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AN AGENDA FOR JAPAN & THE UNITED STATES
HAKONE, JAPAN • OCTOBER 24-26, 2008

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AN AGENDA FOR JAPAN AND THE UNITED STATES
HAKONE, JAPAN • OCTOBER 24-26, 2008

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SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY

AN AGENDA FOR JAPAN & THE UNITED STATES

HAKONE, KANAGAWA, JAPAN • OCTOBER 24-26, 2008

FRIDAY, OCTOBER 24

18:00-18:20 **GREETINGS** – Sagami, 1st floor of Main Building
Hal S. Scott, Nomura Professor and Director, PIFS, Harvard Law School
Tasuku Takagaki, Chairman, The International House of Japan

18:20-19:20 **KEYNOTE ADDRESS** – Sagami, 1st floor of Main Building
Takehiko Nakao, Senior Deputy Director, General of International Bureau, Ministry of Finance *on behalf of* Naoyuki Shinohara, Vice Finance Minister for International Affairs, Ministry of Finance
Robert Dohner, Deputy Assistant Secretary for Asia, U.S. Department of Treasury

19:20-20:00 Cocktail Reception – Musashi, 2nd floor of Annex

20:00- 21:30 Dinner – Musashi, 2nd Floor of Annex

21:30-23:30 After-Dinner Cocktails – Main Bar Hinoki, 1st floor of Main Building

SATURDAY, OCTOBER 25

7:00-8:15 Breakfast Meeting of Panelists, Reporters, and Facilitators (Please sit at the reserved tables) - Restaurant Le Trianon, Ground floor of Main Building

7:00-8:15 Breakfast – Restaurant Sakura, 1st Floor of Annex Building

8:15-8:25 **WELCOME & OPENING REMARKS** – Sagami, 1st floor of Main Building
Robin Radin, Associate Director, PIFS, Harvard Law School
Tasuku Takagaki, Chairman, The International House of Japan

8:25-8:45 **PANEL SESSION** – Sagami, 1st floor of Main Building
Topic 1: The U.S. Credit Crisis and Japan's Banking Crisis - What's the Same, What's Different, and How Can Japan's Experience Help in Resolving the U.S. Crisis?
Japan Panelist: Nobuchika Mori, Director, Coordination Division, Planning and Coordination Bureau, Financial Services Agency, Government of Japan
U.S. Panelist: Richard Medley, Chairman, Medley Capital Management

8:45-10:10 **SMALL GROUP SESSIONS**

Room/Group	*Facilitator*	*Reporter*
1	Hiroyuki Kamano, Thomas Cargill	Arthur Mitchell
2	Tomoo Nishikawa, Donald P. Kanak	Alicia Ogawa
3	Nobuchika Mori, Robert F. Grondine	James Degraw
4	Yo Takeuchi, Robin Radin	William Grimes
5	Tomoyoshi Uranishi, Jonathan Malamud	Christopher Wells
6	Takashi Oyama, Masaaki Kanno	Akihiro Wani
7	Takayoshi Hatayama, Laurence Bates	Andrew Conrad

10:10-10:20 Refreshment Break - Outside of Sagami,1st floor of Main Building

10:20-10:40 **PANEL SESSION** – Sagami, 1st floor of Main Building

Topic 2: Perspectives and Lessons Learned from Global Financial Centers – Re-evaluating Capital Markets Policy, Legislation and Regulation

Japan Panelist: Naoki Tabata, Senior Advisor, RHJ International Japan
U.S. Panelist: Robert Alan Feldman, Managing Director, Morgan Stanley Japan Securities Co., Ltd.

10:40-12:15 **SMALL GROUP SESSIONS**

Room/Group	*Facilitator*	*Reporter*
1	Shigeki Kimura, David L. Shuler	Arthur Mitchell
2	Yasuhiro Harada, Mark Siegel	Alicia Ogawa
3	Naoko Nakamae, Mark O'Friel	James Degraw
4	Shuji Yanase, Paul Speltz	William Grimes
5	Akinari Horii, Satoru Murase	Christopher Wells
6	Mikio Wakatsuki, William F. Jarvis	Akihiro Wani
7	Akira Ariyoshi, Eugene Gregor	Andrew Conrad

12:15-13:30 Lunch

KEYNOTE ADDRESS – Musashi, 2nd floor of Annex

Takafumi Sato, Commissioner, Financial Services Agency, Japan

13:30-15:00 **PANEL SESSION – PLENARY DISCUSSION ONLY** – Sagami, 1st floor of Main Building

Topic 3: Sovereign Wealth Funds - Should We Have Them and How Should We Live With Them?

Japan Panelist: Osamu Yamamoto, Partner, Unison Capital, Inc.
Japan Panelist: Takehiko Nakao, Senior Deputy Director, General of International Bureau, Ministry of Finance
U.S. Panelist: Robert K. Kaproth, Financial Attaché, U.S. Department of the Treasury
U.S. Panelist: John Vail, Chief Global Strategist, Nikko Asset Management Co., Ltd.

15:00-17:45 Free Time

15:00-18:00 Reporters Meeting – Azusa, 1st floor of Main Building

18:00-19:00 **KEYNOTE ADDRESS** – Sagami, 1st floor of Main Building
Atsushi Saito, Chief Executive Officer, Tokyo Stock Exchange Group, Inc.
Sir Deryck Maughan, Managing Director and Chairman of Asia, Kohlberg Kravis Roberts & Co., Asia

19:00-19:45 Cocktail Reception – Musashi, 2nd floor of Annex

19:45-21:30 Dinner – Musashi, 2nd floor of Annex

21:30-23:30 After-Dinner Cocktails – Main Bar Hinoki, 1st floor of Main Building

SUNDAY, OCTOBER 26

7:00-8:15 Breakfast Meeting of Chairs and Reporters (Please sit at the reserved tables) – Restaurant Le Trianon, Ground floor of Main Building

7:00-8:15 Breakfast – Restaurant Le Trianon, Ground floor of Main Building
(Overflow will be in Restaurant Sakura, 1st Floor of Annex Building)

8:15-9:15 **PRESENTATION & DISCUSSION** – Sagami,1st floor of Main Building
Topic 1: The U.S. Credit Crisis and Japan's Banking Crisis - What's the Same, What's Different, and How Can Japan's Experience Help in Resolving the U.S. Crisis?
Japan Chair: Ryusaburo Harasawa, Senior Managing Director - Chief Executive, Operations and Systems Unit, The Bank of Tokyo-Mitsubishi UFJ, Ltd.
U.S. Chair: Royanne Doi, Senior Vice President and Senior Regional Counsel for Asia Pacific, State Street Bank and Trust Company

9:20-10:20 **PRESENTATION & DISCUSSION** – Sagami, 1st floor of Main Building
Topic 2: Perspectives and Lessons Learned from Global Financial Centers-Re-evaluating Capital Markets Policy, Legislation and Regulation
Japan Chair: Shuji Yanase, Attorney at Law, Nagashima Ohno & Tsunematsu
U.S. Chair: Douglas L. Peterson, Chairman/Representative Director/President & Chief Executive Officer, Nikko Citi Holdings Inc.

10:20-10:30 Refreshment Break - Outside of Sagami,1st floor of Main Building

10:30-11:30 **PRESENTATION & DISCUSSION** – Sagami, 1st floor of Main Building
Topic 3: Sovereign Wealth Funds - Should We Have Them and How Should We Live With Them?
Japan Chair: Tadashi Iwashita, Chairman, Lone Star Japan Acquisitions, Ltd
U.S. Chair: Christopher LaFleur, Vice Chairman, JPMorgan Securities Japan Co., Ltd.

11:30-13:30	Closing Lunch - Musashi, 2nd floor of Annex
12:45	Bus to Odawara Station - Please meet in Main Lobby
13:00	Bus to Grand Prince Hotel Akasaka - Please meet in Main Lobby

Japan Participants:

Hiroshi Amemiya	Member of the Board, Senior Managing Director, Tokio Marine & Nichido Fire Insurance Co., Ltd.
Akira Ariyoshi	Director, Regional Office for Asia and the Pacific, International Monetary Fund
Jeffrey R. Bohn	General Manager, Head of Financial Strategies Division, Shinsei Bank
Scott Callon	Chief Executive Officer, Partner, Ichigo Asset Management, Ltd.
Yasuhito Doi	Executive Officer, Bayview Asset Management Co., Ltd.
Richard L. Folsom	Representative Partner, Advantage Partners, Inc.
Hideaki Fukazawa	President, Tokio Marine Capital Co. Ltd.
Atsushi Fukui	Partner, CPA, KPMG AZSA & Co.
Takashiro Furuhata	Executive Director, International House of Japan
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Takayoshi Hatayama	Advisor, ABeam Consulting, Ltd.
Eiji Hirano	Executive Vice President, Toyota Financial Services Corporation
Akinari Horii	Assistant Governor, Bank of Japan
Tadashi Iwashita	Chairman, Lone Star Japan Acquisitions, Ltd.
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Yasushi Kusaka	Director, Genworth Mortgage Insurance Corporation
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Kenichi Nakazato	Director for Administration, International House of Japan
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Yukio Ono	National Board Member/Managing Partner, Audit & Enterprise Risk Services, Deloitte Touche Tohmatsu, Japan

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Atsushi Saito	President & Chief Executive Officer, Tokyo Stock Exchange Group, Inc.
Masanori Sato	President, J-Will Partners Co., Ltd.
Takafumi Sato	Commissioner, Financial Services Agency
Junichi Sayato	Director, Managing Executive Officer, Sumitomo Trust & Banking Co., Ltd.
Yuta Seki	Chief Representative, Nomura Institute of Capital Markets Research
Akio Shinju	General Manager, Investment Planning Department, Daido Life Insurance Company
Tony Sorrenti	Executive Director, International Bankers Association, Tokyo
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Yo Takeuchi	Senior Executive Director, Development Bank of Japan
Eiichi Tanabe	Treasurer, Senior Vice President, Mitsubishi Corporation
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Akihiro Wani	Partner, Linklaters Tokyo
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Yoichiro Yokoyama	Director General, Treasury Department, Development Bank of Japan
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U.S. Participants:

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Thomas F. Cargill	Professor of Economics, University of Nevada, Reno
Andrew S. Carron	President, National Economic Research Associates
Andrew Conrad	Senior Vice President and Counsel, AFLAC International, Inc.
James Degraw	Partner, Ropes & Gray LLP
Robert Dohner	Deputy Assistant Secretary for Asia, U.S. Department of Treasury
Royanne Doi	Senior Vice President and Senior Regional Counsel for Asia Pacific, State Street Bank and Trust Company
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Eugene Gregor	Partner, Davis Polk & Wardwell
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Robert F. Grondine	Partner, White & Case LLP
David Hale	Chairman, David Hale Global Economics
Yuka Hayashi	Tokyo Correspondent, Wall Street Journal
Ross Hikida	President & Chief Executive Officer, Barclays Global Investors Japan Limited
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Lyric Hughes Hale	President, David Hale Global Economics
William F. Jarvis	Managing Director, Commonfund Institute
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Mitsuo Kurashige	President and Chief Executive Officer, Gibraltar Life Insurance Co., Ltd.
Christopher LaFleur	Vice Chairman, JPMorgan Securities Japan Co., Ltd.
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Anthony M. Miller	President, Ramius Japan Ltd.

Arthur M. Mitchell III	Senior Counselor, White & Case LLP
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Hiroshi Murakami	Senior Managing Director, Cerberus Japan
Satoru Murase	Partner, Bingham McCutchen Murase LLP
Kyota Narimatsu	Director of Corporate Affairs, Standard & Poor's
Allan E. O'Bryant	President & Chief Executive Officer, Yunzei Capital, LLC
Mark O'Friel	Managing Director, Steel Partners Japan G.K.
Alicia Ogawa	Director, Program on Alternative Investments, Center on Japanese Economy and Business, Columbia University Business School
Yuri Okane	Policy Analyst, Tudor Investment Corporation
Joe Peek	Professor, Gatton College of Business and Economics, University of Kentucky
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Robin Radin	Associate Director, Program on International Financial Systems, Harvard Law School
Gavin Raftery	Partner, Baker & McKenzie GJBJ Tokyo Aoyama Aoki Koma Law Office
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Setsuya Sato	Executive Director, UBS Securities Japan Ltd
Brian Saunders	Chief Credit Officer, Cerberus Japan K.K.
Jonathan D. Schuman	Vice President, AIG Investment Japan Co., Ltd.
Henny Sender	International Financial Correspondent, Financial Times
Clifford Shaw	Chairman, Chamberlain Holdings, Limited
David L. Shuler	Senior Vice President - Business Development Asia, NYSE Euronext
Mark Siegel	Managing Director, Elliott Advisors (Asia) Limited
Allan D. Smith	General Counsel, AIG Companies, Japan and Korea
David A. Sneider	Partner, Simpson Thacher & Bartlett LLP
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Christopher P. Wells	Partner, White & Case LLP
Bill Wilder	President & CIO, Nikko Asset Management Co., Ltd.
Yukio Yoshimura	Head of Government Affairs, Nikko Citi Holdings Inc.

SYMPOSIUM REPORT

BUILDING THE FINANCIAL SYSTEMS OF THE 21ST CENTURY: AN AGENDA FOR JAPAN & THE UNITED STATES

OCTOBER 24-26, 2008
HAKONE , JAPAN

2008 Symposium on Building the Financial System of the 21st Century:

An Agenda for Japan and the U.S.
October 24-26, 2008

The eleventh Japan-U.S. Symposium was held in Hakone, Japan. Sessions discussed the lessons of the Japanese financial crisis for the United States, reevaluated lessons for Japan and the world from global financial market centers, and considered how to manage the integration of sovereign wealth funds into the global system. Participants expressed deep concerns over the recent worsening of the global financial crisis and spent much of the symposium discussing how the crisis should most effectively be addressed by financial and macroeconomic authorities.

Session I

The U.S. Credit Crisis and Japan's Banking Crisis—What's the Same? What's Different? And How Can Japan's Experience Help in Resolving the U.S. Crisis?

In the first session, participants discussed similarities and differences between the current U.S.-based financial crisis and that of Japan in the 1990s and early 2000s. Discussions ranged from causes to dynamics to responses. There was substantial consensus on lessons, with participants focusing particularly on monetary policy, asset valuation, and the respective roles of recapitalization and disposal of problem assets.

Similarities and Differences—Core Conditions

In comparing the two crises, participants considered both causes—including monetary policy, uneven liberalization, lack of accountability, and problems of due diligence—and characteristics—including financial market structure, scope of contagion, and effects. They agreed that, despite the greater flexibility and sophistication of U.S. financial markets, the current crisis was significantly larger, more fast-moving, and more global than Japan's crisis. This was reflected in expressions of deep concern about the situation and a sense of urgency among many participants.

Similarities

Most participants agreed that both crises had resulted from the bursting of substantial asset price bubbles that had been created, or at least allowed to grow, by macroeconomic and regulatory authorities. There was, however, disagreement over whether authorities could or should have tried to suppress bubbles earlier than they did.

Monetary policy came under particular scrutiny, with participants arguing that easy money had fueled the growth of bubbles in both countries. The ease of borrowing, according to this line of reasoning, had reduced market players' concerns about downside risk and encouraged them to accumulate excessive leverage in pursuit of yield. As several put it, "free money makes you stupid." Nevertheless, not all participants blamed central bankers for policy mismanagement, as they recognized that financial liberalization and innovation prior to both crises had significantly complicated existing relationships between monetary policy instruments, monetary aggregates, asset prices, and consumer and wholesale prices.

Financial innovation was also seen by many participants as having contributed to irrational exuberance and problems of accountability. In both cases, they argued, new financial products and techniques had proliferated among market players despite a lack of understanding of their risk characteristics. These players expanded leverage in the mistaken belief that they had reduced their risk exposure when in fact they had not; meanwhile, the lack of understanding of the new techniques served to camouflage actual leverage throughout the system.

The apparent disappearance of risk and the ease of making money stimulated a frenzy of profit-seeking (which some participants characterized as excessive "greed") and discouraged due diligence. In Japan, participants argued that the lack of due diligence was exacerbated by an overreliance on collateral as a basis for lending and

investment decisions; in the U.S., the equivalent was overreliance on credit rating agencies.

A number of participants argued that in both countries these tendencies coincided with weak individual and managerial accountability, resulting from a breakdown in corporate governance. This factor was seen as having manifested quite differently in the two countries. In Japan, managers' insulation from shareholders reduced incentives to adequately assess risk, while also encouraging a herd mentality. In the United States, compensation practices encouraged risk-taking and "short-termism" among financial professionals, while high profitability led managers to discount the need to rein in such behavior.

Participants also saw parallels in the courses of the financial crises, while recognizing that most of the U.S. story had yet to play out. They observed that problems in the balance sheets of financial institutions led to withdrawal of credit from the system and then to real economy effects, which in turn hurt balance sheets, creating a negative feedback loop. Participants agreed that such real economy effects would be inevitable in the current crisis, and most expressed a sense of urgency regarding government and central bank efforts to alleviate the credit crunch. Others, however, expressed skepticism about the ability of the macroeconomic authorities to reinvigorate lending until there had been a sustained and painful shake-out of overextended financial institutions and firms.

Finally, in both Japan and the U.S., participants agreed that a key factor was uncertainty, as reflected in severe volatility in stock prices and credit spreads. Because of lingering doubts about the quality of available information, as well as the self-reinforcing nature of the crises, neither financial authorities nor financial institutions could understand the magnitude of the problem. In such a situation of uncertainty, they agreed that the possibility of cascading failures and contagion across asset classes and borders would be high.

Differences

Despite general agreement on important commonalities, participants also recognized significant differences between the two crises. One major point of difference they emphasized was financial structure, which they saw as having profound implications for the scope of the crises. Japan's financial system in the bubble years was primarily bank-based, despite a process of disintermediation that had begun in the early 1980s. Moreover, banks remained heavily regulated and continued to operate on a fairly traditional model of lending based on deposits. In the U.S. financial system, by contrast, financial activities of actors throughout the system were carried out in capital markets, and even depositary institutions were heavily involved in capital markets on both the asset and liability sides. U.S. financial institutions in the current crisis were also seen to be operating under much lighter regulatory burdens than had financial institutions in bubble- and post-bubble-era Japan.

Due to the rapid evolution of the U.S. financial system in recent years, participants felt that many new financial institutions and markets had achieved systemic significance. They noted that at various points, the apparent center of the crisis had shifted among a variety of instruments, including subprime mortgage-based CDOs, commercial paper, auction-rate securities, credit-default swaps, and bond insurance. Similarly, the focus of regulatory action and popular blame had fallen on institutions ranging from credit rating agencies to GSEs to mortgage originators and salespeople to securitizers to insurers.

Participants agreed that the structure of U.S. finance made for much more rapid transmission of problems throughout the system. The current crisis, whose epicenter was in capital markets, was understood to be global and to affect all sort of financial institutions and all asset classes. Japan's crisis, on the other hand, began in the banking system, had been essentially domestic, and—at least according to many participants—had remained largely confined to the banking system. (Some participants disagreed on the latter point, pointing to the difficulties experienced by securities firms and life insurance companies.)

The global nature of the current crisis was seen as particularly worrisome by participants. Japan's weakening of domestic demand during its crisis had been at least partially buffered by access to growing markets in Asia, North America, and Europe; participants expressed concern that there would be no equivalent locomotive of growth in the current crisis, even if the Chinese economy were to remain relatively healthy. Global interconnectedness would also have very negative effects on developing economies worldwide, creating additional opportunities for cascading crises.

Finally, participants noted some differences in the effects of the crises. In Japan, they noted, financial markets had never frozen up as some had in the U.S., even though Japan had experienced a severe credit crunch and decline in activity in publicly-traded securities. Several noted that the U.S. had not run into deflation problems, and some argued that it was likely to escape the effects of deflation due to assertive monetary policy actions. Others were less sanguine, suggesting that deflation was quite possible if the crisis were to drag on for an extended period of time.

Similarities and Differences—Responses

Participants also compared the responses of the financial and macroeconomic authorities. Most agreed that U.S. authorities in the current crisis had been far more proactive and effective than their Japanese counterparts had been in the earlier crisis, although many questioned whether that would be enough to stave off a severe economic downturn. Some participants, however, were more skeptical about the U.S. response, arguing that it had been inconsistent and ineffective.

Similarities

A number of participants argued that, as in the Japanese crisis, the response of U.S. authorities to the current crisis had been marked by inconsistency and backtracking. They pointed, for example, to multiple pronouncements over the previous year that the crisis had ended and to Secretary Paulson's initial stand against public recapitalization of solvent financial institutions, which had to be reversed soon after. These participants saw this pattern as driven by fundamental misunderstanding of the situation, which paralleled the lack of understanding on the part of Japanese authorities in the earlier crisis. For many in this group, the fumbling behavior of the authorities was actually a contributing factor to the severity of the two financial crises.

A similarity noted by many participants was over the politics of public funds injection. In both Japan and the U.S., there was deep public resentment over the "bail-out" of financial institutions, which in the case of Japan led to significant delays in taking that step. Public funds injections in both countries also raised significant questions of how the government should exercise its ownership rights. While these questions had yet to be resolved in the U.S. case, participants observed that Japanese public recapitalization had first been extended in haste, with no conditions attached, but that this quickly became politically unsustainable. Only when senior management was punished and the government imposed performance criteria (which in the Daiwa/Resona

case later triggered a de facto government takeover) were authorities able to gain sufficient public support. In the U.S., many participants saw conditions on shareholder liability, executive compensation, and dividend payments to be likely components of a politically acceptable recapitalization program, although they were divided as to whether these would economically rational or not. There was also some speculation that, as in Japan, there would be significant political battles concerning the ways in which the U.S. government would sell off its ownership stakes in recapitalized or nationalized financial institutions.

Differences

Despite the arguments by some participants that Japanese and U.S. responses had actually been fairly similar, most participants felt that the differences were much more striking. In particular, they focused on transparency, the speed of financial institution and government responses, the principles on which those responses were based, and the macroeconomic effects of the crisis. Nonetheless, some continued to question whether the U.S. response was any more credible than that of Japan.

The most striking difference for most participants could be seen in the speed of the responses by financial institutions and authorities. They noted that in Japan, financial institutions had been slow to reveal the extent of their non-performing loan problems. The lack of a requirement of mark-to-market accounting gave financial institutions incentives not to write down or dispose of bad assets, but rather to roll over loans repeatedly in the hopes that asset prices of collateral would rise again. Meanwhile, regulators lacked effective tools or financial resources for dealing with insolvent institutions, and therefore did not force full disclosure of losses and risks. This situation did not change until more than half a decade after the bursting of the bubble. In contrast, in the current crisis, strict disclosure and mark-to-market rules forced ongoing and public reevaluations of asset quality and value. (Ironically, many participants argued that mark-to-market in the current crisis had gone much too far, as discussed below.) While a number of participants expressed doubts about the accuracy of financial institutions' balance sheets in the current crisis, all agreed that the quality of disclosure was much higher than in the Japanese crisis.

In tandem with more rapid disclosure of losses, participants felt that financial institutions in the current crisis had been much more aggressive than Japanese financial institutions in the 1990s in deleveraging, selling off bad assets, and seeking to rebuild their capital bases. Many were particularly impressed with the alacrity with which major financial institutions had successfully solicited investments from patient pools of capital including sovereign wealth funds. Some felt that financial institutions may have been <u>too</u> eager to sell off their impaired assets, which had helped to drive down the price of illiquid assets below what they considered to be reasonable prices based on fundamentals, thus contributing to the downward cycle of prices. This was seen as ironic, given that in Japan avoidance of disposal of impaired assets had been a central part of the problem.

The responses of U.S. and European financial and macroeconomic authorities in the current crisis were also seen by most participants as having been very swift (although some felt that the authorities had in fact been excessively swift, which had led in several cases to backtracking). Monetary policymakers were seen as having been particularly proactive. Although some participants were skeptical of the ability of monetary policy to stimulate economic growth in a time of retrenchment by financial institutions, they agreed that the Fed had moved decisively to try to get ahead of the curve and stave off deflation. They also agreed that the Fed had been very assertive in expanding the scope of its discount window lending to new types of institutions and

expanding the definition of acceptable collateral. Similarly, they noted the boldness of the Treasury (and the Congress that authorized it) in nationalizing Fannie Mae and Freddie Mac, as well as in creating the TARP and then flexibly redefining it to allow for recapitalizations. Not all participants were enthusiastic about these actions, but they were still impressed by the speed of response. Many participants attributed the rapid official response to lessons from the Japanese crisis, noting that Ben Bernanke, Timothy Geithner, and several Treasury officials were particularly well-versed in the Japanese experience. Others argued that the nature of the assets in question forced the issue in the U.S. in a way that Japanese banks' non-performing loan problems did not.

Some participants also noted that principles underlying the Japanese and U.S. approaches to their respective financial crises appeared to differ significantly. In Japan, they argued, regulators had sought for most of the postwar period to stabilize the financial system as a whole by ensuring the stability of each financial institution. Thus, as the financial crisis emerged, regulators lacked basic tools (e.g., sufficient deposit insurance funds) for allowing institutions to go under without creating contagion through the system. In the U.S., on the other hand, stability had traditionally been understood at the level of the system, and many financial institutions over the years had been allowed to fail. They saw this principle at work in the failure of Lehman Brothers and the steep discounts at which Bear Stearns and other institutions were purchased over the previous year. However, there were questions raised about whether this was still a viable option in the era of mega-banks and financial conglomerates that had grown too big—or too interconnected—to fail. In this new environment, some argued, there was no real difference between system stability and unit stability. It was even asked whether the failure of Lehman Brothers would be equivalent in its effects to the 1997 failure of Yamaichi Securities.

In the end, participants were left with the question of whether the U.S. response would be any more credible to the markets than those of Japan over its lost decade. Although most participants agreed that the U.S. response was significantly more credible, others disagreed, pointing to the markets' responses to initiatives of the last year. Regardless of where they stood on that issue, few were willing to state that the U.S response to date – even if credible – would necessarily be enough to end the crisis.

Lessons

Participants sought to draw lessons from the Japanese and U.S. experiences. Although significant disagreements arose, there were some areas of clear consensus.

One major point of agreement was that financial crises call for a comprehensive approach. While public capital injections were seen as indispensable in addressing the Japanese and U.S. crises, participants agreed that recapitalization alone would not be enough. They noted that, although the 1998 public recapitalizations were necessary for preventing a further freefall in the Japanese banking system, real recovery was not possible until banks significantly cleaned up their balance sheets and investors and Japanese consumers regained their confidence in the integrity of financial institutions and the financial regulatory system. For the financial institutions, confidence did not return until they reduced their holdings of non-performing loans; for regulators, several participants noted that it took several years after its creation for the FSA to earn a reputation for strict legal and prudential enforcement by creating a clear bank inspection handbook and implementing stringent inspections based on it.

In addition to policies aimed specifically at financial institutions, participants agreed that proper fiscal and monetary support was indispensable for restoring confidence in the economy and preventing a crisis-induced credit crunch from wreaking

havoc in the real economy. There was more consensus about appropriate monetary policy than fiscal policy. Participants agreed that once a financial crisis had begun, it was important for central banks to ensure sufficient liquidity throughout the system – even through non-traditional liquidity operations if need be. Most also agreed that it was essential for monetary policy to be ahead of the curve by easing aggressively before deflation could kick in and render monetary policy tools ineffective in stimulating economic activity.

There was somewhat more disagreement about fiscal policy—although many participants felt that financial crises called for aggressive fiscal policy, others argued that fiscal stimulus was likely to lead only to increased government deficits with no practical stimulative effects. Rather, they claimed that public works were likely to be wasted and tax cuts to go to precautionary savings by households. They cited what they saw as the minimal effects of Japanese stimulus packages in the 1990s and the U.S. spring 2008 package as evidence for their positions; however, most participants disagreed with that assessment, arguing that conditions would have been much worse without the fiscal support, as seen in the disastrous Japanese experiment with fiscal consolidation in 1997. There was even more disagreement as to what lessons could be learned about the appropriate content of fiscal stimulus. Some argued that public works were a particular waste of public funds, while others countered that the crumbling public infrastructure of the U.S. meant that public works spending could be beneficial for the long term as well as for short-term stimulation. A number of participants expressed concern that the large scale of existing U.S. budget and current account deficits could make significant fiscal stimulus counterproductive, as it might cause foreign creditors to withdraw from the dollar or from Treasuries, especially given the massive amount of new government debt authorized under TARP. Others countered that limits might well exist, but the risks to inaction would be greater. Overall, most participants appeared to agree that additional fiscal stimulus for the U.S. would be essential to avoiding a more severe economic crisis, even though enthusiasm about that course of action was limited.

Another set of lessons focused not so much on the management of financial crises but on their prevention. One of the chief areas of debate was over monetary policy. There was a broad consensus among participants that monetary policy had contributed significantly to both crises, as they invoked statements such as “Easy money makes you stupid,” and (adapting Milton Friedman) “Asset inflation is always and everywhere a monetary phenomenon.” Despite this consensus, however, there was considerable debate over whether it was possible to recognize bubbles as they develop or even when they burst. There was, for example, widespread criticism of former Fed Chairman Greenspan’s assertion that bubbles can only be recognized when they burst – many participants pointed out that concerns about U.S. asset prices had been raised in public and private forums for several years and with mounting urgency prior to 2007-8 and that moreover the Fed and other authorities had not acted to address an obvious decline in lending standards, particularly in housing markets. Thus, while some participants adhered to the usual formula of central banks that asset price sustainability is essentially unknowable and therefore central banks should focus only on general price stability, most seemed dissatisfied with that approach, arguing that financial stability should be defined more broadly than general price level and that central banks should be much more proactive in trying to prevent bubbles.

Discussions of the proper roles of central banks in preventing crises went beyond monetary policy to address prudential regulation as well. Participants noted that the Paulson plan of March 2008 called for the Fed to take a much more significant role in ensuring financial stability and that since the Bear Stearns takeover it had taken a much greater de facto role in prudential supervision. This trend worried some participants,

who feared that the Fed's capabilities might be spread too thin or, more generally, that the responsibility to ensure solvency of the financial system might impair a central bank's ability or willingness to manage monetary policy for the good of the economy as a whole.

Another major concern of participants was how financial institutions should value assets. There was a strong consensus that both crises demonstrated the importance of accurately evaluating impaired assets and making the results of those evaluations public on an ongoing basis, in order to reduce market volatility and to provide a rationale for investors to return to the market. However, there was considerable debate over whether the lessons of Japan's crisis could be applied directly to the current crisis. In the Japanese crisis, it was agreed, the delay in implementing mark-to-market had severely impaired confidence in financial markets. This lesson had reinforced accounting standards worldwide. Although participants continued to agree with the basic principle, a number of them stated that it was inappropriate to value illiquid assets on a mark-to-market basis. Others disagreed, stating that any other means of valuation would be arbitrary, and that in fact financial institutions should not have accumulated so many illiquid assets in the first place. Some suggested that shifting trading in derivatives as much as possible to exchanges would eliminate the problem of illiquidity of complex assets, but others were skeptical, arguing that some types of financial transactions would be impossible to standardize for trading on an exchange.

Session II

Perspectives and Lessons Learned from Global Financial Centers—Reevaluating Capital Markets Policy, Legislation and Regulation

Discussion of the second topic was divided broadly into two separate tracks. There was some discussion of how Japan could utilize lessons learned from global market centers such as New York and London in order to improve its own competitiveness as a regional financial market center. However, most of the time was spent discussing the general lessons about financial regulation to be learned from the failures of financial institutions and regulators in the most advanced markets as revealed by the current crisis. A major concern was that existing rules and practices had led to a severe procyclical bias in the global financial system as a whole. Considerable discussion was focused on how to reduce that procyclical bias, although no clear consensus emerged.

Dealing with Risk

Participants agreed that the crisis had lain bare some severe defects in the way in which global financial centers and institutions dealt with risk. Despite significant efforts to manage financial risks and to contain their systemic effects through sufficient risk-weighted capital cushions, those efforts had not prevented contagion across all asset classes and all types of financial institutions. Discussion of risk revolved around both the reasons that financial institutions had acted as they had and the ways in which risk could be better identified and managed in the future.

Risk Appetite

As in the first session, many participants pointed to excessively easy money as a reason why financial institutions were willing to take on so much leverage and lower their lending and investing standards. With downside risk apparently very low, financial institutions and investors had focused excessively on chasing yield. While much of the blame was laid at the feet of the Fed and some other central banks, a number of participants argued that easy money had also been fueled by global macroeconomic imbalances, particularly the willingness of current account surplus economies to lend in almost unlimited amounts to the U.S. economy without any apparent risk premium.

This problem was seen as compounded by other mechanisms that appeared to eliminate risks, particularly the activities of Fannie Mae and Freddie Mac. Many participants felt that the GSEs had been allowed to take on far too much of the risk of real estate lending, without being forced to adequately charge or provision for it. The situation was exacerbated, they argued, by the implicit government guarantee the GSEs carried. There was a general consensus that the GSE business model and ambiguous relationship with the government created a situation of severe moral hazard, which contributed to the general level of abdication of responsibility.

Finally, a number of participants decried excessive “short termism” among U.S. and other global financial institutions. While some saw this as a problem of organizational culture, others pointed to compensation systems and corporate

governance as having created an overemphasis on short-term gains and concomitant underemphasis on accounting for risks. With rewards based on beating profit targets (and particularly on outperforming indexes), they saw traders as having incentives to take on more risk than was appropriate for the institution as a whole. Not all participants agreed with the short termism criticism, however. They pointed out that traders, bankers, and managers had been heavily impacted by the financial crisis under the very compensation schemes that were being criticized, as much of their compensation was in the form of restricted stock and options that were rapidly losing some—or in some cases all—of their value.

Risk Management

Many participants argued that the basic model of risk management followed by U.S. and European financial institutions was fundamentally flawed. While they agreed that the large-scale securitization of mortgage and other loans was an effective means of spreading risk, they pointed out that many financial institutions had acted as if it were possible to eliminate risk altogether. They saw this partly as a consequence of overdependence on quantitative models that did not take into account counterparty risk or the possibility of high correlation of risk across asset classes. Some suggested that this problem was made worse by the fact that virtually all sophisticated financial institutions were following similar models, leading to herd behavior.

A related critique was that financial products had simply grown too complex for most financial actors to understand; the risk models were, if anything, even less well understood by executives. There was a general consensus that this point was compounded by a “silo mentality,” wherein no one was in a position to fully grasp the risks taken on by large-scale financial institutions as a whole. Among the examples given by participants was AIG, which was seen to have had well-managed risk in most of its business areas, but in which the poorly understood risks of its CDS portfolio had proved to be overwhelming.

In particular, participants discussed the issue of illiquid and non-transparent assets. They agreed that financial actors had clearly not understood the implications of having large amounts of illiquid assets on their books. Once funds had to start unwinding their positions of CDOs and other such assets, the lack of liquid markets made for fire-sale prices, which in turn created automatic pressures to sell more of the assets and thus a downward cycle. Non-transparency of non-traded assets and the resulting uncertainty as to counterparty risk reinforced the rapidity of unwinding, and therefore the creation of downward price spirals, increases in insolvencies and fears of insolvencies, and the evaporation of liquidity.

This (along with prudential regulations in a number of jurisdictions) had contributed to an overreliance on credit rating agencies to assess risk. While credit rating agencies themselves came in for considerable criticism, many participants argued that there was a much more pervasive problem of overreliance on third parties to evaluate risk and carry out due diligence. For example, mortgage originators were not exercising sufficient oversight of salespeople and property assessors, securitizers were not scrutinizing the quality of the mortgages they were purchasing, and no one was seriously evaluating counterparty risk until the crisis hit. In each case, assumptions were made that due diligence was being done by the other side, when in fact the incentive system was set up in such a way as to create severe moral hazard.

Participants noted that these moral hazard problems had led some to question the originate-to-distribute model itself, particularly in Japan. However, there appeared to be a strong consensus that it would be a serious mistake to try to do away with the

model. Participants agreed that it remained an efficient way of diversifying risk and expressed hope that the crisis would force financial actors to improve their oversight and due diligence at all points along the product chain.

Promoting Ethical Behavior

Several participants observed that unethical behavior had been an important element in many of the excesses and mistakes that had led to both the Japanese and U.S. crises. They felt that it was important not only to analyze incentives, but also for individuals to take responsibility for their own actions. According to some, one of the basic problems that led to the crises was the development of a financial culture that encouraged greed rather than more public-mindedness. Others countered that greed is inevitable and even a necessary element in development in a capitalist system, and that the responsibility of regulators and shareholders is to ensure that greed is channeled into constructive uses and that laws address ethical concerns.

For most participants, the key to better channeling greed was improved accountability and elimination of conflicts of interest. One area where they saw room for improvement was in regulation to require firms at each level of the financial system to avoid conflicts of interest. This was particularly seen as important for the credit rating agencies, with some participants arguing that the rating agencies' entire business model had been predicated on conflicts of interest. Within firms and financial institutions, participants also called for greater accountability through improved corporate governance. While oversight was part of the agenda they were suggesting, there was a particular focus on compensation practices, as noted above. There were also concerns raised about outside directors' ability to monitor and contribute to effective management of firms.

