Financial Crisis in Japan in Late 1990s

- Its contrast to Lehman shock -

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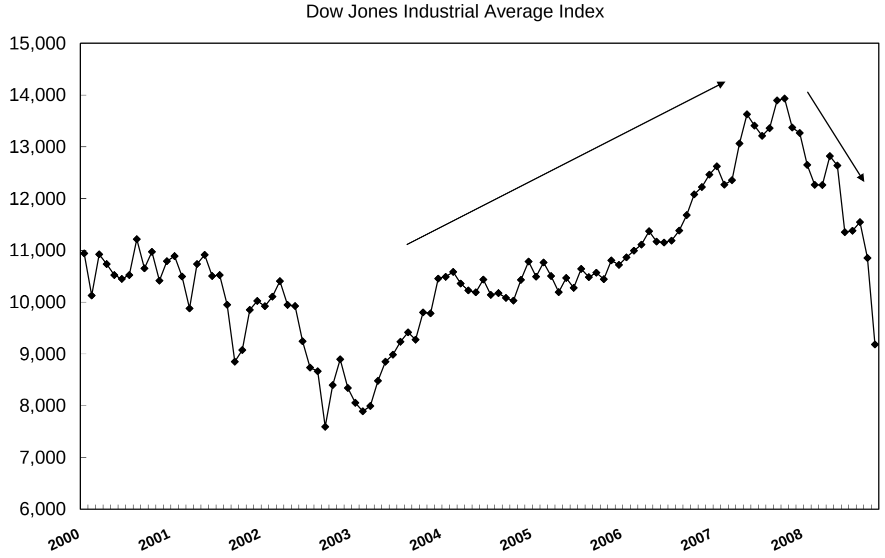
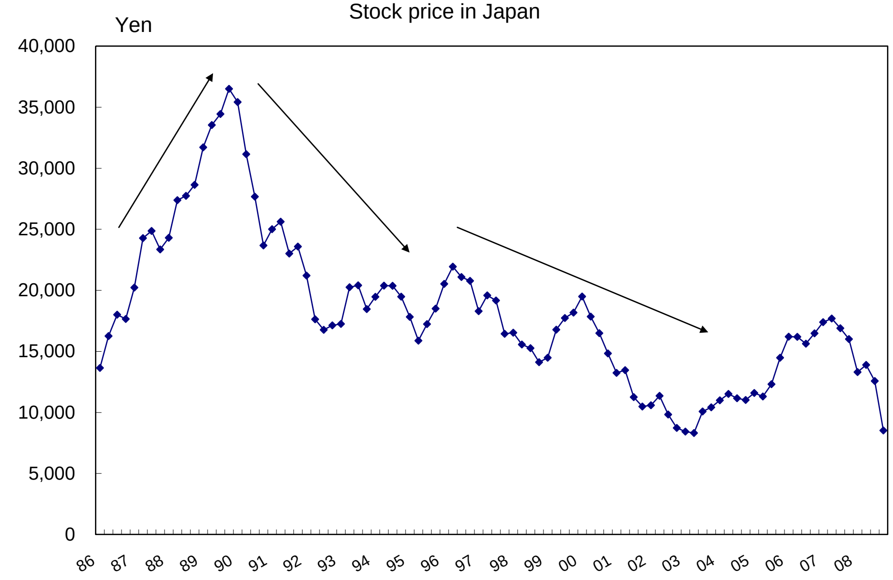
Similarities: Japan and USA

Sharp rise and decline in the price of stocks

US: After the peak in October 2007, a bear environment dominates the stock market.
JP: The price of stock in Japan had declined about 80% since 1990.

