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How Can the U.S. Experience in Removing Bank Bad Debts Be Useful To Japan?

I have been coming to Japan for many years to discuss the banking situation with your bankers and government officials and despite what you read in some newspapers, Japan has already done many beneficial things to deal with its banking problems caused by nonperforming loans.

Among these, it has recapitalized its major banks and recapitalized the long-term credit banks through short-term nationalization. In addition, it has created a new independent bank regulatory agency; the Japanese banking system has adopted international accounting standards and many other beneficial changes.

What has not been accomplished, to the degree necessary to revitalize the banking system and the economy is the subject of this conference – removal of bad debts from the banks and disposal of these problem loans to the private sector.

Your new Prime Minister, to his great credit, has pledged to get this job done and to revitalize the banking system so it can help Japan's economy to recover.

Since I was chairman of the FDIC and RTC (the govt. agencies charged with the bank/S&L clean up) I had a first hand look and participated in the U.S. experience.

I hope Japan can use our experience to help deal with the far more difficult and larger problem it has today in its banking system.

In the U.S. cleanup operations, we made lots of mistakes – and I believe you can learn from our errors as well as our successes. We did get the job done in six years, after the legislation was passed, and I would hope that Japan could do the same or better.

Our banking system ultimately emerged fundamentally safe and sound and able to provide a strong base for our remarkable economic recovery in the 1990s.

The important mechanics of how bad bank debts were handled in the U.S. will be discussed by my colleague, David Cooke, who was the day to day person in charge of the RTC and by others.

I would like to present give you some overall guidance based on the U.S. experience.

First, follow the advice given by the Greek healer, Hypocrites who admonished physicians “First Do No Harm”. This is appropriate advice for those who would attempt to cure a banking system as well.

The purpose of each action in dealing with the bank bad loans is to aid the overall economy as well as to deal with the particular banking debt problem. Accordingly, each non-performing loan must be evaluated to determine how it should be dealt with to achieve the best economic result for the bank, the government and the economy.

The bad debts are really just the evidence of a more pervasive problem – lack of sufficient capital. In general, Japan’s enterprises are undercapitalized and depend too heavily on debt financing. In dealing with the disposal of the debt, some will require the recapitalization of the debtor’s business using capital from private sources and/or government credit. Enterprises, while are viable because they have a sound business, should be properly capitalized. It would be “doing harm” to liquidate them.

But we could not save all companies, and thus other bad loans will require liquidation, closing the enterprise and the sale of assets to the private sector. But it should be remembered that liquidation sales are always the last resort.

“Do No Harm” unfortunately does not mean that there will be no pain. Pain will be felt when business are closed and assets are sold at low values. This is pain that will need to be treated by the government with an appropriate safety net for the unemployed during transition.

Each debt, like each patient, must be individually analyzed and given the appropriate treatment – this is the heart of dealing effectively with the banks’ bad debts.

My second lesson deals with the government's role in the clean-up process. One very important difference between the situations we dealt with in the U.S. and the bad debt problem, as it exists in Japan today. In the U.S., almost all of the bad debts were "owned" by the U.S. government since the banks or S&Ls that held them had failed and been taken over by the FDIC or RTC.

In Japan the great bulk of the bad debts are in the major banks, which are still owned by the private sector. Thus, disposal of these institutions' bad debts will have to be done by the banks under guidelines from the government under present conditions.

Disposal of the major part of the bad loans by the banks has not worked well in the past and there is little reason to expect that result to change in the future. It is very difficult for the private sector to follow the "do no harm" guidance because their responsibility is to their institution rather than to the national economy.

Since the losses on bad debts will, in the final reckoning, be largely paid by Japanese taxpayers, it is appropriate to have the government decide how the bad loans should be handled.

Further, the government can set targets and enforce them much more efficiently than it can through the regulatory system.

A mechanism must be put in place to take the bad loans out of the banks by purchasing them at fair market value. While determining this fair market value is difficult, we had a number of techniques for determining values, which Japan could use:

One way to separate the loans would be to divide these bank assets into good bank, bad bank entities. All the bad debts would thus be removed from the bank. The government, with a new government disposal agency, or perhaps a joint government—private sector entity, could undertake this new liquidation trust job of disposal with the necessary government financing and determination to get the job done.

It is possible to drastically reform the RCC and turn it into a liquidation vehicle but our experience was that a new corporation with limited life and defined goals worked best. As an alternative, short-term nationalization might be necessary in some cases. In our experience, taking over banks that are, in fact, insolvent provided the best way to clean up the system.

Once the bad loans are in the government's hand, the good banks are in a position of strength to finance the private sector and enhance economic growth.

This lesson – government operation of the liquidation – may be the most importance one I can bring to Japan under present conditions.

My third lesson from the U.S. experience is “Start Now” – delay increases the cost.

There is never a good time to begin the painful process of bad debt disposal, especially if the economy is in recession. But the time to begin is now even if all the details of the plans have not been resolved.

