



The Macroprudential Implications of the 1990s Japanese Financial Crisis

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Overview of the paper: *Causes of Japanese Financial Crisis in the Late 1990s*

- ▶ The paper by Professor Mitsuhiro Fukao provides rich details of what led to the Japanese financial crisis
- ▶ Among the causes of the crisis:
 - ▶ Macroeconomic context: rapidly rising real estate prices and stock prices
 - ▶ Rapid growth in real estate lending, including to *Jusen* (Japanese non-bank mortgage-lending institutions)
 - ▶ Unstable funding models: Bank liabilities at long-term credit banks that could “run”
 - ▶ Cross-holdings of shares by banks and their customers
- ▶ Problems were exacerbated by several factors:
 - ▶ Lack of transparency as problems increased
 - ▶ Banks were not forced to address problems quickly
 - ▶ Accounting strategies obfuscated problems
 - ▶ Recapitalization was delayed, lengthened the time to recovery
- ▶ I agree that all these factors contributed to significance of problems

My Observation: Two Other Aspects of the Crisis Deserving Attention

- ▶ The repercussions of the crisis – the large macroeconomic consequences
- ▶ How macroprudential regulations could have mitigated problems

Macro Spillovers – Banking Problems and the Consequences for the Real Economy

- ▶ Credit crunch – impact on broader economy from failure to mitigate banking problems – banks reduced lending to raise capital ratios
- ▶ Misallocation of already-reduced credit – funds flowed to prop up weak borrowers/banks, potentially at the expense of higher-return projects
- ▶ Global ramifications – Japan’s capital-constrained banks had large global presence, and the withdrawal of credit had implications for host countries – often reduced global lending before domestic lending
- ▶ At the time, policymakers were focused more on avoiding fiscal problems generated by bank bailouts than on the broader domestic and global costs of allowing the problems to linger; e.g., slow realization of losses and raising of capital