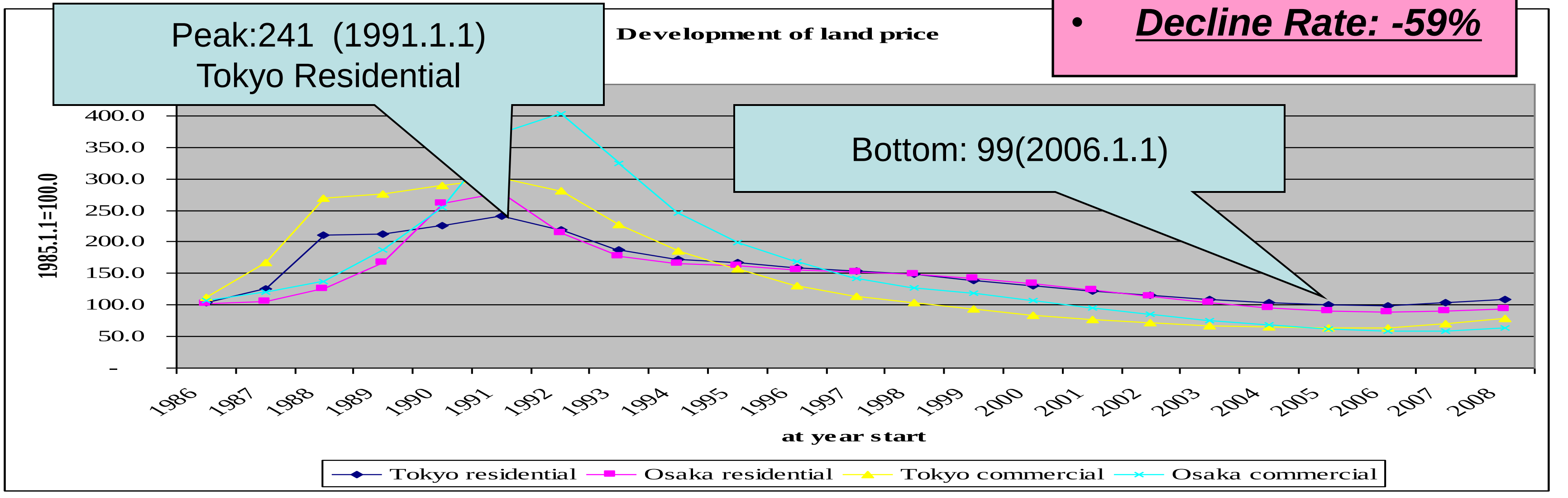




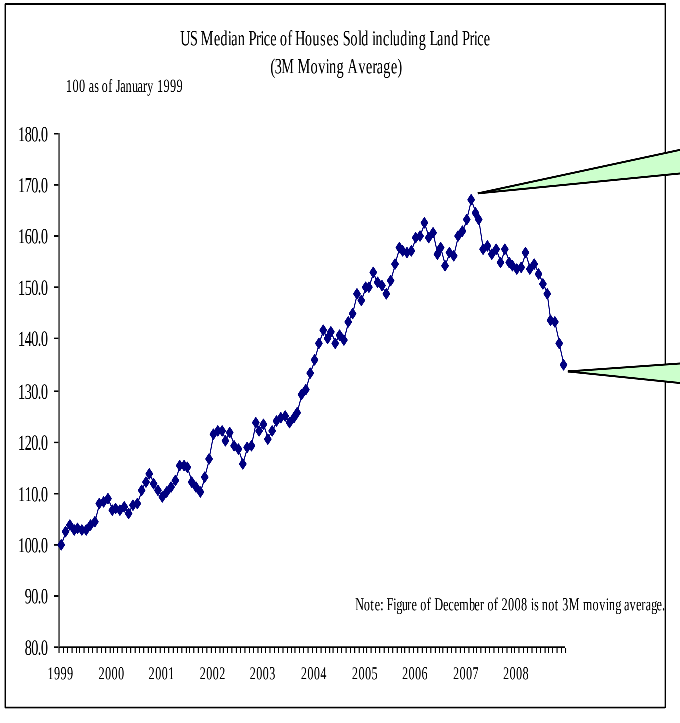
- Peak: 13,930 (Oct, 2007)
  Current: 8,162 (May. 2, 2009)
- ***Decline rate: -51.5%***

- Peak: 38,915 (Dec.29,1989)
  Bottom in 2003: 7,607 (Apr.28, 2003)
- ***Decline Rate: -80.4%***

Sharp rise and decline in housing prices



- ***Decline Rate: -59%***



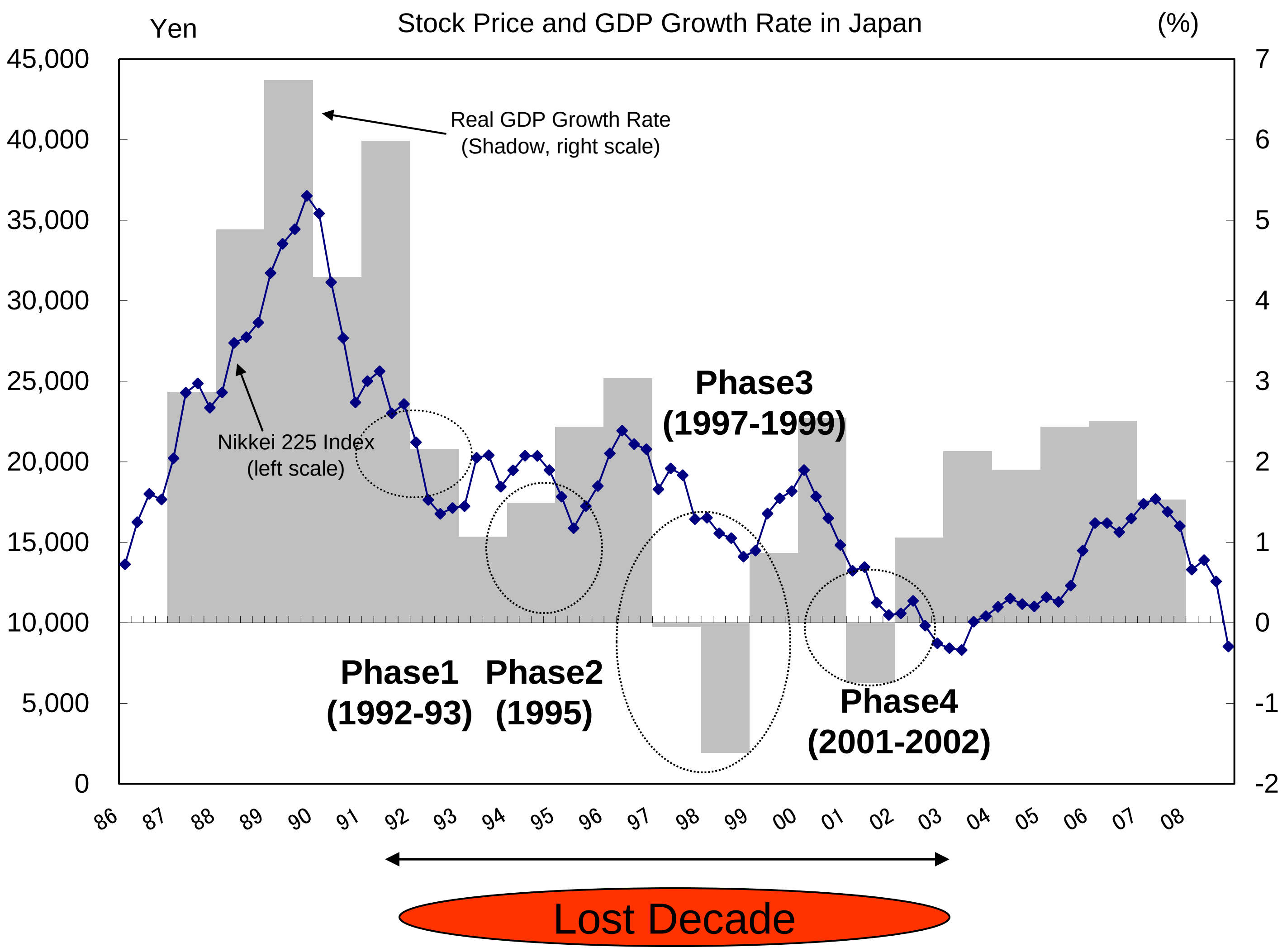
Peak:171.5(March,2007)

