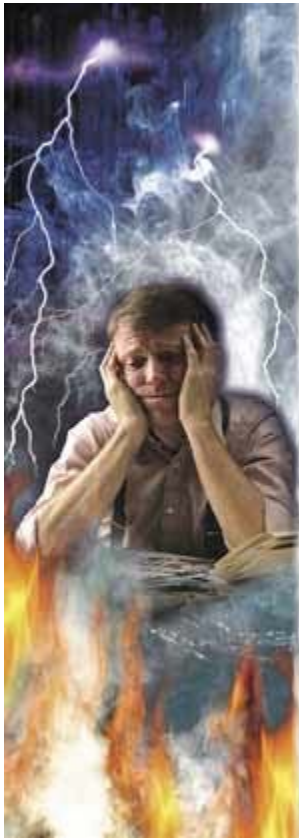


## Econ 103 Money and Banking – Dr. Douglas Rice Week 11 Lecture – Banking and Bank Performance

The text gives a very brief overview of the U.S. Savings and Loan crisis of the 1980s. In this lecture, I would like to focus on the anatomy of recent banking crises, including the banking crisis of the 1980s and the even bigger one that is still going on in Japan and the rest of Asia.



Before turning to Asia, it is worth noting that U.S. banking problems in the 1980s were not unique to S&Ls. A number of large commercial banks (like Continental Illinois) also collapsed in the 1980s. There were some common trends that impacted all banks in those years. First, interest rates had been deregulated (with the end of Regulation Q.) Second, asset prices, especially real estate, were declining. Third, commodity prices (e.g. oil and agriculture) fell sharply, having a particularly severe impact on states (like Texas) which specialized in these areas. Fourth, several Latin American countries defaulted on their debt. On top of that, banks (especially S&Ls) did not receive regulatory oversight commensurate with the significant moral hazard of federal deposit insurance. With deposits insured, depositors were putting their money in the institutions which paid the highest interest rates, regardless of the riskiness of their portfolios. Many of the S&Ls and banks were lending wildly into sectors such as commercial real estate and high-risk energy projects. There was also outright management fraud in some cases. On top of that, regulators (and government officials and legislators that they answered to) were hiding the problem to avoid a banking panic. They, of course, were hoping the situation would resolve itself. But it didn't and it ended up costing the taxpayers more than \$200 billion.

After the debacle, we got some new laws (FIRREA and FDIC Improvement Act) that led to our current regulatory system. The main innovations were higher capital requirements, risk-based deposit insurance premiums, and an emphasis on early intervention (in worst case liquidation) with problem banks.

The banking mess in Japan is even bigger than the 1980s crisis in the U.S., mainly because it involves the entire banking system. There are some similarities, however. First, it involved an asset bubble that ultimately burst (although on a grander scale than the U.S.). Second, it was led by an irresponsible bank-lending binge. Moral hazard existed in Japan on a grand scale. Regulation was light and the banks exerted heavy influence (sometimes through bribes) on their regulators at the Ministry of Finance. Banks owned equity in many of the companies they lent to, and consequently lent heavily to them regardless of creditworthiness. There was substantial over-investment in many Japanese industries, which is still hindering Japan's economic recovery. Bank balance sheet assets were (and

still are) heavily composed of equities in connected companies, the value of which collapsed when the bubble burst. Finally, there was an implicit understanding that the government would fully guarantee depositors and bail out the whole banking system in the event of a problem (a key part of moral hazard).



As you know, the whole process unraveled in Japan. Like the U.S., it took nearly a decade for the government to decide to deal with the problem in the hopes that it would go away. Of course it didn't, and over the past few years a rescue program has been cobbled together. The program, which will probably end up costing more than \$1 trillion, has many similarities to the U.S. S&L rescue. As I am sure you know, Japanese banks have come under renewed pressure recently -- causing loan losses to mount further -- as Japan's economy has continued to wobble and its equity markets have declined further. I will describe Japan's bank rescue program, and ongoing adjustments under the Koizumi administration, in greater detail in my supplementary lecture. The financial press reports on Japan's banking situation daily.

