a banking crisis: reformers do not reform. blame is difficult.

by Gavin Buckley

By everyone’s reckoning, the Japanese economy is in wretched shape.

It shrank at an annual rate of 3.4 percent in the second half of 2001, experiencing the fourth recession in a decade, and the Organization for Economic Cooperation and Development expects unemployment to exceed 6 percent this year. Indeed, the only reason that forecasters are expecting growth to turn positive in 2002 is an upturn in demand from abroad. What’s more, the shadow of deflation over the Japanese economy is growing darker: prices are expected to fall at an annual rate of 1.6 percent in the second half of 2002. Everyone also agrees that the Japanese banking sector is both a cause and a victim of this macroeconomic malaise. The banks are hamstrung by poor-quality assets and a lack of capital, and are therefore unable to perform their critical role as intermediaries between savers and businesses seeking capital. Yet without substantial economic growth in the economy, the banks cannot possibly outgrow their problem loans. The major banks expect to report combined credit costs of 6.4 trillion yen (¥) in the fiscal year that ended in March 2002 in contrast to operating profits of only ¥3.5 trillion in the previous fiscal year. Thus, one way or another, the gridlock can only be broken by government intervention. But here the consensus
JAPAN’S BANKING CRISIS

ends. Discussions about the form that government support should take and the means by which it should be delivered often center on Japan’s Resolution and Collection Corporation. While the RCC has often been likened to the Resolution Trust Corporation, which was instrumental in resolving the savings and loan crisis in the United States, neither the RCC’s bureaucracy nor the government that defines its mandate offers much hope of a fix anytime soon. Indeed, one could argue that the people in charge of resolving the banking crisis have little to gain and much to lose in getting the job done.

WHEN IN DOUBT, MERGE

The Resolution and Collection Corporation was created on April 1, 1999, through the merger of the Housing Loan Administration Corporation (HLAC) and the Resolution and Collection Bank (RCB). The former had been created three years earlier from the assets of seven failed Jusen, or housing loan corporations. The Jusen were established in the 1970s as mortgage finance companies financed by parent depository institutions.

In the 1980s, their focus switched from financing housing to financing more speculative real estate and property companies, which were used by their parents to evade controls that were put on bank property lending during the run-up of asset prices in Japan’s infamous “bubble” economy. Thus, Jusen were among the first financial institutions to fail when the bubble burst in the early 1990s.

The Housing Loan Finance Corporation was created from the failed Jusen with notional assets of ¥13 trillion. These assets are usually referred to as having been “purchased” by the HLAC. In fact, the establishment of the HLAC really amounted to a forced merger of the failed institutions – one facilitated by an infusion of ¥680 billion from the government and a forgiveness of ¥5.7 trillion by the Jusen’s parent financial institutions. Some ¥6.4 trillion of the total Jusen assets of ¥13 trillion were deemed to be uncollectible.

Kohei Nakabo, a lawyer and former president of the Japanese Bar Association, was installed as the HLAC’s director. He made it quite clear that the quasi-public corporation’s focus was debt collection, and pledged to avoid further losses that would necessitate further outlays of public funds. (The Jusen Law obligated the government and the Jusen parent companies to cover the future losses of the HLAC portfolio.) However, since the Jusen assets were valued based on the 1995 land price index and land prices continued to fall, additional losses were inevitable.

Traditionally, the Japanese government has dealt with bank failures before the formal event by arranging mergers with stronger institutions. By the mid-1990s, however, the weak economy and continuing declines in real asset prices brought so many financial institutions to the brink that the remaining ones had neither the stomach nor the balance sheets to absorb them.

In 1994, a number of credit cooperatives failed. The two largest were reorganized in January 1995 as the Tokyo Kyodo Bank, capitalized by the Bank of Japan and various Japanese commercial banks. Kyodo Bank was not a success. More credit cooperatives failed, and in November of that year the Ministry of Finance announced that Kyodo Bank would

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again be reorganized into a receivership institution for these failed cooperatives.