Current:134.9(Dec.2008)

Decline Rate:-21%

Financial Crisis in Japan – 4 phases

❖ The financial crisis in Japan can be divided into 4 phases



Financial Crisis in Japan – Pre-Crisis

Plaza Accord (Sep. 22, 1985): Collective intervention to depreciate U.S.Dollar

❖In 1986, both the United States and Japan lowered their official discount rate four times.

Louvre Accord (Feb. 1987): Continue to lower interests rates to avoid strengthening dollar.

❖While the United States raised interest rates. Japan lowered its official discount rate to a historical low of 2.5 percent.

After "**Black Monday**" crash (Oct. 1987)

❖All major countries marked high economic growth by 1988.
❖As economic growth accelerated, countries raised interest rates to avoid overheating.

❖the Bank of Japan (BOJ) maintained the 2.5 percent discount rate throughout 1987 and did not raise the rate until May 1989.

❖Japan, as the largest creditor, was considered to maintain a low rate, providing the cornerstone to global stability and growth.

The first sales of shares of the privatized Nippon Telephone and Telegraph (Nov. 1986)

Financial Crisis in Japan – Pre-Crisis

1. “Bubble” era in the latter half of the 1980s

- Zaiteku – “Speculative fund investment” by individuals and corporations.

- Property-collateralized credit by banks supported speculative activities by individuals and corporations.

2. Introduction of total volume control of bank loans to real estate industry

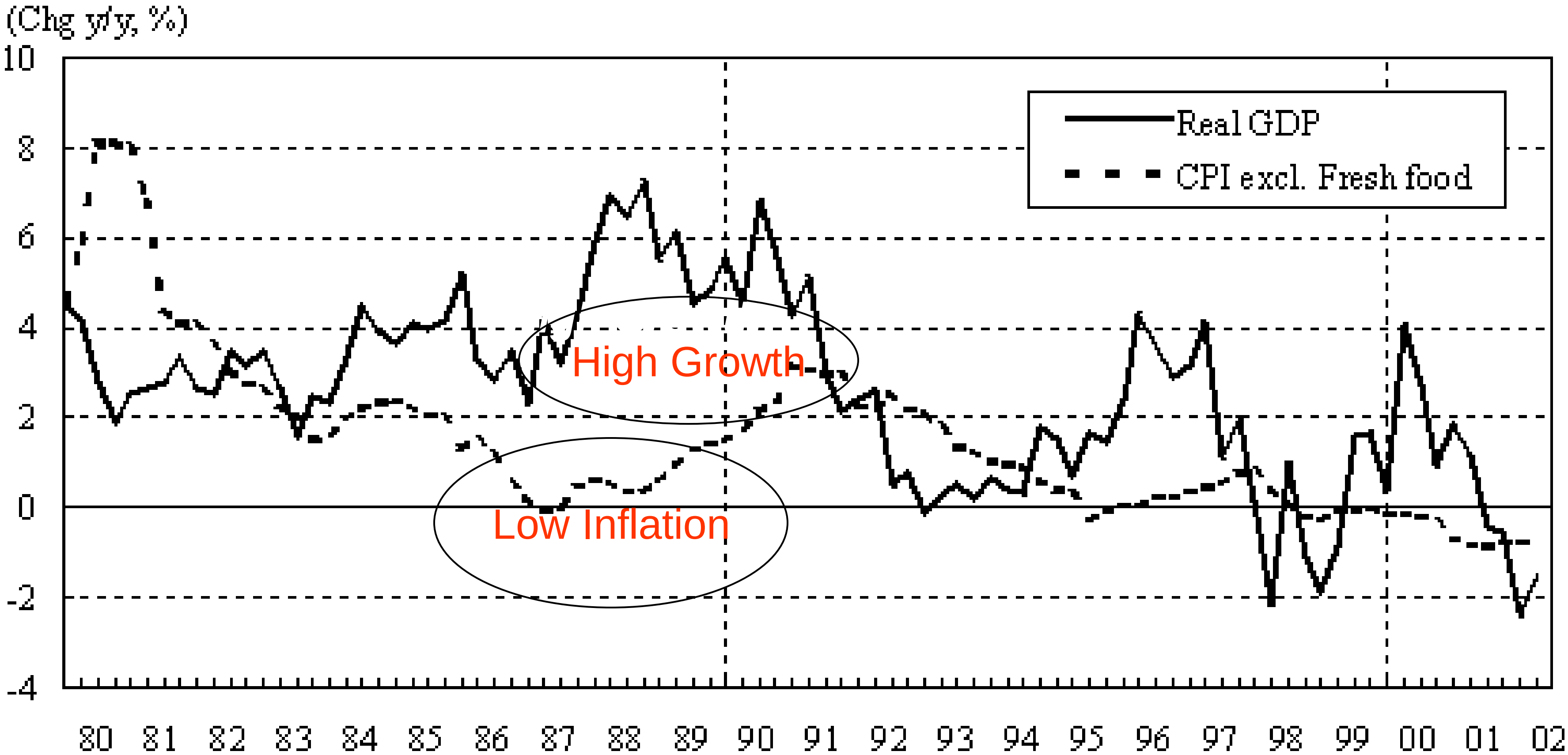
- This guideline, instructing banks to make the growth rate of loans to real estate industries below that of total loans, was implemented by the Ministry of Finance on March 1990.