Figure 1: Japanese Urban Land Price Indices

March 1970 - March 2015

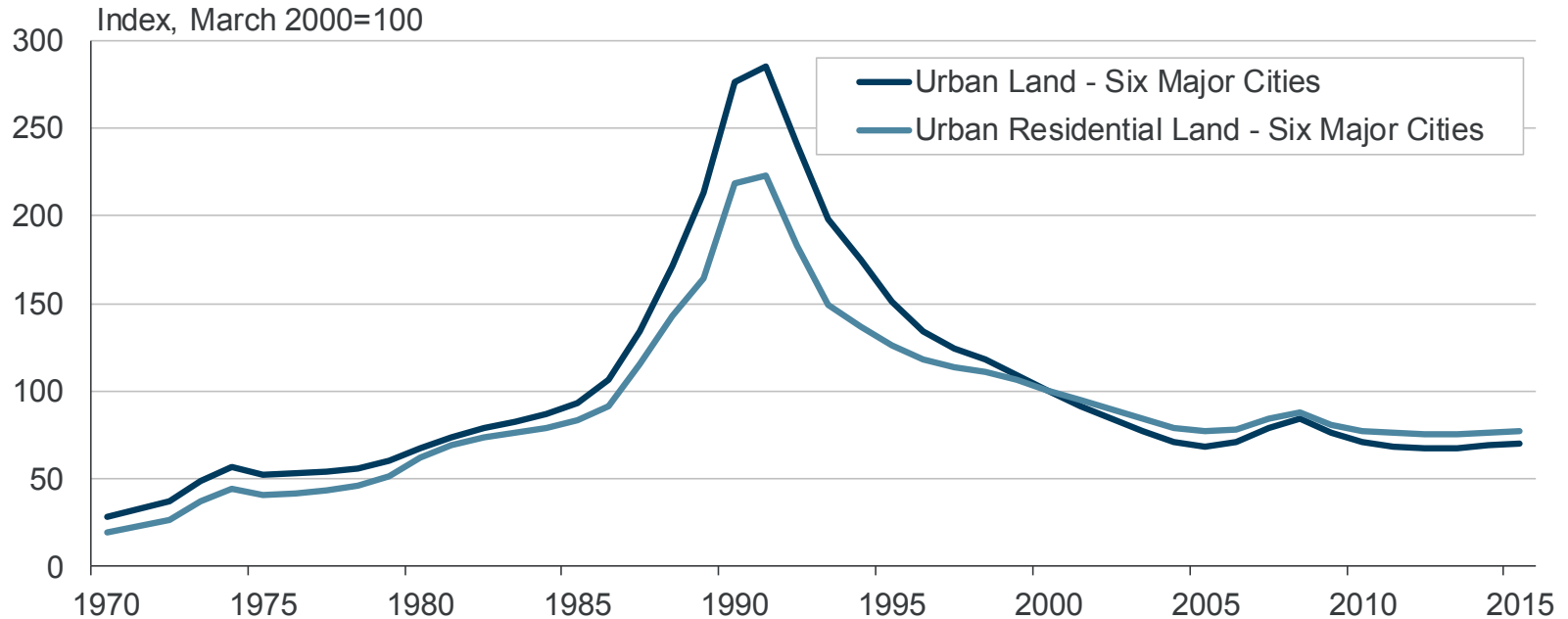
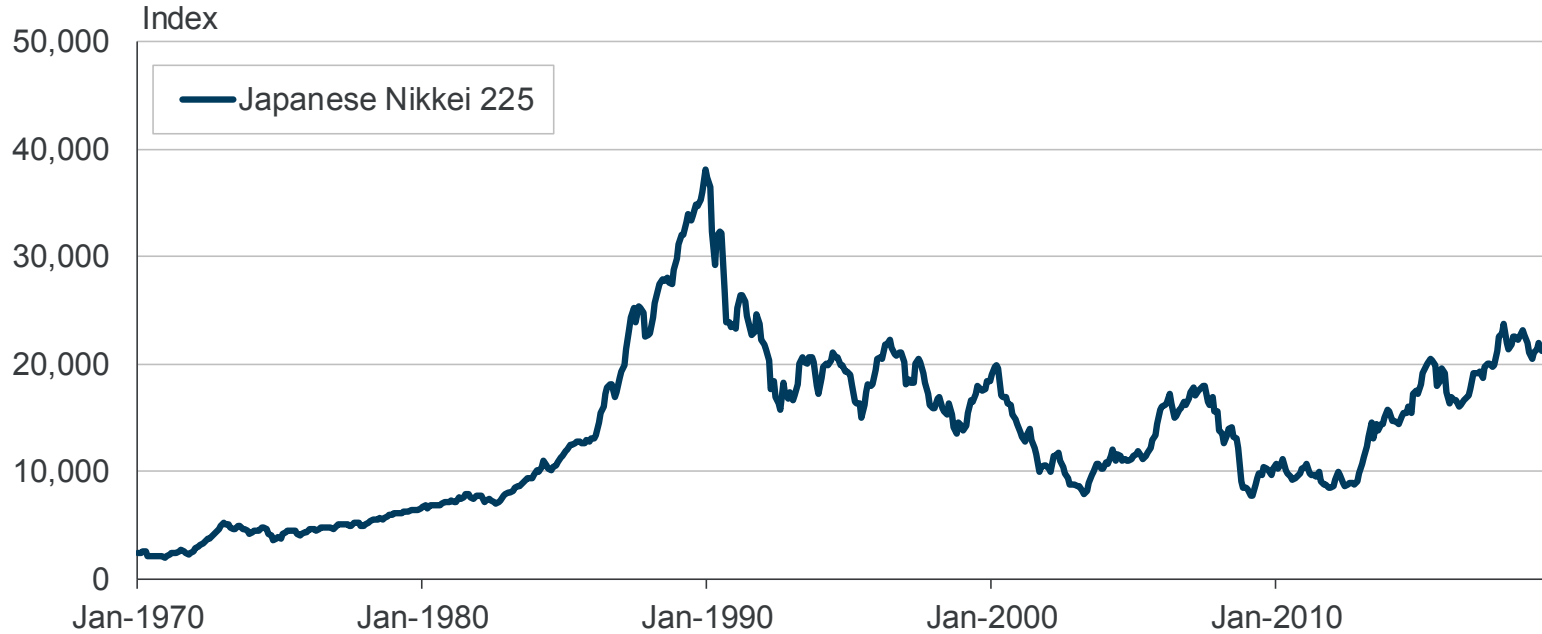


Figure 2: Stock Prices in Japan: The Nikkei 225

January 1970 - May 2019



Could Current Macroprudential Policies Have Helped in the Japanese Financial Crisis?

1. Bank Stress Tests:

- ▶ The “severely adverse” scenario in this year’s U.S. stress test asks banks to consider implications of a peak to trough decline in stock prices of 50%, and in residential and commercial real estate prices of about 25% and 35% respectively. If used in the late 1980s, beneficial effects:
 - ▶ If applied during the rise in real estate and stock prices, it would have encouraged banks to retain more capital
 - ▶ Stresses of cross-holdings of stocks and investments in *Jusen* would have been more apparent, and may have discouraged such aggressive lending

(Continued...)

