Japan's Regulatory Response to Banking Problems

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Outline

- Economists have documented the government's regulatory response to banking problems in Japan (e.g., Cargill, Hutchison, and Ito, 2000, Hoshi and Kashyap, 2000, Watanabe 2014)
- I synthesize the literature and add more recent development.
- Part I
  - Regulatory failure in the aftermath of the collapse of asset price bubble in Japan
  - Economic implication of regulatory failure
- Part II
  - More recent policy development
  - Preliminary assessment

Facts

- Japan endured one of the longest banking crises in recent history!!
  - The banking problem started with the collapse of asset price bubble in 1990
  - Banks restored financial health with Takenaka plan at long last (2002-2005)
- For over one decade, a large segment of banking sector was allowed to operate with insufficient capital (i.e., forbearance policy)
  - Regulators undermined market forces that could have monitored and disciplined problem banks better
  - Banks resorted extensively to "regulatory capital arbitrage" to boost their capital-to-asset ratios in artificial manners
  - Regulators failed to set up a proper rule to assess the size of non-performing loans

Market Discipline

- Banks face market discipline if investors have financial incentives to avoid problem banks
  - The large literature on this topic suggests that extensive financial safety net undermines market discipline (e.g., Demirgüç-Kunt and Huizinga, 2004)
- In Japan, the financial safety net was extensive and also expanded as the problem got worse over time
- "Convoy system"
  - The MOF used moral suasion/regulatory rents to force healthy banks to take over problem banks (Hoshi, 2002)
- Deposit insurance
  - The DIC insured up to 10 million yen until 1996
  - The Japanese government instituted the blanket guarantee of all deposits for 6 years from 1996-2002

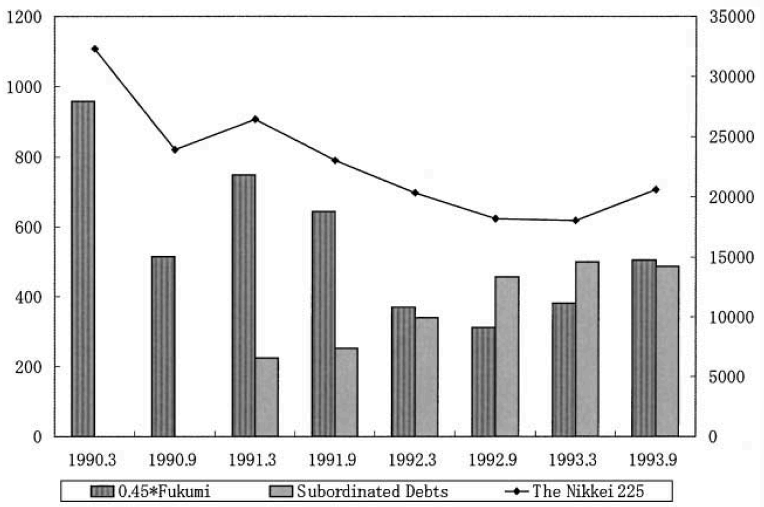
How Did Market Discipline Work?

- Deposit insurance scheme affected the intensity of market discipline in Japan
- Both the quantity of deposits and the interest rate on deposits respond less sensitively under blanket deposit guarantee (e.g., Murata and Hori, 2006; Imai, 2006)
- Depositors made little distinction between healthy banks and weak ones and allowed the latter to grow without financial penalty

Subordinated Debt

- Reported bank capital declined to due a fall in unrealized capital gain on their security holdings (*Fukumi*)
- Banks issued a large amount of subordinated debt to make up for capital shortfall
- Mitigated credit crunch to some extent (Ito and Sasaki, 2002; Montgomery, 2005; Iwatsubo, 2007)

Ito and Sasaki (2002)



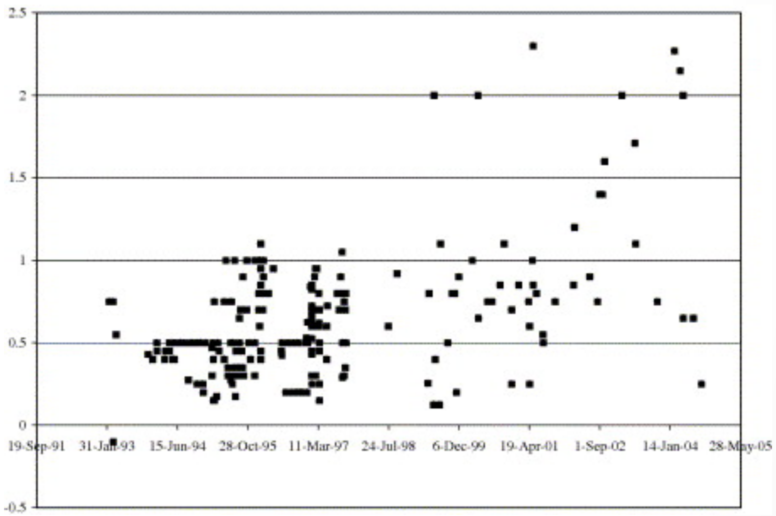
*Left axis: 45% of Fukumi and subordinated debts (billions of Yen).
Right axis: Nikkei 225.