The banking problems in the rest of Asia are similar to Japan. In some cases (e.g. Indonesia, Thailand, and Korea) they have been on a grander scale (relative the size of their economies) than Japan. In recent years, the Chinese banking sector has encountered increasing problems as well. There is one key difference between the crises in Japan and the rest of Asia. Japan's problem is primarily a domestic one, while banking crises in the rest of Asia have had major implications for foreign lenders heavily exposed to the region. Also, Japan (so far) has the wealth and financial capacity to deal (or not deal) with its banking problems on its own, whereas other countries in the region have required financial assistance from the IMF and foreign governments (including Japan) to work their way out of their problems.

## Supplemental Lecture – Japan's Banking Crisis

In the Lesson, I promised more detail on Japan's banking situation and rescue program. Note as you go through this discussion, that there are many similarities to the way in which the U.S. handled its S&L crisis in the 1980s, which cost U.S. taxpayers more than \$200 billion to clean up. The S&L crisis is history, but the lessons from that crisis are being applied (and sometimes misapplied) in Japan and in several emerging markets that experienced (and are still experiencing) banking crises during the past several years.

After several years of delay during the 1990s, Japan finally set up a structure to alleviate its banking problems in 1998. The government put aside 70 trillion yen (\$540 billion at today's exchange rate) of public funds for the bank rescue program. Of this, 25 trillion yen was to be used to re-capitalize so-called "viable banks" (an ambiguous category of banks deemed solvent over the long term).



Re-capitalization involves government purchases of bank subordinated debt instruments and preferred stock. Another 18 trillion yen was set aside to nationalize failed banks and to finance so-called bridge banks. Bridge banks (so far rarely used in Japan) are a temporary mechanism for channeling bad loans of a failed bank to a public agency, while finding buyers for a bank's better assets. The bridge banks also continue lending to sound borrowers that were customers of failed banks. Ultimately, the failed banks are sold or liquidated and the bridge banks are dissolved. The remaining 27 trillion yen was made available to guarantee the deposits of failed banks. Of the total 70 trillion yen authorized to deal with banking problems, approximately 30 trillion yen has been spent to date. There remains a considerable arsenal, and there has been discussion of adding another 10-15 trillion yen to the program.

The government has injected capital into the viable banks, mostly in the form of preferred stock. In return, the banks have written off problem loans more aggressively. Banks have already charged off about 50 trillion yen (\$390 billion) of non-performing loans. Estimates of remaining bad loans range from 37 trillion yen (\$290 billion, the current official number) to 150 trillion yen (\$1.2 trillion). Japanese analysts who follow this closely put the total somewhere in the middle at around 100 trillion yen (\$780 billion).

Unfortunately, with Japan's economy continuing to weaken, problem loans continue to accumulate. It is only a small stretch to forecast that banks will ultimately be forced to recognize \$1 trillion of non-performing loans. While some of these loans may be recoverable, such estimates imply that additional public money will be required to complete the bank rescue. Prime Minister Koizumi has promised to force the biggest banks to write off their existing problem loans within the next two years. A key problem in coming up with reasonable estimates of non-performing loans concerns the methods that Japanese banks use to classify loans. Banks (often with approval from government authorities) have resisted classifying problem loans of some major clients (e.g. big department stores and construction companies). This is slowly changing under tighter supervision. But the government avoids public challenges of loan loss estimates, perhaps for fear of creating panic in already depressed equity markets. Furthermore, beginning this April, the government plans to remove blanket guarantees of bank deposits and begin

implementing a risk-based deposit insurance scheme. Without full deposit guarantees, negative publicity on bank balance sheet problems could lead to panic bank deposit withdrawals.



Two large banks - Long Term Credit Bank and Nippon Credit Bank - were nationalized in 1998. LTCB, which was renamed Shinsei Bank in 2000, was sold to a U.S.-based investment group called Ripplewood (which includes Citigroup, GE Capital, Deutsche Bank, Paine Webber, Mellon Bank, and ABN Amro). Nippon Credit Bank was purchased by Softbank, a Japanese Internet and media group.