Could Current Macroprudential Policies Have Helped?

- ▶ Would have made clearer to regulators and the government potential systemic implications of policies
- ▶ Since stress tests are normally released publicly, would also have encouraged government to recognize losses more quickly and to be more transparent
- ▶ Greater transparency might also have led to a more vigorous recapitalization of banks

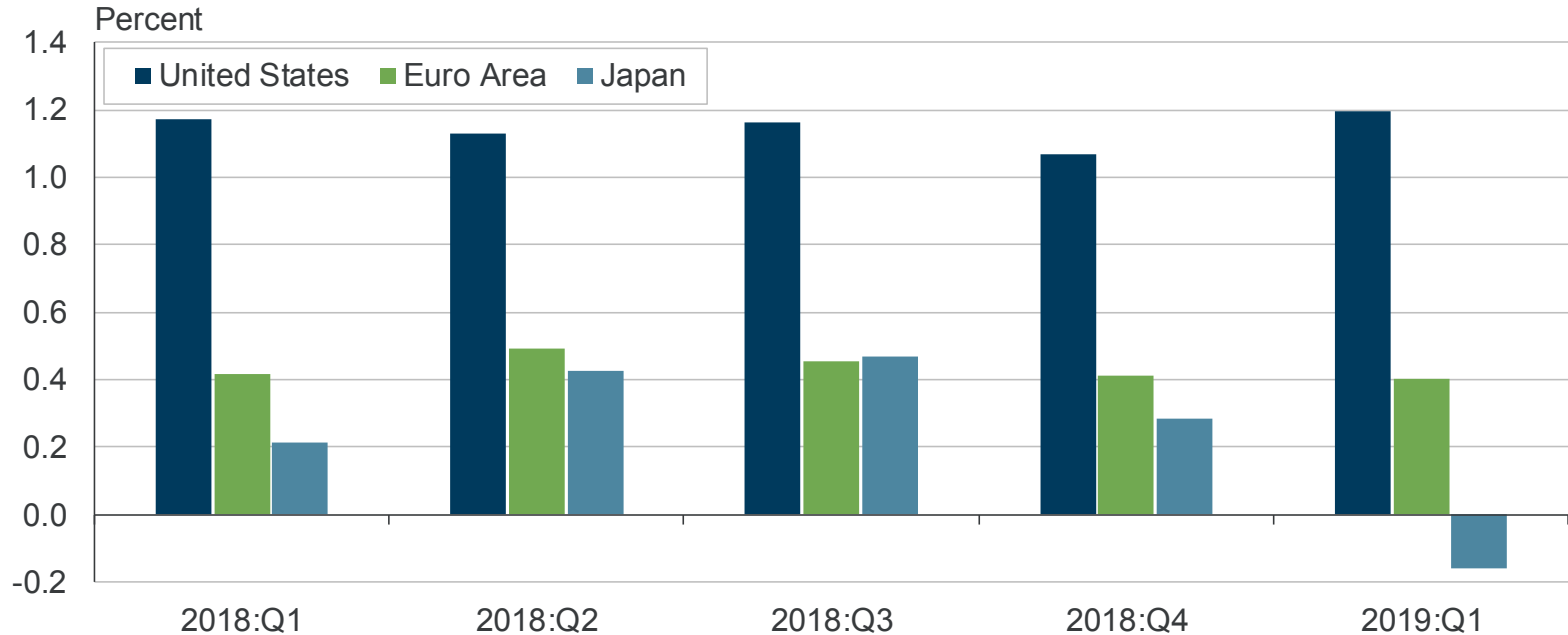
Could Current Macroprudential Policies Have Helped?