Certainly you need a plan for dealing with bad bank debts but don't wait for all the details of your plan to be in place before you begin. The government already has a substantial inventory to dispose of in the RCC and the banks can deal with some of their bad loans under government supervision.

A great deal of what is ultimately done will be developed as the process proceeds. Don't be delayed by attempts to accurately estimate the size of your problem. The numbers will constantly change based on the state of the economy and the markets.

Since estimates of final results will depend on factors as yet unknown, trying to get accurate estimates before beginning the process will be self-defeating.

Why do I say that delay increases cost? Because the economy will not recover until the banking system is repaired. The impending liquidation of assets by dealing with bank bad debts freezes the market with fear. This causes prices to depreciate and costs to increase.

Just the act of starting should result in the economy improving. This was our experience in the U.S. in Texas, Florida and California.

Once the business community observes that the problem is being dealt with effectively it will respond with increased optimism and this will happen well before the process is completed. This change from pessimism to optimism was very clear in the U.S. experience.

To start the process of liquidating bad debts requires restarting the markets to purchase these assets. At present these markets are nearly paralyzed by the large overhang of assets to be disposed of by the banks.

The market will be reenergized by the sale of properties at low prices. Only when bargains are available will buyers begin to appear. In our experience, no one ever bought any of RTC's assets out of a sense of "patriotic duty".

But as the new of bargains goes out, more buyers will be attracted and prices will rise. However, while the RTC sold at low prices, we did have estimates of value for all assets, usually made on a discounted cash flow basis. We used these cash flow values to guide us in evaluating the low mark of a bid. We used to say, "Everything we have is for sale, but not at any price."

To recapitalize Japan's economy buyers must be attracted from all over the world. Japan should make available information about assets on a worldwide basis. New technologies are available.

Recently in the U.S. the FDIC has had some real success in using an internet auction in disposing of assets. The RTC used every type of sales technique known to the private sector in disposing of bad debt and underlying assets.

My fourth lesson, learned the hard way, is that the private sector will prove the people operate to get the job done. While I have stressed that the government should own the bad loans, the job of government employees is largely one of setting the rules and organizing the private sector to carry out their disposal.

We did not start this way in the U.S. and found that we were developing a government bureaucracy interested in continuing the job of management and collection, rather than selling.

Eventually, in the U.S. between ten and twelve thousand government employees directed approximately 70,000 to 80,000 private sector employees in the processing of bad debts. And the U.S. bad assets were probably less than half the size of the current Japanese problem. We out-sourced the processing of bad loans to the private sector because they had the expertise to do the job.



Private sector employees used in the U.S. included investment bankers, accountants, lawyers, bankers, property managers, appraisers, business managers and many others. Based on our experience Japan will need to develop a large private sector support system. Many of these short-term private sector employees will be people who worked in failed banks.

One of the places where U.S. experience should be particularly useful is in developing the rules and regulations by which the private sector will operate. These include bidding, valuation, cost, and internal control procedures.

Another part of the private sector, of course, will become the principal source of buyers for the bad loans inventory. Importantly, these buyers can help develop bulk sales techniques such as securitization, which are essential to getting the huge job done. Large sales will reduce the number of people required in the process.

A final thought: One government leader has to be charged with the responsibility for getting the bad debt disposal job done. The potential of bureaucratic infighting and turf struggles is unlimited. Only centralizing the job in one place and one person can hope to accomplish the job in a timely fashion. The government can keep oversight control by legislative review of operations, perhaps quarterly, and by providing appropriations on a short-term (perhaps every six months) basis.

In conclusion, I have suggested five lessons we developed that can be useful:

- (1) Insure in the process of loan disposal that viable companies are recapitalized (not harmed) and others are liquidated.
- (2) Put the bad loans in government hands for disposal.
- (3) Start the process now.
- (4) Organize the private sector to assist in the government disposal of the bad loans.
- (5) Put one person in charge.

In order for an effort of this nature to succeed, we found it must have support from the people as well as from the government's elected officials. Many difficult and painful actions must be taken and they are not possible without this support.

We found that appropriate support only could be achieved by operating in a transparent manner so that the public knew, understood and believed in what we were doing.

We set up a process that as far as humanly possible operated in an open and transparent way. It also was designed to eliminate insider activities, fraud and political influence and thus, guaranteed a system that would be untainted and fair to all. Thus all of the actions in disposal were open to review by the press and others.

The public must also be able to see that the best talent in the country is making the decisions on which companies will be recapitalized and which will be liquidated and they must be able to see that these tough decisions are made in a fair and professional manner.

The official in charge of this painful process has a major responsibility in communicating to the Diet and the people on a regular basis.

With this public support, the government will be able to provide the funding in amounts sufficient to create a safe and sound banking system. Whatever the cost, it will be repaid by a sound banking system that will support economic recovery.

The world economy needs a strong Japan and we hope you can use our U.S. experience to help achieve a successful cure to the problem of bad debts in the banking system. We stand ready to help Japan with this problem in any way we can.

Thank you for your attention.