Nothing succeeds in Japan like failure: in September 1996 the Kyodo Bank was once again reorganized, this time as the Resolution and Collection Bank (RCB), with a mandate to act as the receiver for all failed depository institutions. The RCB could assume assets from failed institutions for a period of five years, with the requirement that all assets were to be collected or otherwise disposed of within 10 years.

As 1997 progressed, increasingly larger regional banks failed, culminating in the failure of the “superregional” Hokkaido Takushoku Bank. It became all too clear that substantial public resources were needed to deal with additional large bank failures, to recapitalize the remaining banks and to bolster confidence in the safety and soundness of the Japanese banking system.

After much political wrangling, ¥60 trillion were made available for the recapitalization and restructuring of the banking system in October 1998. The Long Term Credit Bank and Nippon Credit Bank, two large banks that had survived the summer on Bank of Japan life support, were nationalized in October and December 1998, respectively. The restructuring laws also directed that the HLAC and RCB be merged into something called the Resolution and Collection Corporation (RCC).

The RCC was established as a joint stock company with the government’s Deposit Insurance Corporation as its sole shareholder. It was capitalized at ¥212 billion, but this represented capital already paid into the RCB and HLAC.

The RCC is a family affair, in a very Japanese way. It has a staff of 2,500 – about 2,000 are ex-employees of failed housing loan companies and banks. The remaining 500 employees are temporarily detailed to the RCC by large commercial Japanese financial institutions. As of Aug. 1, 1999, the RCC had 36 “officers,” most of whom had close ties to the failed financial system.

The majority of the RCC staff members work on collecting payments on assets received from the various failed institutions. Often the staff of the failed institution is, in effect, assumed by the RCC along with the assets. Indeed, each of the larger failed institutions has an organizational office within the RCC. Thus, there are divisions in the RCC that correspond to each of the seven housing loan corporations that failed in the mid-1990s.

These divisions, manned by the original staffs of the Jusen companies, are responsible for the continuing collection on the Jusen loans. There are additional business divisions responsible for collection of debts that have
organized-crime ties, for the purchase of assets from banks that have not failed and for the pursuit of claims or other legal action in the courts and various administrative offices.

**THE RESOLUTION AND COLLECTION CORPORATION: THE MANDATE**

Bank loans in Japan are generally collateralized by real estate. When loans were transferred onto the books of the HLAC and RCB, they were written down to reflect the decline in the value of the underlying real estate collateral. Generally, this write-down was based on a price index specific to location and type of collateral (for example, Osaka, prime business real estate) minus an additional 15 percent as a cushion.

The average write-down on HLAC assets and RCB assets was 55 percent and 78 percent, respectively. The difference in the write-down percentages follows from the fact that RCB assets were added to the books later, after the underlying collateral had further eroded in value. Although the loans were recorded at less than face value, the benefit of this write-down was not usually passed on to the borrower. That is, the borrower was still responsible for the original repayment schedule defined under the original loan agreement. It was hoped that the real estate market would turn around and that collection activities would actually turn a profit. However, prices continued to decline and macroeconomic conditions continued to deteriorate.

RCC officials say the collection process is guided by two main principles:

- Collections will be carried out with “strength,” “speediness” and “transparency.”
- Collections will at least equal the original purchase price of the assets so as to avoid a future burden on the taxpayer.

Leave aside, for the moment, the highly praiseworthy criteria in the first principle. Look at the second principle, for it embodies much of what is wrong with the Japanese approach to disposing of loans and other assets. There are a number of conceptual problems in attempting to equate a flow (collections) with a stock (the book value of assets). More important, while the purported goal of the RCC collection process – to avoid future costs to taxpayers – seems appropriate, it is unlikely to have that outcome. This approach of maximizing collections ignores costs and makes unwarranted assumptions regarding future asset prices.