Becoming a Global Financial Center

While much of the discussion in Session 2 focused on general lessons from the experiences of global financial centers in the current crisis, there was some discussion of what Japan could learn from the U.S. and UK over a longer time frame. Evaluations of Tokyo's potential to be a major regional financial center were mixed, however.

Optimists pointed to the already massive scale of Japanese financial markets, large stocks of accumulated savings, and the status of the yen as an international reserve currency as making it a natural regional hub for financial activity. They also offered positive appraisals of the quality of financial regulation and the sophistication of Japanese financial institutions. These participants felt that what was needed to improve the global status of the Tokyo markets would be relatively small changes in regulations, tax policies, and transaction costs.

Other participants were more skeptical. They argued that Japanese savings did not really constitute pools of risk capital due to the continued conservatism of Japanese households. Moreover, they felt that both regulation/supervision and the business practices of Japanese financial institutions tended to create obstacles to doing business and to stifle financial innovation.

Regulatory Agenda

The failure of both the U.S. and UK regulatory systems to prevent severe financial crisis provoked considerable discussion about what an ideal regulatory system would look like, not only for the financial systems in crisis but also for Tokyo as it seeks to create a world-class financial market center. Discussion stretched across several

themes, including principles vs. rules-based regulation, appropriate prudential standards, accounting rules, and the problem of procyclicality.

Principles-based vs. Rules-Based Regulation

In previous Symposiums, there had been considerable discussion of whether modern financial systems were better served by principles-based or rules-based regulation. There had generally been a preponderance of support for principles-based regulation, on the grounds that rapid change in financial products and strategies would inevitably mean that rules would lag innovation. In contrast, in the Hakone Symposium, there was a striking level of consensus that the debate over principles vs. rules-based regulation was largely irrelevant to the robustness of various financial systems; instead, participants agreed that quality of enforcement was more important than the basis of regulation. (To the extent that advantages of principles or rules were discussed, the main point made by several participants was that principles-based regulation had basically already triumphed—as seen for example in the move toward global adoption of IFRS.)

Prudential Regulation

More discussion was devoted to prudential standards. Participants were particularly troubled by the extent to which systemically important financial institutions had been so heavily leveraged and that even relatively heavily regulated institutions like banks had become exposed to such leverage. A number of participants noted that central banks' decisions to expand access to a variety of new types of financial institutions and to accept non-traditional forms of collateral had made greater prudential regulation of such institutions inevitable. But they also worried that the expansion of regulatory scope would lead investors to move funds increasingly toward still-unregulated areas of the market such as private equity and hedge funds. Some participants worried that this would amount to a regulatory loophole that could lead to new concentrations of risk that would threaten financial stability in the future. Others disagreed that this was a legitimate concern, arguing that the least regulated sectors of the market were in fact those that had been least problematic in both the current crisis and in the Japanese crisis. They felt that market discipline worked best in these sectors and that substantial regulation in fact made many financial institutions inattentive to risk management that was not specifically mandated.

Another lesson that participants drew from the performance of global market centers in the current crisis was the importance of maintaining sufficient capital. The financial institutions that had best weathered the crisis, whether in the U.S., Europe, or Japan, were those that had capital cushions significantly in excess of the statutory minimum. It was noted that, although capital adequacy requirements are meant to provide a capital cushion in case of loss, the crisis had served as a reminder that legally-required capital was in fact a minimum under which banks could not fall. Therefore, only financial institutions with a comfortable excess of capital were in a position to ride out losses on their assets without being forced into a fire sale or even being taken over.

While participants did not come up with a formula for how much capital would be sufficient, there were some principles that arose. For example, there was a recognition that simply mandating more capital would not solve the basic problem, since banks would still need to hold a cushion above the statutory minimum to deal with crises. Therefore, most participants preferred voluntary guidelines.

Procyclicality

More fundamentally, participants recognized that capital requirements as currently constituted contributed to a more general problem of procyclicality. (This problem had also been observed in the Japanese crisis.) Capital-adequacy requirements were seen to accelerate lending in booms and contribute to credit crunches in down cycles for two reasons. First, changes in the valuation of capital itself were seen as procyclical. Perhaps more important, rapid rises in assessments of risk would also cause a contraction of credit at any given capital level. Therefore, a number of participants argued that capital requirements should be higher on the upswing and lower on the downswing to counter their procyclical tendencies. There were concerns about how this could be accomplished on a practical basis (e.g. how upswings and downswings should be identified, whether financial institutions would continue to bolster capital on the downswings out of individual concerns for their own share prices and access to capital, etc.), but the general concept received wide support.

Some participants also suggested other means by which procyclicality could be countered. A particular focus was on monetary policy, with many participants noting the famous aphorism of former Fed chairman William McChesney Martin that the job of central bankers was to take away the punchbowl before the party reached its height. There was also a suggestion of a kind of a global insurance system, in which financial institutions would contribute capital assessments to a fund managed by the BIS that would be drawn on in the event of financial crisis. Discussion of this proposal was limited, however.

Illiquid Assets

Participants also expressed concern that the crisis had shown the inadequacy of existing accounting rules to deal with the issue of illiquid assets. A key issue was how best to determine fair market value for such assets, particularly once financial institutions had to start unloading them to meet their statutory or credit obligations. Participants agreed that mark-to-market did not necessarily reflect the actual value of such assets, and had the effect of forcing financial institutions to sell into down markets and further push the prices down. As several pointed out, although stock, bond, and even basic derivatives markets had taken a severe pounding over the previous year or so, at no point had they completely dried up and so it was always possible to use market prices as fair value.

For some participants, the answer was to allow exceptions to mark-to-market for illiquid products that retained intrinsic value based on expected payment streams. Others objected strongly to this concept, arguing that allowing exceptions to market pricing would only give incentives to financial institutions to issue or accumulate even more opaque and illiquid assets, and therefore to raise the likelihood of future large-scale financial crises. To these participants, there were two (non-exclusive) legitimate solutions to the problem: either to require financial institutions to fully provision against their illiquid assets or to move more of these to mass trading platforms like exchanges to improve liquidity and ongoing price determination. As noted earlier, some participants objected to the latter recommendation on the basis that many illiquid financial assets had been tailored to specific needs of issuers or investors, and were therefore not amenable to standardization. All participants agreed, however, that appetite for illiquid assets would be significantly reduced in the short- to medium-term.

Several participants made an additional point about accounting for illiquid assets. They argued that not all financial institutions should be required to account for such assets in the same way. Rather, accounting rules should be made to match liability

structure. In other words, while they advocated strict mark-to-market for most banks, investment banks, and asset managers, they felt that life insurers and pension funds that would be holding onto many of their assets until maturity should be allowed to price those products based on expected revenue streams of the underlying assets.

Problems of segmentation

As in previous Symposiums, participants expressed considerable concern about the negative impacts of segmentation and regulatory fragmentation. They worried that financial regulators were not well equipped to deal with large financial conglomerates because of lack of coordination among regulators of different financial functions. As in previous Symposiums, participants expressed greater confidence in unitary regulatory systems as in the UK or Japan than in more fragmented systems. The U.S. system was held up as the worst example of regulatory fragmentation among advanced economies. Meanwhile, some participants expressed concern about the separation of central banks from significant portions of financial regulation in many countries, given the likelihood that central bank support would be essential to the resolution of many institutions' problems in the current crisis.

The other aspect of segmentation that participants raised as a concern was what they perceived as a lack of cross-national regulatory cooperation. They argued that the global nature of major financial conglomerates created a pressing need for more effective cooperation, not only at the level of common principles but in actually supervising specific institutions.

Regulation and Financial Innovation

Participants agreed that the tendency of financial innovation to greatly outstrip the ability of regulators to understand products or their implications meant that communication between regulators and financial actors would need to be significantly enhanced. Some called for a "revolving door," or encouragement of movement back and forth between regulatory bodies and financial institutions. Others were more skeptical, worrying about potential conflicts of interest, although they agreed on the need for some sort of ongoing dialogue to improve prudential regulation.

In a related point, a number of participants emphasized that consumer protection should be an important aspect of any revisions of regulations. They noted with approval that financial regulation had increasingly sought to separate markets for sophisticated and unsophisticated investors. Ironically, however, they pointed out the U.S. mortgage crisis had revealed that extremely complex financial products had been marketed to some of the most financially unsophisticated and vulnerable households and individuals, who in many cases had clearly not understood the terms and assumptions of the obligations they were taking on. These participants therefore urged that the distinction between sophisticated and unsophisticated investors be extended to borrowers as well.

Managing a Global System

The last set of lessons from the global financial centers addressed in Session 2 focused on the global nature of the financial system. Although global financial centers will inevitably compete against one another at various levels, participants agreed that global regulatory harmonization—or at least consistency—would be a necessity to prevent excessive risk-taking and regulatory arbitrage by global financial conglomerates. Still, there were major concerns about how to balance global consistency with support for innovation.

One important element of this discussion was over capital adequacy. As noted, many participants felt that one of the major lessons of the current crisis was the need for an adequate capital cushion. Despite the time and effort that had gone into Basel II, however, a number of participants agreed that it was insufficient to head off future financial crises, although there was a strong consensus that guidelines had to be agreed at the global level. Thus, some participants called for a “Basel 2.5” that would reduce the procyclical consequences of the current capital adequacy regime. The idea of a reserve fund for global financial institutions was also floated, as noted above.

More generally, participants called for greater institutionalization of international cooperation. Although specific proposals were not discussed, many expressed the hope that groups such as the Financial Stability Forum and the Basel Committee could contribute to concrete cooperation toward global regulatory consistency. There was also a suggestion that national regulators could form specific task groups, or “colleges of supervisors,” to oversee internationally active financial conglomerates.

Despite the strong preference expressed for better global cooperation and consistency among regulators, however, many participants also expressed concern that global regulation would be inflexible and the agenda would not be controlled by regulators from the most advanced financial systems. They feared in particular that efforts to control “dangerous” practices or “excessively complex” financial instruments would also have the effect of stifling innovation without actually reducing systemic risks. They called on regulators from leading financial market centers to avoid that trap and to work closely with global financial institutions to ensure that innovative financial products and techniques were clearly understood, which they hoped would lead to more effective regulation without stifling innovation.

Session III

Sovereign Wealth Funds—
Should We Have Them and How Should We Live With Them?

The final session addressed questions related to sovereign wealth funds. Much of the discussion revolved around whether SWFs would invest based on economic or political criteria, how to encourage professionalism of asset management, what role SWFs could play in addressing the current crisis, and whether Japan should create an SWF of its own. Most participants saw sovereign wealth funds as responsible players in the global financial system. All agreed that SWFs could not be wished away and that it was important to engage them in a positive manner.

How Do SWFs Invest?

For most participants, a central question in evaluating the role of sovereign wealth funds in the global financial system was how they invest their assets. A number of participants argued that SWFs' performance demonstrated that they were driven by economic rather than political considerations. The general preference for passive investments reinforced the impression that SWFs were not a means of industrial espionage or control as had often been portrayed in media accounts.

It was argued by some participants that SWFs' investment strategies were particularly beneficial in the global economy today because they tended to be patient, long-term investors with contrarian impulses. In the current crisis, with many potential investors either unable or unwilling to commit long-term capital, these participants argued that sovereign wealth funds could both contribute to stabilizing global markets and make good long-term profits by doing so.

Other participants were more skeptical about all of these claims. While they agreed that economic gain had so far been the focus of the most prominent sovereign wealth funds, they wondered whether that would be a good indicator of SWF activities in the future. Several argued that the proliferation of new SWFs meant that study of past activities of the most successful ones (such as Singapore, Abu Dhabi, and Norway) may not be a very good indicator of how newer funds—some of them based in states with more complicated or less stable political situations—may behave.

There was also some disagreement about how to judge SWF activities to date. For example, it was suggested that the focus on the most successful funds tended to obscure the weak performance of others. A number of participants also pointed to the often poor performance of other government investment vehicles in many countries—including some currently starting or considering new SWFs—as evidence that the likelihood of political influence was fairly high. And some participants disputed the claim that even highly respected SWFs were not involved in some ways with politics; rather, they argued, it was just that so far those political motives had been consonant with the preferences of the U.S., Europe, and Japan. (One example given was Norway's resource fund, which follows a code of social responsibility. Middle Eastern resource

funds were also seen as having on occasion invested in ways that reduced political pressures from the U.S. government.)

Regardless of motivations, many participants cautioned that political repercussions might be inevitable when government entities invested overseas. For example, one participant noted the irony that the economically motivated investment by Singapore's Temasek, one of the most highly-regarded funds, in Thailand's Shin Corp had helped to bring down a friendly government and plunge its politics into chaos. Several participants raised the concern that Chinese investment decisions in the U.S. and other advanced economies could easily be construed as political meddling even where there was no such intention.

There were also doubts raised about the claim that SWFs' long time horizons and contrarian strategies were either real or necessarily a good thing for their citizens or for the world economy. Some of these doubts echoed the point already noted that past performance of one group of existing SWFs might be a poor indicator of how new SWFs, each with its own domestic political calculus, might behave. More specifically, it was noted that long-term orientation was by no means guaranteed if governments are responsive to the preferences of their citizens, and indeed that long-term orientation might not even necessarily be the most beneficial for the general welfare. (Several noted the severe domestic criticism of China's CIC for the rapid decline in the value of its well-publicized investment in Blackstone.) Some participants even suggested that investments of patient capital in the midst of the current financial crisis were likely to be more political than economic in nature. Nonetheless, there was a clear consensus that U.S. and European popular suspicions and resentment about the nature and activities of SWFs were far off the mark.

In fact, just as many participants felt that it was not appropriate to focus on the activities of SWFs as separate from those of private-sector actors, a number also expressed the opinion that the definition of SWFs was too narrow to be meaningful. They pointed out that there was a huge number and variety of government-run investment funds at both national and subnational levels around the world including not only SWFs, but also pension funds, domestically-oriented asset management funds, postal savings, etc. They argued that if the relevant issue was the management of pools of capital by public entities, then it was impossible to make meaningful generalizations about strategies and practices; however, by the same token, they saw it as unreasonable to target SWFs for opprobrium or suspicion.

SWF Best Practices

Although opinions about the role of SWFs in the global financial system varied somewhat, participants agreed that SWFs have become an integral and potentially important part of the system. Therefore, they saw it as essential to encourage these funds to behave in a manner that would contribute to confidence and stability and they were supportive of various international efforts to codify best practices. A number of participants were appreciative of the U.S. Treasury's early recognition of the importance of this mission and its work in bringing together major SWFs and host countries to maximize the mutual economic benefits while minimizing political fallout, as well as the efforts of the IMF and members of the International Working Group. The IWG's recently issued Santiago Principles were seen as an important step in this regard.

Participants agreed on several principles that SWFs should follow, generally paralleling those agreed in Santiago. Primary among these was the need for transparency and disclosure. Transparency was seen as important both for allaying the potential concerns of host economies regarding the political nature of investments and

for improving their performance—as some participants noted, accountability to citizens would be impossible without providing accurate information about assets. A second concern was that SWFs should have a clear governance structure to allow for effective internal evaluation of various investments and of the performance of various fund managers. Finally, a number of participants expressed the hope that new or expanding SWFs would take advantage of the highest-quality investment advice and asset management available in the private sector, suggesting, for example, that their investment activities should look like those of the most sophisticated U.S. university endowments.

Nonetheless, it was agreed that the Santiago Principles in and of themselves would not be sufficient to protect SWFs and host economies from poor investment decisions. The political and economic fallout from poor investments was understood to be unpredictable.

SWFs and the Current Crisis

There was a general consensus among participants that SWFs from various countries had played a constructive role in the current crisis. Given the serious need for capital among global financial institutions (particularly banks), it was noted that there were relatively few large pools of capital that were in a position to make strategic investments in them. SWFs had thus become much more important than their size alone would suggest. They were also seen as likely to emerge from the crisis in better condition than most other financial institutions.

Still, some participants cautioned against expecting too much from sovereign wealth funds. Although SWFs had been among the first pools of capital to step in to stabilize global financial institutions in 2007 and 2008 as the crisis took hold, these participants argued that the losses that many of those investments had sustained had made it less likely that SWFs would jump in again before prices had clearly bottomed out. Also, they felt that fears of domestic political backlash might make SWFs less willing to wait out significant losses in the expectation of long-term gains.

Managing Japan's Trust Funds and Sovereign Assets

The final topic of discussion in Session 3 was whether Japan should consider creating its own sovereign wealth fund with a portion of its foreign exchange reserves. Participants noted several recent proposals to that effect by economists and others. There also appeared to be a general agreement that Japan might be in a position to avoid some of the major potential pitfalls facing other new wealth funds. For example, the government would have access to high-quality financial expertise and would be able to draw on its considerable experience in domestic capital markets and in global foreign exchange markets. Several also felt that a Japanese sovereign wealth fund would not be subject to the same level of political scrutiny in the U.S. and Europe as other recent or potential entrants to the SWF sector.

Nonetheless, there appeared to be a striking level of consensus that Japan should not create its own SWF. The main reason was skepticism that investment decisions could be kept insulated from Japan's vibrant democracy. Indeed, a number of participants argued that Japanese government investment entities such as postal savings and national pensions had had both a record of both investment for political purposes (such as the "price-keeping operations" of the 1990s) and poor investment performance. Some participants also noted that, unlike resource SWFs, Japan's foreign exchange reserves are financed by borrowing in Japan in yen, and expressed the opinion that this was not a wise basis for a sovereign wealth fund.

APPENDIX I

KEYNOTE ADDRESS

ATSUSHI SAITO

KEYNOTE ADDRESS

Keynote Address

Atsushi Saito, Chief Executive Officer, Tokyo Stock Exchange Group, Inc.

Saturday, October 25, 2008

Ladies and gentleman, it is my pleasure to speak about Corporate Governance and the Development of Financial Technology here in front of such a distinguished guests.

The current financial crisis raises several questions about the financial technology that has been developed mostly in the U.S. over the past twenty years.

This technology has continued to progress rapidly, while on the other hand there have been discussions mainly at the government or OECD level following this progress about how the financial technology relates to corporate governance, in other words, debate about how it is connected to issues of ownership and management.

However, I believe that we should use the current crisis as an opportunity to thoughtfully evaluate this modern society where stocks are traded in mere milliseconds, and shareholder activists can use legal techniques like empty voting to become potential shareholders and suddenly claim ownership.

For instance, the following are a variety of different ways to view the market.

First, considering the current financial turmoil, it is hard to absolutely reject Japan's system where companies have many internal directors.

As it has been proven that independent directors were ultimately unable to perform adequate risk management.
However, in any case, no one can deny that directors do have a responsibility to their company and shareholders.

Therefore, in cases where there is disagreement over the way a CEO is running a company, we should consider establishing a system that would allow internal employees who have worked their way up to become directors to resign and participate in proxy fights at general shareholder meetings.

Second, institutional investors such as pension funds or investment trusts, despite originally having long-term stock holding motivations, are also being intimidated into competing for performance results. They provide a large portion of their funds to hedge funds. These hedge funds also feel pressure to compete and thus rely on derivatives products and short-term stock trading /carried out at furious speeds.

This means so-called well-intentioned owners are disappearing from the market.

Third, some activists point out that the pressure that activists apply through seemingly short term investments do ultimately have an affect on corporate management. Thus, activists are correct in believing that their ability to pressure for the removal of inefficient management means that they have the potential to affect a company in the long run. This begs the question; can we really call PEFs and activists "owners"?

Forth, we must consider whether or not it is appropriate to make shareholders' rights for short-term investors, including activists, equal to those of long term investors. Essentially, from the

principle of shareholder equality, should we distinguish between them based on their holding periods?
Fifth, we are at the point where we must once again pursue the answers to questions like: what kind of mission and significance do companies have in society?

These are the many types of new challenges that we face in today's financial world where we learned that the efficiency of the market does not necessarily mean the stability.

Now, I am not standing here tonight to profess to have the solutions to all of these complicated issues and I am not blessed with the gracious ability to do so.

However, having observed the market on a daily basis, and now being entangled in the unique phenomenon of competition among world markets, I would like to express one observation I have made as a reference.

It is said that the logical utility of using "markets" for income allocation and price discovery systems from the fact that its trading costs are less than any other policy or measures which participants could otherwise employ.

Some would also argue that markets strive to attract as many participants as possible and can minimize asymmetries in information distribution by preparing transparent and impartial rules to govern the system. This enhances the ability to properly allocate goods and services or discover the fairest price, therefore securing economic efficiency and fairness.

Therefore, our task is to seek how to best prepare transparent and self-explanatory rules in order to find an intersection between sellers and buyers or supply and demand, and determine how we can reduce or eliminate trading costs which sneak into the trading processes as so-called "bugs".

In other words, I understand that a question as to how the government policy should be is how the price determination point should be shifted from the pure theoretical equilibrium point between supply and demand with lesser "bugs", due to unnecessary trading costs of social requirements, culture and sense of value.

People believe that the most effective models of this capitalist system have been in Europe and the United States. Within the last 200 years, socialism and controlled economies that rejected market systems have been defeated in terms of economic growth and stability of national wealth.

Thus we should not dare to reject these functions that use the market to allocate wealth or to discover prices.

However, I do not think it is reasonable to impartially and blindly accept the actions of a limited number of professionals who determine market prices through abnormally developed financial technology using IT and mathematics with no regard for the intentions and responsibilities of market participants.

The market concentration rule started to be abolished at the same time that brokerage commission rates were liberalized in the U.S. Market dispersion or fragmentation policies adopted by the U.S. SEC and the European MiFID resulted in a recent flood of proprietary markets. They are known as ECN (Electronic Communication Network), PTS (Proprietary Trading System), "Turquoise", or MTF (Multilateral Trading Facility).

Today both proprietary order-matching facilities and OTC type trading with intervention of broker/dealers' own orders are existing and these transactions can be conducted at the speed of less than a millisecond.

In the case of current turmoil, market information was completely dispersed, and credit and debt instruments called "sub-prime loans" were sliced into small pieces by financial technologies, which were then scattered all over the world on the OTC markets. The exact same thing is being thrust onto the stock market.

Moreover, investment banks are just one group of market participants. But, what were the original responsibilities of investment banks?

They were supposed to raise and supply industrial capital as well as cultivate promising industries and businesses. Yet the latest financial crisis has financially damaged almost all of the 5 major U.S. Investment Banks, which represented the world's investment banking industry.

This is the result of these companies having concentrated on transactions based on their own accounts (principal trading).

It appears that even executives at these investments banks felt pressure from shareholders to compete and produce positive results; they then abandoned their original responsibility and indulged in quick and efficient principal trading.

In this way, investment banks went from being an intermediary between businesses and investors to becoming just like investors themselves. It is for this very reason that we have an urgent responsibility to conduct a thorough revaluation of the causes of this change and the system itself.

Investment banks dislike more than anything being forced to disclose information on these kinds of principal transactions.

But, it is imperative that we find an appropriate way to require proper disclosure so we can maintain the social order.

This would include placing limits on leverage ratios and reviewing the compensation system for investment bankers.

We must investigate why the United States was unable to perform adequate checks and reports of off-balance accounts like structured investment vehicles (SIV) under the Sarbanes-Oxley Act, We should also demand and a fundamental examination into the reasons why the U.S.'s administrative costs are so high and efficiency is so low, especially when compared to Europe.

We can see similar problems in corporate management.

In the United States, executives are often compensated in company's stocks, creating a system where they become driven by similar motivations as shareholders. I believe that this is a kind of attempt to unite the perspectives of executives and shareholders.

However, although this is the reason why executives have a propensity to try to maximize returns for shareholders; we must verify whether or not other stakeholders are being sacrificed in the process.

If it is true that some stakeholders are becoming victims in the pursuit of profits, then the effort to maximize returns for shareholders is actually increasing costs for society as a whole, and we cannot honestly say that we are working to build a more efficient nation and society.

Actually, although the U.S. maintains the extremely strong competitive power of corporate rate of return, when pension plans and the health insurance system are included in the fiscal account, it is clearly in a dangerous state.

The current account balance is a deficit amounting to 6% of the GDP. Household savings are at zero and the U.S. is borrowing $8 billion dollars a day from overseas to offset its massive account deficit. According to Mr. Bill Cline, by 2026, U.S. international liabilities will have reached 145% of its GDP.

Conversely, in Japan and Europe, there is a heightened sense of awareness about the need for defense of organizations stemming from the belief that stakeholders should be the highest priority. Consequently, this drives companies to employ cross-shareholdings and also avoid taking joint risks.

This leads to a sacrifice of potential profits for the organization, and provokes both investors and companies toward a tendency to create self-interested protection mechanisms.
In this case one could argue that we are actually sacrificing the efficiency of our society for this safety.

Thus, we are once again at the point where the issue becomes "what is a company?" Can we actually cover all the issues of stakeholders' interests in our discussion based on giving shareholders preferential sovereignty?

Are we making unacceptable sacrifices within our society or country for the sake of corporate profits or returns for shareholders?
Or how much can we permit the sacrifice of individual and corporate profits in the name of preserving our society or the nation? These are both questions which must be answered.

In the past, capital has flowed from developed countries into developing countries. Yet, after the current financial crisis, this trend has reversed. We must thoroughly investigate whether this raises any issues from a national security standpoint.

According to Professor Richard Rumelt, in the manufacturing world, companies' production sales ratios within their own countries or region are considerably high, and even in the era of Flat World, sale of goods to other countries or region is less than 20% of total sales. On the other hand, the financial world has become completely "Flat".

Therefore, when a crisis on a certain scale occurs in the financial sector, its influence can spread throughout the world in the blink of an eye. In other words, so-called "systemic risks" are inherent.

During the process of disposition and remedy, the U.S. business model and human resources, and financial technology are likely to spread throughout the world. As a result, are we going to resign ourselves to unimaginable chaos in the next 20 years?

Or can we create new international rules?

I recognize that we are standing on an important watershed.

This concludes a discussion of what I believe, from a practical viewpoint, to be the basic problems we face here today. None of these issues have easy solutions, but I am confident that we will find a way to resolve them. I have great faith in our youth.

Thank you for your attention.

DR. TAKAFUMI SATO

KEYNOTE ADDRESS

Keynote Address: Global Financial Crisis and Japan's Experience in the 1990s

Dr. Takafumi Sato
Commissioner, Financial Services Agency
Saturday, October 25, 2008

Introduction

It is a great honor to be invited to this Symposium to speak before distinguished experts on finance from Japan and the United States. As this year's Symposium is being held in the midst of a global financial crisis, I look forward to stimulating discussions among the participants, including those from academia, governments, and the private sectors.

In this speech, I would like to share with you my thoughts on how to resolve the ongoing global financial crisis, including from the standpoint of what sort of contribution Japan's experience can make to that process. My speech mainly consists of four parts. I will start with comparing the world now with Japan in the 1990s and describe our bitter experience during that period. Then I will turn to the distinctive characteristics of the current crisis and the policy response to address them. Thirdly, I will explore how Japan can contribute to ensuring the global process of an orderly de-leveraging. Finally, I will briefly talk about present Japan's unique position in terms of financial regulation.

I. Policy response to a system-wide crisis: What Japan's experience in the 1990s suggests

Similarities between the two crises

I am sure the past couple of months will be long remembered as a historic period of the financial world. As you all know:

- Two giant government-supported enterprises, or GSEs, have been intervened by the U.S. government;
- The Federal Reserve engaged in extraordinary lending to an insurance company because it had grown systemically important;
- As money markets have dried up, the world's central banks have taken coordinated actions to provide financial institutions with broad access to liquidity;
- Once-mighty investment banks have all disappeared as standalone entities by going bankrupt, by being acquired by commercial banks, or by transforming themselves into bank holding companies; and
- U.S. and European authorities finally intervened in their financial institutions, in the form of nationalization, purchase of troubled assets, capital injection, blanket guarantee of bank deposits, and so on.

As financial regulators, these exceptional measures are the last actions we want to take. For one of Japan's long-serving regulators like me, however, most of the measures taken by our fellow regulators seem to come under one or more categories of measures we took in the 1990s and the early 2000s. During that long period, we struggled to avoid a system-wide financial

breakdown by taking most of the exceptional measures I just mentioned. Our experience clearly shows that taking these kinds of measures is critical in stabilizing the financial system. While they do not sit comfortably with the principles of market capitalism, we need to recognize that extraordinary situation requires extraordinary actions.

Why are the actions taken so similar? If you compare the current crisis with Japan's crisis in the 1990s, you can find that the two crises evolved in a similar fashion.

- First, irresponsible lending had been widespread prior to both crises, on the assumption that real estate prices would continue to go up.
- Second, the financial market turmoil was triggered by the decline in real estate prices.
- Third, the adverse effect of the market turmoil spilled over to the real economy.
- And fourth, the turmoil resulted in a system-wide financial crisis, thereby necessitating public intervention by governments and central banks.

Of course, the current crisis differs significantly from Japan's past crisis in some important aspects, as I will explain later. Particularly, the speed at which the authorities are forced to address the problem is much faster now. Also, the global nature of the current crisis demands cooperative action on a global basis.) Nevertheless, it seems to me that Japan's bitter experience in the 1990s does offer some useful suggestions as to how the authorities around the world should tackle the problems they now face.

Lessons that can be drawn from Japan's experience

The first useful lesson is that prompt and accurate recognition of losses is essential. In the early 1990s, Japan did not have in place effective frameworks for disclosure and provisioning with respect to non-performing loans. This gave financial firms incentives to postpone the disposal of their non-performing loans, and the country plunged into a negative spiral of credit crunch and deterioration of the real economy. Based on this bitter experience, Japan improved disclosure requirements, clarified the rules on write-downs and provisioning, put in place a prompt corrective action scheme, and established an early warning system that enables the supervisors to conduct intense monitoring of banks before they become undercapitalized. In order for supervisors to act promptly, it is effective to have a regulatory framework in which they can make judgment in an objective manner.

From this standpoint, prompt disclosure by U.S. financial firms of the losses on financial instruments is encouraging. Challenges do remain, however, including the methodologies for valuation of financial instruments in cases where their market liquidity dries up, and the lack of data on exposure to complex financial products that are comparable across financial firms.

The second lesson is that toxic assets need to be taken off the balance sheet. This is crucial in order to break the negative spiral I mentioned earlier. If a financial firm is to make provisioning only and leave the assets on its balance sheet, it would be difficult to restore full market confidence as additional losses on those assets could be incurred later. In Japan's case, the Resolution and Collection Corporation, or RCC, purchased the banks' non-performing loans, while the Financial Services Agency, or FSA, strongly encouraged major banks to take their non-performing loans off balance sheet in a steady manner.

I believe that this lesson is relevant in tackling the current crisis, too. Market confidence may not be restored as long as a substantial amount of illiquid financial products remain on the balance sheets of financial firms. In this context, the role expected of U.S. Treasury's Troubled Assets Relief Program to this end is crucial. Also, purchasing prices of those products by the Treasury will become important. If the prices are too high, this could lead to taxpayers' burden. If the prices are too low, the banks would not use the program as they would be forced to incur larger losses by selling their assets. Thus the success of the program hinges on the highest expertise of the U.S. authorities.

Third, undercapitalization of financial firms needs to be addressed, by injecting public funds if necessary. Prompt and sufficient recapitalization is needed if a financial firm becomes undercapitalized as a result of the disposal of bad assets. In cases where a sufficient amount of capital cannot be raised on a market basis, recapitalization with public funds is effective as a final safety net. While capital injection does put taxpayers' money at risk, it may end up with benefiting taxpayers if successful. In Japan, the government injected 12.4 trillion yen in 37 banks, of which 9.2 trillion yen has already been repaid, of which capital gains amount to 1.3 trillion yen. These are on top of a cumulative dividend income of 770 billion yen as of end-March 2008.

In this respect, I welcome the decision of the U.S. government to commit 250 billion dollars to recapitalize the financial firms. At the same time, the authorities should be flexible in responding to new, additional developments. Losses could grow further, because the adverse effect of the deteriorating real economy could hit financial firms if a substantial amount of bad assets remain on their balance sheets.

Fourth, exceptional measures, such as blanket guarantee of bank deposits and temporary nationalization of troubled banks, can be options in times of serious crises. Some European countries have already taken these steps. Japan also introduced full protection of bank deposits in the 1990s. This guarantee was lifted in two steps, in 2003 and 2005, after the financial system had been stabilized. In 2003, Japan introduced full protection of non-interest bearing deposits for settlement purposes as a permanent scheme. In fact, I was deeply involved in the preparation of the legislation necessary to introduce this measure. This protection looks similar to the provision of full coverage of non-interest bearing deposit accounts, which the U.S. authorities have announced recently.

The fifth and final lesson is that short-term measures and re-design of the regulatory framework in the medium-term need to be implemented simultaneously and in a balanced manner. While the work to extinguish the burning fire as soon as possible is of course necessary, it is also essential to put in place a framework to prevent the recurrence of the same kind of crisis. On one hand, if the policies lean too much toward crisis management, it could cause moral hazard or distort the system in the long run. On the other hand, hasty implementation of medium-term measures could rather exacerbate the situation and make crisis management even more difficult. It is therefore important to strike an appropriate balance between these two strands of policies.

Japan in the 1990s may not have been a perfect success story in this respect. However, while encouraging early recognition of non-performing loans and their removal from the banks' balance sheet, as well as raising banks' capital with public funds as an exceptional measure, we introduced, during the same period, the prompt corrective action scheme and asset evaluation rules, thereby reforming the regulatory framework from a longer-term perspective.

Probably, this experience has some relevance to the current situation, too. The keyword among the world's major financial regulators today is "orderly de-leveraging." I believe the word "orderly" signifies the issue of how to strike a good balance between short-term policies and medium-term reforms. Supervisors are never able to escape the fate of pursuing two possibly conflicting objectives at the same time.

II. International work to normalize global finance

As I have just explained, Japan's experience in the past decade seems to provide some useful suggestions regarding the policy response necessary to resolve the current financial crisis. However, it is also true that the two crises do differ in some important aspects, which requires a different kind of measures in the current context.

Differences between the two crises

The main differences between the two crises may be summarized in the following three points:

- First, the current crisis can be characterized as a 21st century crisis, where risks were scattered through the markets to a wide range of investors by means of the financial technology of securitization. In contrast, in 1990s' Japan, risks were concentrated in the commercial banking sector in the form of lending assets on their balance sheets.

- Second, Western banks have been forced to write down securitized products promptly due to mark-to-market accounting. In the 1990s, Japanese banks were allowed to take time to dispose of their non-performing loans because their lending assets were largely not traded in the market. In addition, the banks had an incentive to keep the assets on balance sheet in the hope that the borrowers' performance could be improved, including by the support from the lending banks.

- Third, Japan's financial crisis was contained within the border, and so were its impact on the real economy and the sharing of losses. However, the losses from the burst of the bubble this time have been dispersed globally because of the widespread use of securitization and the "originate-to-distribute" business model. This has caused severe slowdown of the global economy, impacting also Japan's financial system through the decline in share prices and worsening of the broader economy.

Progress made in international efforts

Reflecting these differences, the measures being taken to tackle the current problem inevitably become more market-oriented and take on an international character.

Earlier this month, the G-7 Finance Ministers and Central Bank Governors agreed to a five-point Plan of Action and expressed their commitment to work together to stabilize the financial markets. In view of the nature of the crisis that is market-driven, the Plan highlights the importance of restarting the secondary markets for securitized assets, and the need for accurate valuation and transparent disclosure of assets.

For their part, the Financial Stability Forum, or FSF, which is a grouping of major national financial authorities and international bodies, put together last April a list of concrete recommendations for enhancing market and institutional resilience. Based on the recognition that distorted incentives along the securitization chain had caused moral hazard in the "originate-to-distribute" model, the FSF recommended the strengthening of prudential oversight,

enhancing transparency including through more disclosure of securitized products, review of the role and uses of credit ratings. It also proposed the establishment of colleges of supervisors regarding supervision of the largest global financial firms. At the time of the October G-7 meeting, the FSF issued a follow-up report and announced that it would work on how to better integrate macroeconomic oversight and prudential supervision and reassess the scope of financial regulation. Work is also underway at international groupings of supervisors, including the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions, along with these FSF reports.

III. Japan's possible contribution toward normalization of global financial markets

Let me now turn to the third issue of how Japan can contribute to getting the global financial markets back to normal.

It seems clear to me that the most important challenge faced by the world's financial regulators right now is how to promote the process of orderly de-leveraging. A large amount of toxic assets accumulated as a result of excessive leverage need to be written off, and the recapitalization of financial firms is necessary. While this process was initially carried out by the private sector, the markets could become more unstable unless de-leveraging is undertaken in an orderly manner. The measures taken by the authorities such as recapitalization with public funds and purchase of troubled assets are part of the efforts toward this de-leveraging.

In this context, U.S. and European authorities have been taking exceptional actions, which I think will surely support the process of orderly de-leveraging. For our part, we should take appropriate measures to ensure financial stability in light of the situation of Japan's markets and financial system. In any case, it is essential that the regulators in Japan, the U.S., and Europe take effective measures in a cooperative fashion.

Also, some interesting developments have been witnessed in Japan's markets and in the behavior of Japanese financial firms. For example,

- The market for samurai bonds has grown substantially. According to the Japan Securities Dealers Association, samurai issues in the first half of this year are at around 1.7 trillion yen, up 33 percent compared with the same period last year. Even though new issuance has stopped since the collapse of Lehman Brothers, many experts expect the market to bounce back.

