

TARP II (US, 2008) = RRA (Japan, 1998)

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Now the TARP (Troubled Assets Relief Program) has been transformed from a program that primarily buys troubled assets at financial institutions (as the name suggests) to a program that focuses on injecting public funds to supposedly healthy banks to recapitalize them. The program with the new emphasis, which I call the TARP II, is better than the original TARP in that it directly addresses the issue of capital shortage that is at the center of the current financial crisis, as many have argued.

As I discussed in [my paper with Anil Kashyap](#), Japan eventually shifted from the policy that primarily focuses on purchasing problem bank assets to the one that uses public funds to recapitalize major banks, too. In this sense, the U.S. response is going through the same changes that the Japanese policy went through, although the U.S. is now moving much quicker than Japan did. It took about five years for Japan to move from the bad assets purchases to capital injection. It took the U.S. only five days or so.

Japan conducted two major re-capitalization programs during the late 1990s. One was based on the Financial Function Stabilization Act (*Kin'yu Kinō Anteika Hō*) or FFSA in 1997 and was carried out in the spring of 1998. The other was based on the Rapid Recapitalization Act (*Sōki Kenzenka Hō*) or RRA in 1998 (hence the title of this piece) and was carried out in the spring of 1999. To recap the capital injection episodes from Japan, I cite from [the paper with Anil Kashyap](#) below.

To attack the undercapitalization the Japanese government eventually opted for a pair of public re-capitalization programs. The first, following the November 1997 crisis, made ¥13 trillion (about \$124 billion) of government money available to buy subordinated debt in undercapitalized but supposedly solvent banks. Subordinated debt can be counted as a part of regulatory capital (as long as it does not exceed Tier I capital) and would give the purchasing bank a buffer to absorb losses without having to default on promises to depositors.

This program was initially shunned by the banks. There are two reasons why the banks might not have wanted the assistance. One explanation is that the banks feared applying for the funds would be admitting to large future losses than had been previously disclosed (or that their ability to raise funds elsewhere would be missing). This negative signal would push down the value of existing equity.

A second logical possibility is that the banks balked because new securities would be senior to the existing equity claims. Were the banks to recover, the existing owners would not be able to reap the benefits until after the government's

claims were paid. Either interpretation suggests that accounting for the incentives of the existing equity holders could be important in designing recapitalization schemes.

After some cajoling by the government, 21 major banks each applied for an identical amount of public funds. The amount was set at the level that the healthiest bank was willing to ask for, so for most of the banks, the amount was far less than they needed to restore their capital. In total, only ¥1.8 trillion (about \$17 billion) was distributed over 21 banks in the spring of 1998.

The second recapitalization happened in the spring of 1999, as part of the Rapid Recapitalization Act that passed the Diet in the fall of 1998. By this time, separate legislation had given the Japanese government a mechanism to close down and nationalize weak large banks. Two major banks that were supported in the 1998 recapitalization, the Long-Term Credit Bank of Japan and the Nippon Credit Bank, had already had their shareholders wiped out in the process of being nationalized. Thus, the remaining banks knew that staying undercapitalized was not an option. The size of the second program was larger, with ¥25 trillion (about \$238 billion) available for recapitalization. This time all the major banks except for the most healthy one (Bank of Tokyo Mitsubishi) applied. The government ultimately put ¥7.5 trillion (about \$71 billion) into the 15 banks in the form of preferred shares and subordinated debt with various terms and conversion options into common shares.

(Takeo Hoshi and Anil Kashyap, 2008, “Will the TARP Succeed? Lessons from Japan,” NBER Working Paper #14401.)

The shift of emphasis to recapitalization in the U.S. is a promising one, but the Japanese experience suggests that there are several new problems that a capital injection program is likely to face.

First, it is not guaranteed that banks (especially healthy banks) will participate. Japanese banks worried about sending negative signals about their financial health by applying for public funds. [As the Financial Times reported](#), many European banks seem to have the same concern. Here the U.S. regulators seem to be doing remarkably well in convincing the large banks to accept public funds so far.

Second, the size of the recapitalization is also important. In the Japanese case, the first recapitalization of 1998 was too small to be effective. The second attempt was close to what the U.S. is ready to use (\$250 billion) in its absolute size, although the Japanese government did not use up the whole amount. It turns out that the second recapitalization did not solve the capital shortage after all. As Anil and I showed in [another paper](#), Japanese banking sector continued to be undercapitalized well into the mid-2000s.

I do not get into a detailed analysis here of why Japanese banks stayed undercapitalized even after the recapitalization of 1999, but a major reason was that the banks were slow in recognizing losses from bad loans. The amount of non-performing loans continued to increase and eroded the bank capital faster than the speed of recapitalization.

A similar concern exists in the current crisis as well. The capital shortage problem was originated from the losses that financial institutions suffered from the problem mortgage loans and the securities backed by those mortgages. If the problem continues and the uncertainty about the extent of losses remains, no amount of capital will be sufficient to restore the confidence in the financial system. This suggests the efforts to clean up the balance sheets of banks must continue side by side with the recapitalization efforts.

Finally, it is important not to use the public funds to prop up failing banks. Japan made this mistake especially in the first round of recapitalization. Two major banks, the Long Term Credit Bank of Japan and the Nippon Credit Bank, both of which accepted public funds, failed in less than a year. To avoid this mistake, one would need a way to distinguish healthy banks from sick banks and use public funds to recapitalize only healthy banks. This is easy to say but hard to implement. One way to do this is to use public funds to recapitalize a bank only when it can successfully raise additional capital from the market on their own efforts, as the [Japanese Shadow Financial Regulatory Committee \(of which I am a member\) proposed during the Japanese crisis.](#)