How To Transform a Failed Japanese Bank

Mark Latham

Preliminary draft: September 26, 1998.

Abstract

When Japanese government authorities take over a bankrupt bank, they must decide what to do with the bank's assets and employees. This paper proposes a recapitalization strategy that would remove the three main causes of banking problems: subsidized deposit insurance, the tax advantage of debt, and poor corporate governance. Proceeds from the new bank's IPO would repay most of the government's recapitalization costs, minimizing the cost to taxpayers. By using capital markets to price the portfolio of bad loans, this transformation could be completed in a few months.

Mark Latham is a financial economist and consultant. Contact info: http://votermedia.org/about-contact.html. This and related papers available at http://votermedia.org/publications.

The Proposal

Suppose Japan's Finance Supervision Agency (FSA) determines that Hinotori Bank is bankrupt.[1] Hinotori's liabilities are 1 trillion yen of demand deposits and 3 trillion of time deposits. Suppose the market value of assets (loan portfolio) is about 3 trillion yen, so equity is minus 1 trillion. Japanese taxpayers will have to pay 1 trillion yen to make depositors whole.

What should be done with the bank's employees? Who should own and manage the loans? Here is a proposal.

The FSA takes over management of the bank for a few months. For this first simple example, suppose the old Hinotori shareholders will get nothing, since their company is bankrupt. The Japanese government injects about 2 trillion yen into the bank. This is used primarily to reduce the amount of deposits, by lowering the rates paid on deposits and gradually redeeming some of them. The new Hinotori Bank then has a market value of equity of about 1 trillion, owned by the government. The FSA organizes an IPO to privatize the bank, raising 1 trillion yen which repays half of the government injection.

This new bank can resume taking deposits and making loans, but it operates in a different environment designed to eliminate the three main causes of Japan’s banking problems: subsidized deposit insurance, the tax advantage of debt, and poor corporate governance.

Hinotori will pay the government a base rate of 2 basis points per month on insured deposits, plus a risk premium if the market value of its capital falls below 30% of deposits. Suppose for now that its only liabilities are deposits which have now been reduced to 2 trillion yen, and its only capital is equity. So capital is now 50% of deposits, and 33% of assets. Book value of assets is not used to determine the risk premium because of the difficulty of valuing a risky loan portfolio.[2] Instead, the premium is a smooth function of the market capital to deposits ratio, such as:

Equity/Deposits	Base Rate	Risk Premium	Total Rate
	(bp/mo)	(bp/mo)	(bp/mo)
5%	2	25	27
10%	2	16	18
15%	2	9	11
20%	2	4	6
25%	2	1	3
30%	2	0	2
35%	2	0	2
40%	2	0	2
45%	2	0	2
50%	2	0	2

This gives an incentive to maintain sufficient equity capital. If equity drops below 5% of deposits, the bank will again be taken over and recapitalized.

The double taxation of equity under the existing corporate and personal income tax system creates a disincentive to having more equity. Instead, Hinotori would pay no corporate profit tax, but stockholders would be taxed on dividends and capital gains annually. This would also make for a more level playing field in the competition between securitized and unsecuritized debt. To see this, compare a corporate bond fund or money market fund with a "bank" funded entirely by equity, with no deposits. Likewise, such a bank could be compared with the securitized asset pools now being created with nonperforming assets from Japanese banks.

To ensure accountability of the bank's management, nominations for the board of directors are handled by an outside agency chosen annually by shareholder vote, as described in Latham (1999, 1998abc). This nominating agency is known as a Corporate Monitoring Firm, or CMF.

Treatment of Employees

Japanese people prefer a system with much greater job security than in the U.S. The new Hinotori Bank can accommodate and reflect this preference.

Just before the Hinotori IPO, perhaps 5% of the bank's shares should be given to its employees on a per-capita basis. In addition, employee purchases of shares should be encouraged by offering them a 15% discount on the market price. Part of one's annual bonus could be in shares. All these types of employee shareholdings must be held for at least five years.[3] However, total shareholdings by employees should be kept below 30% of the equity, to prevent the agency problem of voting to overpay themselves.