- The overseas loans extended to non-Japanese companies by Japanese megabanks were on an increasing trend until last summer, although marked developments have not been witnessed recently for the same reason I just mentioned.

- Some Japanese financial firms are active in forming alliance with overseas firms and in acquiring businesses abroad. Mitsubishi UFJ entered into a capital alliance with Morgan Stanley, while Nomura acquired some of the business operations of Lehman Brothers in Asia, Europe and the Middle East. Although these actions are up to the business judgment of the individual firms, they are expected to alleviate disruptions in the global financial markets.

It is my view that these developments took place against the background of the relative stability of Japan's financial system and may be making some contribution to orderly de-leveraging.

Concluding remarks

Finally, I would like to point out that Japan is uniquely positioned at the current juncture in terms of the direction of financial regulation.

As I mentioned earlier, the world's financial regulators need to strike a good balance between short-term measures to cope with the ongoing crisis and medium-term policies to re-design the regulatory framework. Full implementation of the FSF recommendations is vital to this end, as endorsed by the G-7. These developments seem to indicate that the emerging global trend points to a direction of financial re-regulation, with a view to recreating a financial system that has less leverage and is immune from misaligned incentives witnessed in the "originate-to-distribute" model.

However, changes in Japan's regulatory framework have yet another dimension. That is, the FSA aims to invigorate private sector activities and bring about prosperity to Japan's markets through the implementation of "Better Regulation" and "Better Market Initiative". "Better Regulation" refers to improving the quality of financial regulation by enhancing its effectiveness, efficiency, consistency and transparency. "Better Market Initiative" is a concrete policy package to strengthen the competitiveness of Japan's financial markets by creating a reliable marketplace and enhancing the business environment of financial firms. Thus we need to manage the two medium-term processes of "re-regulation" and "deregulation" in a simultaneous manner. This is the reason why I say Japan's current position is unique.

It is my sense that implementing the FSF recommendations could eventually lead to a world of finance more firmly based on value-adding activities in the real economy. This may favor countries like Japan that has a large real economy and a strong manufacture sector with advanced technologies. At the same time, implementation of "Better Regulation" and "Better Market Initiative" will broaden the opportunities in Japan's financial markets for investors, fundraisers, and financial firms from all around the world. It is my hope that Japan will be able to emerge as one of the global financial centers in the post-subprime-crisis world of finance.

Thank you.

NAOYUKI SHINOHARA

KEYNOTE ADDRESS

Keynote Speech

Naoyuki Shinohara, Vice Minister of Finance for International Affairs
(delivered by Takehiko Nakao, Senior Deputy Director,
General of International Bureau, Ministry of Finance)
October 24th, 2008

Ladies and gentlemen:

First of all, let me say that I am very sorry that I can not be here with you today as I will be attending the Asia- Europe Finance Minister's Meeting in Beijing. This year marks the 11th symposium in this series which has provided valuable occasions for financial leaders in both the U.S. and Japan to engage in substantive discussions over issues relating to the world financial system. I am very pleased to note the importance of this symposium in facilitating discussions between U.S. and Japanese leaders.

At the last Symposium in Boston, I mentioned the theory that whenever Yomiuri Giants, a professional baseball team in Tokyo, wins the championship pennant, it leads the Japanese economy into prosperity. But, unfortunately, the Yomiuri Giants lost last year. I doubt that this fact lies behind the present economic challenges we are facing, but nevertheless I can not help but feel a sense of guilt at my discovery!

The current challenges started during the summer of 2007, when the sub prime crisis was revealed by the collapse of the housing bubble. Following the deterioration of its balance sheets, because of the losses related to mortgage backed securities, Bear Stearns collapsed in March of 2008. Although the counter measures taken by the Federal Reserve Bank of New York settled the market down, market sentiment deteriorated again during this summer. These changes in the financial situation prompted the U.S. Treasury to announce a rescue plan on September 8th for Fannie Mae and Freddie Mac.

Those quick responses by the financial authorities gave temporary relief to the market, however, the shocking news on September 15th that Lehman Brothers had begun bankruptcy procedures hit the market and fears of financial turmoil grew again. In spite of the authorities' desperate efforts including the rescue plan for AIG and the Emergency Economic Stabilization Act of 2008, we can not yet discern signs that the market volatility has settled.

During these difficult conditions, on October 10th, G-7 Finance Ministers and Central Bank Governors agreed to the Plan of Action and clearly demonstrated their cooperative commitment to overcome this financial crisis. From now on, the financial authorities in each country, with the greatest speed possible, need to implement the measures contained in the plan.

Whenever I consider the present financial situation, it reminds me of the Japanese experience during so-called "lost decade". During this period, the Japanese economy suffered from similar disorders in financial markets because of the collapse of the real estate bubble.

I know that one of the main discussion topics of this symposium is "the U.S. credit crisis and Japan's banking crisis - what's the same, what's different, and how can Japan's experience help in resolving the U.S. crisis?" Thus, it is a very good opportunity for me too to clarify the similarities and differences between Japan's lost decade and the present U.S. sub prime crisis. There are two particular points I would like to discuss on this topic. The first point is who were or are bearing the risks. The second point is the differences in the speed of response to the crises.

Risk sharing

Let me start by discussing the first point about risk.
In Japan, the bubble economy of the 1980s was caused by the over-heating of the real estate market, driven by excessive investment in this sector. The financial institutions, especially deposit banks, made significant amount of loans with high priced real estate as collateral. However, once the bubble economy collapsed and the price of real estate declined sharply, overdue loans became bad debt and this seriously damaged the banks' balance sheets.

As a result, the banks started to be reluctant to make new loans and the confidence of the financial markets weakened. In Japan's case, these risks had mostly been taken by the domestic banks and thus the impact of the economic collapse was primarily felt inside the domestic market.

As in the Japanese case, American financial institutions provided housing loans without sufficient examination of borrowers' solvency, however, a key point of difference is that the institutions bearing the risk were not only domestic financial institutions but investors from all over the world. Through the development of financial engineering, securitized housing mortgages spread and as a result, risks were mixed and dispersed. In addition, because of the complexity of securitized financial products, we can not estimate with certainty the depth of the losses caused by the defaults on housing loans.

It is possible to say that the present crisis gives rise to bigger fears than the Japanese case because of its direct impact on the global economy and complexity.

The speed with which the problems have been tackled

Next, I would like to discuss the differences in the speed with which the problems have been managed.

As you know, the Japanese economy suffered from financial market insecurity and recovery took quite a long time. There are two main reasons that explain this delay.
Firstly, financial institutions were not necessarily active in their approach to deal with the problem and were slow to disclose their financial positions to the market. Secondly, there were prolonged and divisive discussions leading to a delay to reach the final political decision to use tax revenue for bailouts.

Speaking in more concrete terms, in Japan, stock prices started to drop from 1990 and the price of real estate from 1991 indicating that the "lost decade" recession started in the early 90s. On the other hand, the first bailout which targeted the government financed home mortgage loan institutions was undertaken in 1996 and the second bailout, aimed at deposit banks was conducted in 1998. From the time when the problem was revealed, it took more than 5 years before the first injection of public funds and nearly 10 years before the second injection.

Of the two reasons, political refusal was the more serious impediment to achieving a settlement. Those opposed alleged that the plan would create a moral hazard because it would use tax revenue to bail out those private financial institutions with bad management. For example, when the Japanese government tried to present law which allowed it to finance home mortgage loan institutions in 1996, it took no less than half a year to be approved by the Diet.
In addition, criticism of the injection of public money weakened the effectiveness of the plans. Because the idea that the cost to the public purse should be minimized was dominant in public

opinion, it is hard to deny that the first injection in 1998 was insufficient to completely relieve the fears of a credit crunch. Therefore, the second injection of funds had to be 5 times greater in volume than the first.

As I have explained so far, because of very strong public sentiment blaming the financial institutions, the political system and the government, the Japanese economy lost the chance to promptly manage the systemic risks and delayed the settlement of the financial crisis during the lost decade.

It stands to reason that the people as tax payers should feel aggrieved about using public money to alleviate problems caused by the private sectors' irresponsible management. But ahead of applying sanctions, the first priority must be on tackling the economic turmoil. After all, the soundness of the financial markets is essential for securing the people's welfare. The damaging recession brought about by the results of unfocused, prolonged discussions and a delayed sollution provides a bitter lesson from our experience.

Compared to this Japanese case, the U.S. financial institutions have revealed their losses quicker and have already succeeded in raising capital by themselves to cover part of their losses.

However, as seen in Lehman's case, there are sometimes cases which the financial industry cannot afford to manage. Judging from the Japanese experience, it is obvious that the economic crisis would become severer and longer if the government delays the needed policy actions and allows the occurrence of a prolonged credit crunch.

Fortunately, so far, the U.S. government and financial authorities' reactions have been prompt to tackle the problem. For instance, it took only three weeks from the Lehman bankruptcy to present the Act and get approval by Congress. Of course we were concerned when the House of Representatives voted the Act down once, but the world was deeply relieved when Congress agreed to an amended version of the Act soon after the first rejection. In these speedy responses, we see that both for the American and world economies we are fortunate to be able to expect such rapid measures.

Measures taken by the IMF and World Bank

In addition to the measures being taken by each national government, roles played by the IMF and World Bank are crucial to restoring stability.

When emerging economies and smaller countries take measures such as providing capital to financial institutions and offering deposit guarantees in order to ensure the stability of their financial systems, the IMF should be responsible for providing financial assistance. If the IMF requires additional resources, Japan stands ready to provide supplementary funds as needed.

We also expect the World Bank to actively contemplate how the Bank, and Regional Development Banks, could compensate for the decline in private capital flows, that have been the primary funding source for infrastructure investments in developing countries. And also to consider what kind of catalytic roles the World Bank Group could play in bolstering shrunken private capital flows.

Conclusion

Still, no one can predict with certainty what will happen next. Approval of the amended Act merely signals the start of the difficult process of purchasing mortgage backed assets, which might be more difficult than in the Japanese case. In addition, the U.S. financial authorities should tackle bank recapitalization as an additional measure.

Regarding these difficult processes, I sincerely request you all to keep the fact in your mind that the U.S. economy's insecurity could become the world economy's insecurity as well. I expect the U.S. to take any measures that its economy needs without any hesitation, and of course we are prepared to offer the maximum support to promote the U.S. and world economies' stabilities.

Certainly the current situation is tough, but this should not lead us to pessimism. Indeed, it is a very good sign that the Yomiuri Giants came from behind to win the championship this year. Therefore, let's combine our wisdom and share a positive future.

Thank you for your kind attention.

APPENDIX II

CONCEPT PAPERS

Financial Distress in Japan and the United States: Similarities, Differences and Implications

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Introduction

A wide range of developed and developing economies began to liberalize or "democratize" their economic institutions in the 1970s. The starting date and specific catalysts of change differed from country to country, but the differences pale in comparison to the common elements. Economic institutions shifted from state directed to more market-based permitting greater transparency, flexibility, and competition in determining the allocation of resources. Political institutions, in the broad sense to include government regulatory institutions, shifted from authoritarian and nontransparent to structures more responsive to the citizenry, more transparent and more supportive of market forces.

Domestic and international financial institutions and markets were the first to respond to the new economic, political and technological forces that emerged in the 1970s forcing governments to relax binding constraints on markets and permit greater transparency in the political decision making process. The collapse of the fixed exchange rate system, inflation, low transactions costs of financial innovation, and advances in computer and telecommunications technology combined to ensure financial systems would most likely be the first to respond to the new environment. That is, liberalization would most likely commence in the financial sector. This was especially the case in Japan and the United States. As a result, financial liberalization was the first stage of liberalization in Japan and the United States.

Japan and the United States play an important role in this process in terms of their respective size and roles in the world economy and in the case of the United States, the driving force of liberalization policy. The policy outcomes are remarkable in terms of their successes and failures and suggest a number of important lessons. The intense and historically unprecedented financial distress in the United States (since the 1930s) that began to unfold in 2007 after a year of declining house prices has brought the policy outcomes of the two countries into sharp focus; and at a minimum, revealed that financial distress can as easily occur in an economy that achieved a "successful" financial liberalization policy as it did in a country that achieved an "unsuccessful" financial liberalization policy.

Many are questioning whether "it" – Japan's "lost decade" – could be repeated in the United States. To paraphrase a well-known pamphlet published in 1848, a specter is haunting the United States – the specter of Japan's economic and financial distress becoming a feature of the U.S. economic and financial landscape.

This paper places aspects of the two financial liberalization processes into historical context by considering the recent financial distress in the United States in the context of Japan's banking crisis in the 1990s. In terms of sheer size alone the comparison is interesting, but the interrelationships between the two countries and the growing convergence of the two financial systems, provide additional reasons for comparing the two events. The perspective should shed light on whether in fact there is reason to fear Japan's experience is a specter haunting the United States.

There are many perspectives to the comparison. The following five elements are considered the most important: (1) the policy feedback relationship between Japan and the United States; (2) the role of monetary policy in generating financial distress; (3) the

incompatibility of government financial intermediation with the financial liberalization process; (4) the destabilizing role of government guarantees and policies dealing with troubled financial institutions based on forgiveness and forbearance; and, (5) the potential for a repeat of the Japanese “lost decade” in the United States.

Each will be considered in turn after which the paper will close with a discussion of how the financial distress might influence policy in the future.

Policy Feedback Relationship between Japan and the United States

Japan and the United States found themselves in a close policy feedback relationship over the past three decades. The first phase was characterized by U.S. influence on Japan and the second by Japan influence on the United States.

The United States pressured Japan in the late 1970s and 1980s to liberalize economic institutions and especially, financial institutions. The United States was committed to liberalization as a policy but at the same time, regarded Japanese liberalization as a method to reduce trade imbalances with Japan. There is little doubt the initial efforts of the Japanese to adopt an official policy of financial liberalization was importantly influenced by pressure from the United States in the early 1980s.

In the 1990s when the Japanese economy stagnated after the collapse of asset prices in 1990 and 1991, the United States pressured the Ministry of Finance (MOF) to take more aggressive action to end the “zombie” corporation and bank problem and pressured the Bank of Japan (BOJ) to adopt more aggressive policy to reverse the deflation process that commenced after 1994. The pressure was intense with a member of the Board of Governors of the Federal Reserve System in 2003 (Bernanke, 2003) giving a speech in Tokyo criticizing the BOJ for not adopting larger scale open market operations to reverse the deflation process. There was real concern on the part of the United States that Japan’s financial and economic distress could easily spread, especially after 1997 when the Japanese economy came close to collapse.

The direction of policy influence was reversed in 2001. U.S. monetary policy now became sensitive to the experiences in Japan. The equity asset bubble in the late 1990s and collapse of equity prices starting March 2000 raised concern at the Federal Reserve the same post-bubble financial distress experienced in Japan might occur in the United States without an aggressively easy monetary policy. The BOJ was slow in responding to the growing financial distress in the early 1990s as equity and real estate prices declined and the Federal Reserve did not wish to make the same mistake. Starting January 2001 the Federal Reserve began an unprecedented policy of monetary ease further rationalized by the effects of the 9/11 attack on the United States.

The Federal Reserve officially expressed concern over the possibility of deflation (Bernanke, 2002) and by June 2004 had driven interest rates to levels not experienced in half a century. The target value of the federal funds rate as of June 2004 was 1.0 percent generating a negative real federal funds rate with inflationary expectations ranging from 1.5 to 2.5 percent at the time. Despite the start of the asset bubble in residential housing in 2003 the Federal Reserve only gradually shifted to a tighter monetary policy over the following two years. In hindsight this fueled the housing bubble. As housing prices began to decline 2006 the Federal Reserve shifted to monetary ease to ensure the Japanese “lost decade” of the 1990s was not repeated.

As the collapse of housing prices spread through the economy in 2007 and 2008, financial stress increased. In summer and fall 2007, the Federal Reserve adopted extraordinary lending operations to inject reserves into the banking system. On March 14, 2008 the Federal Reserve provided funds to JPMorgan to purchase the failed Bear Sterns to prevent a liquidity crisis. On September 7, 2008 the government nationalized Freddie Mac and Fannie Mae but refused to provide assistance to Lehman Brothers in late September and permitted it to fail on September 15, 2008. The Federal Reserve provided $70 billion in reserves to the banking system on that day and on September 16, 2008 the Federal Reserve agreed to lend as much as $85 billion to AIG to prevent a financial crisis. The Federal Reserve continued to inject significant amounts of reserves into the banking system and open the discount window to investment banks.

At the time of this writing, the financial distress has deepened and the Treasury and Federal Reserve are considering a major bailout of nonperforming residential mortgage assets based on the 1990s Resolution and Trust Corporation that warehoused and eventually sold nonperforming assets of savings and loan associations. On September 22, 2008 the government announced a $700 billion bailout plan to acquire nonperforming assets.

Role of Monetary Policy in Generating Financial Distress

The policy outcomes of financial liberalization in Japan and the United States both included asset bubbles. Japan's asset bubble in the second half of the 1980s was more intense because both equity and real estate prices increased and decreased together and reinforced each other whereas in the United States, the two asset bubbles occurred sequentially. Equity prices exhibited a bubble in the late 1990s while real estate began its bubble in 2003. The close relationship between bank credit, bank capital, land prices and equity prices in Japan played an important role in the run up of asset prices in Japan whereas the relationship between these variables was much weaker in the United States because U.S. banks are not permitted to hold equity, count equity capital gains as part of bank capital, nor did U.S. banks rely on land and real estate as loan collateral to the same degree as Japanese banks. There are also other differences – the real estate bubble in Japan was concentrated more in commercial than residential, both the run up and decline of real estate and equity prices in Japan exceeded price movements in the United States by a wide margin to date, and while private bank or bank subsidiary (*jusen*) finance played the major role in financing the real estate bubble in Japan, nonbank financial institutions, government sponsored enterprises (Freddie Mac and Fannie Mae), and secondary markets for mortgages played a more important role in the U.S. real estate bubble.

Central bank policy, however, is the common element in the asset inflation experiences of both countries. The BOJ began an easy monetary policy in 1985 that continued up to May 1989 – a few months before the collapse of equity prices. The BOJ erred in several respects. First, the BOJ subverted domestic price stability to external considerations in an effort to limit yen appreciation; second, the BOJ did not appreciate the distress building up in the financial system caused by the run up of equity and real estate prices in the context of a flawed financial liberalization process; third, the BOJ did not take into account lags in the effect of monetary policy when it focused on the current low rate of measured inflation; and fourth, the past success of BOJ policy and world recognition of that success might have enhanced the BOJ's own view of its ability to maintain price stability and limit yen appreciation at the same time.

The Federal Reserve, despite Greenspan's famous 1996 remark about "irrational exuberance" in the stock market continued to provide liquidity as equity prices increased in the

second half of the 1990s. The Federal Reserve overestimated both the shift in productivity and the importance of the "new" computer technology based economy to rationalize why the actual unemployment rate was lower than the natural unemployment rate. In addition, the Federal Reserve in hindsight overreacted to concern over the effect of the new millennium on the public's demand for cash and in late 1999 provided enhanced liquidity to the economy that found its way into the stock market speculative excesses of January and February of 2000. Federal Reserve policy shifted to ease in January 2001 and continued this stance until June 2004, at which point, interest rates had reached lows not experienced in the United States for almost half a century.

Like the BOJ the Federal Reserve's monetary policy contributed to the run-up of asset prices. While one might debate the merits of each policy at the time the policy was adopted, there is little doubt in hindsight each central bank provided the liquidity that constituted an important prerequisite to any asset bubble a la Minsky (1989). Both central banks operated without an inflation target framework and were thus susceptible to time inconsistency.

Incompatibility of Government Financial Intermediation with Financial Liberalization

Japan's Postal Savings System (PSS) and Fiscal Investment and Loan Program (FILP) constituted a major system of government financial intermediation consisting of two elements: first, post offices who collected savings deposits and life insurance premiums from the public and second, government banks, enterprises and corporations received funds provided by the postal savings system and other sources through the FILP administered by the MOF. This system was large. At its peak in the early 2000s postal savings represented about 35 percent of total deposits and the FILP budget represented about 10 percent of GDP.

There is a general consensus the PSS and FILP played a positive role in Japan's reindustrialization process after the end of WW II, but by the 1970s these institutions began to interfere with the financial system by allocating a large part of the public's saving to unproductive and politically sensitive sectors of the Japanese economy. The PSS and FILP played an important role in Japan's "iron triangle" – a system of favors between politicians, bureaucrats, and their client industries and sectors. The PSS enjoyed government-conferred advantages that made it difficult for private banks and insurance companies to compete. The PSS network provided a ready-made subsidized branch system, paid no significant taxes, paid no deposit insurance, had no capital requirements and faced far lower regulatory burdens than private banks. The PSS resulted in substantial misallocation of capital to projects of questionable social value and created systemic risk in the financial system; since PSS investments in these projects were guaranteed by the government, Japanese taxpayers were exposed to large losses because of nonperforming assets and loans embedded in PSS, which were estimated by Doi and Hoshi (2003) at 16 percent of GDP in 2001.

The PSS encouraged disintermediation from private bank deposits to postal savings in times of financial distress and generally complicated Japan's efforts to establish a stronger deposit insurance and supervisory system for private banks. The PSS, with 400,000 employees, representing 30 percent of all national government employees provided a strong grass roots system for the traditional element of the Liberal Democratic Party, which, in turn, has been responsible for much questionable government spending.

Japan finally came to terms with the PSS and FILP under Koizumi in late 2005 (Cargill and Scott, 2006). A series of reforms including a 10-year privatization program for the PSS dramatically reduced the role of postal deposits and the FILP (Cargill and Sakamoto, 2008).

While the reforms left much to be desired and potentially left the government as a major player in the transfer of funds from surplus to deficit units, the reforms represented a major change in the structure of Japanese finance.

Government financial intervention has played a smaller but still large role in the U.S. financial system in the aggregate; however, in the residential mortgage market, government sponsored enterprises in the form of Freddie Mac and Fannie Mae (F&F) have dominated the mortgage market during the past two decades. Cargill and Scott (2005) draw parallels between F&F and Japan's system of government financial intermediation. Like the PSS, F&F are large institutions—they hold assets worth nearly $4 trillion, representing about 30 percent of GDP and they either hold or assume the credit risk of about three-quarters of U.S. residential mortgages. Like the PSS, F&F enjoy competitive advantages over private sector competitors by borrowing with implicit government guarantees. As a result they increase systemic risk by assuming significant interest rate risk, and they misallocate resources by directing most of their subsidy to shareholders, CEO compensation, lobbyists and politicians rather than homeowners. Like the PSS, these institutions have strong grass roots support among homeowners and the home industry as well as many politicians, especially leading democrats who believe government financial intermediation should be used to provide housing to virtually all segments of American society, especially low income households.

Efforts to restrict their portfolios or provide greater regulatory oversight have been intensely resisted by a large number of politicians who regard support of residential housing a part of the social contract, the real estate sector, financial institutions and the securities markets. Greenspan (2004), Stanton (2002), and Wallison (2001) attempted to draw attention to the emerging problem with F&F and the Bush administration in 2003 (New York Times, 2003) attempted to provide greater regulatory oversight after accounting scandals and excessive CEO compensation came to light (Lockhart, 2006) ; however, these warnings were ignored and efforts to rain in F&F were resisted. In fact, politicians used the Community Reinvestment Act of 1977 to require institutions to make subprime mortgage loans and then used F&F to package these loans for sale in the secondary market. The following statements by politicians in response to the 2003 effort of the Bush administration to increase regulatory oversight are illustrative:

> "These two entities -- Fannie Mae and Freddie Mac -- are not facing any kind of financial crisis," said Representative Barney Frank of Massachusetts, the ranking Democrat on the Financial Services Committee. "The more people exaggerate these problems, the more pressure there is on these companies, the less we will see in terms of affordable housing."
>
> Representative Melvin L. Watt, Democrat of North Carolina, agreed.
>
> ' 'I don't see much other than a shell game going on here, moving something from one agency to another and in the process weakening the bargaining power of poorer families and their ability to get affordable housing," Mr. Watt said. (New York Times, September 11, 2003).

The F&F played an important positive role in the U.S. financial system at one point in time by establishing a secondary market in residential mortgages. The secondary market allowed depository institutions, especially savings and loan association, to reduce interest rate

and prepayment risk. F&F purchased these mortgages with funds raised by selling mortgaged-back securities (MBS) to those better able to manage the interest rate and prepayment risks. F&F assumed the credit risk of the mortgages because they guaranteed only that interest and principal would be paid. At the start they were government agencies but became private with a "special" relationship to the government which in turn is part of a social contract with the public dating back to the Homestead Act of 1863 to support residential housing.

Like the PSS, the original rationale of F&F became increasingly difficult to support in the 1980s in light of the potential problems they generated. Securitization was by then a major part of the private market and private market securitization providers would surely have emerged in the absence of the large presence of F&F with a special relationship with the government. Furthermore, in an effort to generate higher earnings, F&F have significantly increased borrowing from the markets to finance purchases of mortgages held in their own portfolios as well as MBS that they previously issued. This portfolio activity generates interest rate and payment risk in addition to credit risk for F&F. F&F were able to borrow at rates only slightly above government security rates, because their debt is perceived as implicitly guaranteed by the government.

F&F have been at the center of current financial distress in the United States. F&F contributed to the run up in house prices and took extensive risk by securitizing and guaranteeing mortgages that had been made without due diligence. In fact, the term "liar loan" has now been added to the financial vocabulary. Liar loans were made on unverified documentation in which borrowers overstated their ability to service the mortgage and the lender permitted this because the mortgage would be soon sold on the secondary market. In the classic bubble psychology, borrowers and lenders believed the mortgage would soon be backed by ever increasing house values. Lenders and borrowers knew the mortgage could only be rationalized if you believed house prices would continue to increase at 20 percent per year. Mortgage brokers and financial institutions passed the loan on to the secondary mortgage and F&F facilitated the sale of these mortgages and used the funds obtained by selling MBSs to repeat the cycle.

The cycle was based on the belief house prices would continue to increase, but like all bubbles, house prices collapsed and weakened the portfolios of all involved in the cycle. The official reorganization of this was made when the government nationalized F&F September 7, 2008.

Moral Hazard, Forgiveness and Forbearance

Moral hazard refers to the incentives insurance provides to the insured that is adverse to the insurer. Government deposit guarantees, whether they are in the implicit form common in Japan until 2003 or the explicit form established in the United States with the Federal Deposit Insurance Corporation in 1934, possess moral hazard. The more extensive the governments guarantee the greater the incentive financial institutions have to take risks. Forgiveness and forbearance refer to regulatory policies directed toward troubled financial institutions that permit continued operation of insolvent, close-to insolvent, or risky financial institutions in the expectation improved economic activity will resolve their balance sheet problems. Forgiveness and forbearance are a variation of moral hazard because they involve government policies designed to allow financial institutions to take risks at taxpayer expense. Forgiveness and forbearance in turn enhance the risk incentive in deposit guarantees.

History illustrates how these two forces generated financial distress, increased the burden on the taxpayer, and prolonged resolution of weak or insolvent financial institutions in both Japan and the United States. They prolonged the financial distress in Japan that saw a nonperforming loan problem in the Japanese financial system equal to almost 25 percent of GDP and the existence for over a decade of a large number of "zombie" banks and corporations. It was not until forgiveness and forbearance policies were reduced in 2003 under the leadership of Koizumi (Cargill and Sakamoto, 2008) that the nonperforming loan problem began to decline. Forgiveness and forbearance combined with the moral hazard of Japanese government deposit and other guarantees played a major role in Japan's banking crisis and "lost decade" of economic and financial development.

Likewise, in the United States they played a major role in the savings and loan association collapse in the 1980s, the banking problems in the early 1990s, and most recently in allowing F&F to operate with inadequate oversight and less than meaningful disclosure of balance sheet risk. This led to nationalizing the two institutions with costs to the taxpayer that will greatly exceed the cost of the savings and loan crisis estimated at $150 to $200 billion (in 1990 dollars). Politicians protected F&F despite warnings they posed a major risk to the financial system. Senator Obama, the democratic nominee for the president, was revealed to have been the second largest recipient of Fannie Mae contributions with Representative Chris Dodd (D) being the largest recipient. A number of former government officials found lucrative employment at F&F; for example, Franklin Raines, an official in the Clinton administration, who left Fannie Mae at the time improper accounting practices were revealed was forced to pay the government about $25 million including fines for improper conduct (New York Times, 2008). Two other former government officials returned about $6 million to the government.

It would not be too much of an exaggeration to argue Japan's "iron triangle" existed in the United States between politicians, F&F, and their client industries – real estate, financial institutions and securities markets. While the U.S. version of the "iron triangle" was not as entrenched as in Japan nor as encompassing in terms of players, it nonetheless was a framework in which moral hazard, forgiveness and forbearance brought the U.S. financial system to near collapse in late September 2008 and will impose a heavy burden on taxpayers in years to come.

Potential for a Repeat of the Japanese "lost decade" in the United States?

There are several factors that make a Japan-like period of prolonged economic and financial distress less likely in the United States following the collapse of house prices and the current financial distress. Six factors seem particularly important for projecting a shorter adjustment to the financial distress of the U.S. financial system in the second half of 2008 than in Japan in the 1990s.

First, the basic structure of the U.S. financial system is better able to adapt to the financial distress and while the United States exhibits many of the same characteristics as the Japanese financial system as explained above, the U.S. financial system is more transparent and the regulatory lag in dealing with troubled institutions is shorter. Once recognized the Federal Reserve and other financial regulatory agencies and the U.S. Treasury brought considerable lender of last resort effort to the market compared to Japan. This of course does not relieve the Federal Reserve and other regulatory agencies of responsibility for the financial distress. It is difficult to understand how financial regulatory authorities under any reasonable view of the economy could permit an expansion in mortgaging lending based on little or no

down payment in the context of accelerating house price inflation and not react to the growing role of lier loans. Nor is it easy to understand how regulatory authorities could stand by and watch AIG increase in size and influence by engaging in risky portfolio activities such as credit-default swaps and not make some effort to redesign insurance regulation along federal lines. While more understandable how politicians could have continued to support F&F despite the warnings and efforts to limit their portfolios, politicians clearly failed in their public trust no less than Japanese politicians did in the 1990s.

Second, compared to Japan the U.S. financial system is far more transparent, there is far more public information about the actions of regulatory authorities and most important, the United States possesses a large number of nongovernment organizations in the form of research institutes that reveal actions contrary to the public interest. This of course did not prevent the financial distress, but it makes it more difficult for politicians and regulatory authorities to engage in forgiveness and forbearance.

Third, Japan's real sector was either declining or stagnating during the 1990s with increasing unemployment far above Japan's natural unemployment rate. This weakened balance sheets of both corporations and financial institutions. In contrast, the real sector of the U.S. economy except for housing has not experienced a decline to date. GDP continues to increase and while the unemployment rate as increased to 6 percent in October 2008; this is not dramatically higher than the natural unemployment rate estimated to be around 5 to 5.5 percent. The U.S. economy has not entered a recession by the standard measures whereas Japan experienced a number of recessions from 1990 to 2003 including a very sharp decline in GDP in 1998.

Fourth, the BOJ permitted rapid disinflation in the first half of the 1990s and then for the next decade permitted the price level to decline about 10 percent. Japan represents the only industrial economy since the 1930s with a period of prolonged deflation. The disinflation and deflation increased the cost of servicing the large volume of debt; increased real interest rates as the nominal rate was close to zero; increased bankruptcy which in turn reduced the willingness of banks to lend; and, increased the demand for money which in turn reduce the effectiveness of monetary policy to end the deflation process. The interaction of these forces caused by deflation on central bank policy has been termed a "discontinuity" in monetary policy (Cargill and Parker, 2003) to distinguish it from the Keynesian-style liquidity trap. The Federal Reserve has not permitted either disinflation or deflation and as a result inflation expectations have remained positive and within the range of 2 to 4 percent over the past decade. This represents a dramatic difference between Japan and the United States.

Fifth, Japan experienced considerable political distress during the 1990s as the political system adjusted to a new and significantly different electoral system established in 1994, as political parties changed alignment and new coalitions formed because of the loss of the LDP in the lower house in 1993. In the 1990s Japan had on average one new prime minister per year. The political distress in the 1990s contrasted sharply with the political stability of the postwar period starting from 1955 when the LDP and the "1955 System" were established. The lack of political leadership inherent in Japanese political institutions up until Koizumi contributed to a slow and incomplete response to the economic and financial distress. In contrast, the U.S. political system is relatively stable and has the potential for strong leadership to deal with a crisis. At the same time, it is unfortunate the financial distress has occurred in the context of a presidential election in which both candidates have exhibited little real understanding of financial markets. Democrats blame Republicans (with some merit) and Republicans blame Democrats

(with much greater merit). Both presidential candidates have taken a populist approach focused on the "greed" in financial markets.

Sixth, cooperation between the Federal Reserve, Treasury, and other financial regulatory agencies has been strong in dealing with the financial impact of the collapse of housing prices in the United States. Despite the Federal Reserve's formal independence from government, it has worked closely with the government to stabilize the situation. This was not the case in Japan. The BOJ and MOF did not cooperate and in fact, during much of the 1990s were often hostile toward each other. Until the Financial Services Agency was established in 1998 the MOF was responsible for most financial regulation and supervision. After 1998 the BOJ became insular and less cooperative with other agencies to ensure it did not violate its new found formal independence provided with the 1997 Bank of Japan Law revision. The lack of coordination between the BOJ and the MOF through 1998 and with the MOF, Financial Services Agency and BOJ after 1998 contributed to the policy malaise in Japan and prolonger the economic and financial distress.

Market Failure versus Government Failure and the Future of Financial Liberalization

There is little debate the structure of the U.S. financial system is more flexible, transparent, and better able to absorb shocks than the Japanese system. Nonetheless, the U.S. financial system generated an equity bubble in the second half of the 1990s and a housing bubble in the first half of the new century. The U.S. financial system despite a more complete liberalization process still had the capacity to fall into crisis. Some will argue this illustrates the instability of liberalized financial markets and the need for greater government oversight and regulation. Continued liberalization will likely experience greater political resistance as it already has in Japan (Cargill and Sakamoto, 2008). Many U.S. politicians are claiming the financial distress has been the result of "deregulation" and call for the need to constrain market forces. Is this correct? The debate can be framed in the context of the market and government failure view of financial distress.

The market failure view emphasizes the inherent instability in markets caused by rent seeking activity in a less regulated environment; and hence, places the blame for the type of financial distress experienced in Japan and recently in the United States on liberalization. That is, providing markets with enhanced portfolio diversification powers allows market participants to assume imprudent levels of risk and increase the market's systemic risk as market participants seek to maximize their own profit. The policy implication of this view ranges from return to the old-style of controls to a much slower pace of liberalization. Unfortunately, this view will become more prominent in the United States and throughout much of the world in the coming years as a result of the crisis in the United States, the country with the most liberalized financial markets and a country with the greatest faith in the market.

The government failure view regards liberalization as a positive and inevitable development that enhances economic growth and focuses on government policy as the problem. Unfortunately, the government failure view is being discarded in favor of the market failure view in the current environment. It should be emphasized in defense of the market view that while the subprime market was ultimately too risky and used for speculation (house flipping), this financial innovation was an effort to provide homeownership to a segment of society previously excluded from the mortgage market (Shiller, 2008). This is nothing less than "democratization" of the financial system. While the financial distress appears correlated with liberalization, government is the third variable more responsible for financial distress than the market.

Government's willingness to protect property rights of various groups such as the housing sector; pursue unbalanced rather than comprehensive reform; unwillingness to reduce government intermediation; permit discretionary monetary policy; unwillingness to reduce government deposit guarantees; and, when government action is required to deal with troubled financial institutions government pursues policies based on forgiveness and forbearance by permitting account gimmicks in hope the financial institutions will "work their way out of the problem" if given sufficient time. A significant moral hazard problem emerges because financial institutions are permitted greater asset-liability diversification powers while at the same time, government continues to guarantee deposits and protect existing financial institutions from competition which in turn, subsidizes risk taking. The government failure view has not been popular among policy makers charged with managing the current financial crisis in the United States despite the evidence of considerable government failure in the current crisis. This is not meant to imply there were no elements of market failure; however, based on our understanding of Japan's financial distress in the 1990s and the current financial distress in the United States, a complete understanding of the financial disruptions needs to place significant importance on the role of government policy.

In this regard, Japan and the United States financial experiences have converged.

