Bank Recapitalization in the West – Lessons from Japan*

SHIMIZUTANI Satoshi, Consulting Fellow, RIETI

Heather MONTGOMERY, Associate Professor, ICU

The current financial crisis has spurred a variety of policy responses around the globe. To help struggling banks, governments have announced plans to purchase bad assets, infuse troubled banks with liquidity, help negotiate mergers in the industry and increase or even expand deposit insurance programs. One of the most important, and hotly debated, policy responses has been the announcements of capital injections into the banking sector. The United States has set aside $700 billion in public funds to relieve troubled banks under the Emergency Economic Stabilization Act of 2008 and European countries have established their own schemes for publicly funded infusions. Even in Japan, where damage from the crisis has so far been limited, legislators have begun deliberating a bill to enable the government to take equity stakes in banks.

Some observers welcome these initiatives, including the focus on bank recapitalization, recognizing that recapitalizations will directly shore up banks' depleted capital levels, the epicenter of the ongoing crisis. Others, however, remain skeptical of the ability of public funds to provide anything more than a temporary fix. The debates resemble those of Japan in the late 1990s, when opinions on the use of public funds to recapitalize the banking sector were sharply divided.

Despite the important implications Japan's experience carries for the rest of the world, our forthcoming study in *Japan and the World Economy* ("The Effectiveness of Bank Recapitalization Policies in Japan" by Heather Montgomery and Satoshi Shimizutani, *Japan & The World Economy* Vol. 21 (2009), pp. 1-25) is the only study we know of that empirically evaluates the two rounds of public funds injected into Japanese banks during the 1990s. In this article, we consider the lessons Japan's experience provides to other countries now coping with the ongoing subprime crisis.

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In 1997, the problems in Japan's financial sector grew severe enough to be officially considered a crisis. The first to fall was Sanyo Securities, a mid-sized securities company, followed in quick succession by Hokkaido Takushoku Bank, which cost the Deposit Insurance Corporation (DIC) more than had been used in all the DIC's previous history. Just one week after the Hokkaido Takushoku bank failure, Yamaichi Securities, one of Japan's oldest and largest brokerage firms, followed suit. It was followed only two days later by the collapse of Tokuyo City Bank, a small regional bank. The following year, two other top banks were nationalized: The Long-Term Credit Bank of Japan and Nippon Credit Bank.

All of these institutions had previously been considered "too big to fail". The three banks were ranked among the nations "top 20" banks, which dominated the lending markets, and Yamaichi was one of the top 4 securities houses, which together had accounted for over 70% of the securities business. These failures marked the end of the traditional "convoy system" safety net. The news led to a sell off of bank shares on the stock market and the emergence of the so-called "Japan Premium" in overseas lending markets.

In March 1998, the Japanese government responded with an injection of a total of 1.8 trillion yen of public funds into 21 banks. The following year, in March 1999, another 7.5 trillion yen in public funds was pumped into 15 major banks. From 2001 onward, the government made a special push for banks to accelerate the write-off of nonperforming loans (NPLs), conducted special audits on major banks and implementing the Program for Financial Revival, which among other things called for applying stricter asset valuation standards.

Were the capital injections a success? Despite widespread skepticism at first, many factors point to the conclusion that the government bailout was a success. Panic and large-scale bank runs were successfully avoided, the banks eventually dealt with almost all of their bad loans, and the preferred stock held by the government as part of the capital injection plan has actually increased in value.

But anecdotes are not a solid base upon which to make policy decisions. To go beyond anecdotal evidence to a quantitative assessment of the effectiveness of Japan's bank recapitalization policies, we looked at the "business revitalization plans" banks filed with the government when they applied for recapitalization funds. These plans specified measures by which the banks' would: (1) strengthen their capital base, (2) accelerate the write-off of NPLs, (3) increase loans, particularly to small and medium-sized enterprises (SMEs), and (4) promote restructuring. Using the data provided in these plans, we conducted a quantitative analysis of the effects of the first and second rounds of public fund injections in March 1998 and March 1999.

Effects of Bank Recapitalization in Japan

		International banks		Domestic banks	
		1st round	2nd round	1st round	2nd round
Increase in capital adequacy ratio		1.90%	1.20%	-	0.60%
Increase in write-offs to total assets ratio		-	1.00%	-	1.70%
Growth in lending	All industries	-	4.40%	5.50%	2.20%
	SMEs	-	4.50%	-	2.40%

Notes: Measured in terms of the impact of a one percentage point increase in the ratio of capital received to total bank assets.

"-" represent statistically insignificant figures.

Our main results are summarized in the table above, which presents the impact of a one percentage point increase in the ratio of capital received to total assets on a variety of the policy objectives. Broadly, our conclusions are that the impact of the first round of public fund injections was greater than the second round and that in both rounds of capital injections, the impact was greater for internationally active banks.

On the whole, the first round capital injection served mostly as a "band-aid" to help international banks meet the minimum capital adequacy ratio of 8% as required under the Bank for International Settlement (BIS) accord. But the second round of capital injections were effective in achieving other policy objectives as well[1]. Round two had a positive impact on both international and domestic banks by not only raising capital adequacy ratios, but also accelerating NPL write-offs, and increasing lending, particularly to SMEs. We estimate that a one percentage point rise in the ratio of capital received to total assets increased lending activity of recapitalized domestic and international banks by more than 2% and 4%, respectively. These growth rates exceeded by far the average growth rate for all banks in Japan.