FIG. 1. Components of tier II (21 banks).

Market Discipline in Sub-Debt Market

- Sub-debts are risky
  - Potential to play an important role in monitoring/disciplining banks (Flannery and Sorescu, 1996)
- In Japan's case, investors did not distinguish weak banks before 1998 (Imai, 2008)
  - Privately issued and held by keiretsu-related non-financial firms and insurance companies (Horiuchi and Shimizu, 1998; Fukao, 2002)
  - They are likely to have anticipated government bail-out as well

Subordinated debts spread for Japanese banks (1993–2004): Imai (2008)



Regulatory Capital Arbitrage

- Banks manipulated regulatory capital-to-asset ratios in various ways that would not alter the true economic value of bank capital
- According to Basel Accord, Japanese banks could count 45% of unrealized gains on their stock holdings as tier II capital, but 100% of retained earnings as tier I capital
  - Sold stocks to realize capital gains and then purchased them back to maintain cross-shareholdings (Shrieves and Dahl, 2003)
- It became increasingly more difficult banks to raise capital ratios through the sales and re-purchase of stock holdings in the late 1990s
- The government began allowing banks to count deferred tax assets as capital (Fukao, 2002; Skinner, 2008)

Perverse Incentive Structure

- Widely documented in the Japanese media as well as in the academic literature (e.g., Sekine, Kobayashi, Saita, 2003; Peek and Rosengren, 2005)
- For every non-performing loan, there is a non-performing (zombie) borrower
- A bank whose own solvency is questionable keeps lending to a zombie firm to keep its loan current
  - Otherwise, the zombie firm is forced to restructure or declare bankruptcy, which, in turn, increases the reported NPLs for the bank
- The government largely ignored the severity of hidden bad loan problem, based on hope and fear
  - Hope: economic recovery will solve the non-performing loan problem
  - Fear: the fiscal and, more importantly, the political consequence of massive bankruptcies
- Banks, zombie firms, and the government all had strong incentive to hide the extent of bad loan problems from the public

Economic Effects of Zombie Lending

- It favors unproductive firms
  - Dispersion in MPK
  - Unproductive (productive) firms will be characterized by overinvestment (underinvestment) and and low MPK (high)
- Caballero, Hoshi, and Kashyap (2008) show that zombie firms distorted the entry decision of productive firms as well as the exit decision of unproductive firms

Banking Crisis (1997-1998)

- Sanyo Securities (a mid-sized security firm), Hokkaido Takushoku Bank (a major bank), and Yamaichi Securities (a major security firm) failed in 1997
- Voters became increasingly discontent with the ruling Liberal Democratic Party's (LDP's) handling of financial and economic affairs
- The LDP lost its majority in the July 1998 Upper House election.
- The LDP had to make a compromise with the largest opposition party, the Democratic Party of Japan (DPJ), which had long advocated for the immediate closure and nationalization of insolvent banks