3. Rate hikes continued after the burst of the bubble

- Bank of Japan raised its Official Discount Rate twice after the decline of stock price began in 1990.

Favorable Economic Conditions Produced "Euphoric Views".

- Co-existence of **high growth and low inflation** made people believe in productivity growth, and produced excessive optimism for the future.



Financial Crisis in Japan – Phase 1 (1992-1993)

1. What happened?

❖ Non-performing loans increased among Japanese banks reflecting declining land prices and the sluggish economy

❖ Prime Minister Miyazawa raised the possibility of an injection of public funds to stabilize the Japanese financial system (August 1992), but that action wasn't taken

2. Policy direction / Major initiatives

- Basic stance of the government, banks and the corporate sector was "wait and see", based on an expected turnaround of asset prices.

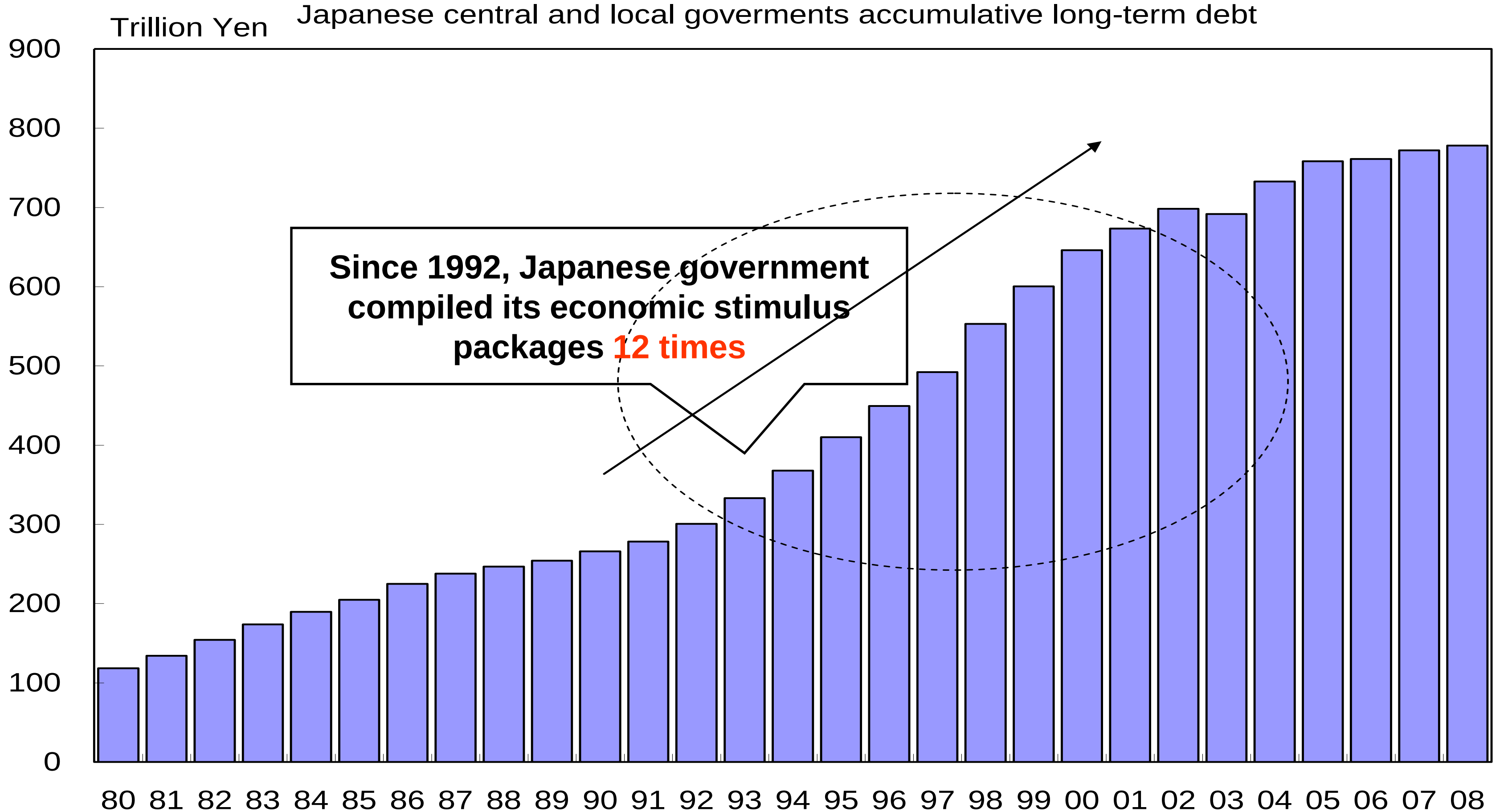
- Strong objection to an injection of public funds