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1 Our finding that the second round capital injections had broader implications are consistent with the research results of Ito and Harada (2004), who found that the Japan premium disappeared after the second round of capital injections.

What lessons does Japan's experience offer in the current global financial crisis?

The first lesson concerns the timing and scale of capital injections. The U.S. government understood the importance of both and was quick to take action when it injected capital into banks a little more than a year after the subprime mortgage loan problem first surfaced in the summer of 2007. In terms of scale, $125 billion was injected into nine major U.S. banks during the first phase of the U.S. bank recapitalization scheme, which is comparable to the total sum of public funds pumped into Japanese banks over two rounds of recapitalizations.

However, the business and financial conditions of individual banks are not necessarily reflected in the amount of capital they received, with the average ratio of capital received to total assets fairly uniform across banks at about 2%. The U.S. government even went so far as to infuse capital into banks that did not need to be recapitalized.

If Japan's experience is to serve as a reference, this is cause for concern. As discussed above, the second round of recapitalizations was much more effective than the first round in Japan and the magnitude of capital injected in the second round - four times as large as in the first round- is certainly a big part of the reason why. But so is the fact that capital injected in the second round was allocated among banks based on their financial position and business revitalization plans. This level of scrutiny and discrimination was not reflected in the first round of recapitalizations.

Acting quickly to keep the banking sector functioning while also carefully evaluating the banks' individually to tailor recapitalization packages appropriately is a difficult balancing act. From the banks' point of view, requesting a capital injection means publicly announcing financial weakness, which can become a self-fulfilling prophecy. Banks often are reluctant to apply for funds, especially so if they come with tough strings attached in terms of management accountability. Policy makers may be understandably reluctant to impose measures that will delay the implementation of necessary measures and prolong the damage to the economy. But it is also unrealistic to expect results from capital injections implemented in a uniform (and mandatory) manner. While applauding the swiftness of their response, we question whether the authorities in the U.S. and Europe have sufficiently examined the management and financial health of recipient banks in deciding how to allocate the public funds.

The second lesson to be learned from Japan's experience is the importance of setting clear policy goals for the recapitalization program. Only in the second round of recapitalizations were Japanese banks required to submit the business revitalization plans mentioned above, which bound them to implementing measures to achieve the four goals set out by policy makers, and this is now perceived to be another factor that contributed to the greater effectiveness of the second round of recapitalizations compared to the first round.

Policy makers in the U.S. and Europe state that they have “made clear” to the banks the objectives of their recapitalization plans and in most cases this means a push to boost lending and prevent a credit crunch. But their have not been any agreements tying the recipients of funds to those alleged promises.

It is an understandably tricky issue. In Japan in the late 1990s, the government urged banks to boost lending to small and medium enterprises - a well known high-risk sector. The motives were at least as much political as economic. U.S. and European regulatory authorities may be reluctant to push policies on the banks that might further weaken the soundness of the sector. Further, even if authorities are able to agree on boosting lending to SMEs as a policy objective, it is questionable whether this can be achieved just by giving the banks an infusion of capital. In Japan in the late 1990s there was a lot of pent up demand for financing. Thinking of current economic conditions in the U.S. and Europe, it is hard to imagine that there is robust demand for financing, especially in the household sector, which is suffering from severe debt overhang.

Whether increased lending to SMEs is a top priority or not, U.S. and European policy makers should clarify their policy objectives and use those as a criteria for guiding the magnitude of capital injections.

The third lesson is the importance of coordinating recapitalization and other government policies. On this point, Western leaders seem to have learned from Japans mistakes. In general, Japan's policy responses the banking crisis were poorly coordinated and policy measures were implemented piecemeal. U.S. and European policy makers, in contrast, have made policy coordination central to their response. Across the globe, countries have taken a multi-pronged approach, linking recapitalization with other policy measures such as purchases of NPLs, providing liquidity, raising deposit insurance limits, and facilitating consolidation in the banking sector.

However, as Keio University Professor Heizo Takenaka has pointed out in this column earlier, the maximum benefits of recapitalization can only be achieved under strict asset valuation standards. It is necessary to ensure that banks thoroughly and properly disclose their NPLs under the stringent supervision of the relevant regulatory authorities. The greater effectiveness of the second recapitalization round in Japan was partly attributable to the implementation of stricter disclosure requirements by the Financial Supervisory Agency at that time. The current crisis packages are not stringent enough in imposing such requirements and the supervisory institutions in both the U.S. and Europe desperately need consolidation themselves.

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Markets across the globe are being affected by the current financial crisis. Increasingly sophisticated asset securitization has spread mortgage default risks beyond the boundaries of the banking sector, and highly leveraged investment banks, financing investment with an excessive reliance on debt, have magnified its impact and spread it around the world. According to a report published by the International Monetary Fund (IMF) in November, the ongoing subprime crisis has cost the banking sector losses comparable to the total losses incurred in Japan's financial crisis in the late 1990s. But losses incurred by nonbank financial institutions are estimated to be twice as high. In this environment, regulatory authorities face special challenges in accurately assessing the extent of losses and designing appropriate policy responses. But it is perhaps especially important to get things right this time around.

The current global financial crisis continues to surprise observers with the unpredictability of events. Certainly no two crises are identical. However, it is important to draw lessons from past experience to guide policymakers struggling to stabilize the world’s financial markets. Japan’s experience in the 1990s suggests a need for clarifying the policy objectives, tailoring the response to those objectives and the conditions of each individual bank receiving support, and finally, a tightening of bank supervision and asset valuation.