The Corporate Monitoring Firm system gives all shareholders a real influence on the bank's management policies. Outside agencies competing to be Hinotori's CMF will build reputations and outline policies to appeal to the majority of shareholders. Employee shareholders will be a significant minority. Including them, most shareholders will be Japanese. Their voting will reflect their preference for a kinder, gentler treatment of employees than in the U.S., while balancing this with their desire for income and share price appreciation. Employee share ownership makes employees think more like owners, understanding the realistic tradeoffs faced by a firm in an industry with excess capacity. So we can expect some layoffs to improve efficiency, but not mass layoffs. The free and discounted shares provide an additional cushion to the usual employee severance package.

Treatment of Borrowers

Similarly, Japanese tend to prefer not to foreclose on a borrower in difficulty as quickly as a U.S. bank might. The CMF system allows the Japanese shareholders to imbue Hinotori Bank's policies with this preference, balanced with profit-seeking. Note also the long-run effects on the reputations of Hinotori and its CMF if they treat borrowers well.

Hinotori vs The Old Banks

The proposed tax rules and deposit insurance fees for Hinotori are so different from those of existing banks that there are sure to be competitive advantages in one direction and/or the other. Thus it is important to bring all banks into the new regulatory structure as soon as possible.

Other Applications

This proposal can be adapted for banks that are not bankrupt but close to it. If the IPO would generate more funds than necessary to repay the government fund infusion, then the sale of shares can be stopped at that amount and the remaining shares given to the old stockholders. If there is no remainder then the bank was bankrupt. Notice that if taxpayers have to pay anything then the old stockholders get zero, and they no longer own stock in the bank. They only get to keep something after repaying the government in full. This is clearly cheaper, and encourages more responsibility, than other policies of dishing out government money to badly managed banks.

I have not studied the Korean banking problems, but they seem broadly similar so may be amenable to a similar solution as proposed here for Japan.

Advantages of This Reform Proposal

1. It provides continuity for the bank's employees, depositors and borrowers. They continue dealing with the same bank.

2. It makes managers accountable to shareholders, who will ensure that the value of their shares is not lost again through mismanagement. This in turn ensures that management decisions on old loans and new loans have a sound economic basis.

3. The main regulatory mechanism for controlling risk is automatic, simple and smooth. This minimizes the chance of regulatory laxness and errors, thus enhancing the credibility of carrying out this reform, once enacted.

4. By limiting the bailout to covering deposits, and requiring only a few months to recapitalize and privatize a failed bank, it minimizes the cost to taxpayers.

Conclusion

The present banking crisis is an opportunity to make several fundamental improvements to Japan's financial system: Phasing out subsidized deposit insurance, ending the tax advantage of debt, and introducing the Corporate Monitoring Firm system for management accountability. These can be achieved by recapitalizing failed banks under new tax and regulatory rules. The CMF system enables Japanese shareholders to vote for management policies that balance profit with consideration of employees and borrowers interests. Employee interests are especially enhanced by making them voting shareholders also.

By using capital markets to value the bank's portfolio of bad loans in an IPO, a bankrupt bank can be privatized within a few months of being taken over. This reform plan is the quickest and cheapest (to taxpayers) of the available proposals, and would create the strongest banking system. The Japanese government should enact it promptly.

Footnotes

1. This example is fictitious. *Hinotori* means firebird, or phoenix.

2. In market value terms: Assets = Deposits + Equity. Here, assets includes not only the bank's loan portfolio but also its "charter value" – the present value of economic rents of the ongoing business, for example resulting from reputation.

3. The 15% discount and five-year holding period are based on an employee share ownership plan at Salomon Brothers in the early 1990's.

References (Most are available at http://votermedia.org/publications)

Latham, Mark (1999): "The Corporate Monitoring Firm," *Corporate Governance - An International Review*, volume 7 number 1 (January).

-------- (1998a): Japanese translation of "The Corporate Monitoring Firm," Japan's *Security Analysts Journal* (August).

-------- (1998b): Korean translation of "The Corporate Monitoring Firm," Seoul University's *Journal of Finance and Banking* (October/November).

-------- (1998c): "Corporate Monitoring: New Shareholder Power Tool," *Financial Analysts Journal* (September/October).