plan for banks. Many countries' experience, Japan's included, show that it is much harder to design a bankruptcy plan in the middle of a crisis because bank rescues are politically unpopular. On the other hand, disorderly closures are also very damaging. Without a systematic method for closing non-systemically-important banks, there is a danger of rescuing more banks than is necessary. Carefully considering the design of Japan's system could assist in the creation of such bankruptcy plans for banks.

CONCLUSION

It appears that Japan's financial system is no longer one that should be considered in decline. Furthermore, aspects of Japan's banking and financial regulation appear to be at the leading edge of OECD countries. The test of these systems of course only comes when the next crisis occurs, and Japan's current system has not yet been tested. In addition, political commitment to following the rules that have been set up remains a critical element of how well a regulatory system will function. The current government in Japan (the DPJ government elected in 2009) has not focused on banking policy in its first year in office and has shown some signs of a willingness to roll back the disciplines that have been put in place by previous reforms. It is not possible to conclude that Japan would easily weather another financial crisis but it is clear that policy structures in place are as good as they can be on paper.

NOTES

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