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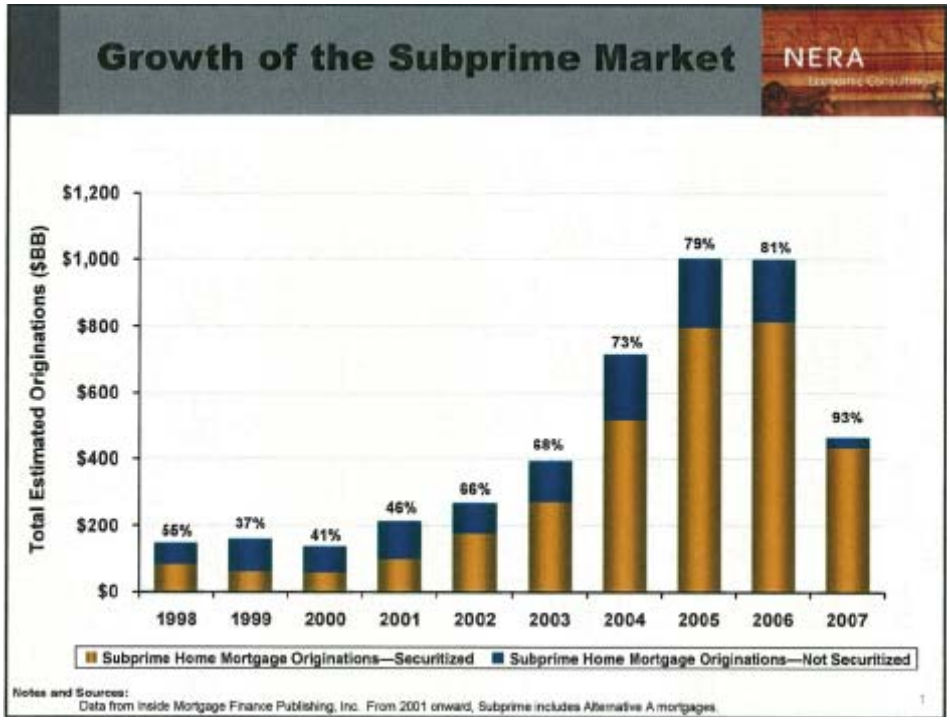
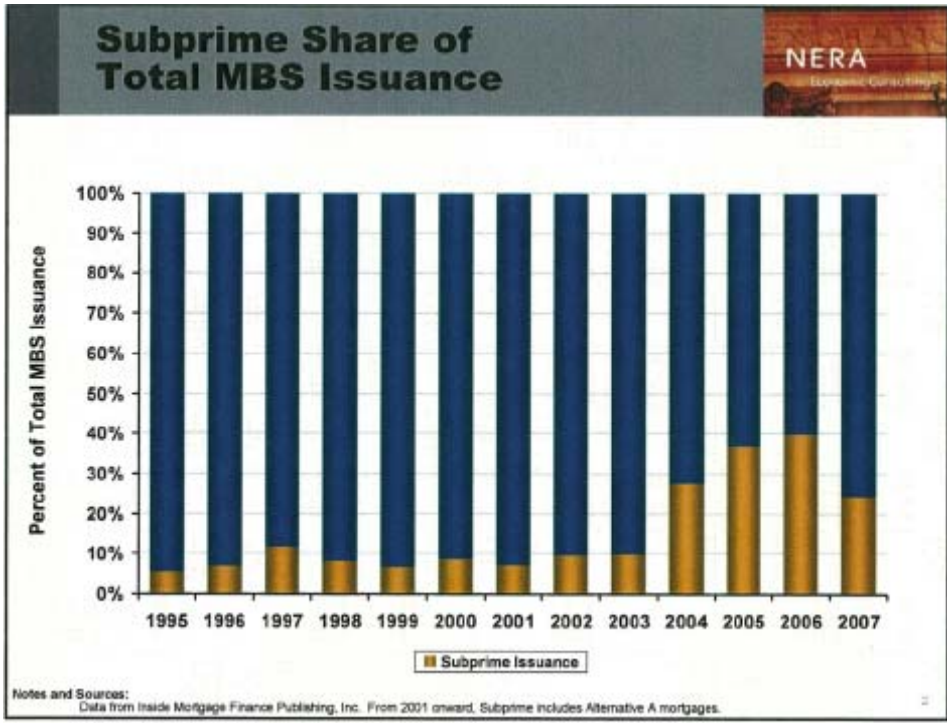
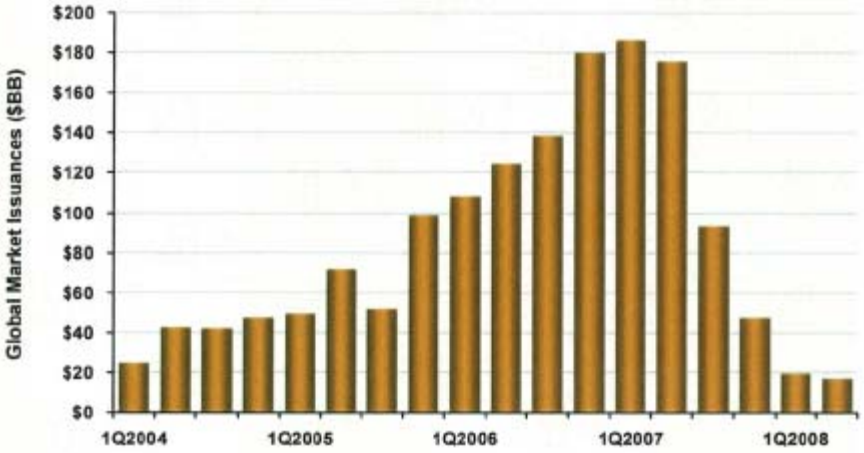
Key Factors in the Subprime Mortgage Crisis
Andrew S. Carron, Ph.D
National Economic Research Associates, 2008





Collateralized Debt Obligations:
Global Market Issuance

NERA



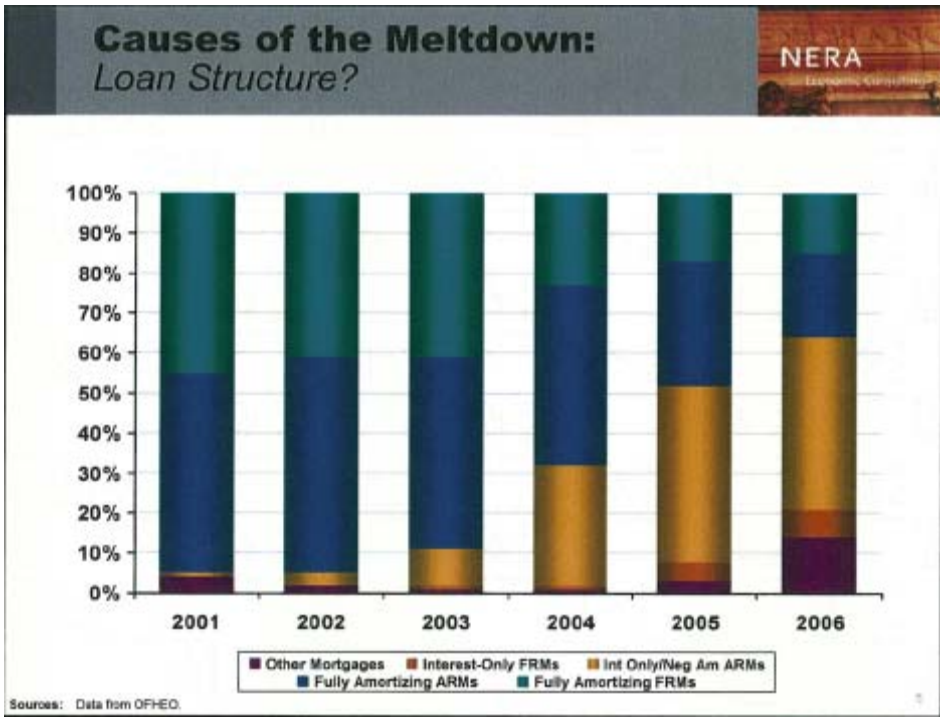
Source: SIFMA, Data from Thomson Financial (http://www.sifma.org/research/pdf/SIFMA_CDOIssuanceData2008q2.pdf).

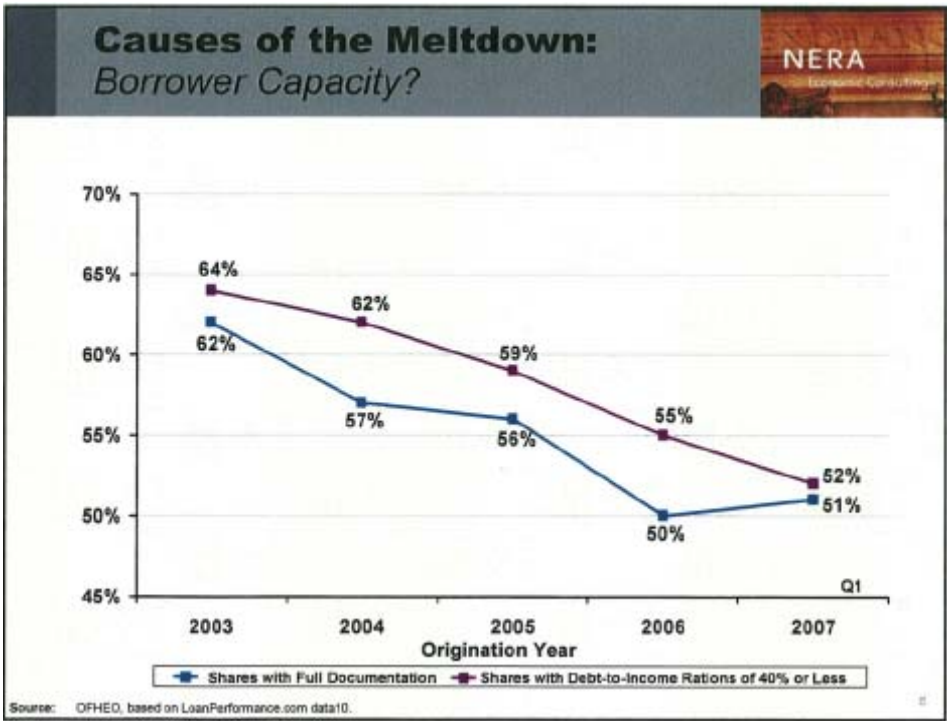
Dimensions of the Problem:
Actual Losses to Date

NERA

	Aaa	Aa	A	Baa	Ba	B
Corporate Bonds	0.03	0.11	0.26	1.17	6.37	15.74
Residential MBS	0.00	0.00	0.27	0.77	2.06	1.90
Home Equity Loans	0.00	0.00	0.32	3.12	5.37	24.27
Commercial MBS	0.00	0.00	0.04	0.17	0.43	8.97
CDOs	0.00	1.28	2.09	10.48	11.31	24.41
Nonresidential ABS	0.12	4.15	1.56	4.83	17.39	26.26

Sources: 5 Year Loss Rate: 1998-2006 for Residential; 1993-2006 for ABS and CDOs; 1982-2006 for Corporate Bonds Moody's, "Default & Loss Rates of Structured Finance Securities: 1993-2006", April 2007; "Corporate Default and Recovery Rates", 1920-2007, February 2008.


Causes of the Meltdown:
Loan Structure?
NERA
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
2001
2002
2003
2004
2005
2006
Other Mortgages
Interest-Only FRMs
Int Only/Neg Am ARMs
Fully Amortizing ARMs
Fully Amortizing FRMs
Sources: Data from OFHEO.


Causes of the Meltdown:
Borrower Capacity?
NERA
70%
65%
60%
55%
50%
45%
64%
62%
59%
55%
52%
62%
57%
56%
50%
51%
Q1
2003
2004
2005
2006
2007
Origination Year
Shares with Full Documentation
Shares with Debt-to-Income Rations of 40% or Less
Source: OFHEO, based on LoanPerformance.com data10.

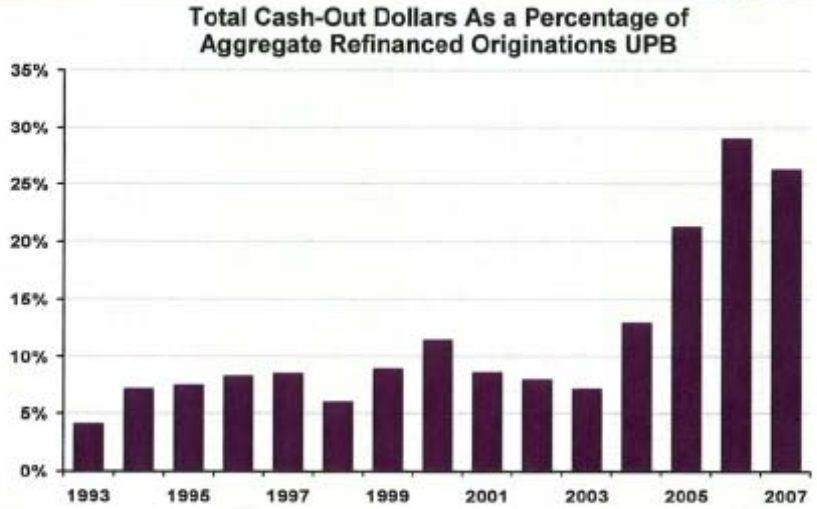
Causes of the Meltdown:
Housing Price Volatility?

NERA

Source: Federal Reserve Bank of St. Louis, OECD All-Buildings Construction Cost Index obtained from Bloomberg LP, Standard & Poor's Case-Schiller HPI, Bureau of Labor Statistics. OECD index discontinued in 2007.

Causes of the Meltdown:
Reduced Homeowner Equity?

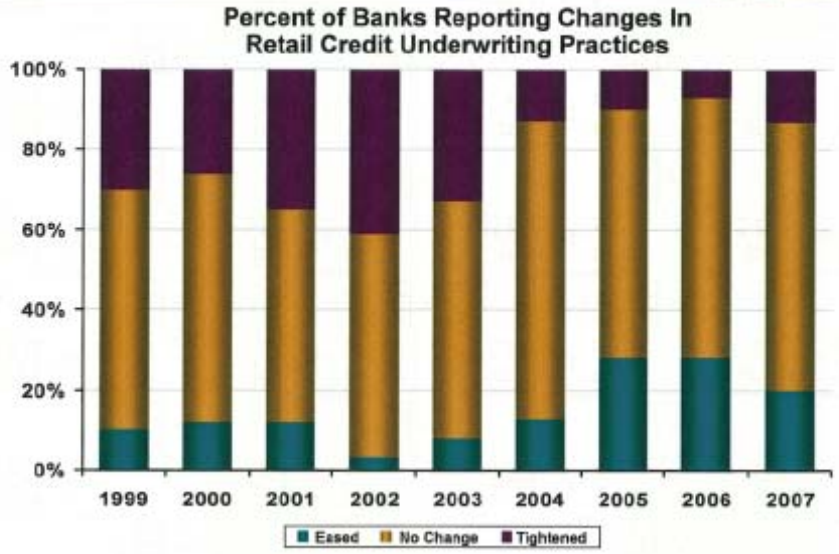
NERA



Source: Freddie Mac.

Causes of the Meltdown:
Loose Underwriting Standards?

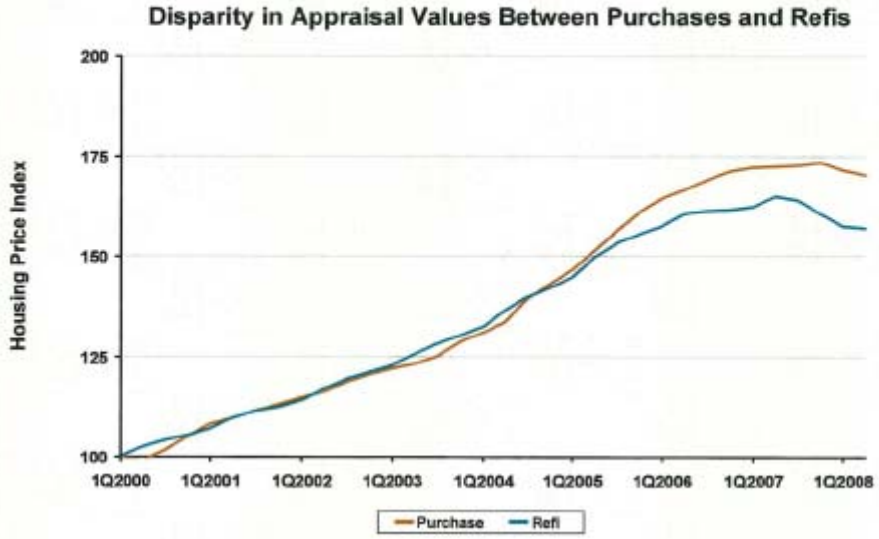
NERA



Source: 2007 Survey of Credit Underwriting Practice, Office of the Comptroller of the Currency

Causes of the Meltdown:
Appraisal Errors?

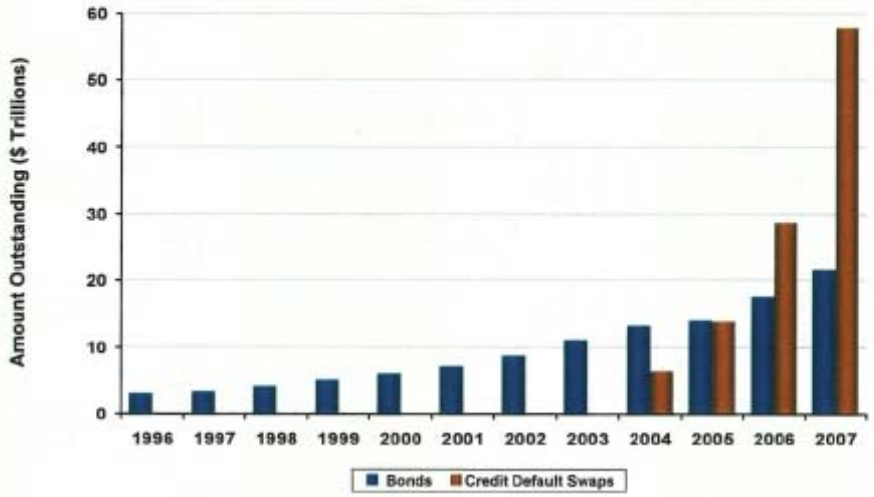
NERA



Source: NERA calculations based on data from OFHEO.

Causes of the Meltdown:
Leverage & Synthetics?

NERA



Source: Bank for International Settlements ("BIS").

Causes of the Meltdown:
Risk Migration?

NERA

Similarities and Differences between Current U.S. Credit Crisis and Japanese Banking Crisis in 90'

Yasuhito Doi
Bayview Asset Management Co., Ltd.

Japan experienced the "lost decade" in 90' after bubbles in stock markets and real estate markets collapsed. In this decade, the Japanese economy growth was only 0.9%, the lowest in the OECD. Nikkei dropped from 38,915.87 in 1989 to 14,309.41 in 1992, about 60% decline. Land prices in the urban areas of Japan tripled from late 80' to 1990 and dropped 70% from the peak through the decade.

As the subprime crisis in the United States worsens into a broader economic slump, articles in newspapers both of U.S. and Japan were beginning to suggest that U.S. is repeating Japan's route from bubble to a long recession. Lehman brothers' filing for Chapter 11 in mid Sep. reminded us of the bankruptcy of Yamaichi Securities in 1997. We feel vaguely some similarity between the nationalization of AIG and that of Long Term Credit Bank of Japan while one is an insurance company and another was a bank.

	U.S.	Japan
Origin	Housing Bubble (07/2007)	Asset Price Bubble(1990)
Corporate Crisis	Acquistion of Bear Sterns (03/2008)	Bankruptcy of Sanyo Securities.
	the Federal Takeover of Fannie Mae and Freddie Mac.	Hokkaido Takushoku Bank, Yamaichi Securities (1997)
	The Bankruptcy of Lehman Brothers.	The Nationalization of Resona Bank(2003)
	Bank of America's acquisiton of Merrill Lynch(09/2008)	
Government Bailout	Emergency Loan to Bear Stearns(03/2008)	685 bil JPY Capital Injection through RCC (1996)
	Conservatorship of Fannie Mae and Freddie Mac (09/2008)	Special Public Loan to Yamaichi Securities (1997)
		Capital Injection into Japanese Mega Banks (1998,1999)
Purchase Plan of Bad Debt	Announcement of $5 bil Purchase Plan in Mortgage Backed Securities (09/2008)	The Operations of RCC (1996 ～)
		BOJ 's Purchase of Banks' Stocks (2002)
Monetary Policy	Consecutive Cut of FFR to 2% (2007/2008)	Zero Interest Rate Policy (1999)
Liquidity Supply	Expansion of Fed in its Borrowing Facilities to Accept Eequities (2008/09)	Expansion of Money Market Operation to Corporate Debt
	Plan to Purchase Large Amounts of Illiquid, Risky Mortgage Backed Securities (2008/09)	

(Based on Mainichi Newspaper)

But as many economists and professionals show that there are so many different points which should be counted for to get the appropriate suggestions. As an executive officer in a Japanese independent asset management company, the analysis of this crisis is beyond just

personal interests. While the situation is changing every day and this paper may not be valid at the time of Japan-U.S. Symposium, I want to summarize the similarities and differences in these two crisis.

Similarities

Miss-Control of Change of the Environment

The origin of Japanese bubble is the Plaza Accord in 1985. In the Accord, the U.S. government and the other finance ministries agreed the monetary policy in a way consistent with a weaker dollar. In 18 months, Yen was appreciated from 260 to 130 and Japanese government had to cut interest rate to support less competitive Japanese economy. Under the low interest rate environment, the money flew into real estate markets and stock markets and as the result the prices increased. Japanese government miss-controlled the change of the environment by the shift of the currency exchange system.

In the U.S. the change of the environment is the financial innovation. Credit derivatives and securitization were developed highly and prevailed in the industry. The risk was scattered in the reformation of the original one and underestimated. U.S. Government and the financial industry including credit rating agency lost the control of the change of the environment.

Professor Edward Lincoln suggested that almost any country where there is financial deregulation and/or innovation is often associated with mistakes and problems, at least in the initial phase. These two crises both in U.S. and Japan were the case of it.

Underestimation of the Problem

Even though the stock prices went down severely and land prices began to go down in 1992, the Japanese government did not take actions fast enough.

In the United States, when the subprime loan problems were being revealed in the summer of 2007, people thought that subprime market couldn't be so big that it would be small impact on the rest of the U.S. economy.

But from December 2007, we found major financial institutions in Europe and U.S. began to writedowns. In the securities markets, based on the invisibility of the impact of loss, the de-leveraging accelerated. As a result, major banks had to post massive first quarter loss, which caused the further de-leveraging. The stock markets began to be priced based on the position cleansing instead of the fundamentals strength of the corporation. A lot of the short-term lending between financial institutions began to dry up and Bear Sterns was bought by JPMorgan with the deterioration in the cash management.

U.S. Government seems to implement a series of measure to provide the relief on the situation much faster than Japanese Government. But at the first stage, both of them underestimated the magnitude of the problem.

< Remarks on the Subprime-Related Losses since the Beginning of 2008 >

January 17, 2008	U.S. Federal Reserve Board Chairman Ben Bernanke said that the subprime-related losses were estimated at 100 billion dollars so far, but it could grow further to several times that figure, if the repayment rates and the number of foreclosures rose as well.
February 12, 2008	German Finance Minister Peer Steinbrück explained his belief that the losses linked to subprime mortgages could reach 400 billion dollars. (From a report in the Financial Times issued on February 12)
March 3, 2008	U.S. Treasury Assistant Secretary for International Affairs Clay Lowery said that the total subprime-related losses released by financial institutions around the world exceeded 200 billion dollars.
March 17, 2008	Director of the IMF's Western Hemisphere Department Anoop Singh said that the world financial system might face, altogether, a total of 800 billion dollars of losses across all banks, insurance companies, hedge funds and pension funds.
April 8, 2008	The IMF estimated in its Global Financial Stability Report that the total losses linked to subprime mortgages to be posted by banks, insurance companies, hedge funds and other financial institutions could reach up to about 945 billion dollars. (The losses in the banking sector may reach 440-510 billion dollars.)
April 15, 2008	The Organisation for Economic Co-operation and Development estimated the total subprime-related losses at 352-422 billion dollars.

(Financial Markets Strategy Team Second Report)

Differences

Magnitude of the Issue

Most analysts believe the U.S. subprime crisis will cost about $250 billion, or 2% of U.S. GDP. Assuming the worst and doubling that figure to 4% of GDP, that would be about the same size as the savings and loan crisis of the early 1990s. Even if we use the current maxmum estimate of loss $1,000 billion, it is only 8% of GDP. By contrast, in Japanese crisis, total writedowns of non performing loans amounted to 20% of GDP. Currently U.S. subprime crisis seems not so big as Japanese crisis based on the economic scale.

This is supported by the scale of the underlying property bubble. While U.S. housing prices in the 20 biggest cities rose by almost 200% over the 10 years prior to the 2006 peak, Japanese commercial land prices in its six biggest cities rose by almost 500% in the 10 years prior to 1991. After the peak, Japanese land prices went down below 1981 levels. Most forecasts estimate U.S. housing prices will drop 20-30% from peak levels. S&P's PE raio stay around 15x in 2008 which is much healthier than in IT bubble period while PE ratio of Japanese equity markets in 1987 was about 90x.

The magnitude of the issue in U.S. can not be said small but comparing to Japanese one, the impact to the real economy seems to be much smaller.

Disclosure

In Japan, the full scope of the problems at the Japanese banks, which had been lending money for both real estate and stock market speculation was not disclosed until the end of the 1990s. Because of it, Japanese government took eight-to-nine years of drifting of policy.
In contrast, after the subprime problem began to be announced a year ago, U.S. and Europe big financial institutions began to report the losses.

Quick disclosures realize us the issue in time and will lead to find the solution in relatively early stage.

Inflation/Deflation

The lost decade of Japan was the time of deflation. Under the condition of surplus of employment, equipment and debt in 90' of Japan, deflation brought difficult issue for the policy maker. It's hard to get out partly because monetary policy doesn't work well anymore. BOJ introduced the zero interest policy in 1999, which means the constraints of the monetary policy. It is not clear whether such situation may happen in the United States, but it seems to be unlikely, partly because of the more globally connected economy, especially with emerging countries which keep relatively high inflation. Also U.S. has cut interest rates very quickly with some fiscal package.

The difference of the price conditions may help U.S. to slip out the current difficult situation.

Response of Policy Maker

The other major difference is macroeconomic policy response. In 1996, Japanese economy showed the symptom of the weak recovery. The Hashimoto Cabinet did decide to increase the consumer tax to 5%. Also it decided to decrease the fiscal stimulus in order to adjust the imbalance of the national finance. This backfire of the fiscal policy set off the huge public investment to sustain Japanese economy and stock markets. While it is understandable that Prime Minister Hashimoto's concern was the balance of the national finance and the lower interest of long bonds might have helped the economy growth but it was too early or at least could not get the support of the investors.

Also in the monetary policy, there were inappropriate measures. It was said that cutting interest rates and providing administrative guidance to the banks in the mid-1990s was excessive. After that, interest rate was raised too far and kept high too long. BOJ brought them down slowly after about 1993 but didn't get them down to a really low level until 1997-1998. In general the decisive and quick monetary policy action to deal with the issue was not achieved. While BOJ implemented the zero interest rate policy in 1999, in 2000 BOJ decided to raise interest rates at too early timing.

In the United States, so far it seems to have had the quick response. Fed is cut interest rate rather quickly and decisively. Also liquidity was provided properly and so the markets seems not to loose the confidence on the policy makers.

Conclusion

Japan took so much time to deal with the reformation of the banking system because banks were thought to be too big to fail. But finally in 2000', they are integrated and repay the public funds which were injected in the stage of crisis.

Policy makers always face to the difficult issue whether they have to save a particular institution to keep the financial system or they allow the institution to be bankrupted to realize the loss and solve the issue quickly.

So far U.S. government already studied deeply the similarity and difference with

Japanese experience in 90' and does the very quick and well-balanced response to the issue. The conditions seem to be better than 90's of Japan, such as relatively healthier economies of the emerging countries.

But from the investor's view point, it is too early to take bull position. We experienced the consecutive increase of the estimate of bad loans' amount through 90's. It was not only because of the issue of the disclosure but mainly because the decline or stagnation of the economy increased the bad loans. Now U.S. economy is declining and we do not have enough conditions to have confidence that we are near to the exit of the tunnel.

Concept Paper

Hideaki Fukazawa
Tokio Marine Capital, September 24th, 2008

The U.S. Credit Crisis and Japan's Banking Crisis-What's the Same, What's Different, and How Can Japan's Experience Help in Resolving U.S. Crisis?

As if the timing were planned for the participants in this Symposium, the series of financial crises breaking in the U.S. is naturally causing major consequences in Japan. I would like to recognize some of the similarities with the bursting of the bubble that continued to plague Japan for more than ten years, which I believe will be excellent talking points in regard to a response to the current circumstances.

Points of Similarity to the Japanese Financial Crisis (Table 1)

As the severity of the U.S. financial crisis continues to deepen, sadly I get a strong impression that this is exactly what the Japanese experienced from 1997 to 1999. In particular, the most recent events seem to have been timed to strike just when the grip of the administration is weakening, chillingly reminiscent of the start of the succession of bankruptcies of major financial institutions that began with the failure of Yamaichi Securities in 1997. Table 1 shows developments in Japan from 1994 when the bubble began to burst in earnest through 2006 when the bubble appeared to have run its course. This is compared with U.S. developments from the so-called Paribas shock in August 2007, and it seems to me that there is a disconcerting degree of similarity.

Japan's financial crisis led to an Upper House election July 1998 in which the administration of Prime Minister Hashimoto, who had emphasized financial recovery by raising taxes, led to a major defeat of the ruling Liberal Democratic Party resulting in a situation in which "nobody was able to do anything." After the failures of Yamaichi and Hokkaido Takushoku Bank the previous year, and despite the injection of ¥1.8 trillion in public funds in major banks beginning in March 1998, the investment proved to be only part of what was needed and two major banks, the Long-Term Credit Bank of Japan and Nippon Credit Bank, were swept up in the waves of nationalization. There was a second injection of ¥7.5 trillion in public funds in 1999 before the bottom of the financial crisis was finally in sight.

If the comparison with Japan's situation fits the current U.S. financial crisis, the recent financial assistance to AIG (this was a revolving loan at Libor+8.5%p.a., which seems to me to be little different from a high-interest loan that takes advantage of a person's weakness) is a measure that holds little promise of effectiveness in removing financial uncertainty, and it was last weekend (September 20) before the announcement of an arrangement for purchase of bad assets from banks by investing public funds finally brought relief to the markets.

In Japan's financial crisis over a decade ago, the typical criticism leveled at Japanese policies by scholars in Japan and internationally, and by international financial and administrative authorities including the U.S. was "Clear away the senseless optimism (the reality is more severe) and do not hesitate to make one large investment of public funds." After World War Ⅱ, there were no major bank failures in Japan. The financial authorities as well as the bankers were very reluctant to disclose bad debts, and were not able to go against the argument of the opposition parties and the media that "It is out of the question to use citizens' tax money to defend wealthy bankers." As a result of consistently sticking to a gradual policy, the national wealth of Japan lost almost ¥700 trillion in stocks and land alone between 1994 and

2006.

In looking at the current response by the U.S. financial authorities, I have the feeling that they have not sufficiently made use of the earlier unfortunate example of Japan.

Differences from the Japanese Financial Crisis

The Japanese and U.S. financial crises are separated by more than ten years, and there are differences in the countries themselves as well as differences due to time that are difficult to clearly categorize. However, in Japan in the late 1990s “the myth of bank invincibility” was still alive. It was a matter of practical concern for bank managers that their very act of accepting public funds could set off a storm of credit uncertainty about their bank. This is considered one reason why disclosure of the true state of bad debts was so slow. In the U.S. on the other hand, financial institutions including banks are strictly private corporations, there is an understanding that “failures do happen in extreme circumstances”, and there appears to be no senseless stalling in disclosing the content of business. Mergers and acquisitions among financial institutions are accepted as normal in Japan these days, but ten years ago they were very difficult to pursue without guidance from the (then) Ministry of Finance and the sense of speed in financial reform was very different from that of the present time.

Another major difference between Japan and the U.S. is that the U.S. runs a current account trade deficit ($711 billion in calendar 2007) whereas Japan normally had a current account trade surplus (¥16 trillion in 1997).

Table 1
Comparison of the U.S. and Japanese Financial Crises

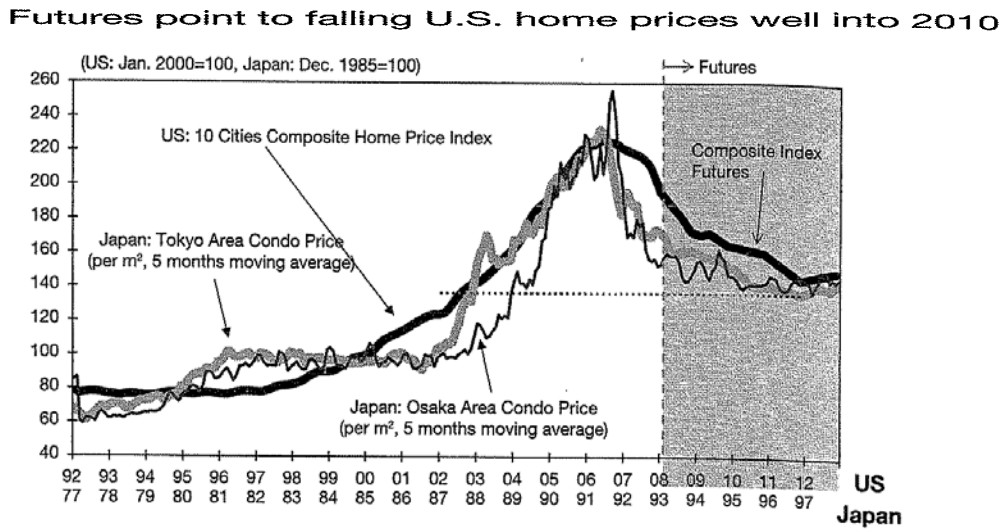
	U.S.		Japan	
Period	2007-?		1994-2006	
Trigger	Residential housing bubble burst. Defaults on sub-prime loans and drop in value of mortgage backed securities.		Real estate bubble (commercial/residential) burst. Defaults on financing of real estate.	
Political state	2008	Administrative absence during Presidential election	July 1997	LDP (Hashimoto government) defeated in upper house election. Political instability continues until the 2000 lower house election.
Major developments	August 2007	BNP Paribas freezes investment funds	1996	Public funds for specialized mortgage lending agencies
	March 2008	Bear Stearns effective bankruptcy	1997	Sanyo Securities, Hokkaido Takushoku Bank, Yamaichi Securities bankrupt
	September 2008	Public mortgage financing companies bailed out	1998	Long-Term Credit Bank, Nippon Credit Bank are nationalized

		Lehman Brothers bankruptcy	1999	15 major banks receive injection of public funds
		BOA takes over Merrill Lynch in merger		Mizuho, Mitsui Sumitomo and other major banks announce consolidation
		AIG bailout	2003	Risona Bank effectively nationalized
Administrative response	Investigating framework for purchase of bad debts		Injected public funds into healthy banks as well, encouraged processing of bad debts. Ultra-low interest rate policy.	

Applying Japan's Experience to a Response to the U.S. Crisis

First, I would venture to say that the current financial crisis is not a "U.S." crisis but a global crisis originating in the U.S. Neither Japan nor Europe, nor China, nor anyone else can think of this as "a fire on the opposite shore" and as a result the so-called "decoupling theory" has recently vanished into thin air. The cooperative response measures taken by a number of U.S. authorities, together with major leading central banks working in concert with the U.S. authorities, appear to have avoided the worst-case negative chain of events for the time being. However I believe we have to take the view that matters have not improved to the point where we can be confident as to when the current state of emergency will end or that no second or third Lehman Brothers will really occur.

Figure 1



Source: Bloomberg, Real Estate Economic Institute, Japan, S&P, "S&P/Case-Shiller® Home Price Indices", as of Mar. 25, 2008.

The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession P235 by Richard Koo

Figure 1 above is excerpted from a book by Richard Koo, Chief Economist of Nomura Research, with a subtitle that suggests it might have been published for this Symposium. Mr. Koo posits the pessimistic view "before the current financial crisis" has worsened, that if we

apply Japan's earlier example to the U.S., the drop in the U.S. housing market will continue to 2011 or 2012.

At the time, in 1998, I was working at the Long-Term Credit Bank of Japan, which ultimately was nationalized, but at the time we, who were considered scholars and professionals with good jobs, were wrapped up in a hysterical argument just like a witch hunt, that went something like "The use of public funds to rescue LTCB can in no way be permitted. If public funds are injected, even retired officers will have to return their pensions to the country (?) and employees with comfortable lives will have their company housing and recreational facilities sold off immediately." In the midst of this, it was Mr. Koo who calmly made the argument that "Rather than make micro-arguments about saving or not saving one financial institution, the government and financial authorities need to directly inject public funds into banks so that this financial crisis originating in Japan does not get exported to the entire world."

In that same sense, in the current U.S. crisis as well, Mr. Koo makes the case for early, unconditional investment of funds by financial authorities in banks as well as other financial institutions, and for the use of financial policy to the utmost, arguing that there should be no hesitation in investing capital. Similar arguments have come from former Treasury Secretary Summers, and from IMF Managing Director Strauss-Kahn at the start of the year, and I believe that the U.S. authorities also have come to the stage of specifically considering all-out financial action along with Mr. Koo. I believe that this, more than anything else, is the lesson to be taken from Japan's financial crisis in regard to the financial crisis of today.