- The government compiled an economic stimulus package, which was the first of the series of packages in the Lost Decade

- Through initiatives by major banks, Cooperative Credit Purchasing Company (CCPC) was established in January 1993. CCPC purchased bank loans with collateral to liquidate the pledged real estate

Financial Crisis in Japan - Phase1

The Japanese government's long-term debt



Effectiveness of fiscal stimulus was limited with uncertainty in financial market

Financial Crisis in Japan – Phase 2 (1995)

1. What happened?

❖ In December 1994, two credit cooperatives (Tokyo-Kyowa and Anzen cooperatives) went bankrupt. This was the first bankruptcy in the financial industry after WWII

❖ Subsequently, a small regional bank (Hyogo bank) went bankrupt

❖ Large mortgage financial institutions (so called Ju-sen) went bankrupt

2. Policy direction / major initiatives

- "Takeover bank" (Tokyo Kyodo Bank) which absorbed the assets of troubled institutions was established in cooperation with major banks and BOJ

- In September 1996, Tokyo Kyodo Bank was restructured as "Resolution and Collection Bank" (Japanese RCC) to expand its operations.

- In December 1996, an injection of public funds ($6850MM) was approved to compensate for the loss of Ju-sen. This move brought strong criticism of the government and the banking industry

Financial Crisis in Japan – Phase 3 (1997-1998)

1. What happened?

❖ Consecutive bankruptcies of the financial institutions, including large banks and securities in a short time (so called “Black November” in 1997)

> November 3, Sanyo Securities (7th largest) went bankrupt
> November15, Hokkaido-Takushoku Bank went bankrupt
> November 24, Yamaichi Securities (4th largest) announced its liquidation (Nov.24)
> November 26, Tokuyo-City Bank went bankrupt

I was the director in charge in MOF

❖ ... r 4, due to the bankruptcy of Sanyo S... urities, the first default of ... in the short-term money market occur... rendering the money market dysfunctional

Bear Sterns (7th largest)
Lehman Bros.(4th largest)

❖The resulting credit crunch caused by the banks ... economy. GDP recorded negative growth (-0.1% ...

❖Scandals among bureaucrats in Ministry of Finance - cozy relationships between traditional bureaucracy and banks

❖The stormy Financial System Parliament – debated a lot of important financial system related laws

Financial Crisis in Japan – Phase 3 (1997-1998)

2. Policy direction / Major initiatives

- Injection of public funds to increase the capital of major banks

•The **injection of public funds** was implemented twice

(Details to be discussed later)

- Introduction of new financial regulatory framework

- Establishment of JFSA (June 1998)
- Introduction of a system of **prompt corrective action** (April 1998)
- **New financial inspection manual** becomes effective (July 1999)

Again I was in charge in FSA

- Introduction of “bridge bank” scheme for troubled banks

- **Temporary nationalization** schemes were applied to two major banks. (LTCB and NCB) Finally, these banks were sold to investors

- BOJ lowered its target interest rate to zero (February 1999)

Difference in liquidation process between Yamaichi and Lehman

Yamaichi

All cross border transactions were cancelled over weekend

→ Did not affect foreign financial institutions — No contagion

→ Japanese government bore all burden

→ With the boom of world economy, Japanese economy recovered

Lehman

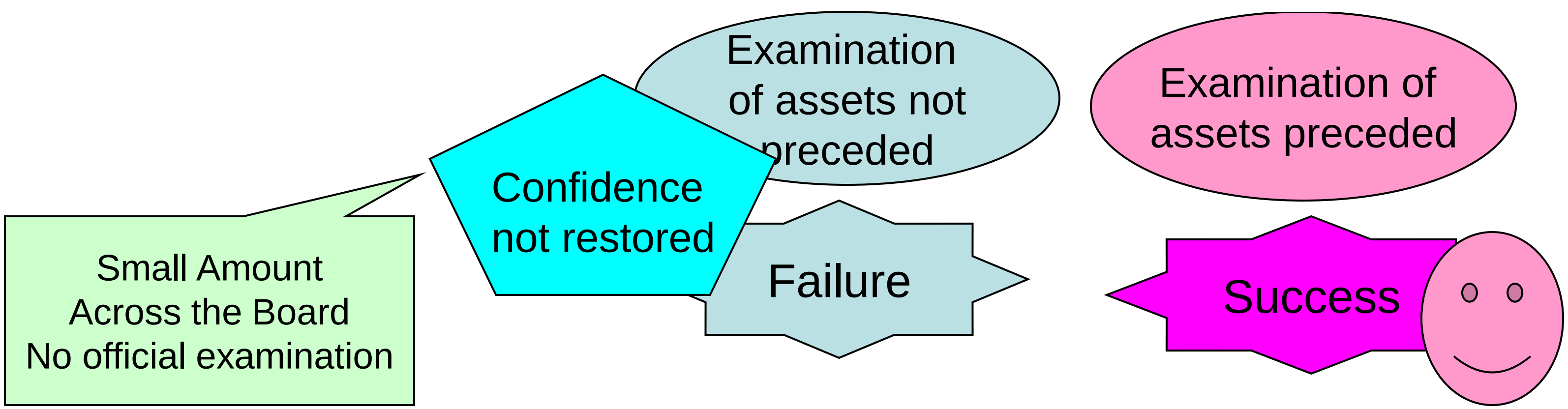
Went bankrupt without cancelling cross border transactions

