Chicago professor says FSA should stop fibbing
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Anil Kashyap has some advice for Japan’s financial regulators as they grapple with the country’s bad loans problem: Stop fibbing.

Visiting Tokyo to give a presentation to the Cabinet Office on reviving the financial sector, the University of Chicago professor said his suspicions had been aroused anew by UFJ Holdings Inc.’s plan to merge with Mitsubishi Tokyo Financial Group Inc.—a move he saw as revealing lax oversight by the Financial Services Agency.

“I just don’t believe that when we see the size of the losses that UFJ claims it’s going to take now that when (the FSA) certified the books in March they were being honest about it...The regulators have clearly lied about this—every time one of these banks fails, the condition is vastly worse than what the regulators certified within the past six months,” Kashyap said in an interview with The Daily Yomiuri.

A respected commentator on Japan’s banking industry, Kashyap, 44, has spent the past 10 years traveling back and forth to Tokyo from his base at the University of Chicago’s Graduate School of Business for discussions with policymakers in the government and central bank. With his presentation to the Cabinet Office the latest in a series, Kashyap can claim to have the ear of the Japanese government. Whether his audience wants to hear his message is another question.

A plainspoken, irreverent man who gives the impression he is impatient to get things done, it is easy to see why the regulators’ tendency to obfuscate and smooth over would be one target for Kashyap’s ire. It is this regulatory forbearance, he argues, that has allowed four specific problems to flourish: bank insolvency, with many lenders bankrupt by any proper evaluation; inappropriate credit allocation, with loans still going to companies that cannot repay them; overbanking, with too many lenders chasing too few loans; and inadequate profitability, thanks to an ongoing inability to devise high-margin products.

Now the proposed UFJ-MTFG merger—a deal that would create the world’s largest bank by assets—appears devised as a test case for the sector’s ability to tackle these four problems without a costly new public bailout. Kashyap is not optimistic.

Far from tackling insolvency, he asks why the healthiest of the country’s megabanks, MTFG, would want to buy the sickest? UFJ is saddled with bad loans almost three times greater than those of its suitor, according to figures from financial information service Toyo Keizai Inc. Even on official figures, its capital-adequacy ratio is barely more than 1 percent above the minimum required for banks operating internationally.

But instead of waiting for UFJ to fail, and then buying the remnants from the government after the inevitable nationalization, MTFG is opting for what is a costly takeover in all but name.

That might be acceptable to the market if the tie-up held out the prospect of massive cost savings that would help both banks to boost the bottom line, but here again, Kashyap’s analysis is bleak. In the two years following its creation from the merger of two smaller banks, total employment at UFJ Group rose, he points out. While job cuts among full-time employees at UFJ Bank were hailed as evidence of cost cutting, the reductions were more than offset by increasing employment of part-timers and rising job rolls elsewhere in the group.

“Total employment at UFJ’s overall holding company is higher, not lower, two years later. Against that backdrop, I just don’t see how MTFG gets in there and just starts slashing and getting rid of people if they haven’t been able to do it when you took two very sick, weak banks and couldn’t find reasons to cut there,” Kashyap concludes.

The UFJ-MTFG deal may not fare any better when judged against Kashyap’s other three tests. Capital will continue to be allocated inefficiently as long as Daiei and other deadbeat borrowers remain on UFJ’s books. Overbanking won’t necessarily be addressed, with the merger reducing the number of banks, but doing nothing to pare the
amount of underperforming assets in the system. And innovation in more profitable products does not seem to be on the agenda, with MTFG saying the merger is more about getting bigger, not getting smarter.

In searching for answers to all this, there is one thing Kashyap says certainly won't work--sitting back and hoping economic growth can restore profitability and recapitalize the banks. After a period of strong gains, the Nikkei has risen just 3.7 percent over the past 12 months, meaning banks cannot rely on capital gains on their share holdings. Margins on lending are among the lowest in the world, meaning bank income will not rise rapidly even if growth does drive new corporate borrowing. And if the recovery does roar ahead, that will mean interest rate rises and a consequent hit on the banks' bond holdings.

Kashyap's solution is what he calls a "selective and aggressive" recapitalization of the banks--a suggestion that attracts the obvious criticism that it has been tried before. In March 1998, the government injected 1.8 trillion yen into 21 banks. When that had little effect, they tried again a year later, injecting 7.5 trillion yen into 15 major banks. In 2001, 12 regional banks got 500 billion yen. But by Kashyap's own analysis the injections achieved little beyond short-term stabilization, begging the question, what is to be achieved by throwing good money after bad?

Kashyap maintains it need not work that way, however, as long as any future recapitalization meets two simple criteria.

First, it would have to be based on a rigorous and honest assessment of which banks were viable, and which were not--with no money doled out to lenders that were really beyond repair. This is where regulatory honesty comes in.

"All it would take is the regulators to stop fibbing about the condition of the banks. The minute the regulators said, OK, you're capital deficient, you either raise the capital or go out of business and get liquidated, this thing could turn quickly," Kashyap said, summing up the message he was to give to the Cabinet Office.

Second, the recapitalization would have to be big--really big. Exactly how big, Kashyap cannot say, since the murky nature of Japan's bank finances means the extent of the existing undercapitalization is hard to estimate. But if 7.5 trillion yen was not enough last time, it is fair to assume it would require much more next time.

That raises the objection that Japan--with the highest public debt of any advanced nation--simply cannot afford a bailout of this kind. Kashyap describes that argument as "bogus," turning it around to ask whether Japan can afford not to do it. Which, in the long run, will prove more costly: a big bailout now, or 10 more years of stagnation?

Another major stumbling block is the question of political leadership--or the lack of it. Kashyap admits the first few months after his plan went into effect would be "brutal," with mass layoffs and many companies going under. Getting through that period without major unrest would require dynamic, charismatic political leaders capable of explaining why the gain was worth the pain.

Oddly enough, that is exactly what many in Japan thought they were getting with Prime Minister Junichiro Koizumi: a charismatic break from the past who promised pain then gain, and reform without sacred cows. But with most of Koizumi's domestic reforms moving slowly or not at all, Kashyap agrees with many commentators in thinking his moment of opportunity may have passed. Japan may still need to find a Thatcher or Reagan, he says.

Even if such a figure does emerge, Kashyap's plan would still need that bracing blast of honesty from the regulators in order to be set in motion. In saying that they have been less than forthright so far, the professor from Chicago has not always endeared himself to the FSA and friends. But then, as Kashyap says, perhaps that is exactly what he is here for: "If you're a bank analyst, to say that the FSA is incompetent or has been lying about this bank isn't going to do you any favors next time you want to find out what's going on, so there's an advantage for someone like me who's got nothing to lose in saying the emperor's got no clothes," he said.