October 1998

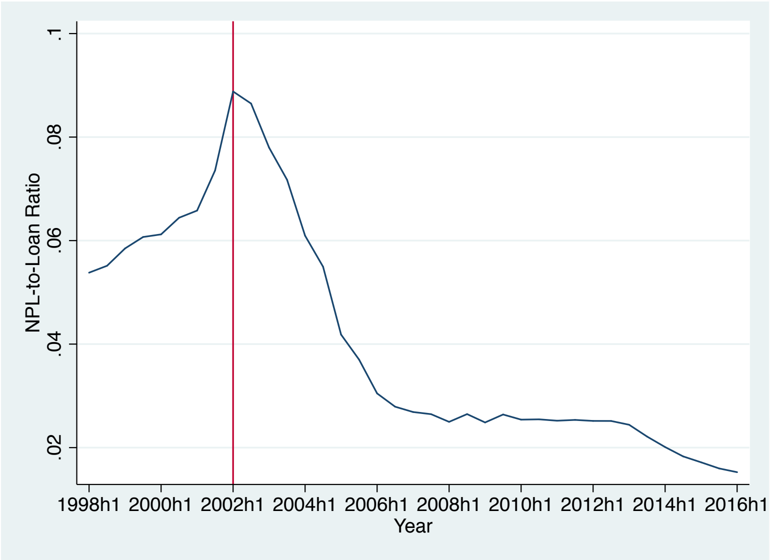
- The new Diet enacted two important laws
  - The Rapid Recapitalization Act (RRA)
  - The Financial Reconstruction Act (FRA)
- FRA
  - Created the Financial Reconstruction Commission (FRC)
  - Stipulated a formal mechanism under which the FRC could resolve insolvent institutions
- RRA
  - Provided a legal basis to inject public capital into undercapitalized yet viable banks
- The newly created Financial Supervisory Agency (FSA) commenced aggressive bank examinations in 1999

Slow Progress

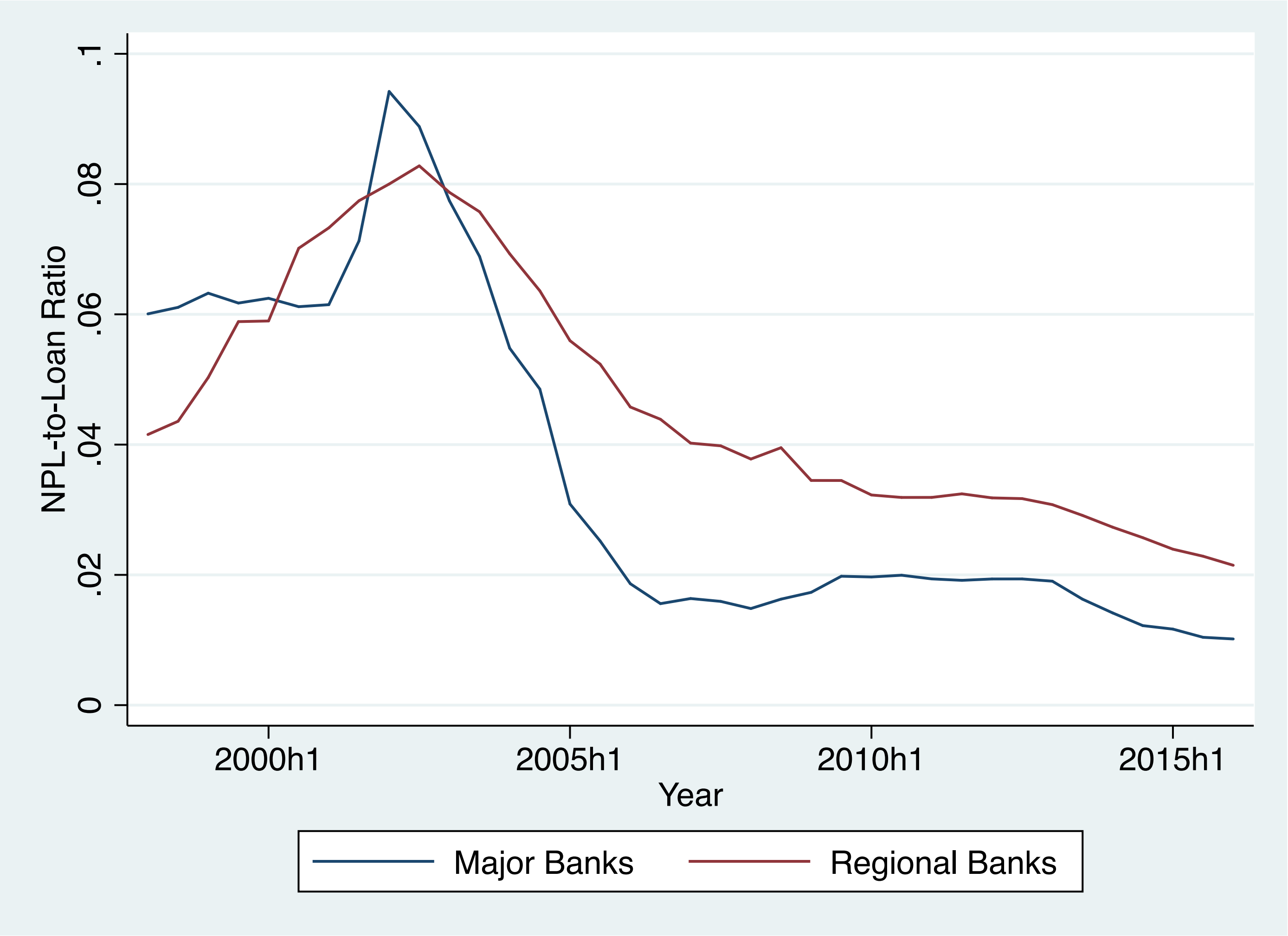
- As the banking crisis subsided in 1999, the government began to lose its zeal
- The chair of the FRC, Hakuo Yanagisawa, who was widely credited for his aggressive approach to take over insolvent banks, was sacked in 1999 and replaced by Michi Ochi, a former MOF bureaucrat and consummate LDP insider.
  - "*We're now most worried about credit associations and cooperatives. Government financial inspectors will audit them between July and next March. If you think audits on your institutions are too strict, please inform us about it. Please tell Mr. Hasumi about it. If you give related documents to him, and he will in turn pass it over to me, I'll give the utmost consideration*." —A speech by Financial Reconstruction Minister Michio Ochi at a gathering of regional bankers and credit associations and cooperatives officials in Tochigi prefecture hosted by Susumu Hasumi, a senior Lower House member of the ruling Liberal Democratic Party on February 19, 2000
- In January 2001, Yanagisawa was brought back to serve as the head of the Financial Services Agency, which took over the tasks of the FRC and the FSA
  - However, he continued the policy of denying the presence of large nonperforming loans and insisted that there was no need for another round of capital injection