2. Countercyclical Capital Buffer (CCyB):

- ▶ Could potentially have had a big impact
 - ▶ When asset prices rose so abruptly, raising a CCyB would have provided a much bigger bank capital cushion during the period when asset prices rose
 - ▶ Capital cushion would have further insulated banks from the capital-eroding effects of falling asset prices, and likely would have discouraged aggressive lending into increasingly risky sectors
 - ▶ Once asset prices began to fall, the CCyB could have been reduced – easing binding capital requirements, reducing the pressure on banks to shrink domestic and global lending
 - ▶ Buffers unlikely to eliminate “credit crunch” but would have helped

Figure 3: Average Return on Average Assets for the Three Largest Banking Organizations

2018:Q1 - 2019:Q1

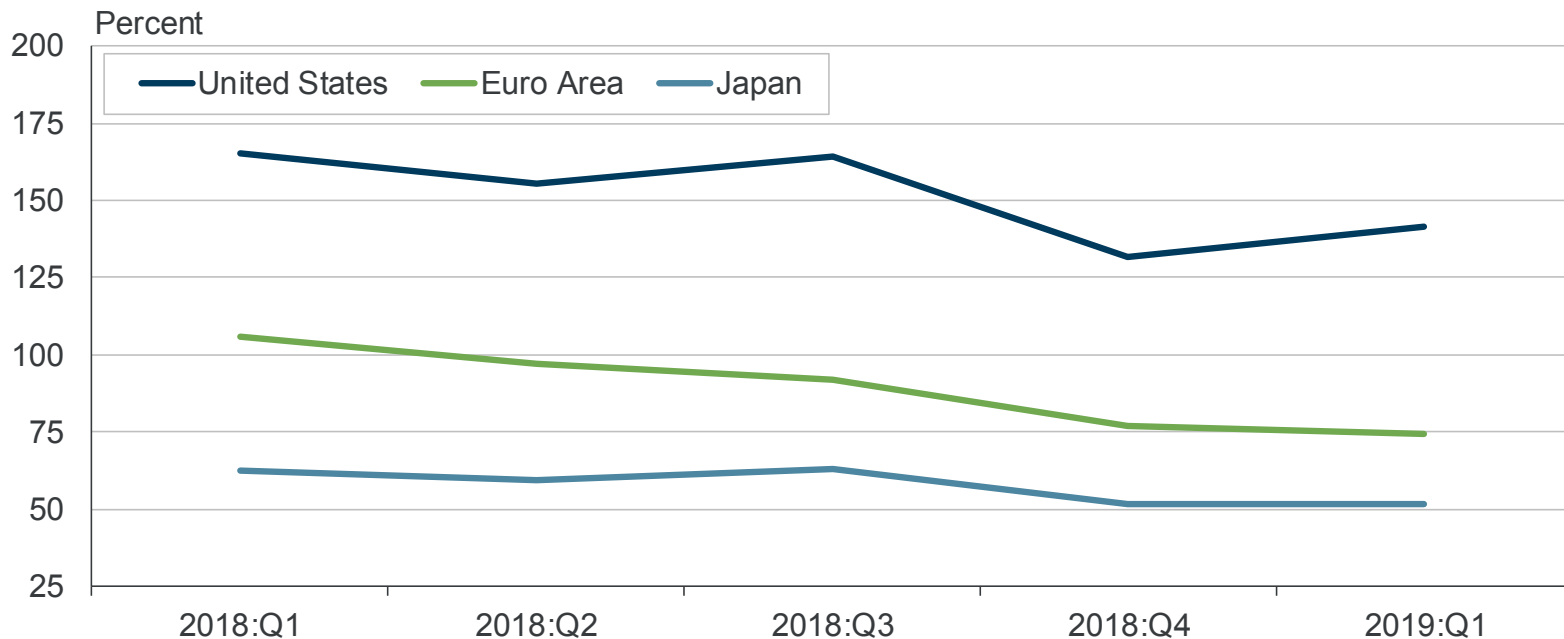


Note: The U.S. average includes Bank of America Corporation, Citigroup Inc. and JPMorgan Chase & Co. The Euro Area average includes Banco Santander, SA, BNP Paribas SA and Crédit Agricole SA. The average for Japan includes Mitsubishi UFJ Financial Group, Inc., Mizuho Financial Group, Inc. and Sumitomo Mitsui Financial Group, Inc. Japan Post Bank Co., Ltd. is excluded due to its unique postal-banking business model.