→ No contagion effects first on AIG in Longon and then all world

→ World economic crisis

Injection of public funds into the capital of Japan major banks

	March 1998
Daiichi-Kangyo Bank	99
Fuji Bank	100
Sakura Bank	100
Sumitomo Bank	100
Bank of Tokyo-Mitsubishi	100
Sanwa Bank	100
Tokai Bank	100
Asashi Bank	100
Daiwa Bank	100
Other banks (average per a bank)	917 (76)
Total (# of banks)	1,816 (21)
(Total in USD)	(USD 18.1 billion)



Outline of the Prompt Corrective Action

Class	Capital Adequacy Ratio		Actions (Order)
	International Standard	Domestic Standard	
1	Less than 8%	Less than 4%	➢ The formulation of a management plan and its implementation.
2	Less than 4%	Less than 2%	➢ Formulation of a capital increase plan. ➢ Restraint/prohibition on paying dividend or bonuses to director and senior overseers. ➢ Restraint on the increase/reduction of total assets. ➢ Restraint/prohibition on receiving deposits at high interest rate. ➢ Prohibition on entering new business. ➢ Curtailment of currently performing business. ➢ Prohibition on opening new offices and curtailment of currently operating offices. ➢ Curtailment of business activities of subsidiaries, etc., and prohibition on establishing or holding such entities.
3	Less than 2%	Less than 1%	➢ Significant increase in capital. ➢ Drastic curtailment of currently performing business. ➢ Merger or closure
4	Less than 0%	Less than 0%	➢ Suspension of the whole or a part of banking business

President Obama's Policy

Financial Crisis in Japan – Phase 4 (2001-2002)

1. What happened?

❖ The merger and consolidation of banks accelerated

❖ Early and full completion of non-performing loan issues among major banks was strongly expected

❖ Limit and change of bank's supporting stance
- bankruptcies of large corporate with excessive debt increased
- Focusing on need for turnaround of companies with excessive debt