Which Asian Model for the US Financial Crisis: Japan's "Lost Decade" or Asia 1997-98

Richard Katz
Oriental Economist Report 212-868-4380, September 27, 2008

Key points:

• America's current crisis is not at all like Japan's "lost decade," which was caused by deep-seated structural flaws. It is closer in nature—though not anywhere near in magnitude—to the Asia crisis of 1997-98, which was caused primarily by policy blunders

• Those policy blunders were driven by a combination of ideology and interest group politics

• The US turmoil differs from Japan in three major ways: the cause of the crisis; the size of the crisis; and the response of policymakers

• There is no credit crunch outside of the financial sector; lending to nonfinancial corporations and non-mortgage lending to consumers has done nothing worse than decelerate at a pace typical of past mild recessions

• There is no credit crunch because bank balance sheets remain strong and the rate of nonperforming loans remain no higher than the rate typical of mild recessions

• Balance sheets of firms and households remain strong; consumers can afford to keep spending, albeit with some slowdown from historically high rates

Overview

Alarmists in the US keep warning that the US risks heading down the same path that led to Japan's infamous "lost decade" during 1991-2002. The fact that many of the same people made many of the same warnings during the dot.com bust has not stopped them from "crying wolf" again. There is, however, another crisis in Asia that may pose better lessons for US policymakers: that of emerging Asia in 1997-98.

Of course, when it comes to severity, the current US recession bears no resemblance to the storms in Asia. Whereas some Asian countries suffered huge, even double-digit, declines in GDP, it's hard to find any economists who project negative growth for the US in 2008 as a whole, and more than a couple who project a negative year for 2009. At least that was the case before the investor panic that began with the failures at Lehman Brothers and AIG. As of this writing, we still don't know the outcome of negotiations for a massive governmental bailout, but we have little doubt that something will be approved sooner or later.

Where the Asia crisis and the US recession do bear resemblance is in the causes and cures. In both Asia and the US, the primary cause of the downturn was massive policy mistakes that brought on the crisis, and, in the Asian case, even more massive policy blunders during the crisis. One of policy blunders before the crisis was the combination of pegged currencies and hot money flows that made monetary policy ineffective in cooling off an overheated economy—a recipe for disaster that anyone reading Robert Mundell should have known to avoid. Then, when the crisis occurred, the US helped impose on Asia incredibly foolish measures that it would never impose on itself: higher interest rates and budget cuts during a recession. Once the US Treasury and the IMF reversed itself and allowed standard macroeconomic stimulus, Asia

rapidly recovered. So much for the theory that it was crony capitalism which brought down Asia.

Both Asia then and the US today stand in stark contrast to Japan, where deep-seated structural flaws were the root cause of the lost decade. Yes, Tokyo made lots of policy errors that took a bad situation and made it much worse. But, even without the policy errors, Japan would have run into lots of trouble. Moreover, the magnitude of problems was so much greater in Japan than those in the US that the two countries are not even in the same ballpark. For example, US housing prices exploded to perhaps 30% over sustainable value, but in Japan, urban land rose to a level several hundred percent above sustainable value.

What Asia does show is that, even in economies that are fundamentally sound, the combination of policy errors and financial panic can wreak havoc in the real economy. So far, despite the depths of the financial crisis, the real economy has not suffered more than a mild recession. Moreover, despite the Fed's pronouncement of a "credit crunch," and occasional seizing up of various markets, no such crunch has yet shown up in the numbers for credit to nonfinancial firms or non-mortgage consumer credit. Instead, what we see is nothing worse than the normal deceleration of credit in a downturn. This "disconnect" between a tremendous financial crisis and a mild recession is hardly unprecedented. In the 2000-2003 dot.com bust, the loss of stock market wealth equaled 90% of GDP, dwarfing the 60% of GDP loss in the two years after the crash of 1929. Yet, the 2001 recession was the mildest in postwar history. GDP fell for just one quarter and by only 0.3%.

The US economy is very resilient. It would take a lot of policy errors and investor panic to send it into sharp recession. But such errors and panic—which tend to feed on each other--are hardly a non-trivial possibility.

America Is Not Japan

It seems that every time American gets into trouble, alarmists trot out the specter of Japan's lost decade. The last time this happened, during the dot.com bust at the beginning of this decade, clever analysts produced impressive-looking charts claiming that US stocks were retracing the ups and downs of their Japanese counterparts. Yet, today, the Nikkei 225 is still 70% below its all-time peak 18 years ago. By contrast, the S&P 500 is about 17% lower than at its 2000 peak (top figure on pg. 11). That's hardly anything to boast about, but it's a far cry from Japan's plunge.

One Japan-oriented investment newsletter, citing Soros, commented that, America's financial turmoil, "is beginning to sound like Japan's financial crisis in 1997." This makes us think of Soros' 1998 tome, The Crisis of Global Capitalism, in which he mistakenly called the recovery from the 1997-98 financial crash a "false bottom" and went on to predict that, "The disintegration of the global capitalist system will prevent a recovery, turning [global] recession into depression."

Assuming aggressive, competent action by policy makers, modern mature economies are surprisingly resilient even in the face of very large financial shocks. That's due to the combination built-in stabilizers and greater skill with fiscal-monetary tools. As John Kenneth Galbraith once explained to this reporter, back in the 1920s-30s, the economic structure amplified shocks. But now, built-in stabilizers plus fiscal-monetary policy dampens shocks. The absence of such stabilizers was one reason Asia was hit so hard in 1997-98.

Three factors define the difference between America's subprime crisis and Japan's lost decade: 1) the source and nature of the crisis; 2) the magnitude of the crisis; and 3) the response of policymakers.

The Cause of the Crisis

Japan's crisis was woven into the very fabric of its political economy. The 1980s "bubble" was as much a symptom of Japan's flaws as a cause of the ensuing bust. Although mistakes certainly made a bad situation even worse, even the mistakes reflected deeper structural flaws. For example, Japanese authorities took so long to address the nonperforming loan (NPL) problem, not just because of blindness, but because zombie firms provided "disguised unemployment" for millions of workers.

Japan has structural flaws on both the supply-side and demand-side of the economy. On the supply-side, flagging productivity limited Japan's potential growth. On the demand side, it suffered what we call "economic anorexia," i.e. a consumption disorder. Personal consumption lagged as a share of GDP, not because of lack of will, but because of lack of wallet. Real household disposable income kept falling as a share of real GDP. In the absence of sufficient consumer demand, Japan pumped up artificial sources of demand, from a rising trade surplus to the use of monetary steroids to bring the capital formation rate to historic highs. Much of private investment was really disguised public works with little more value than the fabled pyramids of Egypt. The result of a mountain of money-losing capital stock and its financial mirror, bad debt.

By the contrast, America's subprime fiasco—just like Asia's 1997-98 meltdown—is primarily the result of discrete, correctable policy mistakes. Traditional prudential banking regulations forbid banks from lending to people with no downpayment or proof of ability to repay the loan. However, when non-banks became the country's biggest mortgage lenders, the Federal Reserve did not apply the same rules to them. Moreover, mortgage originators lost their incentive to make sure that loans could be paid back because they rapidly sold them to investment banks that repackaged the mortgages into securities. The market was flooded with "Ninja loans" (No income, No Jobs or Assets).

In 1994, under bipartisan leadership, Congress passed a law enabling the Federal Reserve to force non-banks to follow the same mortgage standards as banks. Unfortunately, Fed chairman Alan Greenspan refused to use these powers because he overestimated the self-correcting capacities of financial markets. Then, in a succeeding Congress now controlled by the Republicans, Congress Barney Frank tried to pass a law requiring the Fed to implement these rules. Initially, some Republicans signed on, but then Tom Delay forbad Republicans from joining the effort. Fortunately, with the benefit of hindsight, current Fed chair Ben Bernanke seems more opening to tighter supervision.

There was an additional ingredient in America's crisis: a bizarre compensation system that gives CEOs incentives to take outsized risks with other people's money. The combination of tax-incentivised stock options, golden parachutes and the like, means that, if CEOs gamble correctly, they can earn hundreds of millions of dollars. And if they gamble wrong and the company goes belly up, they can still walk away with at least tens of millions. Stan O'Neal walked away with a $160 million severance package as he put Merrill Lynch on the road to bankruptcy. Alan Fishman was given $20 million for 17 days presiding as CEO of Washington Mutual as it went bankrupt; of that $11 million was a severance package. This is a classic mismatch of the interests of the company and of its CEOs. This is violation of fiduciary duty on massive scale.

A study of 950 corporations entitled, Swinging For the Fences: The Effects of CEO Stock Options on Company Risk-Taking and Performance, found that the higher the percentage of CEO pay represented by stock-option grants, the higher the level of company investment spending and the more extreme the firm's financial performance, particularly stock performance. CEOs have an incentive to take big risks. If they win, they win big. If they lose, the company loses, but they simply have less of a gain. As a result, "option-loaded CEOs … strike out much more often than they hit home runs." For example, in companies where stock-option grants constituted half or more of the CEO's pay, 10.1% sustained big shareholder losses, while only 6.8% enjoyed big gains. In addition, 6.9% suffered extreme losses in return on assets, while only 3.9% reaped extreme gains. In contrast, no such disparity existed when stock options constituted less than 20% of CEO pay; in fact, extreme shareholder gains outnumbered extreme losses.

As Jesus said of the poor, “Bubbles we will always have with us.” But there are bubbles and there are bubbles. It is hard to believe that the bubble would have gotten as bad as it did, except for the combination of extreme and irresponsible deregulation and a bad compensation system.

The Size and Pervasiveness of the Crisis

How about the difference in size? The government is talking about a bailout of $700 billion, or 5% of GDP. But much of that will be retrieved over time as assets are sold off and money recouped. If that is the size of the crisis, it would be just a bit bigger than the Savings & Loan crisis of the early 1990s. And yet, the 1990-91 recession was the second mildest of the postwar era. By contrast, in Japan's NPL crisis, total write-downs and write-offs of NPLs amounted to a mammoth 20% of GDP.

Over the ten years prior to the 2006 peak, US housing prices in the 20 biggest cities rose by almost 200%. In the ten years prior to the 1991 bust, Japan's commercial land prices in its six biggest cities rose by almost 500% (bottom figure on pg. 11). The subsequent bust brought Japanese prices down to a level well below that of 1981 and now, just as prices have recovered to their level of 26 years ago, they are turning soft again. While US housing prices have yet to hit bottom, most forecasters think they will drop "only" 20-25% from peak levels. No one is suggesting that prices will fall below what they were in 2000, let alone 1996.

Japan’s crisis was not just one of real estate, but one that pervaded virtually the entire corporate and financial world. Through non-financial corporations, debt levels were high and ROA was low. There was excess physical capacity (see charts on pg. 12). In Japan, corporate debt over the last 20 years has been 10 times as high as the pre-interest operating profits out of which interest payments are financed. Even today, after years and years of debt reduction, the debt:profit ratio is still 7.1. In the US, by contrast, the debt:profit ratio is only three (see top chart on pg. 13). In Japan, until the era of ultra-low interest rates, debt service siphoned away 50-80% of profits (see bottom chart on pg. 13).

Policy Response

Finally, US policymakers and financial institutions are responding far more quickly than in Japan. There is no need to rehearse here the years of delay and even criminal cover-up of

the debt crisis, the mismanaged fiscal and monetary policies, the effort to prop up zombies, and so forth. By contrast, in the US, the Fed rapidly dropped interest rates; the government applied fiscal stimulus equal to 1% of GDP, financial institutions are rapidly writing off bad assets while seeking new capital, even big firms are being allowed to fail, Congress is already preparing legislation to tighten lending rules, and the government is about to inject a massive amount of capital.

There is certainly room to argue over the wisdom and efficacy of various steps. But, when one proves ineffective or insufficient, others are tried.

Indeed, if the problem in Japan was excess complacency, the problem in the US may be excess alarmism, talk of a Great Depression and such. When markets are already so shaky, they need the blunt truth, but not scare stories.

An Asian Mirror: Keynes Was Right About the Power Of Ideas

It is worth taking a paragraph to look at the cause of the Asian crisis because it shows how policy errors can wreak havoc. The cause of the crisis was partly poor sequencing, i.e. opening these countries to “hot” international capital flows before shoring up the domestic banking structure, and sticking to a fixed currency system despite this capital opening. The second error was maintaining a currency peg while opening the countries to hot money flows. That rendered monetary policy useless. An effort to cool overheated economies or property markets through higher interest rates would just attract more money. When the countries exports softened, the hot money flows left in massive doses.

Then, a big problem was turned into absolute disaster when the International Monetary Fund (IMF) and US Treasury recommended the complete opposite of what every textbook recommends in a recession. Instead of applying fiscal and monetary stimulus the IMF-Treasury team imposed the opposite, forcing the Asian debtors to raise interest rates and cut budgets. They did this in the mistaken belief that this would bring foreign investor money back to Asia. In reality, by plunging basically sound countries into depression, these measures frightened already-panicky foreign investors even more. Once the IMF and Treasury relented, Asia enjoyed a rather rapid recovery. For example, after suffering a 7% fall in GDP in 1998, Korea has enjoyed 5.6% average GDP growth since 1999.

The IMF has said that, had it known the recession was going to be so bad, it would not have imposed fiscal austerity. The truth is: had the IMF not imposed fiscal austerity, the crisis would not have been so bad. (It did not issue a similar mea culpa for its high interest rates).

When smart people make such bad mistakes over a significant period of time, we need to ask why. Usually, in such cases, there is either a political imperative or an ideological mental block. In the case of Asia 1997-98, there was not only undue attention to the needs of foreign creditors over the domestic economies, but also an ideological predisposition to see fiscal largesse at the root of every problem. Hence, the IMF’s common nickname of "It’s Mostly Fiscal."

Ideological blinders also stand at the root of America’s subprime crisis. When it came to monetary policy, Alan Greenspan was the supreme pragmatic number cruncher. Yet, when it came to regulatory policy, he was an unabashed true believer in the “magic of the marketplace.” Greenspan refused to apply to “non-banks” that now issue a very large percentage of America’s

mortgages the same common sense rules that have been applied to banks for decades. How can any responsible regulator allow mortgages with no downpayment and not documentation of a borrower's ability to pay? How can it do this when mortgage originators no longer keep the loans on their books and have no incentive to make sure mortgages are serviced?

Meanwhile, corporate executives used their lobbies to make sure that they could deduct stock options as an expense when it came to paying taxes, but not count them as an expense when it came to reporting corporate profit. Tax and regulatory policies gave firms incentive to compensate top executives with stock options. The options, in turn, give CEOs an incentive to take big risks with other people's money.

In short, the current crisis in America is not a result of Japanese-like structural flaws but Asian crisis-like blunders created by a powerful combination of ideology and special interests.

Disconnect Between Financial Crisis and Real Economy—So Far

Despite all the financial panic, there is so far surprisingly little damage to the real economy.

Out of 55 economists surveyed regularly by the Wall Street Journal, not a single one in the September survey foresaw negative GDP growth in 2008 and only one predicted negative growth in 2009. Moreover, on average these economists believe that 2009 will be somewhat better than 2008, with 1.9% growth in 2009 compared to 1.5%. 1.9% is hardly a great year, but it is far from the disaster that one might assume from reading the newspaper headlines about the financial crisis. Only 10 of the 55 believe 2009 will be worse than 2008. The rule of thumb definition of a recession is two consecutive quarters of zero growth. Yet, out of these 55, only five forecasters predicted two consecutive quarters of negative growth (the fourth quarter of 2008 and first quarter of 2009). These economists put the odds of a recession at 60%, down from 70% back in April just after the March financial turmoil. However, depending on how the current financial panic is handled, it is certainly possible that the current financial turmoil will result in a downgrade of forecasts when the October survey is made.

How about job performance? So far in the first nine months of this downturn, job losses have been only half as much as in the same period of the 1990-91 recession and a two-thirds less than 2001 recession (see top chart on pg. 14). The WSJ economists see the unemployment rate hitting 6.2% by December of this year and remaining at that level as late as December 2009. If they are right, that would be a lower rate than the 7% average that prevailed in the two decades from 1974 through 1995.

So, on the one hand, the current situation is a terrible and avoidable disaster for Wall Street, many ordinary household investors who have used the stock market for their retirement funds, and many people who will lose their homes. But, if these forecasters are right, it will be a relatively mild recession by postwar standards.

One reason for the apparent disconnect between finance and the real economy is that the financial crisis is—at least so far— nowhere near as bad as the press and investment banking newsletters would have us believe. Nonperforming loans remain low and nonfinancial firms still have plenty of access to credit.

Credit Crunch: On Main Street or Just Wall Street?

Despite all the talk of a “credit crunch” since the Fed declared on in August of 2007, there is so far little evidence of one. True, various markets have seized up from time to time. There is a dearth of loans for Leveraged Buyouts by private equity firms. But in the broad market for nonfinancial firms and for non-mortgage lending to households, there is so far no evidence of any credit crunch.

One of the most important indicators is a monthly survey conducted by the National Federal of Independent Businesses (NFIB), the voice of the small and medium companies that employ most Americans. In regard to the credit crunch, the NFIB reported the following based on a September survey of its members:

A year has passed since the Fed declared the existence of a "credit crunch", but no evidence of serious credit problems has appeared on Main Street. It remains a Wall Street issue. The net percent of owners reporting loans harder to get in recent months rose one point to a net 10 percent. In 2003, only 3 percent reported loans harder to get. "The data make it clear that there was no 'seizing up' of credit markets, no 'frozen' supply, no sudden reduction in credit availability to Main Street firms as portrayed in the media," said William Dunkelberg of the NFIB…Only 2 percent of the owners cited the cost and availability of credit as their No.1 business problem (down a point), far from the record 37 percent reached in 1982.

What we see, at most, is the kind of credit deceleration that is typical of mild recessions. That could change if investor panic is not handled properly by the authorities. But so far, that is not the case. The Federal Reserve’s just-released Flow of Funds data shows that the so-called credit crunch has, so far, mainly related to the mortgage business and certain Wall Street instruments. Nonfinancial businesses and consumers looking for non-mortgage loans are still able to get credit. In past reports, we have focused on bank lending. But these figures are much broader because they also include all the debt markets, such as bonds and commercial paper.

When we deflate debt growth by inflation (to avoid distortions caused by high rates of inflation in the 1970s-80s, we see that, by historical standards debt growth is still at the 1968-2008 average of 4.5% (top chart on pg. 15). It has not gone even close to negative territory as in the recessions of 1973-74 and 1980-82, nor as low as the recession of 1990-91. Taking quarterly data (at annualized rates), we can certainly see that debt growth slowed dramatically in the April-June 2008 quarter. But it has not yet descended to the rates of some recent recessions. So, far from a credit crunch, what we seem to see is the normal slowdown associated with an economic downturn (bottom chart on pg. 15).

If we then look sector-by-sector, we can see that most of the slowdown is due to a slowdown in mortgage debt. In April-June, mortgage debt turned negative for the first time since the early 1980s (see top chart on pg. 16).

By contrast, outstanding business debt is still 8% above what is was a year ago, a high rate of year-on-year growth by historical standards. Yes, in April-June, debt expansion for business slowed dramatically to a 4.5% annual rate. But that is still the average for the past 40 years. There is not yet any big credit crunch in lending to business from banks and the credit markets (bottom chart on pg. 16). Consumer debt for items other than mortgages is about 4.5% above year-earlier levels. That, too, is still above the 40-year average of year-on-year growth (top chart on pg. 17).

If we total all the debt of consumers and nonfinancial business for things other than mortgages, we see the normal deceleration that we should expect in an economic downturn.

We do not yet see a credit crunch (bottom chart on pg. 17).

Bank Balance Sheets Still Strong

One reason for the lack of a credit crunch is that most commercial banks are nowhere near as capital-starved as the public believes. As of Sept. 3, the ratio of net worth to assets among all banks was 11.1%, a tiny bit higher than the 10.9% ratio back in August 2007, when the Fed claimed the beginning of a credit crunch. In fact, the net worth ratio is at the highest point in three decades (see top chart on pg. 18). Note: this is not the same number as the capital:asset ratio used to meet the Basle II standards,

NPLs Up But Not Yet As Bad As Last Recession

Naturally, as in any recession, nonperforming loans are rising. But so far they are not as bad as in the 1991 recession, which was the second mildest in postwar history. The good news is that most of the bad loans are focused on the real estate sector. The bad news is that real estate loans have more than doubled from 25% of all loans four decades ago to 55% today.

Delinquent loans, i.e. loans past due more than one month, have doubled to 3.3% of all loans, compared to only 1.5% in early 2006. But that is only half of the 6.1% peak that they reached in 1991 due to the Savings & Loan crisis. Among single-family mortgages, the NPL rate is 4.3% (see bottom chart on pg. 18). Since this is just the beginning of the downturn, we would expect the NPL rate to keep rising for a while and would not be surprised to see it surpass the 1991 peak before the crisis is over.

Banks are being very aggressive in getting these bad loans off of their balance sheets, either by foreclosing and recouping what they can or by selling off the loans. The charge-off rate for all loans has tripled to 1.24% from a couple years ago. But that is still below the peak of 1.75% in 1991 (see top chart on pg. 19). One reason the charge-off rate has risen so quickly is that banks are being more aggressive than in the past. They are less patient about keeping bad debt on their books. Among all loans, charge-offs in April-June equaled 44% of all NPLs, a much higher rate than the 32% peak in 1990-91. Among mortgages, the charge-off ratio to NPLs has soared to 30% from an average of 5% in the past ten years (see bottom chart on pg. 19).

While NPLs are high among real estate loans, NPLs remain low on non-real estate consumer and business loans, which together make up 45% of all loans. One-month arrears stand at 3.6% of consumer loans, more or less the same rate prevailing over the past two decades. On business loans, delinquencies are only 1.7%, nearly the lowest rate in the last two decades. In the late 1980s-early 1990s, NPLs averaged 5-7% on business loans (see top chart on pg. 20).

Mortgage Crisis Mainly a Subprime Phenomenon

Even though all sorts of mortgage-backed securities have been hit by the financial crisis—mainly because no one knows how to price them—the fact is that the mortgage payment crisis is primarily a subprime phenomenon. Prime fixed rate mortgages account for 65% of all mortgages and the foreclosure rate is a mere 0.7%. Half of all foreclosures are on subprime loans—even though they comprise only 12% of all loans—and the foreclosure rate for adjustable rate subprime mortgages was 17% in January-March (see table at bottom of pg. 20). This pattern continued in April-June.

Corporate and Household Balance Sheets Are Strong

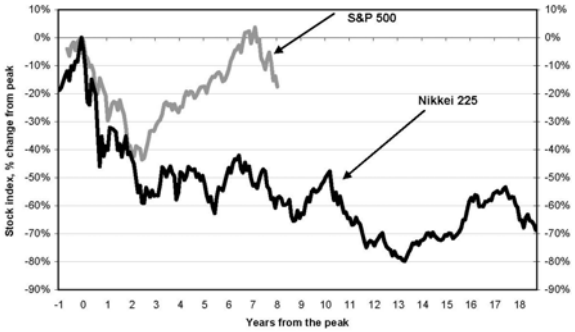
The fear is that the housing crisis will cause households to stop spending due to a wealth effect. But, despite the recent drop in net worth, household net worth remains at is historical ratio to annual income. Household balance sheets are strong; and so are those of non-financial corporations (see charts on pg. 21).

Conclusion

In one sense, John McCain was right: the fundamentals of the US economy are strong. Where he was wrong was his implication that this meant the economy was okay. The fact is that it is in the midst of a big financial crisis that could disrupt the real economy if the right policy steps are not made. But so far, there is no credit crunch outside of the financial sector, balance sheets are strong, and the real economy has had a mild downturn. With the right policies, there is no reason the US should suffer more than relatively mild recession.

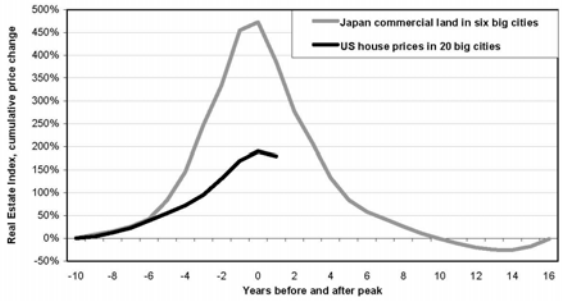
America is not Japan.

False Parallels



Source: Nikkei and Yahoo Finance
Note: For Nikkei 225, 100 = December 1989; for S&P 500, 100 = August 2000

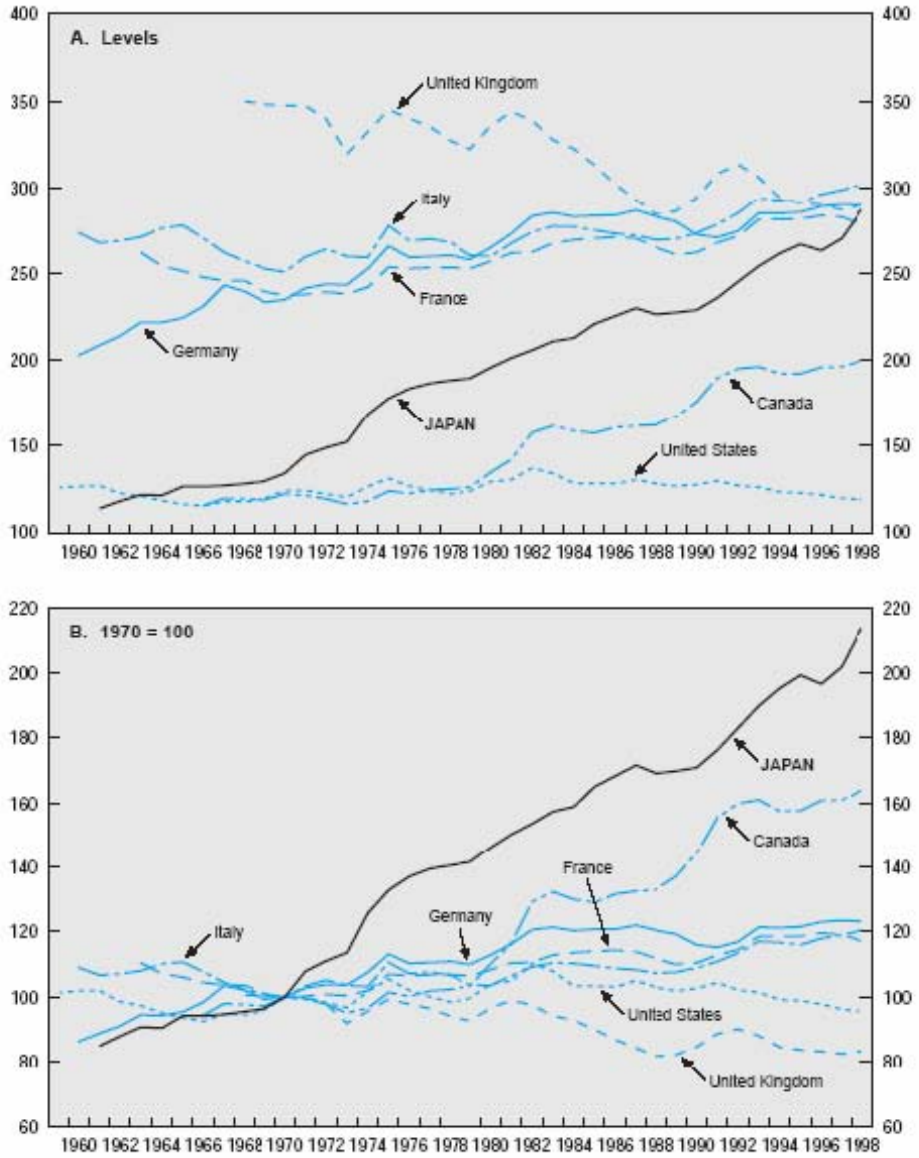
Japan real estate bubble dwarf's America's



Source: Japan Real Estate Institute and Case-Shiller Index

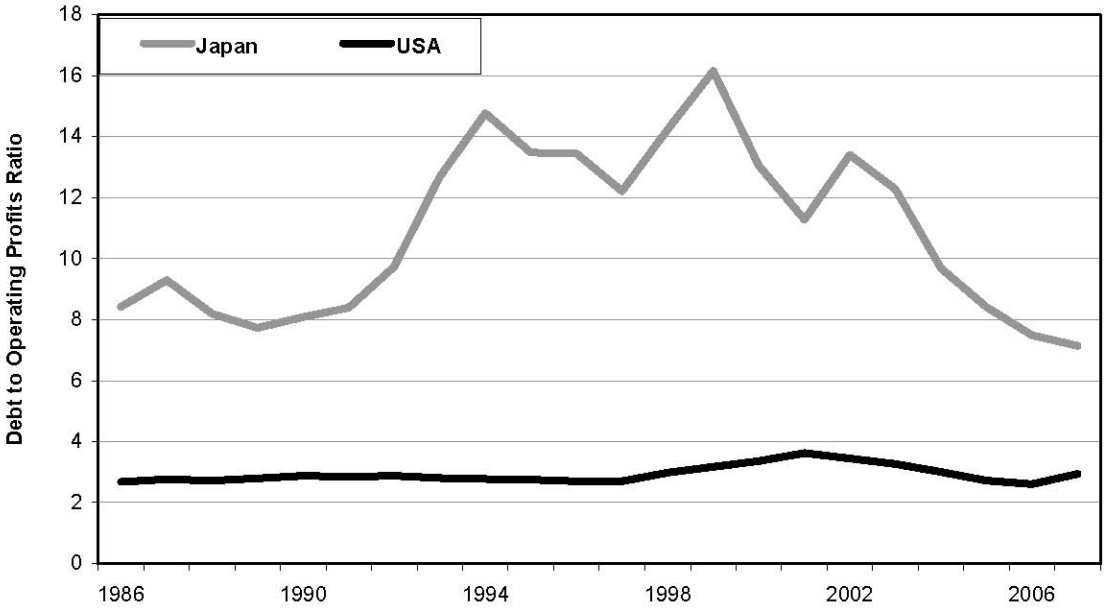
Note: This chart shows the cumulative percentage increase in real estate prices beginning ten years before each country's peak. For Japan, the chart shows price increases for commercial land in Japan's six biggest cities beginning in 1981. For the US, the chart shows the price hikes for houses in America's 20 biggest cities beginning in 1996

Figure 15. **Capital-output ratios: an international comparison**
Total business sector, constant prices



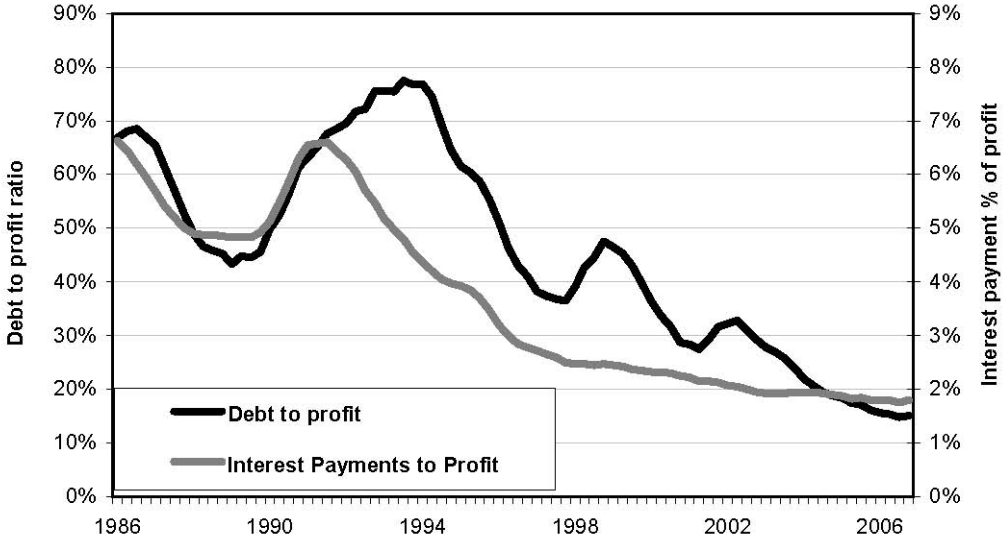
Source: OECD

The Debt Load of Corporations: Japan vs. US



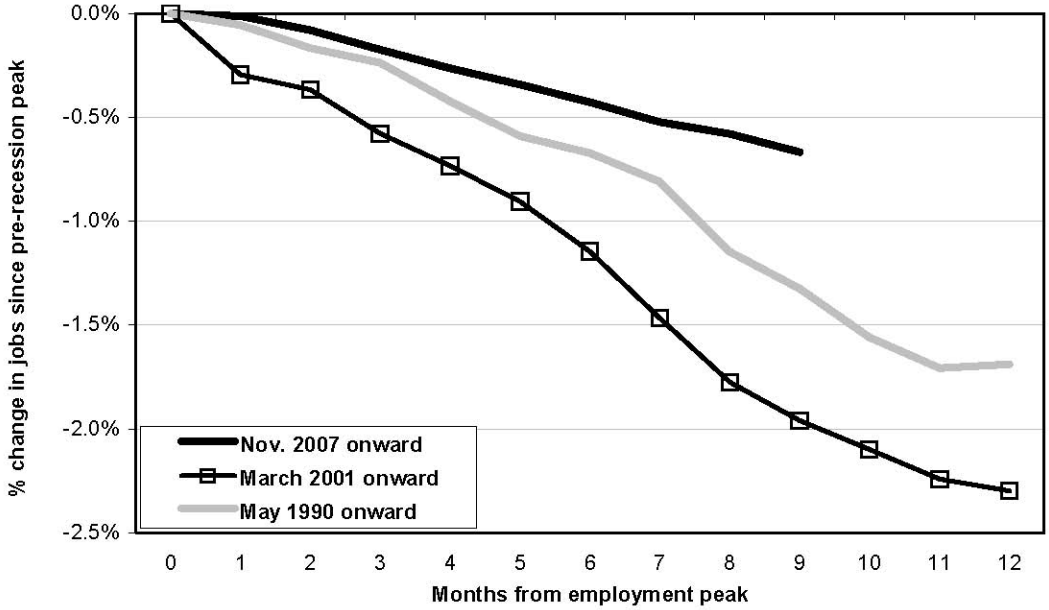
Source: Japanese Ministry of Finance, US Commerce Department and Federal Reserve
Note: Operating profits, i.e. profits before interest payments and taxes, are the source out of which interest payments on debt must be paid. Hence the ratio of debt to operating profit is a key measure of the debt burden. This figure overestimates the burden on US firms since the Commerce Department figures are for net interest rather than gross interest as in the Japanese data.