The Japanese government encouraged the remaining big banks to merge in order to strengthen their financial positions. Over the past couple of years, several mergers were announced and consummated: (1) Dai-Ichi Kangyo Bank/Fuji Bank/Industrial Bank of Japan; this merger was consummated in Sept. 2000 and is now called the Mizuho Financial Group (2) Sumitomo Bank and Sakura Bank merged in April 2001 (3) Tokai Bank/Sanwa Bank/Toyo Trust; this merger (called the UFJ Group) also occurred in April 2001. Also, Bank of Tokyo merged with Mitsubishi Bank in 1996 to form the Bank of Tokyo-Mitsubishi Bank, which merged with Mitsubishi Trust & Banking Corp. in April 2001. When these mergers, Japanese banks once again join the top rankings (measured by assets, not profits, and the asset numbers are questionable) among global commercial banks. Unfortunately, there have been few management changes at these mega-banks, creating the impression of business as usual.

Japanese banks are also reducing their cross-equity holdings with large Japanese industrial conglomerates. These equity holdings are extremely large, and they have been a major source of moral hazard in the banking system. Beginning in September 2001, banks were for the first time required to recognize their equity holdings at market value. Sharp declines in the Japanese stock markets (the recent rally excepted) have forced banks to record significant losses on their equity portfolios, eroding bank capital. To alleviate stress from this problem, the government has indicated it will set up a "private" fund that will purchase, and gradually sell bank equity holdings over the next couple of years. (Japanese bank regulators say that equity holdings are currently equal to 130% of bank capital, and the government wants to reduce this ratio to 100% through this program.) The government wants the banks to finance this fund with loans, which will be guaranteed by the government. If sharp losses are recorded on the fund's equity holdings, the government would of course be left holding the bag. Barring a substantial rally in Japanese stock markets, this could prove quite expensive. Given Japan's already precarious fiscal condition (public debt is around 130% of GDP and rising), there is reason for concern about additional public spending. But it may be unavoidable. One way or the other, banks will require additional public money to get out of the current mess.



More important than the bank rescues are changes to Japan's bank supervisory structure to prevent similar problems from developing in the future. A sound supervisory environment is critical to preventing future banking crises. The most important change has been the creation of a Financial Services Agency (FSA) and, below it, a Financial Reconstruction Commission (FRC) responsible for implementing banking reform. The FSA has taken over bank regulatory responsibility from Japan's Finance Ministry,

which was perceived as too cozy with the banks and was involved in numerous corruption scandals. When the FSA and FRC were set up, there was some question about whether they would have the nerve to go after the banks. So far, the results are mixed. The current FSA head, Hakuo Yanagisawa (he was the original agency head who was brought back after all of his successors flopped), is trying to be more vigilant with the banks. The accession (last year) of Prime Minister Koizumi, who strongly supports bank reform, has given Yanagisawa some additional backing to be tough. But others within Koizumi's Liberal Democratic Party still seem intent on blocking bank reforms. As yet, Koizumi and Yanagisawa have not made measurable strides with banking reforms, but rather have maintained the incremental approach of previous administrations.

The FSA is trying to model itself after the U.S. Office of the Comptroller of the Currency (OCC), which supervises most of our banks. But there have been many problems in implementation. For example, the FSA has maintained a very light touch with Japan's smaller banks, which through their lax lending policies prop up many Japanese enterprises that would otherwise be insolvent. LDP stalwarts rely on these enterprises for political support.

Japan has also set up a Resolution and Collection Corporation to receive and dispose of bad assets of banks. This is similar to the U.S. Resolution Trust Corporation that was set up to dispose of S&L assets in the United States. To date, the RCC has not purchased many loans, although the government has recently directed the agency to become more aggressive (as banks are forced to recognize more bad loans).

In addition, Japan has established a Deposit Insurance Corporation. This agency issues bonds to finance the capital injections into viable banks. Adoption of a risk-based deposit insurance system similar to the U.S. FDIC insurance system was planned a couple of years ago, but implementation was delayed for political reasons. The current plan calls for a phase-in of risk based insurance between April 2002 (covering time deposits) and April 2003 (covering demand deposits). There has been strong popular resistance to placing limits on the amount of guaranteed deposits per account (as we have with our \$100,000 limit in the U.S.). But limits are necessary to mitigate moral hazard risk. The plan calls for a limit of 10 million yen (\$78,000) per account. Currently, the government provides blanket guarantees of all bank deposits.