**HLAC AND RCB COLLECTION: REALITY BITES**

The first table below shows the collection performance of the Housing Loan Administration Corporation (HLAC) with regard to the Jusen assets. “Collections,” in this context, means gross income from loan payments and asset sales. The majority of collections are actual loan payments. By the end of 2000, the HLAC or its successors had collections that equaled more than 50 percent of the value at

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**CHANGE IN AVERAGE COMMERCIAL LAND PRICE IN JAPAN**

![Graph showing change in average commercial land price in Japan](image)
which the assets had been transferred to government books. That is, as measured against the second principle of collections above, the Jusen problems are almost half resolved.

Recoveries are slowing, however, and officials acknowledge that much of what remains may be uncollectible. Moreover, the HLAC’s expenses are relatively high, leaving little for asset write-down. On April 1, 1999, ¥4.1 trillion in Jusen assets was transferred to the new RCC. Thus in more than four years, despite collection totaling ¥2.4 trillion, Jusen assets under management have declined by only about 10 percent.

In contrast to the Jusen account, the RCB has continually added assets from newly failed institutions and direct purchases. Like the HLAC, the RCB was primarily a collections operation – very little was sold outright. The RCC touts a “recovery rate” of 56 percent on these assets. As was the case with Jusen assets, however, very little had actually been disposed of. Through the end of the 1998 fiscal year, of ¥6,324 billion in assets held by the RCB and HLAC, only ¥68 billion, or about 1 percent, had been sold outright. Another ¥31 billion had been sold to the government for official use.

**RCC Collections Performance**

In April 1999, the HLAC and RCB assets were transferred to the RCC, although collections on the accounts continue to be tracked separately. In addition to receiving assets in connection with bank failures, the RCC may also purchase assets from banks still in business in order to increase their liquidity and keep them in business. Often these assets are tainted by association with yakuza (Japanese criminal organizations) and are purchased at huge discounts from the price at which the bank booked the asset. In fact, the daily newspaper *Nihon Keizai Shimbun* reported last October that the RCC had purchased more than half of its loans from operating institutions for one yen each.

The RCC’s balance sheet is financed almost entirely from money borrowed through the Deposit Insurance Company. The bulk of the RCC’s assets consists of property from the RCB and HLAC (more than ¥8 trillion)
and convertible and subordinated debt purchased by the Japanese government to shore up banks’ balance sheets in 1998 (¥7.5 trillion). In addition, the RCC holds bonds to generate income from the spread between short-term borrowing and the longer-term Japanese government bond rates.

Consistent with the RCC’s argument that its mandate is to collect rather than to dispose, the balance sheet has only marginally contracted between the end of the 1999 fiscal year and the end of the 2000 fiscal year. Asset sales were offset by new asset purchases (¥1,916 billion in the 1999 fiscal year and the 2000 fiscal year).

A few items on the RCC’s income statement merit special note. First, more than 20 percent of gross income in the 2000 fiscal year was from dividends, presumably from the ¥7.5 trillion holdings of bank capital. Non-interest income includes asset collections and asset sales. The fact that this income almost doubled from the 1999 fiscal year to the 2000 fiscal year suggests that the RCC has increased its efforts to dispose of assets – albeit from a very low base. Finally, loan write-offs and transfers to loan loss reserves absorb sufficient operating income so that net income is close to zero.

A RECIPE FOR GRIDLOCK
Thanks to its history, staffing and mandate, the Resolution and Collection Corporation is run like a private bank rather than a public-sector asset disposal organization. Asset disposal would mean that the institution is temporary in nature: when the assets are depleted, the RCC would close up shop as the Resolution Trust Corporation did in the United States in 1995. However, neither the RCC’s owner – the Japanese government – nor its staff members wish that to happen.

For its staff the job of collecting income from assets (rather than disposing of them) means job security. For the government, keeping assets on the RCC books and slowly writing them down with collections, dividend and interest income means not having to recognize losses and use taxpayer money. But the capture of the RCC by bureaucrats and politicians with a stake in preserving the status quo constitutes a disaster for Japan as a whole. As long as the banking system remains in gridlock, the prospects for economic recovery will remain poor. And as long as the RCC is in charge, the prospects for breaking the gridlock are equally poor.