Japan Debt Service Burden Was Unaffordable Until Ultra-Low Interest Rates



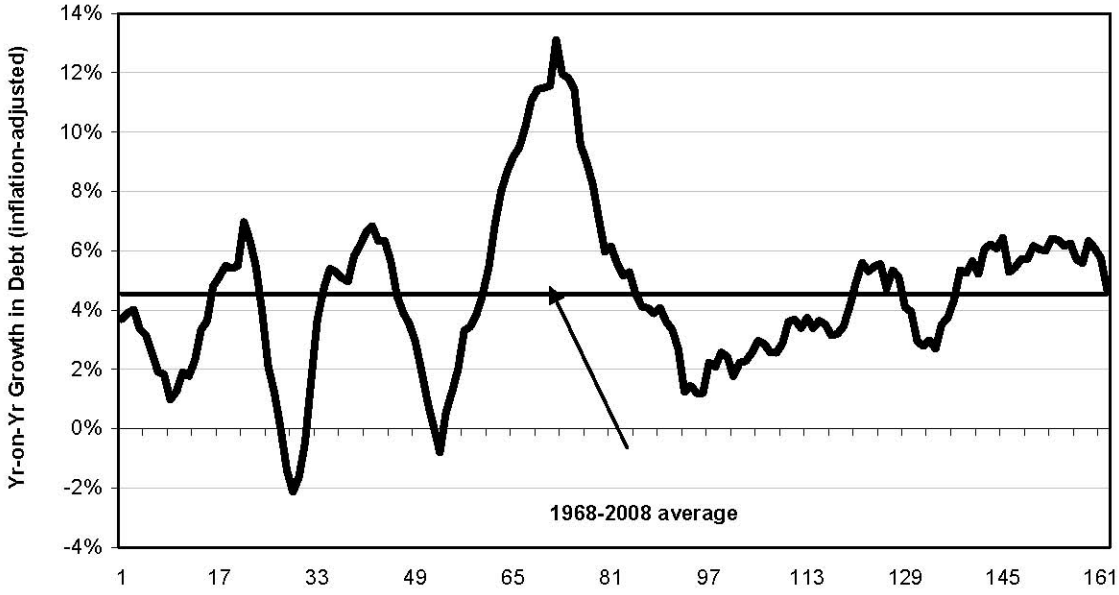
Note: The grey line is, in essence, the interest rate; the debt burden didn't drop below 50% of profits until interest rates dropped below 3%. Unfortunately, we do not have comparable figures for the US at hand right now

Job Losses So Far Less Than in 1990-91 and 2001 Recessions



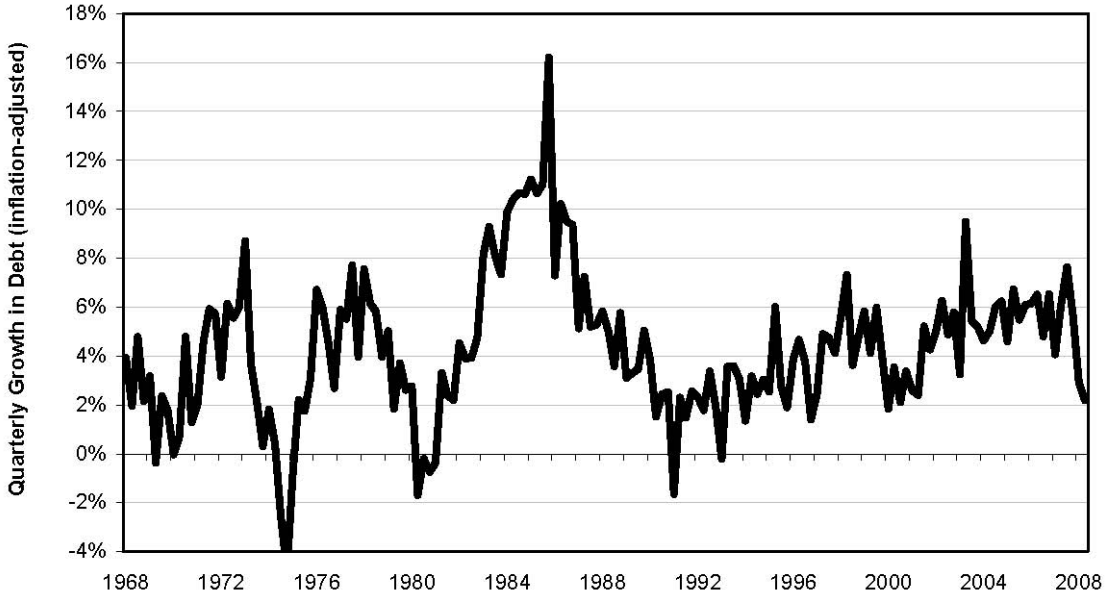
Source: BLS
Note: Private sector jobs

Year-on-Year Growth in Credit (Debt) Still High



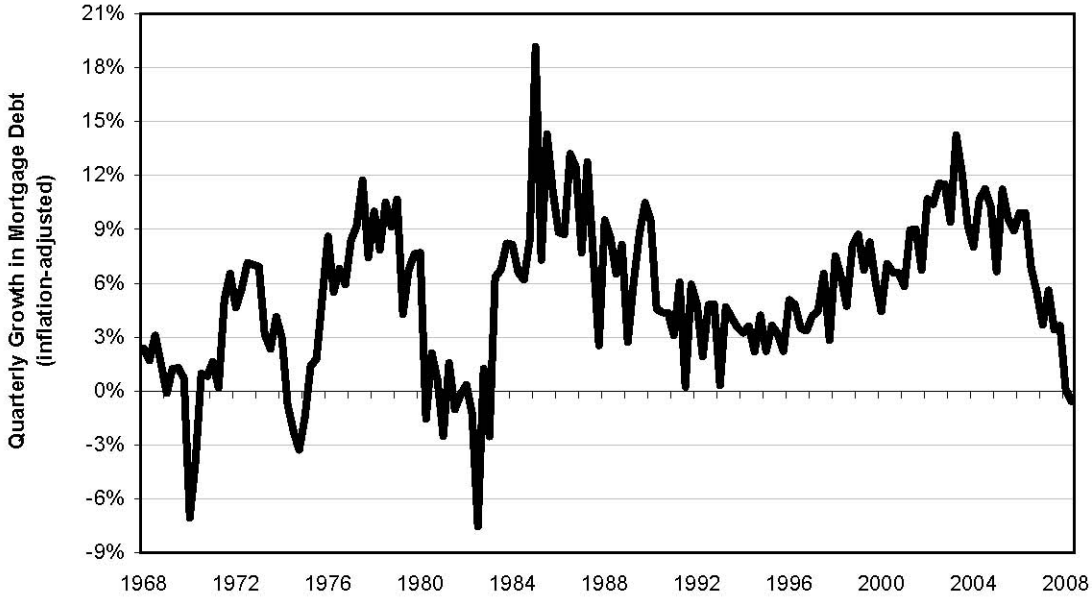
Note: The line shows the debt deflated by the GDP deflator

Quarterly Deceleration of Debt Growth

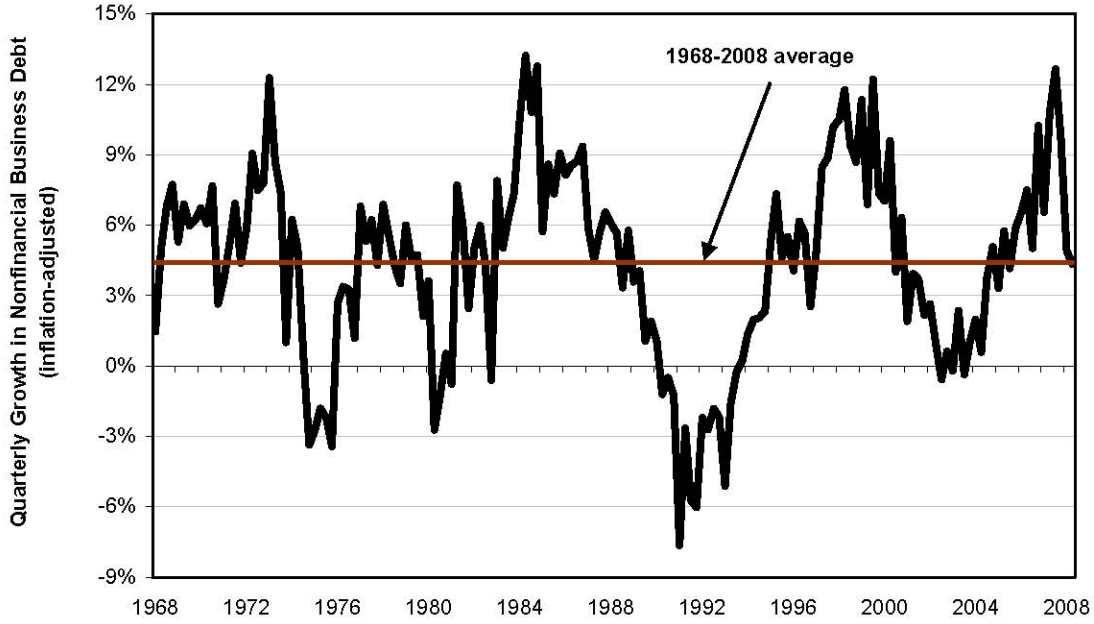


Note: In this and succeeding charts, quarterly growth in inflation-adjusted debt at annualized rates

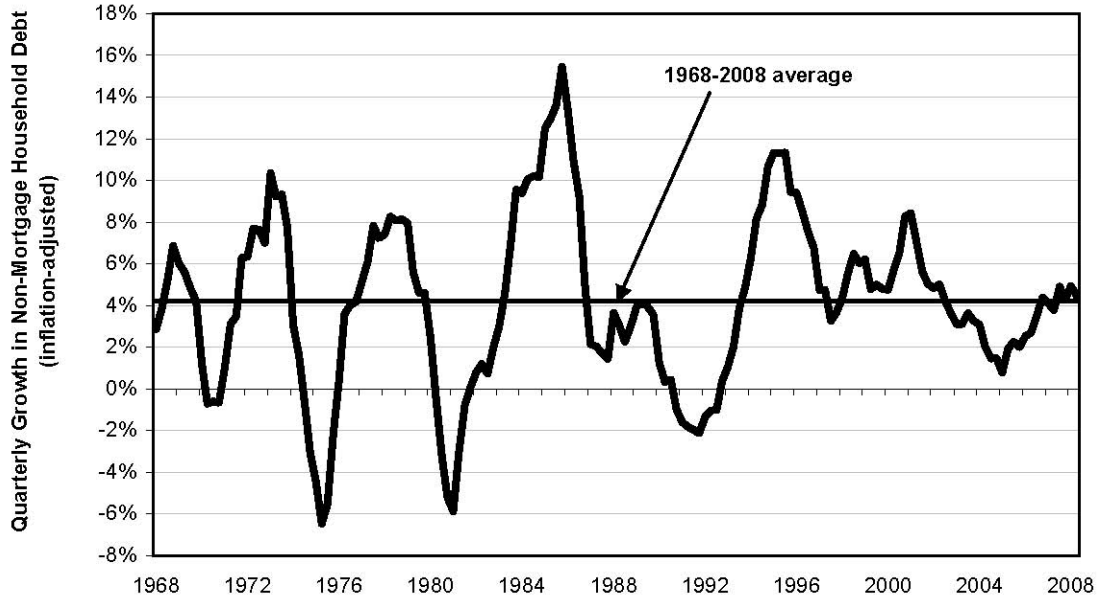
Dramatic Slowdown in Mortgage Debt (Quarterly)



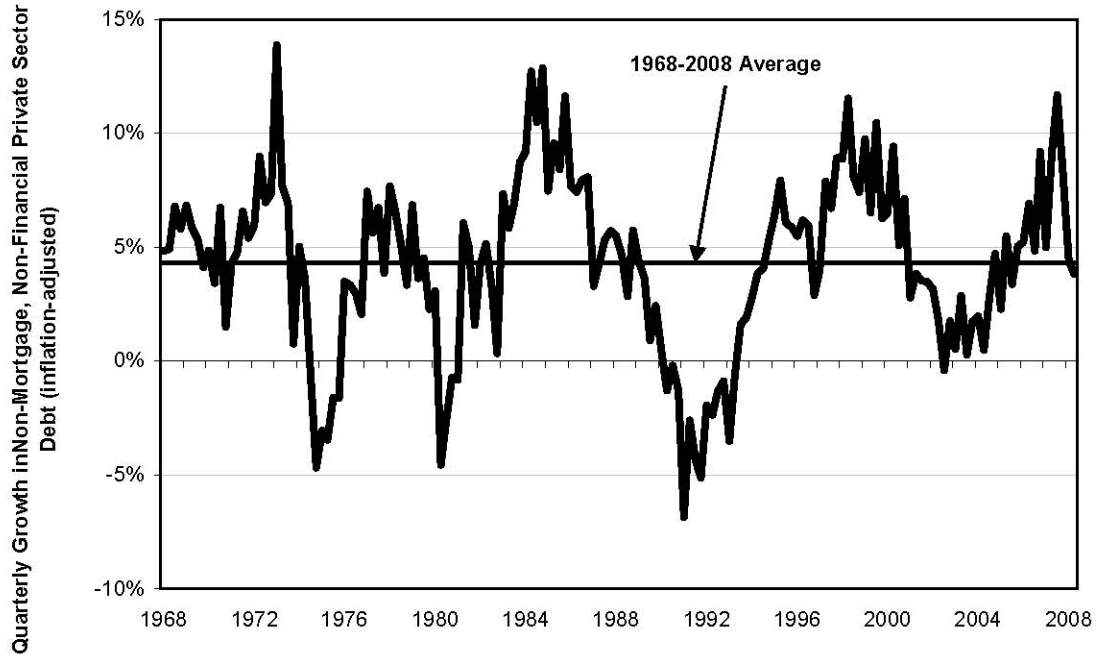
Despite Deceleration, Business Debt Still Growing At Good Rate



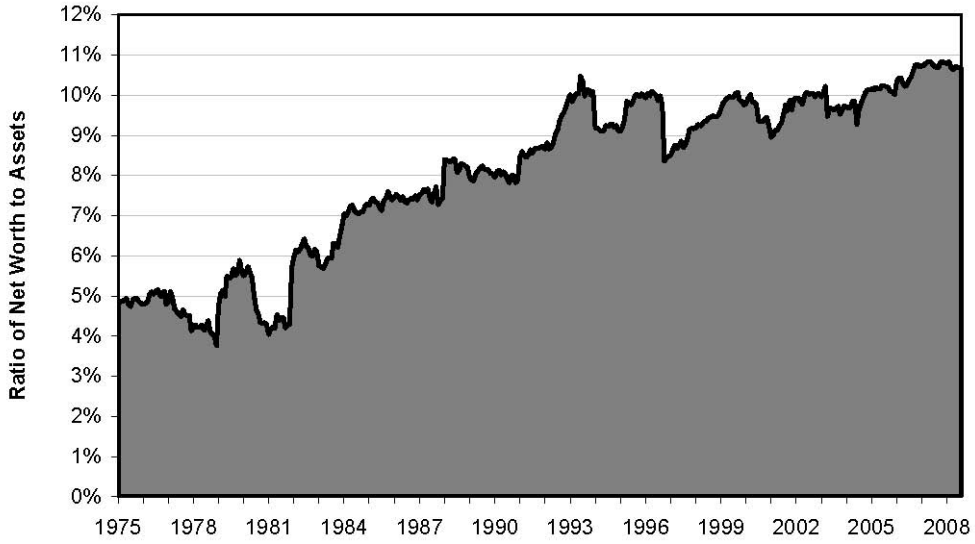
Consumer Loans (Non-Mortgage) Still Growing Well



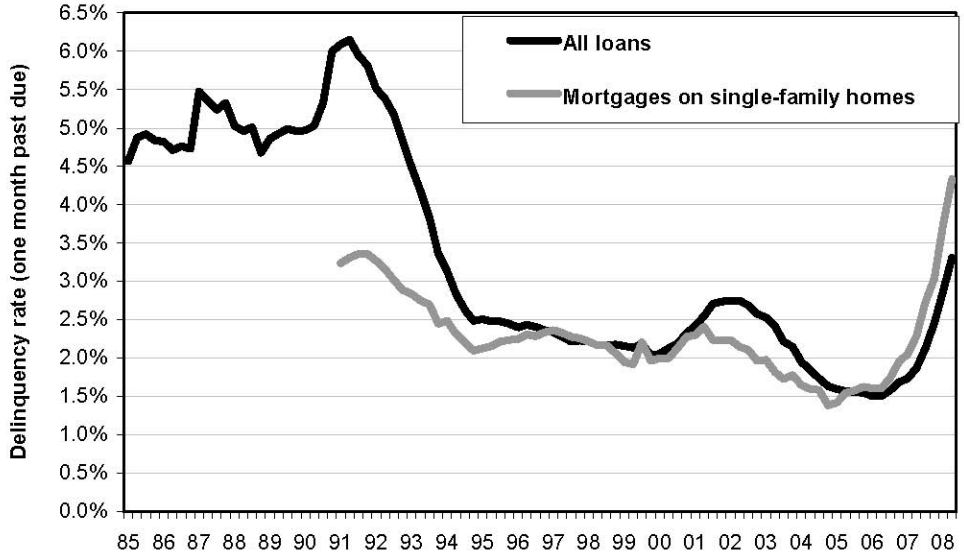
Except for Mortgages, Non-Financial Debt Suffering Nothing More Than Usual Recession Slowdown



Strong Bank Balance Sheets: Net Worth Ratio At 11%

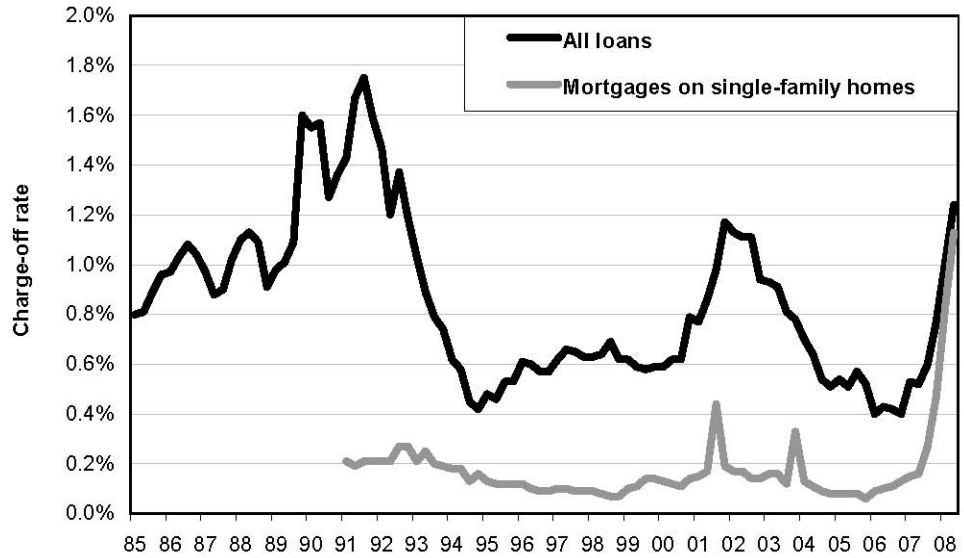


Delinquency Rate of Loans Rises But Not Yet At Rate of Last Recession

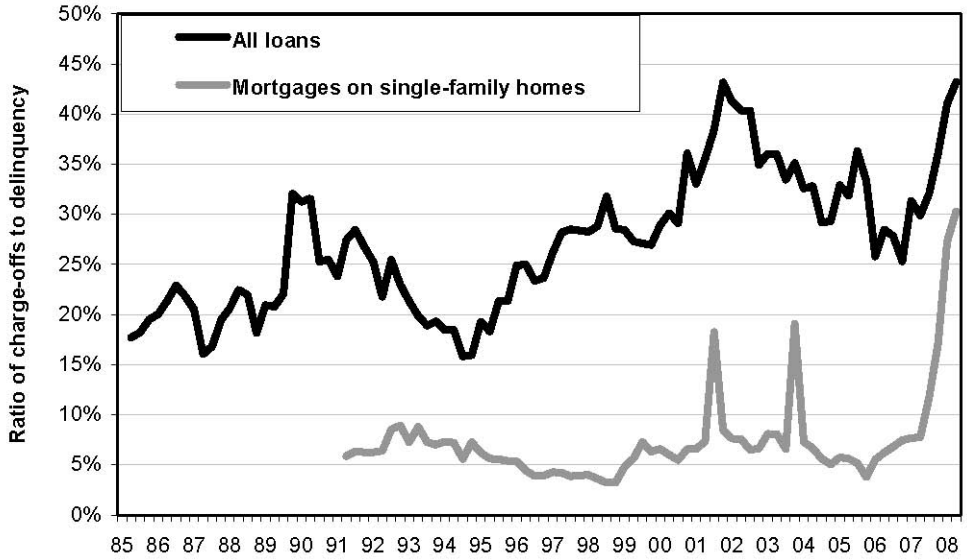


Note: Delinquency data through April-June 2008

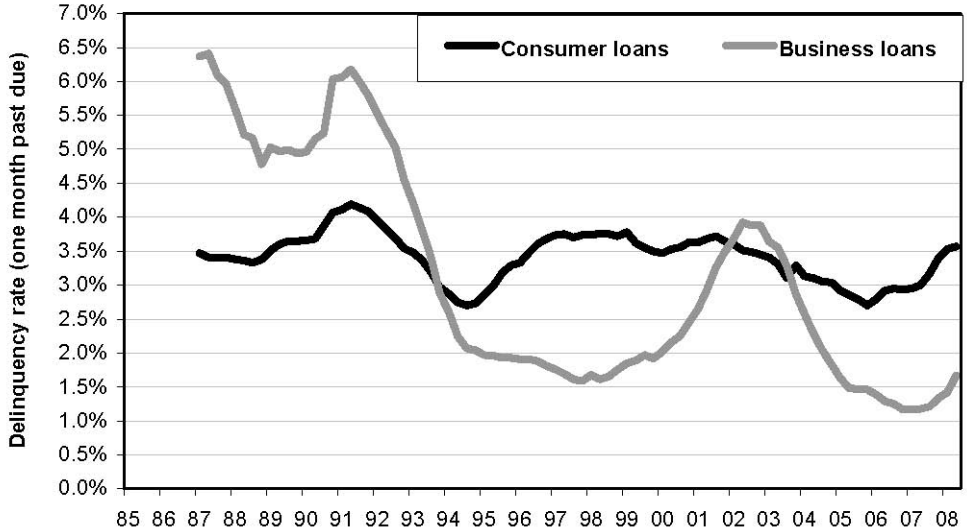
Charge-Off Rate Rises, But Not Yet At Rate of Last Recession



Banks Writing Off Delinquent Loans More Quickly Than In Past



Delinquency Rate on Consumer Loans No Higher;
Business Loan Delinquencies Near 20-Year Low



Mortgage Foreclosures Mostly Subprime; Very Low on Fixed Prime

	% of Outstanding Loans	% of Total Foreclosures	foreclosure rate
Prime Fixed	65%	19%	0.7%
Prime ARM	15%	23%	3.5%
Subprime Fixed	6%	11%	4.5%
Subprime ARM	6%	39%	17.1%
FHA & VA	8%	7%	2.2%

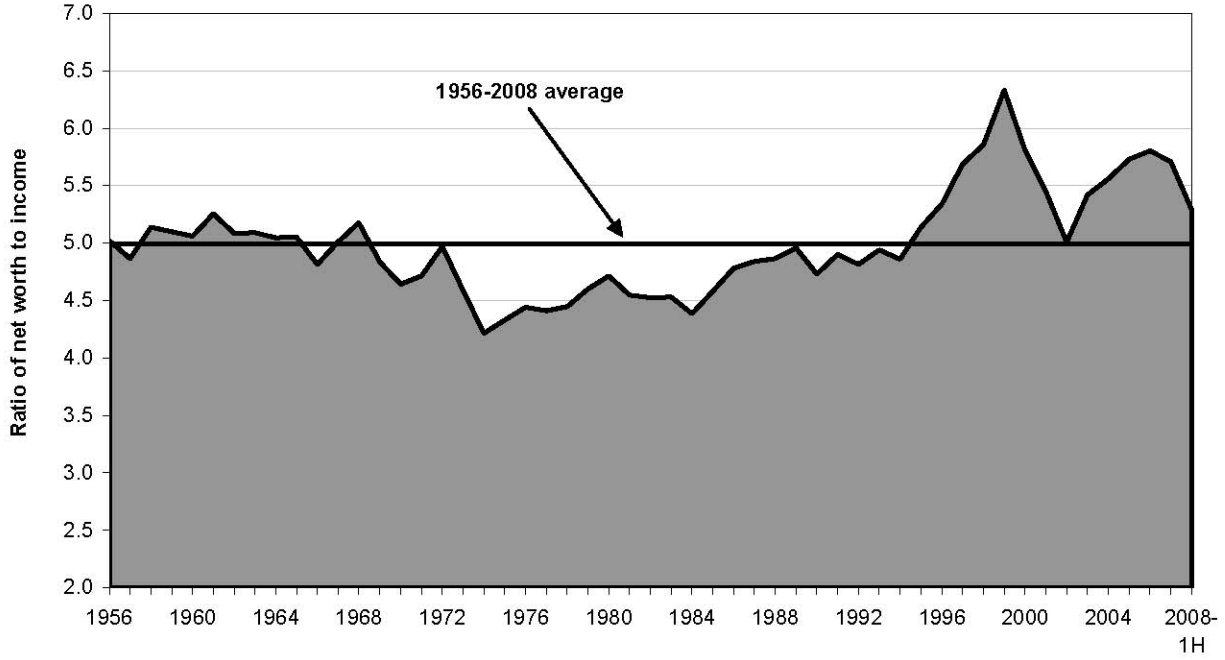
Total foreclosure rate: 2.47%

ARM = Adjustable rate mortgage

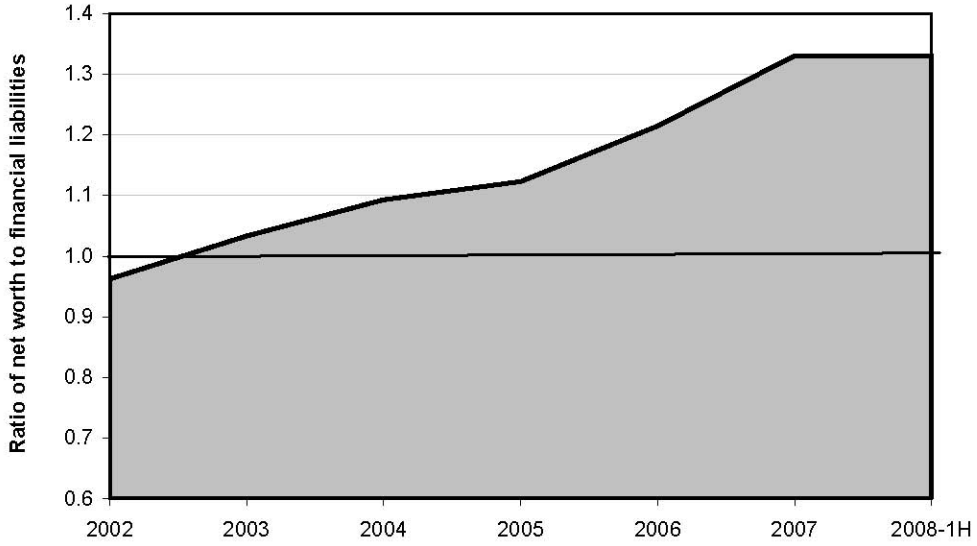
FHA & VA = loans financed by Federal Housing Authority and Veterans Agency

Note: Data for January-March 2008, but April-June data follows the same pattern

Household Ratio of Net Worth To Income Still Above Half-Century Average



Corporate Net Worth 1.3 Times Liabilities



Concept Paper
Masaakira Kitazawa

Masaakira Kitazawa was the investigation committee member of the Long Term Credit Bank of Japan ("LTCB") when it was nationalized under the Financial Rehabilitation Law in 1998 and, under the mandate of the law to investigate the civil and criminal liability of the old management, investigated a broad range of the bank's and its management's attempt to keep the bank afloat after the burst of bubble in early 90s. After LTCB was bought by the New LTCB Partners, he acted as the chief senior counsel for Shinsei Bank, the successor of LTCB and oversaw all aspects of the bank's resurgence, including (i) addressing the well-known cancellation rights (put option) agreed upon between Shinsei and the Deposit Insurance Corporation ("DIC") under which Shinsei was entitled to put certain loans back to DIC when the calculated value declined by more than 20% and (ii) ultimate re-listing of Shinsei on the Tokyo Stock Exchange in 2004.

The recent Lehman collapse may be analogized to the Yamaichi Securities bankruptcy in 1997, which was followed by nationalization of LTCB and another long term credit bank, NCB, currently Aozora Bank - that is, Lehman might represent the merely first stages of what might become a lengthy process.

By virtue of the wisdom of talented people in the financial and legal industry, the resolution would have a similar methodology as in Japan. For illustration purposes, note that the bad assets issue was substantially resolved by 2005. In order to so resolve the bad assets issue, it is apparent that Japanese financial, regulatory and legal specialists looked to the then-latest US precedent of the early 90's savings and loans collapse.

The methodology to address the US credit crisis would be the same or substantially similar in essence as that used to address the Japanese banking crisis, which includes the provision of government money, separation of bad assets, collection of receivables, and completion of asset disposals and resolutions in an organized manner. Japan had the same approach but also had distinct and unique features which delayed the completion of asset disposals and resolutions until the middle of 2000s. Such distinct and unique features would be as follows.

1 Weakness of the legal enforcement tools or lack of knowledge or experience for such enforcement

Among the lawyers and financial institutions, forcible collection of debts is a very exceptional matter and expertise is found in only a very small group of professionals. In particular, there was no concept of bulk sale and purchase and there was no technology to determine the price of bulk bad assets. The law did not permit non-lawyers to engage in collections on behalf of a third party or to purchase bad assets for collections under the Lawyers Law so that the collection by company employees through telephone or other mass collection systems was not available.

2. Baseless belief that the economy would recover in the near future (due to past experience of continued economic expansion after the war) and once such belief was betrayed, endless attempt to conceal the bad assets.

The first major mistake would have been that people believed that there would be recovery of asset price and that bad assets would disappear in a very short time period. When

it became apparent that it would not happen in the foreseeable future, they concealed the reality by unrealistic assumption of the value or unrealistic development plan of bad assets, including an extremely long term plan or optimistic profit forecast. As such assumption is by nature more or less explainable or permits the exercise of discretion or judgment, such assumption often passed the test of accountants and the regulators.

3. The rule of disposition of bad assets was unclear and disclosure guidelines were ambiguous due to the lack of experience of real cases and the attempt to subvert the real purpose of disclosure was made by interpreting such rules in arbitrary manner.

The rule of disclosure existed but people did not look through the letters of the rule and uphold the purpose and spirit of such rule. Such attitude could have existed where the disclosure is more or less a formality and for the satisfaction of regulators, and not for the protection of shareholders or other stakeholders in the value of the financial institutions. For a very long time, the Japanese counterpart of 10-K or 10-Q was a document which was not very useful for lay investors with an average knowledge or financial sophistication. The derivative suits were not very common although more and more in 1990s, listed companies and their managers became aware of the risk of law suit for failure to disclosure. In essence, there was a belief that no financial institutions should fail because such failure would have an enormous impact on the Japanese economy and the regulators would not let such failure happen.

4. There was vehement opposition against the use of government money.

There was vehement opposition against the use of the government money. Although the Communist Party and other leftist or opposition groups had no ability to take over the government and people did not let them take over the government, these political groups nonetheless had a certain amount of influence over policymaking. The first financial institutions which were helped in 90s were Housing Loan Companies ("HLCs"), which were in essence agents of banks or substituting lenders of banks. The opposition parties opposed the rescue of HLCs on the grounds that "they are not deposit taking institutions and that there is no need to protect them as there is no harm to depositors." Without knowledge or experience of HLCs' bankruptcy and effect to the economy, the opposition parties claimed that HLCs should go bankrupt, and the Liberal Democratic Party of Japan (which was then the party in power) did not have any good contingency plans if in fact HLCs went bankrupt as the official position of the government was that there were no unmanageable bad assets in Japan. The trouble of HLCs was in fact a trouble of banks. But the reality was forgotten or neglected and it took so much time to finally put money in HLCs. Even when HLCs were recapitalized with money, the amounts invested were too small to resolve real issues. This pattern of provision of small and insufficient money in a substantially delayed fashion over years caused significant waste of time for resolution of the extremely stretched banking crisis. HLCs would have been the first example. The Japanese LDP government consequently did not begin to take productive actions until a great deal of time had already passed.

5. Banks looked good at the cost of HLCs

In fact the HLCs and other non-banks were effective affiliates of banks and the top management consisted of secondees from banks. However, HLCs were not consolidated with the relevant banks. That is because of the practice of nonconsolidation of "friendly companies". In practice however, HLCs and such banks were effectively "persons acting in concert". When the effective parents were looked to, they took the position that they were not affiliated but this attitude blurred the real issue that there is a problem with the Japanese financial system. In fact,

the bank people knew which HLCs and which other non-banks are affiliated to which banks and they mutually supported other banks non-banks in return for the support by such other banks of its own non-banks. No resolution initiative was possible under these circumstances and it was probably believed that the first failed bank would be hardest hit by the public opinion and legal liability. In fact, the old management of LTCB was indicted in criminal cases and sued in civil cases. (It should be noted that due to ambiguity of the rules they were finally found not guilty and not responsible for civil claims in major cases.)

6. Regulations incomplete

HLCs were not banks and, after the public voiced that real estate prices were rising outrageously, the government restricted the banks from lending, but such restriction caused the volume of lending by HLCs or other non-banks (which were not controlled by law as they were not affiliated or otherwise controlled by the banks or outside of the scope of the then Banking Law) to increase. This huge black hole worsened the situation because the visibility of the reality of the lending market was lost from the public eyes and no effective legal or regulatory control was posed on those non-banks.

7. Insufficiency of accounting rules

Banks had significant number of friendly companies which were not consolidated. HLCs were one category but there were also friendly leasing companies and friendly money lending companies that significantly invested in real estate during the bubble era. These companies were not consolidated and were kept out of the financial statements of banks. Above all, the accountants were often friendly to the banks' managements and stretched the rules and exceptions, not only as to the consolidation rules but also in terms of recognition of losses or sufficiency of reserves. In fact, following the collapse of the bubble, accountants were also held liable civilly and criminally in many cases.

8. Bad assets were simpler

Banks lent too much to the real estate business and securities firms provided illegal indemnity in connection with customers' funds managed by securities firms (eigyo tokkin). They took measures to conceal the reality from the public eyes because they hoped that asset prices would recover in the near future - banks expected an upsurge in real estate prices and securities firms expected the same as to stocks and other securities. Until then they determined that not disclosing the losses would be the best course for their own future and for the Japanese economy. It is important to note here that there were no systematic transactions of derivatives which constituted bad assets. The banks' problems (and the underlying assets) were substantially uniform, too much lending to real property industries. On the other hand, the Yamaichi Securities problem was not common to any other major securities firms but was instead a result of the misjudgment of the stock price. Sanyo Securities, another securities firm which went bankrupt, made a significant guarantee for its subsidiary's real estate borrowing and also made a huge investment in trading facilities which became useless after the burst of bubble. This is unique to that company.

Land Valuation during the Bubble Years

Shiziharu Kubono

1. Introduction

During the years of the asset-bubbled economy (1987-1991), land and stock prices soared. In some places, land prices rose by as much as 10 fold. Spurred by the low cost of borrowing and equity finance enabled by excess liquidity, companies increased their investments in capital and real estate. Banks and other financial institutions strengthened their capital base through low cost equity finance and unrealized capital gains from stocks, and against this background, increased their property-collateralized loans to unfamiliar medium-sized companies and their lending in so-called three industrial sectors – real estate, construction and non-banks.

On the other hand, while the price of land kept falling as the bubble burst, real estate transactions decreased so precipitously that it became difficult for even experts to determine the level of land valuation and the rate of decrease in land prices. Consequently, it also became extremely difficult for banks to determine and write off the amount of non-performing assets they owned as well as to collect on property-collateralized loans they made during the bubble years.

There are similarities between the difficulty Japan faced during its bubble years and the difficulty in determining and writing off the fair value of illiquid assets the United States is now facing amid the turmoil triggered by the subprime crisis of August 2007.

In 1991, I was the director in the Tax Bureau in charge of the new national land tax that was introduced as a land holding tax to contain the property bubble. I led the effort to bring the land valuation as close as possible to the market value for assessing the amount of land tax to be imposed.

After 1995, in the Banking Bureau, I was placed in charge of planning a system for disposing non-performing assets held by banks and legislating laws to protect depositors and creditors through the deposit insurance and capital injections to ailing banks. I was also involved in legislation for effective debt collections through disposal of collateralized real estate. At present, I am a board member of the Japan Real Estate Institute, a leading institution for land valuation in Japan. I would like to take this opportunity to review the system and practice of land valuation in Japan.

2. History of Land Valuation

(The discussion below is mainly based on Kazuo Sato'2005 Tochi to Kazei ("Land and Taxation") Nihonhyoronsha)

(1)Assessed land valuation as basis for levying land tax

- In the land levy ordinance that was revised in 1873, the government decided the legal land value as basis of for land levy, and land valuation was assessed for each parcel of land based on a nationwide survey.
  In case of both owned and tenanted land, the amount of earnings was assessed in accordance with a formula for calculating the capitalization value of land based on a status system of earnings classification.

For 50 years after the land ordinance of 1873, nationwide and general land value was not revised, and the assessed land valuation established in 1873 remained valid. After around 1904, it became possible to get information on changes in land value. According to the Statistical Yearbook of the Tax Bureau of the Ministry of Finance, land value fell in 1904 (at the time of the Russo-Japanese War), and also in 1914 and 1915, but rose 59.5% in 1919 during the post World War I economic boom).

- The basis for levying land tax was shifted from legal land value to rental value pursuant to the new land tax law that was enacted in 1931.
  The shift was made on the grounds that neither tax levied on rice yield nor tax levied on sales price was considered a suitable basis for levying land tax, the former because of difficulty of survey and complicated calculation, the latter because sales price did not always fluctuate in step with rent value or net earnings. What's more, ground leasing was widely practiced, and surveys of land leasing were considered to be relatively easy to conduct.

- Looking at the fluctuations in land valuation prior to World War II in terms of the index of pre-war urban land price developed by the Japan Real Estate Institute, you can see that if the average land value nationwide for all land under use in 1936were set at 100, the average land value nationwide in 1945 would be 210, while the average for all land under use in the six metropolitan areas would be 125.

(2)Criteria for evaluating property tax

- Soon after World War II, in 1946, wealth tax was introduced that imposed one-time only tax on the entire property Under this wealth tax, property value was calculated in terms of market value, while land value was calculated by multiplying the rental value assessed in accordance with the land tax law by a certain multiple (as stipulated by the finance bureau director).

- In 1947, land tax was transferred from national tax to local tax, but rent value continued to be the basis of taxation.

- The Shoup Report of 1949 recommended the government to expand and reorganize the land tax as a property tax, and shift the basis of taxation from rent value to the value of capital. These recommendations were made on the grounds that, instead of limiting the property tax to land and buildings, the said tax should be imposed on all forms of business property that can be written down for depreciation.

- Under the New Local Tax Law passed in 1950, the basis of taxation was defined as the multiples of the rent value of 1949 by 900.

- Looking at the rise in land prices that occurred in the decade from 1945 to 1955 in terms of the Japan Research Institute index, you can see that in 1955 the average land prices nationwide rose sharply to 31.060, but this rise in land prices is about the same as the rise in land prices to 33.130 calculated in terms of the Bank of Japan's wholesale price index.

- In accordance with the local tax revision of 1955, the valuation of land came to be assessed once every three years, and the basic taxable year formula was adopted under which land prices were left unchanged during the intermittent period.
  Fluctuation of land prices triggered by this re-evaluation (+30% in 1955, +5% 1958, +5% in 1961) sometimes lead directly to increased tax burden and caused a host of problems after the decade from 1955 to 1965 when land prices began to rise sharply.