Takenaka Reform

- In August 2002, the government replaced Yanagisawa with nonpolitician Heizo Takenaka
- Called for a strict accounting standard and the resolution of problem loans



Major Banks vs. Regional Banks



Regulatory Response in 2008-2009

- The exposure of the Japanese banks to sub-prime loan markets was limited, but the serious economic downturn ensued
- Banks were relatively healthy but small and medium sized non-financial firms had difficulty paying back debts
- The government seems to have reverted back to the old habit (Harada, et al. 2015)
  - e.g., Debt Moratorium Law

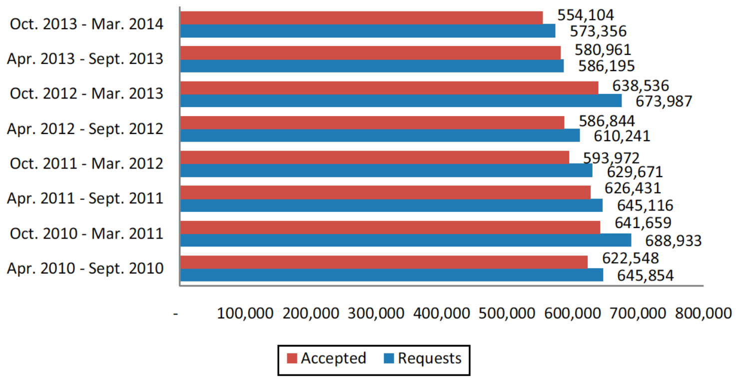
Debt Moratorium Law

- The LDP lost the majority in the Lower House Elections in 2009
- The DPJ, now in control of both lower and upper houses, proposed to force banks to accept a 3 year moratorium for SMEs
- The compromised was reached
  - Banks have obligations to make the utmost effort to reschedule loans for small and medium size enterprises (SMEs)
  - FSA allows banks to exclude the restructured loans from non-performing loans
- Financial Services Minister Shizuka Kamei
  - “As long as I’m financial services minister, I’m not going to leave small companies in the lurch, unable to get loans. If a bank takes that approach, I’ll hit them with a business improvement order.”
- The final bill, the Debt Moratorium Law, was approved in Nov 2009

Debt Moratorium Law, cont.

