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Comment Takatoshi Ito

Let me first illustrate what I think the most important aspect of the so-called Takenaka plan. By now, many policymakers and academics share a high praise for the Takenaka plan of October 30, 2002 as the decisive way of ending the decade-long banking crisis of Japan.[1] However, few remember how its reputation has evolved from being too tough to being too compromised, and finally to producing moral hazard by rescuing shareholders of a failing bank. Ironically, appearing too tough made the stock prices decline, and failure, nationalization, and bailing out shareholders of the Resona Bank produced a moral hazard rally in May 2003.

Let me explain the evolution briefly. (See Hoshi and Ito [2004] for a review of the Financial Services Agency from 1998 to 2004.) In the spring to summer of 2002, a hot debate regarding the soundness of the Japanese banking system took place. Minister Yanagisawa, then in charge of Financial Services Agency (FSA), maintained the position that banks have ample capital and basically sound. Critics, including Mr. Takenaka, Minister for State for Economic and Fiscal Policy, argued that much of bank capital consists of deferred tax assets (DTA) that are based on optimistic profit streams in the future. Mr. Takenaka won the debate and the FSA Minister position. When Mr. Takenaka took the position of minister in charge of the FSA, he planned to use discounted cash flow (DCF) for classification of firms, to harmonize classification of large borrowers among commercial banks, to assess rigorously the collateral values, and to disallow banks to count much of DTAs toward Tier 1 capital.

The previous classification of performing and nonperforming loans relied on whether interest and principal payments have been made as scheduled. However, banks were suspected to have assisted firms to continue pay interest by lending more. This was called *ever-greening* (Peek and Rosengren 2001). This concern prompted Mr. Takenaka to propose DCF.

Because banks have reported heavy losses in 2000 to 2001, they could carry over losses toward the future for offset. If they would earn profits in the future, corporate income taxes would be waived in order to offset carried-over losses. This tax rebate in the future was declared as deferred tax assets (DTA). This is part of normal accounting rule for expecting fu-

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1. The so-called Takenaka plan is officially called "Program for Financial Revival—Revival of the Japanese Economy through Resolving Non-Performing Loans Problems of Major Banks" issued on October 30, 2002. The link can be found at http://www.fsa.go.jp/en/news/2002.html#02oct.

ture extra income. What was unusual was that the DTA was allowed to be counted toward Tier 1 capital in the risk-based capital ratio (Basel capital adequacy rule). Moreover, the portion of DTA in Tier 1 capital had become more than half for some banks. What if a bank would not earn profits, but just break even? Then the DTA would disappear, thus depressing the Tier 1 capital instantly. It is not hard capital, but could be a mirage—many critics argued.

The Takenaka plan of adopting DCF and disallowing DTA would reduce greatly the banks' capital. Then the government would be ready to nationalize any banks being undercapitalized for the Basel capital adequacy standard. Minister Takenaka was reported to have said that no bank was too big to fail, which prompted a big decline in the stock prices. The original version of his plan was attacked by bank executives and the bank lobby at the Diet. Bank executives argued that the change in the capital adequacy rule on DTA would be like a change of the rule in the middle of a game: the DTA was introduced to accelerate the write-off of nonperforming loans without worrying too much about undercapitalization by counting future tax rebates as Tier 1 capital. Minister Takenaka, by proposing to disallow part of DTA for Tier 1 capital, was portrayed as being naive for pushing too tough a plan that would make most banks being nationalized.

The stock market reacted negatively to tough talks by Mr. Takanaka right after his assuming the minister position in September 2002. By the time of disclosure of the Takenaka plan at the end of October, threatening words had disappeared. The stock prices, especially those in the banking sector, declined sharply after the plan was announced and the conflict arose between the Minister and the bank executives. Those who regarded that a tough action would be good news for the market were disappointed by the negative reaction of the stock market. The stock prices continued to decline toward the end of the year. The Nikkei 225 went down from 9,619 yen at the end of August to 9,383 yen one month later, to 8,640 yen two months later. Although the stock prices rose in November, it sank again in December, and the Nikkei 225 ended the year at 8,579 yen.

With political opposition being strong, and the stock market being weak, Minister Takenaka had to retreat a little bit. This compromise, or truce, was crafted toward the end of 1997, in that the DTA was allowed to be used as before, but an accounting firm had to evaluate how realistic it would be to have a projection of future profits from which DTA would be derived. Pressure was placed on accounting firms in that if an accounting firm certifies the balance sheet and a bank fails only a few month later, the accounting firm has to be held responsible. In classifying firms into nonperforming and performing categories, the discount cash flow (DCF) method was proposed for evaluation of true worth (and solvency) of a firm. Also, a special examination of banks was introduced to make sure that all banks were putting a particular firm in the same category of nonperforming loans.

The stock price continued to decline in the first four months of 1998, and by the end of April, the Nikkei 225 index became 7,831 yen—a 20 percent decline in eight months.[2] In April 1998, the accounting firm of Resona Bank refused to allow full DTA that the banks thought to deserve. The accounting firm argued that the prospect of profit trajectory, which indicated a sharp rise in profits in the next several years, was unrealistic. On May 17, Resona Holdings applied for capital injection by the government. Due to less DTA, Resona Bank became undercapitalized even for a domestic bank (minimum of 4 percent capital ratio). Resona Bank was nationalized although it was still determined as solvent. The Takenaka plan was indeed implemented although it took seven months to crystallize into some concrete result. Despite nationalization, the shareholders of Resona Bank were essentially bailed out, keeping their shares at the remaining values of the bank. The government maintained that the bank was undercapitalized, but solvent, to that shareholders should have claims to the remaining assets, while the government would take over the bank by obtaining newly issued stocks. Shares were diluted, but the existing shareholders were allowed to continue having rights to assets in the bank.