- In 1959, the Property Evaluation Council was established, and the following disparities were cited: (1) the large gap between the assessed value of land and its market value (slightly less than 20% of market value in the case of residential lands); (2) evaluation disparity between properties; (3) disparity between municipalities; (4) separate evaluation for inheritance tax, which is a national tax (60% of market value in the case of residential lands).
  In a report released in 1961, the Council maintained that the value of land should be based on the cash value of land actually sold and purchased. In the 1964 re-evaluation, which was based on the new property evaluation criteria, the new valuation of residential lands was 6.5 times the provious assessed land value. Nevertheless, the tax rate was not lowered, and the tax burden was adjusted up to 1.2 times the basis of taxation for residential lands.
  After that, lowering of the tax rate was postponed, and adjustment measures based on the establishment of an across-the-board upper limit continued to be implemented. This meant that the significance of across-the-board re-evaluation based on new evaluation criteria was virtually lost.

(3) Adoption of a licensed appraiser system and a posted land prices system

(Discussion in the later sections is also based on Yoshio Morita', 2004 Koji Kakaku no Hatan ("Collapse of Posted Value") suiyosha.

- During the high-growth period, the difficulty of site acquisition due to rising land prices was cited as a factor hindering efforts to improve Japan's social infrastructure. In 1963, a licensed appraiser system was adopted aiming at the establishment of the basis of consolidating land land valuation.
  In addition to tax assessment, there were other occasions for assessing the value of real estate, which were not necessarily uniform: appraisal at the time of public site acquisition, collateral appraisal by financial institutions, and appraisal at the time of real estate transactions.
  In 1969, the Real Estate Appraisal Standards were established as a uniform basis for land appraisal by licensed appraisers.
  The appraisal standards describe in detail three categories of methodologies for determining value: (i) the cost accounting approach, (ii) the transaction price comparison approach, and (iii) the earnings capitalization approach. The appraisal standards also describe ways to apply these methodologies.
  When ordinary people think about land valuation, they probably think of market value, that is, transaction price, but in land appraisals, it is considered necessary to make adjustments with earning capitalized value, which yield much lower values.

- In 1970, a posted land price system was adopted with the view to assigning indices to general land transaction prices, thereby contributing to the formation of appropriate land price publication.

When a license appraiser makes a land appraisal, he/she is required to maintain a balance between his/her appraised value and the price level that is indicated by the posted price.

- During Japan's high-growth period (1955 to 1970), residential land prices rose 14 fold, exceeding the 9-fold nominal GNP growth during the same period. Furthermore, after 1972, land prices soared as a result of the boom triggered by the Plan for Remodeling the Japanese Archipelago. Land prices increased 1.7 fold during the three years from 1971 to 1974.

- In 1974, the Act for Planning the Utilization of the National Land was passed to hold down soaring land prices and rampant development, and the Land Appraisal Committee issued a proposal shown below.

  (i) When land prices are rising, make use of the earnings capitalized value as an checking method for assessing transaction prices that tends to precede the price fluctuation.

  (ii) Since earnings form the essence of real estate value, even in a residential property for personal use, the earnings capitalization method should be applied by assuming the property is rented.

  (iii) In the case of transactions undertaken for speculative purposes or transactions as wealth holding that includes excessive price expectation, the special portion of the transactions should be corrected as transactions undertaken under special circumstances.

- In the re-evaluation of the property tax executed in 1973, partly in response to heightened public criticism of the land tax system, land was said to be valued at around 40 % of the posted price. In the tax system revision, a special exception was made for residential land setting 1/2 of the assessed value as the basis of taxation, while the value of land owned by corporations was set close to the assessed value.

- In 1975, based on the posted price of land, land prices declined 9.2%, and from 1975 to 1985, the Index of Urban Land Price increased 1.5 fold, which was less than the 2.16 fold growth in nominal GNP recorded in the same decade. Thus the value of land moved at a steady pace in this timeframe.

- Around 1978, the posted price of land was said to be about 50-60% of its market price. But by the mid-1980s, the former was around 80-90% of the latter, which means that the prudently assessed value took into consideration the balance with the earning capitalized value.

3. Land Valuation during the Bubble Years

(1)Posted price and the current market price during the bubble years

- A glance at the rate of fluctuation of posted price reveals that from 1987 to 1990 (or 1991), the property bubble occurred sequentially, from commercial land to residential

land, from the Tokyo metropolitan area to the outlying regions (Fig. 1, 2-(1), 2-(2)). Rising at a double digit rate, in each are as follow;

(%)

		1986	1987	1988	1989	1990	1991
Tokyo area	Commercial land	12.5	48.2	61.1			
Osaka area	“		13.2	37.2	35.6	46.3	
Regional area	“					15.4	16.3
Tokyo area	Residential land		21.5	68.6			
Osaka area	“			18.6	32.7	56.1	
Regional area	“					11.4	13.6

- What triggered the soaring land prices was the rapid increase in demand for office building sites in the central commercial districts of Tokyo that occurred in 1984 and 1985. In the commercial district of Chiyoda Ward, land prices rose 24.7% in 1984 and 29.7% in 1985.
  The current market price of land in this period probably doubled, but the appraisal community at the time failed to recognize the sudden rise in land prices. Some observers have claimed that appraisers became aware of the soaring land prices 1-2 years after the start of the soaring, and for all it’s worth, they then raised their assessed land prices by 56.2% in 1986 and by 43.6% in 1987.
  It is also pointed out that appraisers pushed the actual rate of fluctuation up by changing the so-called locations selected for appraisal.

- To meet the strong demand for building sites, “Jiage-ya” (land price riggers) scooped up lots in residential areas in the inner city that were suitable for constructing office buildings on.
  Then these vendors, with plenty of quid pro quo funds, took advantage of the tax incentives for replacement of residential property . In this way, the real estate bubble spread from one area to the next.
  Two events accelerated the flow of the real estate investment bubble:
  (i)A report issued by the National Land Agency in March 1985 stated that “there is a demand for 20-50 new skyscrapers in Tokyo to catapult the capital into a financial center.
  (ii)The Plaza Accord of September 1985to depreciate the US dollar in relation to the Japanese yen and other currencies, resulting in further easing of monetary conditions.
  Provided with abundance of funds by financial institutions, medium and small-sized real estate companies and even major manufacturing companies participated in the real estate investment and speculation that fueled the bubble.

(2)Countermeasures for the land bubble

- In December 1986, the government set up a council of ministers to start dealing with the problem of soaring land prices.
  Under the tax system revision enacted in September 1987, the government newly created a system of imposing heavy tax on capital gains derived from ultrashort-term (less than 2 years) land transfers.

The Basic Act for Land, which was enacted in 1989, contains provisions regarding, among other things, (1) tax measures and (2) measures to improve public land appraisals.

- In February 1990, the Banking Bureau of the Ministry of Finance released the so-called total volume control notice, which aimed to limit the increase in the amount of loans extended to so-called three industrial sectors – real estate, construction and nonbanking – to below the increase in the amount of loans extended to all industrial sectors (Fig. 3).
  Even after the notice was released, agricultural cooperatives and federation of agricultural cooperatives continued lending to “Jusen” (housing loan companies), and although the total volume control notice literary regarded the latter as nonbanking companies, officials of agricultural cooperatives prejudicedly regarded them as financial institutions. This suggests that there was not enough coordination between the Ministry of Finance and the Ministry of Agriculture, Fisheries and Forestry. Moreover, after 1986, that is, prior to the issuance of the total volume control notice, the Banking Bureau released several notices I was involved and monitored banks to bring land-related lending under control but in vain.

(3)Introduction of land holding tax and improvement of land valuation

- The basic report on land taxation released in October 1990 called for the creation of a land holding tax as a national tax on the grounds that, given the situation where the utility value of land is so far removed from the exchange value of land, a land holding tax would be able to fulfill the role of restraining speculative land transactions by reducing the advantage of land as an asset. In 1991, in response to this proposal, the Diet enacted the land holding tax, which went into effect in April 1992.
  The current market price of land was used to determine the valuation of land as the basis of taxation. Specifically, it was decided that the valuation of land should be determined based on the valuation of the inheritance tax by the National Tax Agency, and the valuation of the inheritance tax, in turn, should be raised from 70% of the previous level of the posted land price to 80%.

- The basic report summarized the property tax thus: “The property tax imposes a tax burden commensurate to the value that would accrue from using the land. As such, the property tax is not slated to employ the value of the transaction as the basis for taxation.”

- In the 1991 re-evaluation of the property tax, on the one hand, burden adjustments were made for more than three years regarding residential land. On the other hand, regarding commercial land owned by corporations, more rapid burden adjustments were made for levying tax on the amount assessed.

- Furthermore, in the re-evaluations executed in 1994, the goal was to achieve a land valuation equivalent to 70 % of the posted land price.
  This was not anticipated in the basic report of the land tax system that introduced land-holding tax on the assumption that there would not be any sharp increase in the property tax burden.

(4) Land valuation in the bursting bubble

- In terms of the rate of fluctuation for the posted land price, in Japan's three main metropolitan areas, land prices peaked in 1991, and in regional areas, they peaked in 1992.
  Looking at the land valuation in commercial districts in Tokyo, you can see that it declined 7% in 1992, 19% in 1993, 18% in 1994 and so on, and that the percentage decline was in the teens every year until 1997. Even after 1997, the land valuation in commercial districts in Tokyo continued to decline every year by anywhere from 7% to 10%(Fig. 2-(1)).

- Meanwhile, since March 1988, the Japan Real Estate Institute's index of urban land price has indicated declines in land valuation in the Tokyo segment.
  Furthermore, under the law for heavy tax on capital gains derived from ultrashort-term land transfers, which was passed in 1987, land prices began to fall, and as a result of the total volume control introduced in 1990, land prices in Tokyo in mid-1991 dropped to half the level achieved at the peak period, according to an experienced professional.

- After peaking at the end of 1989, prices on the Tokyo Stock Exchange plummeted and continued declining for some time afterwards. This precipitous drop in stock prices suggests the stock market was aware of the irreversible decline in land prices. Thus land prices could not have possibly remained high level as plateau until 1991(Fig. 1).

- Cases of land transactions in the heart of Tokyo that began to emerge in the two to three years after 1987 were those involving land price rigging and substitute land transactions. These land transactions pushed the value of the land price market by 5-10 fold. On the other hand, there were virtually no buyers willing or able to pay such exorbitant land price in conventional transactions.
  This suggests that appraisers who pursued only transaction cases overlooked the turning point for land prices and their subsequent fall. These appraisers realized that land prices had declined only after 1991-2 when finance that had been provided by banks began to dwindle and the number of transactions involving price rigging began to decrease exponentially.

- Regarding a special point in Tokyo, Mr. Morita has drawn up an interesting graph that illustrates the time lag that existed between the precipitous rise and collapse of land prices on the one hand and the posted prices on the other. The graph also illustrates the situation where there are four categories of land prices: the current market price, the posted price, the assessed value of the inheritance tax, and the assessed value of the property tax (see Fig. 4).

(5) Land valuation and disposal of nonperforming assets by banks

- Even land valuation experts almost completely lost sight of the land prices as they plummeted. This had a huge impact on the ability of banks to understand the extent of nonperforming assets they possessed and the timing for disposal and resolution of nonperforming assets. I believe this phenomenon is similar to the financial turmoil now gripping the United States: The securitized financial product market, especially CDO market, has become illiquid, thus making it difficult to apply mark- to-marketaccounting.

- Banks sharply increased the amount of property collateralized loan to unfamiliar medium and small-sized companies. In their assessment of collaterals valued not only a prudent inheritance tax assessment and posted prices but also indicated prices that had soared in the bubble.
- Furthermore, in case a large company provided with an existing corporate loan engaged in land investment or speculation, so long as its main business was going well, its valuation as a going concern went unchallenged. But when its main business began to go into a slump, it became necessary to appraise the company's settlement balance, resulting in a significant depreciation in value because of being in a hurry to sell and flaw lack of system for recovering the collateral.

- It is estimated that there was a time lag of 3 to 4 years for the posted price to be able to accurately grasp and recognize the decline in land price triggered by the collapse of the bubble economy. Furthermore, since determining the rate of fluctuation in land prices from the previous year is at the core of the appraisal practice of posted land prices, after the 20% decline in the initial two years, the adjustment of the level of land prices was made, not in a single stroke, but very gradually, so that the posted price fell at a snail's pace of 10% per year. This gradual adjustment of the posted price may also be cited as a factor that forced Japanese banks to take such a long time to dispose of the nonperforming loans(Fig. 5). Additionally, when the rating of a company in FSA's inspection was lowered from watchful to bankruptcy concerned, the appraisal changed from a going concern to a company in liquidation. When this happened, the assessment of the company's land collateral and speculative real estate suddenly declined in value, and the severity of the change in assessment undoubtedly led to the collapse of companies and banks.

(6) Improvement in land valuation as land prices fell

- Introduction of the land holding tax in 1992 and the raising of the inheritance tax appraisal to 80% of the posted price were executed as the price of land in terms of posted price began to decline. Moreover, as I described earlier, it is highly probable that the current market price had already declined considerably. Additionally, the average increase in property tax burden was not something that the lawmakers expected. As a result, in the 1996 tax system revision, the tax rate of the land holding tax was lowered from 3/1,000 to 1.5/1,000, and furthermore, the said tax levy was frozen in the 1998 tax system revision. Moreover, in the payment of the inheritance tax, payment in kind instead of payment in cash increased.

- In the re-evaluation of the property tax assessment executed in 1994, the substantial increase in the valuation from the level of 10-20% of the posted price up to 70% level was executed while the decline in land prices advanced, so that the burden adjustment lasted more than 10 years, without reducing the tax rate. Consequently, every year, as the price of land continued to fall, the tax burden increased at a considerable ratio, and, as an inversion phenomenon, there were more than 20,000 cases of administrative objection, some of which ended in court.

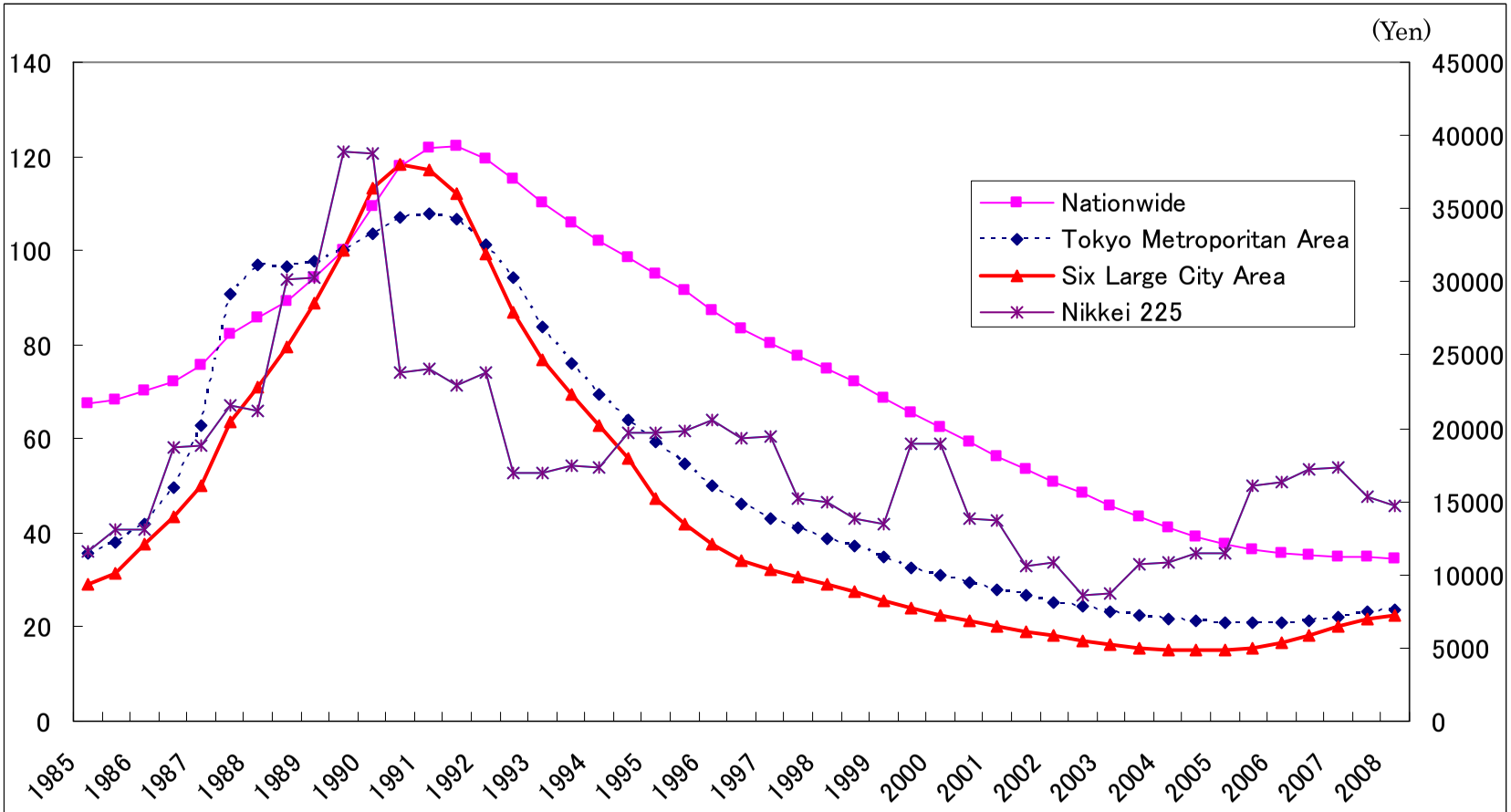
Concluding remarks

- When large fluctuations on prices occur in the land market, which is strong in severalty but weak in liquidity, as in the formation and collapse of the bubble, it becomes difficult to determine its level of price, so that even experts lose sight of the land price. Transaction prices based on land price rigging, resale motive, and so on diverge greatly from earnings capitalized value, and when land prices fall, transactions virtually fade away, so that cases where transactions surface indeed become rare.
  In such an environment, licensed appraisers need to avoid relying too much on transaction case prices, and they will need to collect information concerning prices that are offered in conventional real estate transactions and price information that is thought to be legitimate to sell and buy. This, however, will not be easy.

- Should a nation's land markets experience such a situation, it would be useful to have appraisers, certified public accounts, financial inspectors and land specialists hold a council to draw up an index of a certain level and rate of change that could serve as a rough standard for land transactions, account processing and settlement procedure. As Japanese and American experiences show, it would be needed to establish a special institution by the alliance of financial institutions, the central bank or the government as a market maker which will purchase huge amount of illiquid assets of certain reasonable price.

- In addition, at the financial institution where I was in charge of risk management until June 2007, investment in home equity loans were limited to only prime loans and investment was stopped up to 2004 vintage. This is because I thought subprime loans were predatory, and because I read a survey published in American Banker that found that more than half of real estate appraisers in the United States are under pressure from loan originators, banks and borrowers to file lenient land appraisals.

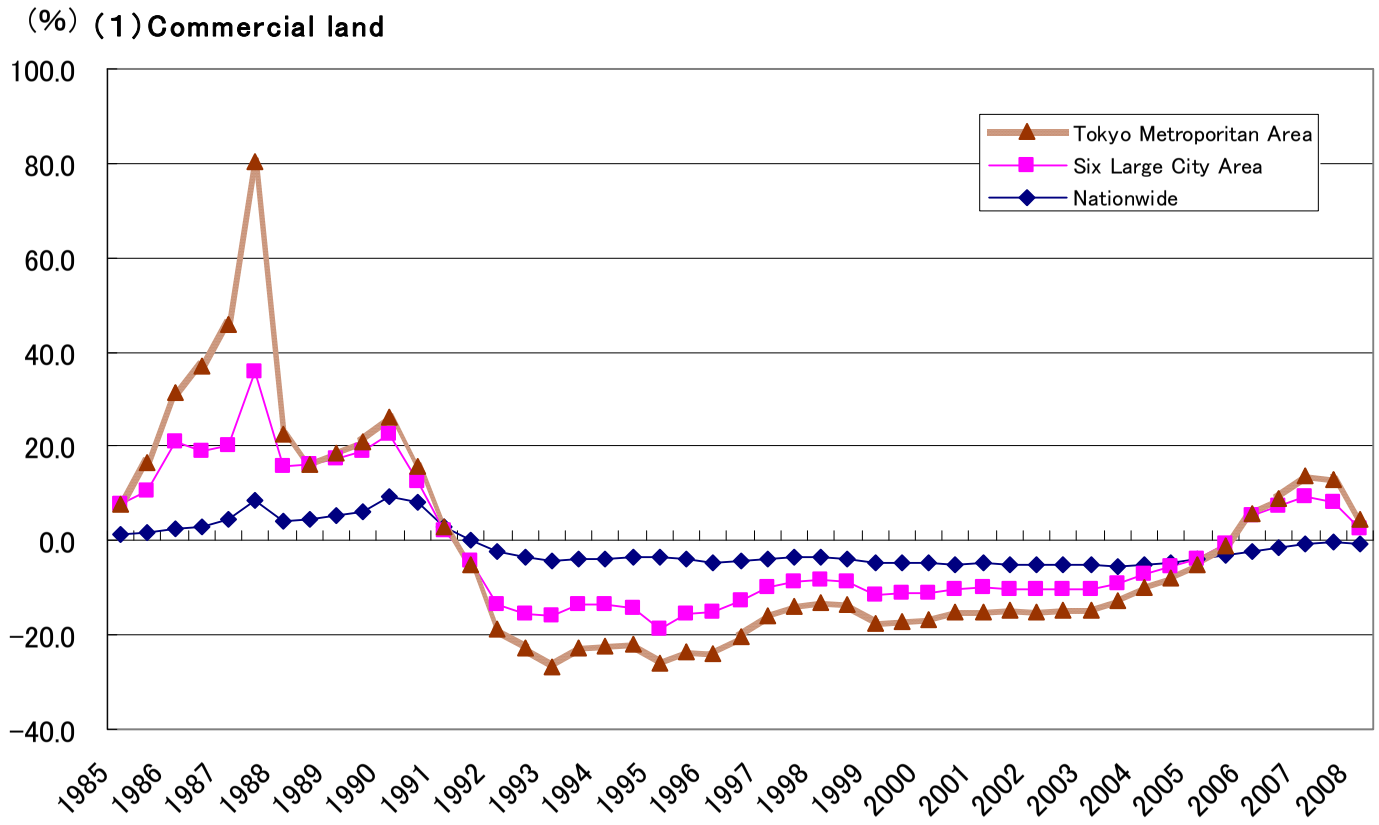
Figure 1 **The level of Urban Land Price Index (Commercial Land)**



Source : *Urban Land Price Index*, produced by Japan Real Estate Institute.
The Nikkei stock Average (http://www3.nikkei.co.jp/nkave/data/year4.cfm).

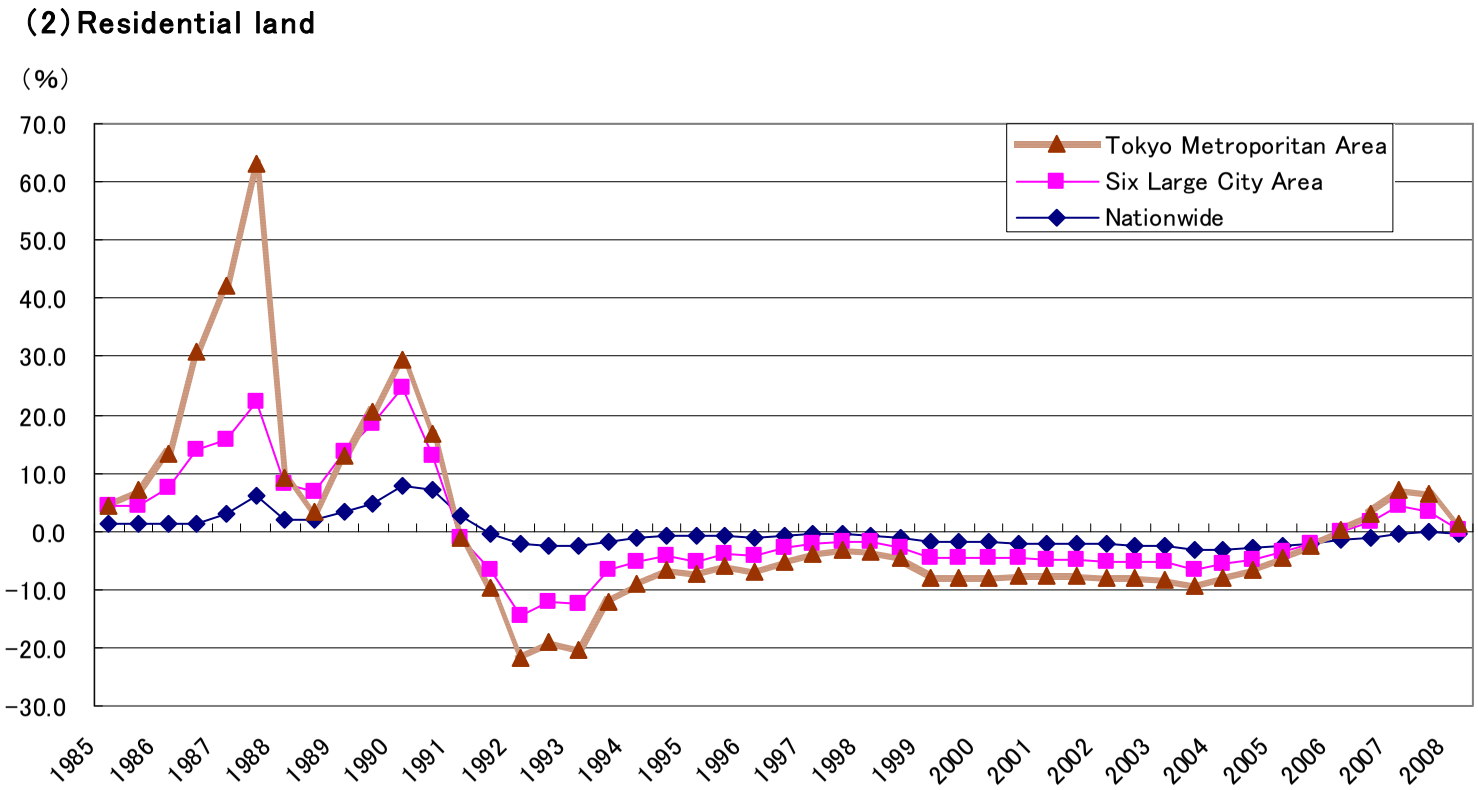
Note : Servey points are at the ends of March for the first half and September for the second half in each year.
Indices(excluding Nikkei 225) are based on the figure at the second half of 1989, which are converted to 100.
Six Large City Areas are Tokyo(23 words), Yokohama, Nagoya, Kyoto, Osaka and Kobe.

Figure 2 (1) **The Rate of fluctuation of Land Price by Use and Region**



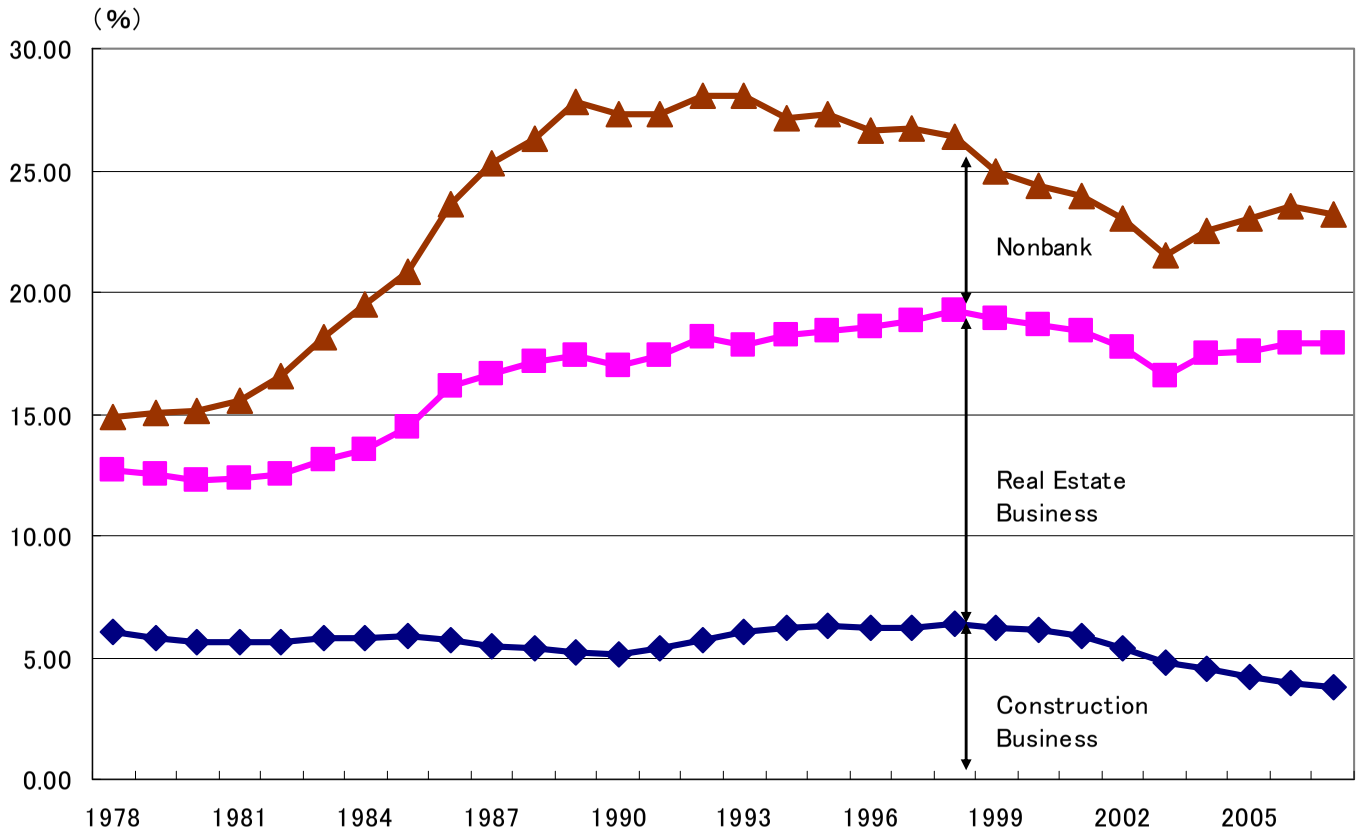
Source : Urban Land Price Index, produced by Japan Real Estate Institute.
Note : Servey points are at the ends of March for the first half and September for the second half in each year.
Six Large City Areas are Tokyo(23word), Yokohama, Nagoya, Kyoto, Osaka and Kobe.

Figure 2 (2) **The Rate of fluctuation of Land Price by Use and Region**



Source : Urban Land Price Index, produced by Japan Real Estate Institute.
Note : Servey points are at the ends of March for the first half and September for the second half in each year.
Six Large City Areas are Tokyo(23word), Yokohama, Nagoya, Kyoto, Osaka and Kobe.

Figure 3 **Ratio of Loans to Real Estate Related Business by Banks**



Source: Bank of Japan, "Financial and Economic Statistics Monthly"

Notes:1. The figures of Nonbank show the total of "Other financial operation" 1978 through 1993 and show the total of "Nondepository credit institutions including money lenders and call brokers" 1994 through 2000.

2. The figures are the ratio of each business in total loans.

Figure 4

Source: Yoshio MORITA (2004) 'Collapse of Published Land Price', Suiyo sha.

'Tsubo' = 3.3 square meters.

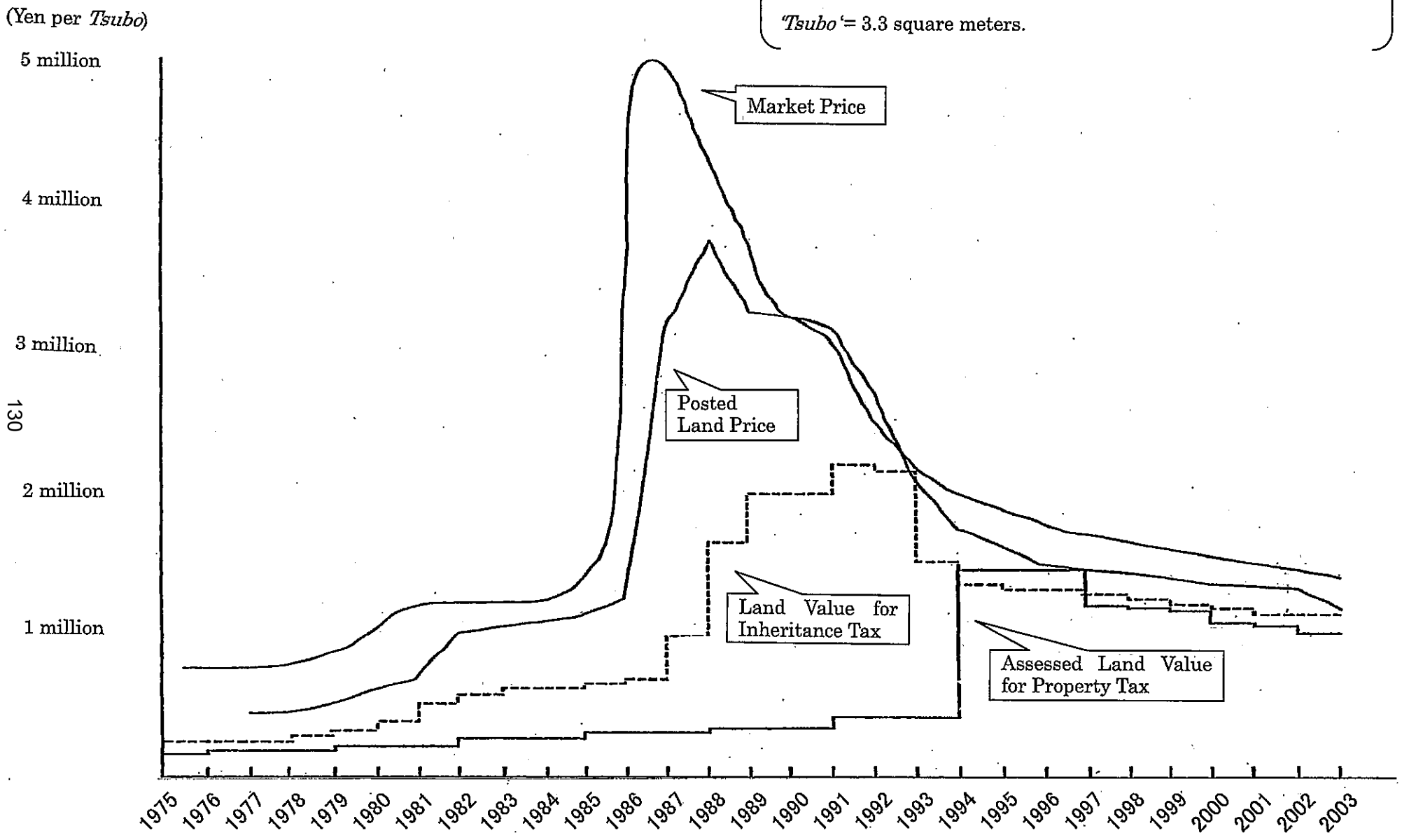
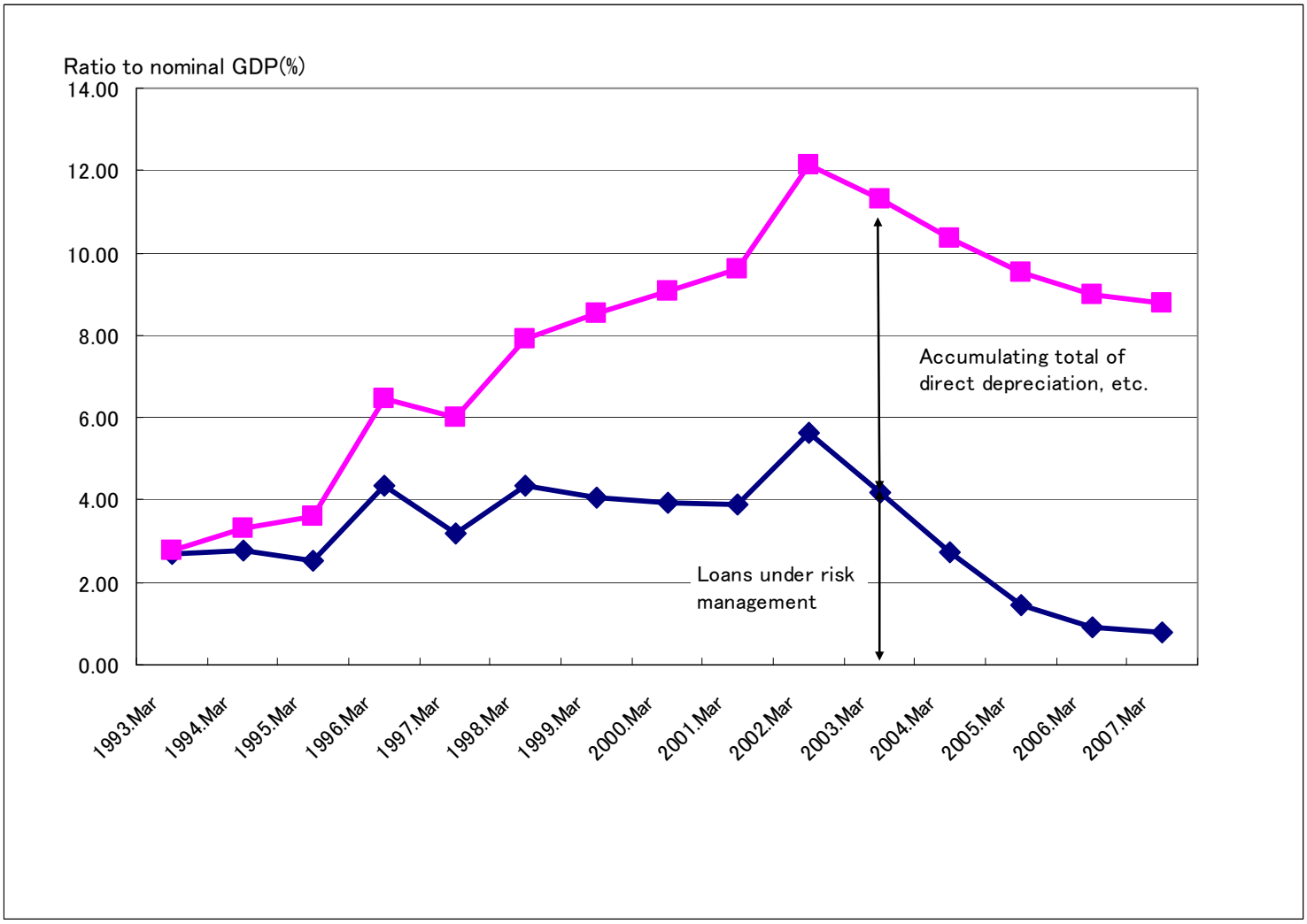


Figure 5 **Bad debts**



Source: Financial Supervisory Agency(http://www.fsa.go.jp)
Cabinet Office, "National Economic Accounting"

Notes: 1. Figures are those of main banks including city bank, long-term credit bank and trust bank(Figures of all banks are unable to be retroactive before 1996/3).