I should mention that the Bank of Japan is deeply involved in the new regulatory process, and is perceived to be doing a fairly good job. The Bank of Japan became independent in April 1998, though the government still tries to exert a heavy hand over BOJ policies. There has been some talk of bringing the BOJ back under direct government control because of BOJ Governor Hayami's refusal to cooperate with the government's desire to create more money. Hayami has, in turn, told the government that monetary policy will be less effective until the banks are fixed. I concur with his view. Bank lending in Japan has been spiraling downward due to a combination of weak credit demand and financially strapped (in many cases technically insolvent) banks.

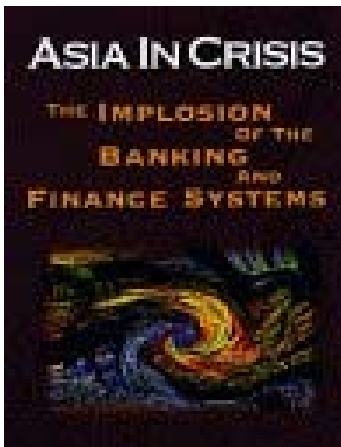
It should be acknowledged that Japan, despite many problems, has made some important strides in dealing with its banking problems during the past couple of years. In particular, government capital injections and widespread mergers have strengthened capital adequacy of the big banks. But many problems endure. Banks are still reluctant to recognize non-performing loans, and their balance sheets remain burdened by large holdings of real estate and equity that are declining in value. As long as Japan's economy remains in the doldrums, the value of bank loan portfolios and other assets will remain weak. The ultimate question is whether banks will begin to operate more on market principles. This will depend upon several factors, including the supervisory environment (mainly a political question), changes in Japan's corporate and legal structure, and the degree of financial and capital market development. Regarding, financial market development, Japan has been actively deregulating financial markets (referred to as the "big bang") in recent years. In addition, foreign banks and financial services firms are being permitted to expand their activities in Japan. Many people think foreign bank involvement provides the best hope for creating the competitive conditions for successful reform of the banking sector.



One reason why Japan's banking problems have persisted is the reluctance of the government to permit bankruptcies of prominent Japanese companies. Some positive changes are underway in this area as well, but they are occurring much too slowly. A major department store, a supermarket, and a couple of construction companies declared bankruptcy over the past year. But banks (with government encouragement) continue to bail out big-name failing companies.

As more bankruptcies are permitted, we are likely to see greater loan losses and even more loans turned over to the government, boosting the fiscal bailout costs even higher. And of course there will be impacts on Japanese employment and income as more firms go under. It appears that Japan still has much pain to endure in its path to restoring financial stability.

As I mentioned in the Lesson, many other countries in Asia face similar problems to Japan, but on even larger scales relative to the size of their economies. Most are also adopting restructuring programs to Japan. However, these countries are much poorer than Japan and they do not have the internal financial capacity to bail out their banks. They thus depend on financial assistance from international agencies like the IMF, and from foreign governments (ironically Japan). Foreign (including many U.S) financial institutions have been fairly aggressive in buying bad loans from Asian banks and from government agencies that have taken over these loans. Foreign banks are also snapping up local banks that are up for sale. This indicates foreign investors are confident that banking problems can eventually be resolved. But some countries (such as Korea) have been reluctant to accept significant foreign ownership of their banks. Interestingly, emerging markets where foreign banks already had significant ownership stakes were less severely affected by the financial crises during the late 1990s. Hungary and Poland are good examples. Argentina also has high foreign (mostly Spanish) ownership of its banking system. Although all banks face tremendous losses following Argentina's default (which was largely caused by fiscal problems), the presence of foreign banks (if they stick around) should help the country to recover. Foreign banks have also made significant inroads into the Mexican and Brazilian banking systems in recent years.



Krugman's paper is a simplified, but insightful, view of the Asian financial crisis. Krugman places most of the blame on countries' financial sectors that encouraged moral hazard. While there were many intertwined variables that contributed to the Asian crisis, there is a growing consensus that weak and poorly supervised banking systems were a common denominator. The same applies to the 1994-95 Mexican peso crisis. Mexico is still struggling to pay for a \$100 billion bank bailout program adopted following the peso crisis. Turkey's ongoing financial crisis is intimately related to weaknesses in its banking system as well.