2. Policy direction / Major initiatives

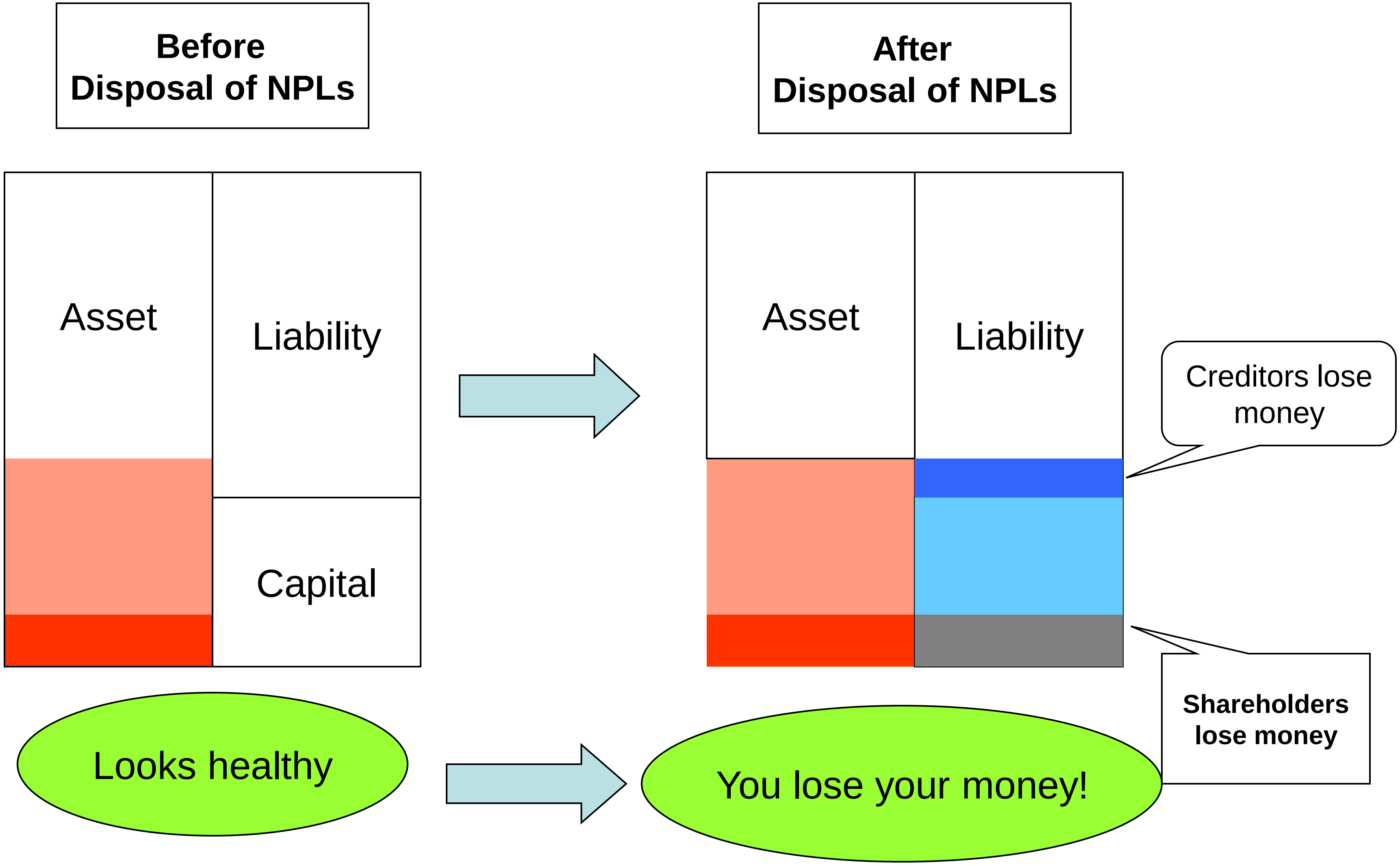
Again I was in charge

• Mandatory disposal of NPLs from B/S within 2 to 3 years (major banks only)

• A mandatory quantitative objective was imposed on major banks
-- NPL / total asset ratio must be lower than half of the current level by FY2004

• On April 2003, Industrial Revitalization Corporation of Japan (IRCJ) was established to support companies while they were being restructured (see page28)

Why afraid of zombies
(*Insolvent Counterparty*)?



Road to the Establishment of Industrial Revitalization Corporation of Japan (IRCJ)

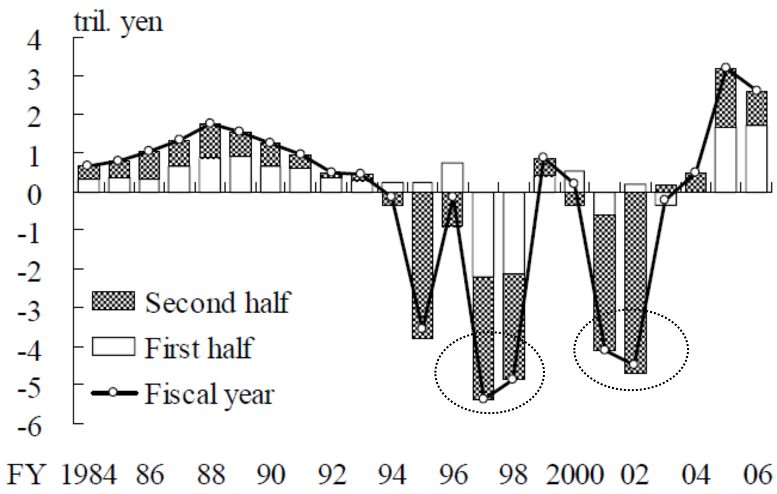
2002-2003

- September 30: Mr. Takenaka assumed the Minister in charge of FSA
- October 21: PM Koizumi approved Mr. Takenaka's Financial Reform Plan
- October 22: Scheduled announcement of Financial Reform Plan cancelled
- October 30: Comprehensive Plan for Acceleration of Reform (Proposal to establish IRCJ)
- November 7: Appointment of Mr. Tanigaki as the Minister in charge of industrial revitalization with <u>three stuff</u>
- November 11: Special Task Force started with 30 members
- January 2003: The bill "Industrial Revitalization Corporation Law" submitted to the Parliament
- February 2003: The Lower House passed the bill.
- April 2, 2003: The Upper House passed the bill.
- May 8, 2003: IRCJ started operation.

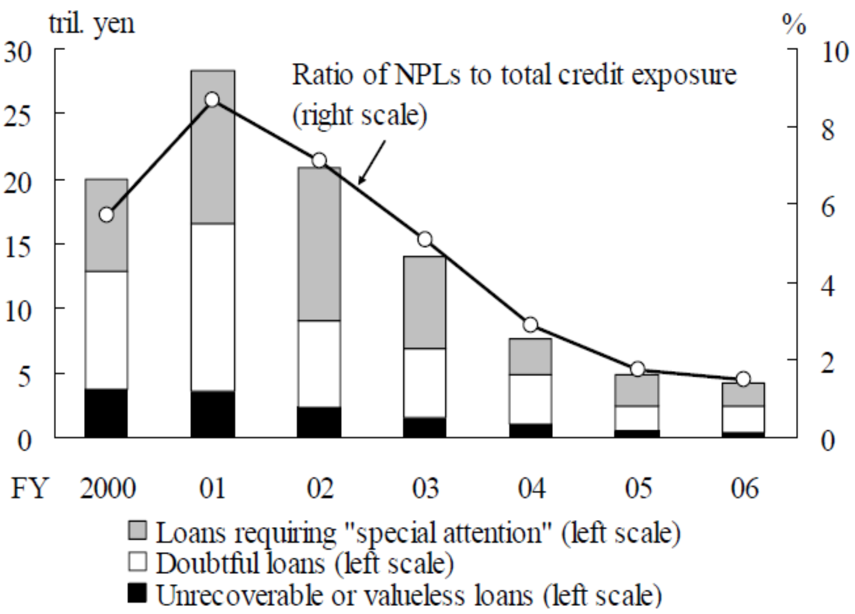
For the third time again I was in charge