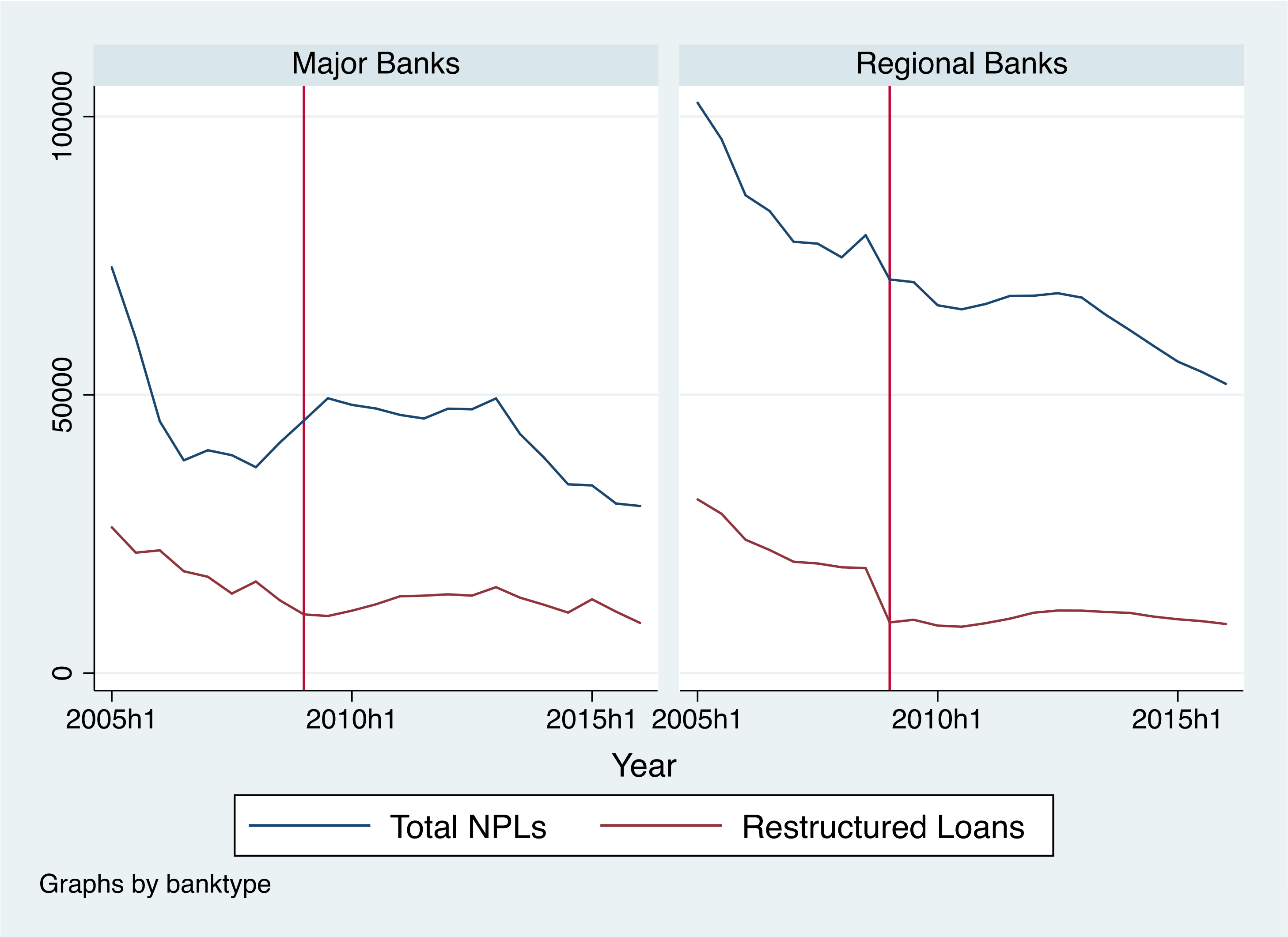
- It was set to expire in 2011 but twice extended to 2013
- Even though the law expired, the FSA continued to
  - Encourage banks to extend loans to distressed SMEs
  - Allow them to exclude these restructured loans from non-performing loans.

Harada, et al. (2015)



Note: This figure shows the number of requests by SMEs to restructure their loans and the number of those that were accepted by banks during each of the six-month periods
Source: Financial Services Agency of Japan (2014b)

Hidden Non-Performing Loans at Regional Banks



Economic Implications of Debt Moratorium Law

- In theory, the debt moratorium law might have mitigated credit crunch for SMEs, but it has become more difficult to assess the extent of financial problem at small banks
- It might have undermined market discipline and promoted moral hazard problem again
- It also sets up a financial environment in which zombie firms tend to thrive just as the forbearance policy has done in the 1990s
- Moreover, it might have signaled to financial markets that the political incentives to bail out zombie firms remain powerful in Japan

Concluding Remarks

- Japan’s response to financial crisis is widely considered failure
- Regulators undermined market discipline and allowed weak banks to grow and continue to lend to unproductive zombie firms
  - Many believe that this regulatory failure contributed to slow productivity growth in Japan
- Recent development seems to confirm that the political incentive to protect zombie firms remains strong