Source: S&P Global Market Intelligence, SNL Financial Data

Figure 4: Average Price to Tangible Book Ratio for the Three Largest Banking Organizations

2018:Q1 - 2019:Q1



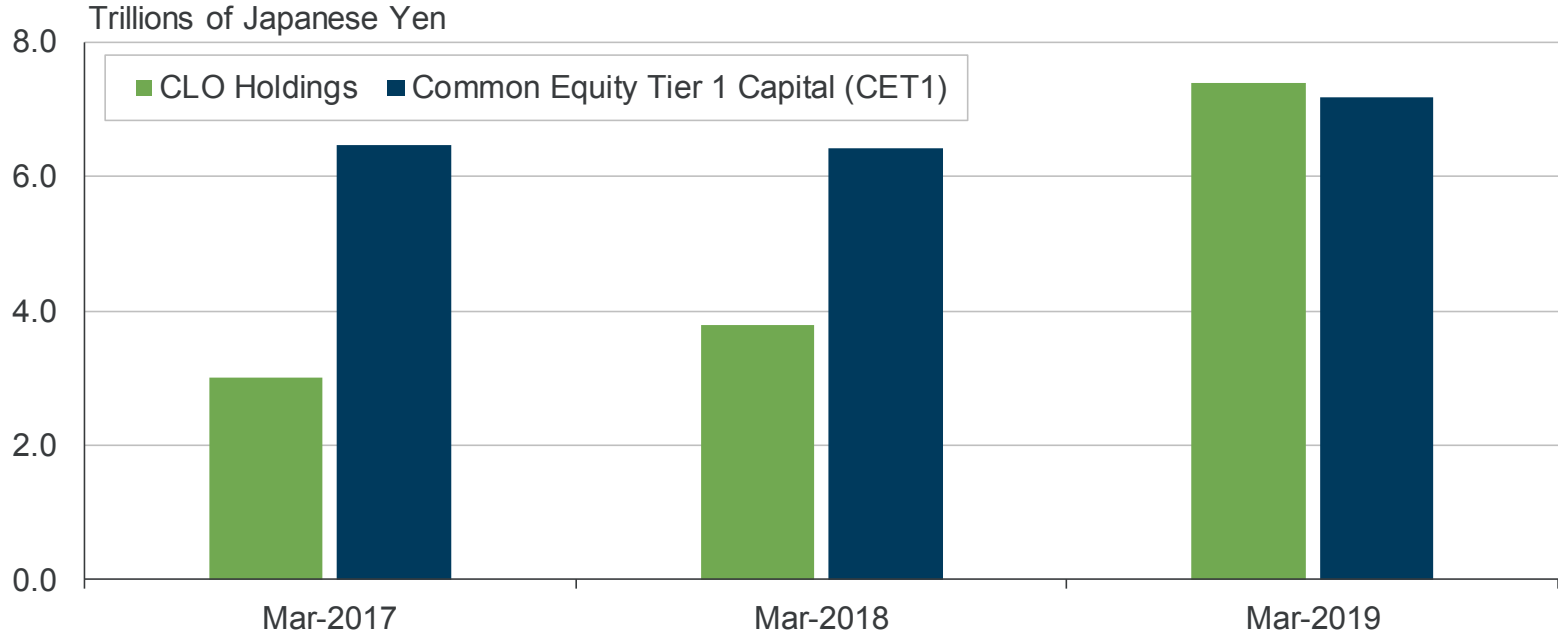
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Source: Bloomberg Finance L.P.

Implications for Japan Today

- ▶ Japanese macroeconomy poses significant challenges for banks
 - ▶ Demographics provide fewer lending opportunities
 - ▶ Low term premia make financial intermediaries' transformation of assets role less profitable
 - ▶ Low short- and long-term rates make banks less profitable more generally
- ▶ Key questions:
 - ▶ How critical are more vibrant and profitable banks for dynamism in the economy?
 - ▶ How will Japan's banks fare in an economic downturn given their current performance?

Figure 5: Example of CLO Holdings and Capital of One Large Japanese Bank



Is the Environment Encouraging Reach for Yield Behavior?

- ▶ Japanese banks have become an important source of financing for CLOs in the U.S. and Europe
- ▶ Holdings tend to be AAA tranches of CLOs
- ▶ High ratings – high interest rates – profitable even with hedging cost
- ▶ Risk – economic downturn – significant credit migration
- ▶ Large losses at some institutions in U.S. during the financial crisis
- ▶ Just one example of reach for yield risk of current macroeconomic environment

Concluding Observations

- ▶ Japanese financial crisis had significant implications:
 - ▶ Japan's domestic economy was severely impacted
 - ▶ Global economy was impacted by severity of problems at Japanese global banks and the protracted response
- ▶ Macroprudential policies could have mitigated problems:
 - ▶ Rigorous stress tests
 - ▶ Countercyclical Capital Buffer
- ▶ Japanese situation now:
 - ▶ Little room for profitability
 - ▶ Difficult macroeconomic environment that encourages reach for yield
 - ▶ Important to address resilience for possible global economic scenarios