The stock prices of other banks started to soar at the news of Resona Bank nationalization, without hurting the current shareholders. The apparent moral hazard at Resona Bank was good news for shareholders of other large banks—who would surely escape zero valuation even at the nationalization. The stock prices started to rally after the nationalization, and by the end of May, it rose to 8,425 yen, a 9 percent rise from a month earlier. The stock prices continue to increase. The Nikkei 225 index rose to 10,560 yen by the end of October.

On November 29, 2003, Ashikaga Bank was determined to have failed when its accounting firm denied all of the DTA for the Bank. This time, the bank was regarded to be insolvent so that shareholders lost their values. However, this did not stop bank stocks from rising further. Four days earlier, the major banks, except for Resona Bank, reported positive profits for the half year (ending September 2003). The increasing trend of stock prices was not affected.

Now let me turn to my comments to the Sakuragawa and Watanabe paper. The stated objective of Sakuragawa and Watanabe is to evaluate market reactions to the Takenaka reform. They examined the stock price reactions to five events: the announcement of the Takenaka plan (October 30, 2002), the announcement of its work schedule (November 28, 2002), the release of the package of monetary policies (March 25, 2003), the failure of

2. The bottom of Nikkei 225 was on April 28 at 7,607 yen.

Resona Bank (May 17, 2003), and the failure of Ashikaga Bank (November 29, 2003). For each event, the authors examined the stock market return as a whole, whether returns are similar among other banks, and whether price changes reflect individual banks' balance sheets or a contagion.

I have several comments on identifying event dates and expected signs on abnormal returns on each event date. First, the so-called Takenaka plan was announced on October 30, 2002, as mentioned in the Sakuragawa and Watanabe paper. However, this was after one month of tough talks by Mr. Takenaka who assumed the minister position on September 30, 2002. He had been very vocal about how to force the banks to restructure, which caused stock prices to decline. The Nikkei 225 index dropped by 7 percent, from 9,384 yen in September 30, 2002 to 8,756 yen on October 30, 2002. By taking October 30 as an event day, the analysis misses the earlier tough talks that were real shocks to the market (and bank executives). In fact, compared to the specific threat during the first month of Takenaka's term, the announced plan was not that tough, but a compromise. The market was more relieved than shocked. Although the bank stock prices were affected, the negative abnormal returns on the day of plan announcement were not large.

Second, the real difference between the Resona Bank and the Ashikaga Bank was the differential treatment of shareholders of the two banks. Shareholders of the Resona Bank were bailed out, while the shareholders of the Ashikaga Bank, including those firms and municipal governments who subscribed to new share issues by Ashikaga bank, suffered sudden total losses. This difference is not discussed enough in the paper. The temporary nationalization of the Resona bank produced a turning point and a minirally in the stock prices, while the Ashikaga did not. After the Resona failure, the Nikkei 225 rose by 10 percent in less than three weeks. After the Ashikaga failure, no such rally took place. This observation put a question on evaluating only a two-day window. The effect of such a plan may extend for several days because analyzing the plan may take a week.

Third, expected signs of surviving banks' stock prices may not be so straightforward. An event analysis should take only an unexpected part of the "announcement," or a surprise, as a variable. This is a standard procedure in the literature dealing with macroeconomic statistical release, where such an expectation can be measured by consensus forecast. However, for events described in this paper, it is rather difficult to construct such a surprise. Hence, even a failure of a bank could produce a positive reaction among surviving banks, except a few, if it is taken as a sign of taking appropriate actions.

Fourth, a new monetary policy package on March 25 is only one of a series of monetary policy measures in 2003 to 2004 (see Ito and Mishkin [2006] for details). Why March 25 is singled out is not clear, although it may be an event, signaling a new policy by a new governor. Bank of Japan had played significant role in attempts to stabilize the financial system as well as to prevent deflation from becoming a serious deflationary spiral. Providing ample liquidity is one way that would work both to stabilize the financial system and to stop deflation. This was implemented by increasing target amounts of the current account balance (held by financial institutions) at Bank of Japan in 2003 to 2004. The target amount of current account balance had become an instrument of monetary policy when the interest rate became zero in the spring of 2001.

The Nikkei 225 stock prices hit the bottom at 7,607 yen on April 28 and started a recovery. What made that turnaround may be interesting to discuss (in the future work). Whether new monetary policy contributed to this more than the Takenaka plan can be debatable.

The paper highlights the importance of the Takenaka plan, but further investigations in the future would produce a comprehensive assessment of the role of Minister Takenaka's role at the bottom of the financial crisis in Japan.

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Comment Randall Morck

This chapter is a useful addition to our knowledge of bank regulation. Its importance transcends Japan because it is really about how monetary and fiscal authorities should go about providing lender-of-last-resort services. But its importance also transcends macroeconomics because it is ultimately about how strategic thinking needs to guide economic institutions.

The framework the authors use to develop these issues is Japan's prolonged financial malaise around the turn of the twenty-first century. Successive capital investment, stock market, and real estate bubbles left the country's banks severely weakened. These bubbles played out roughly along

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