---And Finally Japanese Banking System was stabilized in 2003

- (Major Banks' Net Income)



(The amount of NPLs of Major Banks)



Disposal of NPLs in Japan

- The cumulative amount of Japanese Banks' NPL disposal from fiscal 1992 through 2001 stood at about 90 trillion JPY.
  - This is equivalent to about 80 percent of the increase in loans during 1986 through 1990.

25% of Japan's GDP

(Disposal of NPLs)

tril. yen

Fiscal year	1992	93	94	95	96	97	98	99	2000	01	Total
All Banks[1]	1.6	3.9	5.2	13.4	7.8	13.3	13.6	6.9	6.1	9.7	81.5[2]
City banks, long-term credit banks, and trust banks	1.6	3.9	5.2	11.1	6.2	10.8	10.4	5.4	4.3	7.7	66.7

Notes: *1.* The figures for All Banks from fiscal 1992 through 1994 are only for city banks, long-term credit banks, and trust banks.
2. Including disposal of NPLs by bankrupt banks, disposal of NPLs from fiscal 1992 through 2001 amounted to about 90 trillion yen on a cumulative basis.

Why did Japan have long crisis ?

1. Six years to crush and establish safety net. (1992-1998)

1998 in Japan=2008 in USA

   1) The definition of NPL was not finalized until 1997.
      - Tough fight between banking communities & government
   2) Short-selling was not legally defined until 1997.
   3) There was no Credit Default Swap market in the world.

2. Another five years to revitalize real economy (1998-2003)

   Market concerns about;
   - viability of **non-financial entities,**
   - unexpected liquidation of banks,

   had to be removed. ------------How?

Establishment of IRCJ (Industrial Revitalization Corporation of Japan) (2003)

Bail-out of Risona Bank(2003)

What went wrong in Japan's measures in addressing financial crisis?

- The *order* of policy measures was wrong.
  - First measures restore confidence in financial market; i.e. measures to enable
    - *disposal of non-performing loans,*
    - *recapitalizations,*
    - *guarantees on inter-bank lending,*

and then,

- Fiscal stimulus

Policy measures to address economic crisis after Lehman shock (as of 2010)

1. The measures to protect financial sector from further adverse developments in the ongoing crisis, (**Safety Net**)
✓i.e., the package of three measures,

Established among advanced countries

- recapitalizations,
- the disposal of non-performing loans.
- guarantees on inter-bank lending and

2. The implementation of these measures. This includes actual injection of public money and the disposal of non-performing loans.

Not yet completed

3. The measures to be taken to avoid a vicious cycle between problems in financial sector and those of real economy. (**Fiscal Stimulus**)

Work-in Process

4. The lessons learned from the ongoing crisis and the measures to be taken in order to avoid the repetition of the crisis in the future. This include, among other things,

- strengthening transparency and accountability
- enhancing sound regulation
- promoting integrity in financial markets
- reinforcing international cooperation, and
- reforming international financial institutions.

-in Process

Not Urgent

5. The architecture of future global financial systems.

Not Urgent

Arrest of top executives—Necessary sacrifice?

- Top executives of four major entities which either collapsed or nationalized (i.e. *Hokkaido-Takushoku, Yamaichi, Long Term Credit Bank and Nippon Credit Bank*) were arrested for the allegations of illegal conducts, including window dressing settlement of their BS.

- After several years of court proceedings, those of LTCB were found innocent by the Supreme Court. Those of NCB are under review by the Supreme Court. Others served time in jail.

What to do? (Urgent Task)

- **Clear up balance sheets of financial institutions** and wipe out the concern about the potential zombies (i.e. hidden insolvent entities) as your counterparties

- To achieve this objective, it is necessary;
  - *To evaluate the* ***value of Non-Performing Loans,***

    (Securitized instruments including; CDOs, SIVs)
  - *To calculate* ***required amount of write-off*** *of NPLs ,*
  - *To inject, if necessary, required amount of* ***recapitalization to viable institutions.***

- Without this approach, concern about the existence of **zombie entities as your counterparty** lingers round in the market

Key to the success is----

Official Inspection by Supervisory Authorities ----Why?

- Left alone, banks have no incentive to honestly disclose assets.
- Simultaneous inspection of the assets of major banks is necessary.
- Need incentive--Lack of cooperation by banks should trigger criminal charges of executives.

Delay in implementing these measures could lead to------

Vicious Cycle between Financial Sector and Real Economy

Banks' Capital Constraints

Credit Crunch

Malfunctioning of Monetary Policy Transmission Mechanism

- Decline in Collateral Value
- Increase in Credit Costs
- Increase in NPL

"Vicious Cycle"

(Feedback between the real and financial sectors)

Economic Slowdown

Deterioration in Business Conditions
Increase in Corporate Bankruptcy
Asset Price Decline

and could lead to----