2. The amounts of claims under risk management show the total of loans to debtors in bankruptcy and delinquent receivables until 95/3.

Also the amounts of claims under risk management show the total of loans to debtors in bankruptcy, delinquent receivables and deduction of loan interest rate, etc. in 95/3 as well as 96/3.

The End Is Near!

Joe Peek
University of Kentucky, September 24, 2008

If I were to ask, "Is the end near?" I might receive several types of replies, from the Clintonesque "it depends on the meaning of 'end'," to the Churchillesque, "the beginning of the end or the end of the beginning?" Still, I believe that most would agree that an end of some type is very near. Maybe not the end of the world, but perhaps the end of the U.S. form of capitalism as we have known it; or the end of U.S. financial (de)regulation as we have known it; or the end of the traditional U.S. aversion to a financial structure dominated by universal banks. Certainly, the end of large independent U.S. investment banks is here, and not simply near. Things will change, but it is still too early to know exactly how or how much…or even how much it will cost taxpayers.

Could we be in for a repeat of the "lost decade" experienced by Japan? I think not. While both crises were preceded by a popping of asset bubbles, I believe that there are important differences in the economic environments, the regulatory environments, and policy responses that will lead to quite different outcomes, although it is still going to hurt…a lot. However, compared to the Japanese case, we now have a better understanding about what can go wrong, and we have much more riding on the outcome this time, since the crisis is not primarily a domestic crisis: the globalization of financial markets has allowed the financial turmoil that began in the U.S. subprime mortgage market to spread, disrupting financial institutions and markets worldwide.

What, me worry?

Among the key ingredients that contributed to the prolonged malaise of the Japanese economy following the bursting of the stock and real estate markets were procrastination by government officials, weak and ineffective bank regulators, political considerations dominating economic considerations in policy making, lack of accountability, lack of transparency, and a widespread aversion to relying on market signals and market forces by firms, banks, and the government.[1]

Rather than responding quickly to adverse shocks, the Bank of Japan was slow to respond by easing monetary policy. Much time passed before a meaningful tightening of regulatory policy occurred. It was the late 1990s before the government undertook a widespread recapitalization of banks, and the banks apparently didn't feel sufficient regulatory or market pressure to recapitalize themselves from private sources until the end of the 1990s. The almost total absence of the political will to adopt bold measures to address the problems that gave rise to the crisis certainly contributed to the persistence of the stagnation of the Japanese economy. Strong proactive policies were needed, rather than the, for the most part, weak reactive policies that were implemented. A typical pattern was that promising policies were discussed and, in some cases, put in place, although usually in a watered-down form. However, the policies often had an implementation date well in the future, before which the policies were either rescinded, weakened, or had the implementation date delayed further. And apparently when policy makers finally heard the cry, "Do something, stupid," they ignored the comma and simply did something stupid: for example, raising consumption taxes in 1997 and tightening monetary policy in 2000. To be fair, policy makers did eventually get a few things

[1] For a nice overview of the lost decade and why it will not happen again in Japan or the U.S., see Richard Jerram, "US & Japan Financial Crises," Macquarie Research Equities-Report, July 28, 2008.

right, such as tightening up bank regulation, but it occurred many years later than it could, or should, have.

Because the Japanese political system was essentially a one-party system, policy makers faced little accountability for their actions and inactions. The lack of transparency and the use of accounting and other gimmicks allowed government officials to regularly announce official levels of bank capital ratios and nonperforming loan ratios that dramatically understated the severity of the problems in the banking sector, and to overstate the degree of progress that was being made in addressing the problems. How many times did government officials assure us that the end of the banking crisis was near, or here? Given that the official line was that the problems were essentially resolved, the urgency of meaningful changes dissipated and procrastination ruled.

The Perfect Storm

The economic and political environment in Japan was not conducive to providing a solution on its own. Waiting for banks to earn their way out of their undercapitalization was futile. While Japanese banks dominated the top of the list of banks in the world ranked by asset size, they typically ranked near the bottom among internationally active banks in terms of profitability. Japan was "over banked." Furthermore, Japanese banks had to compete with subsidized government financial institutions, were losing business to a deregulated bond market, were under government pressure to make uneconomic loans to small and mid-sized firms, and followed a tradition of basing lending decisions on criteria other than profit maximization, having a perceived national duty to support troubled firms. Many banks (and firms) did not face market discipline, since cross-shareholding relationships kept many shares in the hands of "stable" shareholders, allowing banks to operate inefficiently and to pursue goals other than maximizing shareholder value. Hostile takeovers were virtually unknown in Japan. And it wasn't just market discipline; banks also did not face serious regulator discipline. Substantial evidence exists of the complicity of bank regulators in allowing banks to hide the extent of their problems in order to continue the fantasy that banks had sufficient capital. The pervasive forbearance by bank regulators led to forbearance by banks with their sick borrowers. Had banks honestly valued loans, the substantial write downs would have wiped out their reported capital. Banks had to support unhealthy firms in order to delay or prevent those firms being forced into bankruptcy that, in turn, would have forced the banks to write down their loans to nonviable firms. The perverse incentives emanating from this threat of mutually assured destruction led to the well-known "evergreening" of loans to troubled firms, allowing zombie firms to continue to operate. Such behavior misallocated credit and blocked the forces of creative destruction that were needed to get the economy back on track. These problems were compounded by weak corporate governance, rigid labor markets, and an aversion to market solutions, resulting in delayed firm restructuring, slowed new firm entry, an absence of hostile takeovers, and an amazingly small number of listed firm bankruptcies. So, of course, the malaise persisted.

The U.S. Contrast

U.S. capitalism is different from Japanese capitalism: market discipline is operative, with large (and small) financial firms failing, banks quickly moving to recapitalize themselves, and house prices and financial asset prices reacting quickly. While regulatory policy everywhere tends to be reactive rather than proactive, both the Federal Reserve and the Treasury have responded, rather quickly and innovatively, with a variety of programs. Treasury quickly implemented an income tax rebate. While the Fed reduced the federal funds rate relatively

quickly and substantially, it also realized that simply cutting the interest rate was a blunt instrument that would not get directly at the underlying liquidity problems. In response, it broadened the operations of the discount window (both instruments and types of borrowers) and introduced new programs (Term Auction Facility and Term Securities Lending Facility) to provide liquidity and mitigate counterparty risk that were freezing up financial markets. Fannie Mae, Freddie Mac and AIG have been essentially nationalized, and the Fed and Treasury orchestrated acquisitions of troubled financial firms to prevent a meltdown in financial markets. The current proposal being debated is the establishment of a $700 billion bailout facility.

Rather than accusing U.S. policy makers of procrastination, many are concerned that they are making decisions too fast without due consideration of the eventual consequences, especially to taxpayers. It now appears that the Fed is becoming one of the largest sovereign wealth funds (pawnbrokers?) in the world. And yes, some actions have impeded market discipline, such as limiting short selling and providing guarantees for MMMFs. Certainly, mistakes will be made. However, the Japanese crisis (and other banking crises) has made clear that delay or inaction is likely an even greater mistake, resulting in even larger economic costs.

The U.S. economic environment differs in other important ways as well: labor markets are less rigid, hostile takeovers occur, large firms go bankrupt, the provision of credit is market-centered rather than bank-centered, transparency is greater, corporate governance is more effective, and financial regulation and enforcement are much stricter. The forbearance that severely hampered the recovery in Japan is unlikely to occur in the U.S. In fact, fair value accounting has been blamed by some for magnifying the crisis.

Now what?

The crisis continues to evolve, and policy makers continue to react, essentially pursuing a policy of triage. It is like a game of whack-a-mole; more keep popping up. Financial markets still are not functioning smoothly, suffering from a lack of liquidity and a fear of counterparty risk. The liquidity squeeze and fears of counterparty risk put even more pressure on the already low capital ratios of many of the biggest and most important financial firms. The regulatory reach of the Fed keeps increasing with the expansion of its role as lender of last resort. Thus, one lasting change from this crisis will be the enhanced role of the Fed as the (de facto, if not de jure) umbrella financial regulator. And, as with earlier U.S. crises, one should expect a political response of re-regulation. After we get past the inevitable political posturing and blame games, it is not clear just how extensive the regulatory changes will be, but there will certainly be critical reevaluations of capital ratios, counterparty risk, consumer protection, and the increasing complexity of financial instruments. More generally, we might expect increased interest in further extension of the Basel Accord, which began with credit risk and expanded to include interest rate risk and operational risk, to eventually include considerations of liquidity risk.

The resilience of the U.S. financial sector has been exhibited through many crises. In recent years, we have survived the third-world debt crisis, the junk bond crisis, the S&L crisis, the bank credit crunch, LCTM, the popping of the tech bubble, and more. This, too, will pass; however, not without substantial pain. Economic growth will be adversely affected for some time by the tightening of bank credit as banks rebuild their capital ratios. Given the hoarding of liquidity by large firms in recent years, much of the brunt of the bank capital/credit crunch will likely be borne by smaller firms that rely primarily on banks for their credit.

When will it end? Certainly, necessary conditions include a recapitalization of the banking sector and an end to the decline in house prices. How will banks be recapitalized? Sovereign wealth funds have already been burned by their earlier investments. Private equity and hedge funds have the money, and the Fed has just made it easier for them to invest in banks. And, certainly, the government has the money.

The current proposal for a $700 billion bailout fund has fans and detractors, especially since the devil is in the details and as of today the details are not yet worked out. Still, taxpayers must keep in mind that $700 billion is the gross, not the net, cost. Assets, toxic as they may be, will be purchased with the funds and will have some value. Furthermore, unlike physical assets, paper assets do not necessarily depreciate over time. In fact, by significantly increasing the demand for impaired securities, their prices will likely rise, which will, in turn, contribute to a recapitalization of banks holding similar securities. To the extent that current prices are well below "fundamental" prices, liquefying the market will reduce the illiquidity premium currently embedded in security prices. Thus, as with the Chrysler bailout, the operation could in the end be profitable for taxpayers, and, in any case, by increasing liquidity in securities markets can hasten the eventual recovery. Of course, the overall impact on bank recapitalization will depend on how the securities are purchased, which depends on the purpose of the program: is the goal to simply make the markets more liquid (paying market prices) or is it to directly recapitalize banks by overpaying for the securities? If it is the former, can that be accomplished with a further expansion of programs (Term Auction Facility and Term Securities Lending Facility) already in place?

Of course, in getting from here to there, the risks are many. Policies may be hijacked by lobbyists and special interests, political gridlock may result as both Democrats and Republicans posture for the upcoming elections, re-regulation may go too far without sufficient thought given to the (intended and unintended) consequences for the functioning of the economy and markets, Fed independence may be reined in and overly politicized, and policy makers and regulators may lose credibility.

The end is dear

Whenever the crisis does finally end, we can be sure of at least one thing: it will have been expensive. Bank crises throughout history have consumed a measurable percentage of a country's GDP, although the percentage has varied substantially across episodes. Getting the policy response right is a Goldilocks predicament. A hands-off policy that results in bank runs and contagion makes the adjustment too fast. Heavy-handed government intervention that short-circuits market forces and market signals, insulates firms from market discipline, impedes creative destruction, and intensifies moral hazard problems makes the adjustment too slow (see Japan). Policy makers, like Goldilocks, must find the policies that make the adjustment speed 'just right."

APPENDIX III

SPONSOR PROFILES

LEAD SPONSOR

With $15.3 trillion in assets under custody and $1.9 trillion under management (as of June 30, 2008), State Street Corporation (NYSE: STT) is a world-leading specialist in providing institutional investors with investment servicing, investment management and investment research and trading. State Street operates in 26 countries and more than 100 geographic markets worldwide. We combine an unwavering customer focus with in-depth experience and leading-edge technology to offer an unrivaled breadth of products and services to the global investment community.

State Street's customers are among the most sophisticated investors in the world: investment managers, pension plan sponsors, collective investment fund managers, banks, multinational corporations and non-profit organizations. As a specialist provider, we work closely with our customers to develop a thorough understanding of their needs. This consultative approach enables us to deliver a comprehensive array of customized solutions that help global investors achieve their business objectives, across all phases of the investment process.

SPONSORS

Advantage Partners

Advantage Partners, LLP is a leading provider of services to private equity and similar funds focused on the Japanese and Asian markets. Advantage Partners was founded in 1992 by Taisuke Sasanuma and Richard Folsom and has been providing services to funds since 1997, when the firm established the first buyout fund in Japan. Funds served by Advantage Partners have invested in 29 separate companies representing total enterprise value of approximately US$5 billion across a wide range of industries and sectors. Advantage Partners has achieved top-tier returns by executing at a high level across the investment cycle including sourcing proprietary deals through a deep network of contacts and relationships, enhancing value through hands-on consulting and a focus on operations, and achieving successful exits through tailored and creative solutions. Advantage Partners is based in Tokyo and recently opened an office in Hong Kong.

For more than 50 years, Aflac products have given policyholders the opportunity to direct cash where it is needed most when a life-interrupting medical event causes financial challenges. Aflac is the number one provider of guaranteed-renewable insurance in the United States and the number one insurance company in terms of individual insurance policies in force in Japan. Our insurance products provide protection to more than 40 million people worldwide. Aflac has been included in Fortune magazine's list of America's Most Admired Companies for seven years and in Fortune magazine's list of the 100 Best Companies to Work For in America for ten consecutive years. Aflac has been recognized three times by both Fortune magazine's list of the Top 50 Employers for Minorities and Working Mother magazine's list of the 100 Best Companies for Working Mothers and has also been included in Ethisphere magazine's list of the World's Most Ethical Companies for two consecutive years. Aflac Incorporated is a Fortune 500 company listed on the New York Stock Exchange.

American International Group, Inc. (AIG), world leaders in insurance and financial services, is the leading international insurance organization with operations in more than 130 countries and jurisdictions. AIG companies serve commercial, institutional and individual customers through the most extensive worldwide property-casualty and life insurance networks of any insurer. In addition, AIG companies are leading providers of retirement services, financial services and asset management around the world.

AIG traces its roots in Japan to property-casualty operations that were established in 1946. Over the course of the past 60 years, AIG's businesses in Japan have grown substantially. Today, AIG Japan consists of more than 20 member companies including five major insurers; AIU Insurance, American Home Assurance, ALICO Japan, AIG Star Life and AIG Edison Life.

American Securities, L.P.

American Securities was founded in 1947 as the investment office of the William Rosenwald Family.

As financial markets have changed and needs and interests of the Rosenwald Family have evolved, American Securities has responded by identifying smart people and partnering with them to create new businesses early in investment cycles.

Among the areas in which American Securities has recognized opportunities and built operating businesses, joint ventures or private investment vehicles are:

- Computer Technology – 1983
- Merger Arbitrage – 1986
- Private Equity – 1991
- Real Estate – 1991
- Distressed Advisory and Investing – 2005
- Japan – 2006

American Securities' activities are created with like minded investors and private families, combining smart people, well executed investment ideas and absolute discretion.

ANDERSON MŌRI & TOMOTSUNE

Anderson Mōri & Tomotsune is one of the largest full-service Japanese law firms. We are expert in all areas of business law and routinely represent domestic and international clients in high-profile M&A, capital markets, finance, regulatory, and contentious matters.

As to finance matters in particular, the firm acts for lenders, sponsors, and borrowers in a wide variety of domestic and international financings and represents banks, trust banks, securities companies, and other regulated entities in obtaining regulatory approvals as well as in their other dealings with Japanese regulatory authorities. Members of the firm also drafted key portions of Japanese finance-related legislation. As such, we have an excellent grasp of the state of the market, the regulatory stance of the Japanese authorities, and the rationale behind finance-related laws.

For more information about the firm, please visit our homepage at: andersonmoritomotsune.com.

BAKER & MCKENZIE

Baker & McKenzie's 3,900 qualified lawyers in 70 offices across 38 countries deliver the quality corporate and commercial legal services required to respond to global and local business needs consistently, confidently and with sensitivity for cultural, social and legal practice differences. The Firm has a presence in all of the major financial centers around the world, including Tokyo.

Baker & McKenzie Tokyo is the largest integrated law firm in Japan with more than 150 qualified professionals. Our attorneys in Tokyo have been assisting domestic and international companies in addressing the full spectrum of legal and business issues in Japan for over three decades. The ability of our Tokyo office to combine Japanese and foreign legal expertise and to deliver the value of Baker & McKenzie's global network places us in a unique position to provide truly international service to our clients.

Baker & McKenzie Tokyo regularly acts for major Japanese and International banks, providing sophisticated, solutions oriented, legal support to navigate the maze of banking, securities and finance issues in Japan. We have particular expertise in securitisation, project finance, acquisition finance, derivatives and financial services work. Our Japanese Banking and Finance practice comprises thirty attorneys, four of whom were named leading individuals in the banking and finance practices by Asia Pacific Legal 500 in 2007.

Bank of America is one of the world's largest financial institutions, serving individual consumers, small and middle market businesses and large corporations with a full range of banking, investing, asset management and other financial and risk-management products and services. The company provides unmatched convenience in the United States, serving more than 57 million consumer and small business relationships with more than 5,700 retail banking offices, more than 17,000 ATMs and award-winning online banking with more than 22 million active users. Bank of America is the No. 1 overall Small Business Administration (SBA) lender in the United States and the No. 1 SBA lender to minority-owned small businesses. The company serves clients in 175 countries and has relationships with 98 percent of the U.S. Fortune 500 companies and 80 percent of the Fortune Global 500. Bank of America Corporation stock (NYSE: BAC) is listed on the New York Stock Exchange.

Bank of Tokyo-Mitsubishi UFJ

The Bank of Tokyo-Mitsubishi UFJ, Ltd. (BTMU) was formed in January 2006 through the merger of The Bank of Tokyo-Mitsubishi, Ltd. and UFJ Bank Limited. BTMU offers an extensive scope of commercial and investment banking products and services to its domestic and overseas customers. It also provides trust banking, securities, credit card, consumer finance and many more fields of financial services in close cooperation with group companies. The bank has the largest overseas network of any Japanese bank, comprising office and subsidiaries, including Union Bank of California, in more than 40 countries.

Bayview Asset Management Co., Ltd. (BVAM) is a Tokyo-based asset management boutique focused on the active investment in Japanese and U.S. equities as well as currency. The firm has advised Japanese investors on assets of approximately $3 billion in traditional and alternative investment strategies that include equity and currency hedges. Originally founded as a subsidiary of RS Investments in January 1998, BVAM, with a staff of 40 professionals, is today an employee-owned Japanese company that primarily serves institutional clients in the life insurance, property and casualty insurance, banking, and quasi-governmental sectors as well as corporate pension programs and university endowments.

One of the few fully-licensed independent boutiques in Japan
Financial Instruments Firm Registration Kanto Local Finance Bureau Director-General (FIF) No. 397

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The nearly 1,000 attorneys in our U.S., London, Hong Kong and Tokyo offices advise and represent major corporations in numerous deals and disputes involving Japan and Asia affiliated companies. The firm provides clients with the strategic insight crucial for navigating the unique cultural framework of the region. Our firm offers teams of professionals with broad experience in cross-border matters, including M&A, project finance, financial transactions, joint ventures, complex litigation, intellectual property, governmental relations and regulatory matters with special strength in major cross-border insolvency and corporate restructuring matters.

Our Tokyo office has over 60 Japanese lawyers (bengoshi) and U.S. lawyers providing a broad range of legal services with special strength in large-scale, cross-border insolvency and financial restructurings, finance, corporate/M&A, intellectual property, employment, antitrust and litigation matters.

Caxton Associates, L.L.C

Cerberus and its affiliated funds comprise one of the largest groups of funds globally with over US$25 billion of equity capital under management. Cerberus specializes in providing both financial resources and operational expertise to help transform undervalued companies into industry leaders for long-term success and value creation. Cerberus holds controlling or significant minority interests in over 50 companies globally. These companies collectively employ over 250,000 people, conduct business in over 140 countries, and generate annual revenue in excess of US$45 billion. Cerberus is headquartered in New York City and maintains offices throughout the US and in several foreign countries.

As part of its global investment platform, Cerberus is one of the largest investors in Japan. Since commencement of activities in 1998, Cerberus has completed approximately US$10 billion of investments in Japan, representing Cerberus' second most active market after the United States. Cerberus' extensive experience in owning and operating businesses includes financial institutions (Aozora Bank), transportation and leisure businesses (Kokusai Kogyo and Seibu/Kokudo) and real estate development and management businesses (Showa Jisho).

Citi, the leading global financial services company, partners with clients, corporations, governments and institutional investors in more than 100 countries and offers a broad range of financial products, advice and services, including consumer banking and finance, corporate and investment banking, securities brokerage, and wealth management. Citi is a component of the Dow Jones Sustainability Index and FTSE4Good Index, which acknowledge leadership in setting standards in sustainable growth and in demonstrating exceptional environmental, social and economic performance. Additional information may be found at www.citigroup.com or www.citi.com.

Since Citibank opened its first Japanese branch in Yokohama in 1902, Citi companies in Japan have grown to become some of the country's most recognized financial services companies. As of May 2008, Citi and Nikko Cordial Corporation combined have more than 16,000 employees nationwide, in entities conducting its corporate, consumer and investment banking businesses as well as its credit cards, consumer finance and brokerage operations.

-Dai-ichi Life was the first mutual insurance company in Japan, established in 1902.

-Implementing a proactive operating strategy and introducing new products to capture changes in the Japanese life cycle since our inception, we have steadily grown to become a leading life insurer with an extensive product portfolio.

-We had premium income of 3.2 trillion yen in 2007 and have consolidated our position among the top three Japanese life insurers.

-Fundamental profit, an indicator of profitability for the core insurance business, was over 450 billion yen and total assets reached approximately 32 trillion yen at March 31, 2008.

-We have established a solid presence in Japan, which is the third largest life insurance market in the world.

-Our traditional embedded value was roughly 3.2 trillion yen at the end of March 2008.

-In the individual insurance area, we have an extensive customer base of 8.24 million policyholders, representing 7.9% of the adult population in Japan.

-We have more than 42,000 sales reps and a network of over 1,600 sales offices across the country.

DAIDO LIFE INSURANCE COMPANY

Daido Life is a leading provider of life insurance in the SME (small to medium sized enterprises) market and is the market leader with 21.4% share in terms of individual term life insurance based on policy amount in force in Japan.

Daido Life's basic policy on investment is to sustain a healthy asset portfolio and liability-driven ALM in accordance with the characteristics of the products it offers. Based on this policy, the Company carries out strict risk management for each asset category.

Since fiscal year 1999, Daido Life has invested positively in alternative investments within the scope of appropriate risk control with the objective of improving the investment performance over the medium term. Among these investments are private equity funds, hedge funds (mostly fund of funds) and other alternative products. The Company plans to increase alternative investments in the portfolio with the goal of building a well diversified portfolio capable of generating stable returns.

Daiwa Securities SMBC, Japan's first wholesale investment bank, was born in 1999 of a strategic alliance between Daiwa Securities (the present-day Daiwa Securities Group) and Sumitomo Bank (the present-day Sumitomo Mitsui Financial Group).

Daiwa Securities, one of Japan's leading brokerages, was established in 1902, and its long-standing strength in international operations and its substantial product development capabilities were two of its major strengths. Inheriting this legacy, Daiwa Securities SMBC utilizes the unique business model and solid business foundation built through this joint venture between a major brokerage and a megabank to further reinforce its advantages while at the same time working to offer unique, groundbreaking financial solutions that are made possible by collaborating with a megabank.

As part of the Daiwa Securities Group we are forging ahead on the "Passion for the Best" mid-term business plan, and we are working to provide products and services that exceed our customers' expectations based on our vision of building Japan's best investment bank on our customers' trust and our employees' passion.

For further information on Daiwa Securities SMBC Co. Ltd., please visit our web site at http://www.daiwasmbc.co.jp/english/index.html.

DAVIS POLK & WARDWELL

For nearly 160 years, Davis Polk has advised industry-leading companies and global financial institutions on their most challenging legal and business matters. The firm ranks among the world's preeminent law firms across the entire range of its practice. Based in New York City, Davis Polk has approximately 700 lawyers in ten offices, including Tokyo, Hong Kong and Beijing.

Davis Polk has a long history as one of the leading international firms in Japan. We opened a Tokyo office in 1987 and since then have played a leading role in the development of cross-border capital markets, M&A, private equity, credit, dispute resolution and other matters involving Japanese companies. Our Tokyo office is also closely integrated into our growing and diverse Asia practice, with Tokyo-based Davis Polk lawyers regularly engaged in matters involving Korea, China, Hong Kong, the Philippines, Indonesia and India.

For more information visit our website at dpw.com.

Deloitte Touche Tohmatsu (Japan Group) is the name of the group consisting of member firms in Japan of Deloitte Touche Tohmatsu (a Swiss Verein), and Deloitte Touche Tohmatsu (Japan Group) provides services in Japan through Deloitte Touche Tohmatsu （Japan）, Tohmatsu Tax Co., and all of their respective subsidiaries and affiliates. Deloitte Touche Tohmatsu (Japan Group) is among the nation's leading professional services firms and each entity in Deloitte Touche Tohmatsu (Japan Group) provides services in accordance with applicable laws and regulations. The services include audit, tax, consulting, and financial advisory services which are delivered to many clients including multi-national enterprises and major Japanese business entities through nearly 6,000 professionals in almost 40 cities of Japan.

For more information, please visit Deloitte Touche Tohmatsu (Japan Group)'s website at www.deloitte.com.

ELLIOTT

Elliott Associates, L.P. and its sister fund, Elliott International, L.P., together have more than $14 billion of capital under management. Founded in 1977, Elliott is one of the oldest funds of its kind under continuous management. The Elliott funds' investors include large institutions, high-net-worth individuals and families, and employees of the firm.

Elliott employs more than 100 investment professionals in New York, London, Hong Kong, and Tokyo. The firm has major investment interests around the world, and pursues a diversified investment and trading program, emphasizing a culture of thoroughness, hard work, creativity, and tenacity. The firm seeks to generate a moderate return with a high degree of consistency, regardless of fluctuations in the stock and bond markets. From inception Elliott has generated for its investors a 14.7% net compound annual return, compared to 11.7% for the S&P 500 stock index. The annual standard deviation of returns over this period was only 5.2%, compared with 15.4% for the S&P 500. Elliott's returns have been highly consistent throughout many market cycles, and have resulted in only seven losing quarters during its more than 31-year history.

Fidelity International Limited (FIL) was established nearly 40 years ago and operates in markets outside the Americas. The company and its subsidiaries currently manage more than $250b for major institutions and individual investors globally. Our US affiliate, Fidelity Management and Research (FMR), was founded in Boston in 1946 and is one of America's largest mutual fund companies. Fidelity opened its first overseas office in Tokyo in 1969 and operates throughout the world. In Asia Pacific, Fidelity has offices in Japan, Hong Kong, Taiwan, Australia, Korea, India (Delhi & Mumbai), Singapore, and China. Over 70 research professionals and fund managers based in these offices identify investment opportunities in this diverse and rapidly growing market. With access to over 600 total Fidelity investment professionals globally, FIL and FMR together covers 95% of the world's stockmarkets by capitalization, giving us a view of the world markets that few other investment managers are able to match.

GE is a diversified global infrastructure, finance and media company that is built to meet essential world needs. From energy, water, transportation and health to access to money and information, GE serves customers in more than 100 countries and employs more than 300,000 people worldwide. GE is Imagination at Work.

For more information, visit the company's Web site at www.ge.com.

Ichigo Asset Management is an independent Japanese investment manager that invests in small and mid-sized Japanese companies that we believe are trading well below their true, intrinsic value. We care deeply about success for our investor clients and the companies we invest in. We believe good corporate governance lies at the heart of strong company performance, and are seeking a new model for Japanese corporate governance that includes active, committed, and responsible shareholders.

JSDA is a hybrid association functioning both as a self-regulatory organization (SRO) and as a trade association in the Japanese securities market. JSDA's more than 500 members consist of securities firms and other financial institutions operating securities businesses in Japan.

As a full-fledged SRO, JSDA extensively regulates market intermediaries. Its self-regulatory functions encompass rule-making, enforcement, inspection, disciplinary actions, accreditation of sales representatives, and dispute mediation.

As a trade association, JSDA relays the voice of the industry to the government and other related parties, conducts and promotes investor education to expand the base of knowledgeable investors, and implements various research and studies to generate policy recommendations for further activating the market.

J.P. Morgan is a wholesale arm of JPMorgan Chase & Co. (NYSE: JPM), a leading global financial services firm, with assets of $1.8 trillion and operations in more than 60 countries. JPMorgan Chase & Co. is a leader in investment banking, financial services for consumers, small business and commercial banking, financial transaction processing, asset management, and private equity. The firm serves millions of consumers in the United States and many of the world's most prominent corporate, institutional and government clients under the “J.P. Morgan” and “Chase” brands.

In Asia Pacific, J.P. Morgan has over 20,000 employees in 14 countries with an unparalleled client base and leadership across the full spectrum of financial services. The firm has a strong regional footprint with its Asia Pacific headquarters in Hong Kong and offices in Tokyo, Sydney, Beijing, Singapore and other major financial centers in the region.

In Japan, J.P. Morgan offers specialized services across a range of businesses from investment banking, corporate banking, treasury & securities services, foreign exchanged to asset management with a client base that includes public bodies, financial institutions and multrm’s expertise and primary focus on international business transactions, the firm regularly assists overseas clients conducting business in Japan, as well as guiding Japanese clients with investments and businesses abroad.

KAMANO SOGO LAW OFFICES

Kamano Sogo Law Offices offers a full range of legal services in international and domestic business transactions. Practice areas are: International, Corporate, Commercial, Banking, Trust, Securities, Finance, Leases, Anti-Monopoly, Mergers and Acquisitions, Foreign Investments, Intellectual Property and Litigation. Based on the firm's expertise and primary focus on international business transactions, the firm regularly assists overseas clients conducting business in Japan, as well as guiding Japanese clients with investments and businesses abroad.

Mr. Hiroyuki Kamano, the firm's founding partner, and other members of the firm have various international experience which enables them to provide clients with a comprehensive legal representation from a global perspective. All of the members of the firm are committed to providing clients with legal representation based on dedication, experience, continuing legal education and active involvement in legal and business developments.

KPMG AZSA & Co. is one of Japan's leading audit corporation with approximately 3,700 people in major cities across the country. KPMG AZSA & Co. offers clients a variety of professional services tailored to the emerging needs of today's business environment, including audit, attestation and advisory services such as preparation for initial public offerings and financial advisory services.

KPMG AZSA & Co. is a Japanese member firm of KPMG International, a global network of professional firms that encompass nearly 113,000 people in member firms worldwide. KPMG member firms provide audit, tax, and advisory services in 148 countries.

Linklaters

Linklaters is a law firm which advises the world's leading organisations on their most challenging transactions and assignments. With over 2,500 lawyers in 30 offices in the world's major business and financial centres, the Linklaters network delivers an outstanding service to our clients anywhere in the world. Our lawyers work closely with leading corporates, investment banks and other major institutions, offering the highest quality advice to meet our client's global and local requirements. We offer our clients an unrivalled range of leading practices, making us the obvious choice for legal advice in the areas of corporate/M&A, employee incentives, employment, competition/antitrust, financial markets, investment management, pensions, banking, capital markets, projects, restructuring & insolvency, corporate tax, environment & planning, intellectual property, litigation & arbitration, real estate & construction, trusts and TMT.

Linklaters in Tokyo is Japan's first fully-merged Japanese and international law firm, offering international and domestic advice from a single source. The firm's team of more than 65 specialist lawyers in Tokyo has established a reputation for providing a better service to clients on their most complex deals, ensuring that their multi-jurisdictional advice is co-ordinated and consistent. The Tokyo office advises on all main practice areas including real estate finance, securitisation, structured finance and derivatives, corporate/M&A, project and asset finance, acquisition finance, banking and regulatory advice, capital markets, dispute resolution and investment trusts.

Additional information can be found at http://www.linklaters.com/.

LONE STAR JAPAN
ACQUISITIONS, LTD.

Lone Star Funds (Lone Star) are closed-end, private-equity limited partnerships that include corporate and public pension funds, university endowments, foundations, bank holding companies, family trusts and insurance companies. Since 1995, the principals of Lone Star have organized private equity funds totaling more than $13.3 billion to invest globally in secured and corporate unsecured debt instruments, real estate related assets and select corporate opportunities. Lone Star has affiliate offices in London, Tokyo, Seoul, Taipei, Dallas, Dublin, Brussels, Luxembourg, and Frankfurt. Its general partner is a Bermuda-based entity headquartered in Hamilton.

In Asia, Greater North America and Europe, Lone Star has been a successful investor in non-performing loans and real estate. The volatility of capital flows and the tendency of the banking system to cyclically over-finance and then under-finance the property and other sectors provide investment opportunities for Lone Star around the world. Global real estate and capital markets continue to offer opportunistic investment situations. Periodic disruptions, private/public market price disparities and out-of-favor assets provide financing opportunities for a fast-moving investor such as Lone Star. In this environment, Lone Star has the ability to identify, structure and finance investments efficiently and discreetly to produce optimal results.

MEDLEY

Medley Capital LLC ("MC") is a private investment management firm with offices in New York, San Francisco, and Hong Kong. MC invests capital in public and private securities globally through a variety of investment funds. MC has 32 investment professionals who bring a diverse knowledge base including a wide range of finance, global industry expertise and senior domestic and international government experience.

Mitsubishi Corporation

Mitsubishi Corporation (MC) is Japan's largest general trading company (sogo shosha) with over 200 bases of operations in approximately 80 countries worldwide. Together with its over 500 group companies, MC employs a multinational workforce of approximately 60,000 people. MC has long been engaged in business with customers around the world in virtually every industry, including energy, metals, machinery, chemicals, food and general merchandise.

MC seeks to contribute to the enrichment of society through business firmly rooted in principles of fairness and integrity.

Although our activities encompass everything from trading to business investment, the essence of what we do at MC can best be described as focusing on the needs and seeds of customers and society, conceiving business models, and reliably providing functions and services to propel these businesses forward.

Through consistent and dedicated efforts, MC is committed to further strengthening the high level of trust earned from our customers over the years.

MHCB provides optimal solutions to the increasingly diverse and sophisticated needs of clients in the areas of both finance and business strategies, focusing its efforts on serving major corporations (such as those listed on the first sections of domestic stock exchanges), financial institutions and their group companies, public sector entities, and overseas corporations including subsidiaries of Japanese corporations.

Specifically, it is revamping its organization to dramatically strengthen its ability to provide solutions through competitive services at the global level.

In addition to taking full advantage of the functions of other group companies such as MHBK, MHSC and MHTB, it is cooperating with foreign investment banks and various types of investment funds as it pursues a "deal after deal" marketing strategy that offers clients cutting-edge financial solutions on a continuous, multi-faceted basis.

Monex Group, Inc. was established in 2004 as a holding company of Monex, Inc. and Nikko Beans, Inc., both established in 1999 as online brokerage firms. In 2005, Monex, Inc. and Nikko Beans, Inc. merged and became Monex, Inc., a core subsidiary of its group. The group also contains the companies in charge of asset management business, investor education business, M&A business, FX business, etc. and has overseas offices in New York and Beijing. Monex Group, Inc. is listed in the first section of TSE and is continuing to grow its businesses, aspiring to become a technology-based global online retail financial service provider.

Morgan Stanley

Morgan Stanley is a leading global financial services firm providing a wide range of investment banking, securities, investment management and wealth management services. The Firm's employees serve clients worldwide including corporations, governments, institutions and individuals from more than 600 offices in 35 countries.

Our long-term, relationship oriented approach has led to more than 35 years of capital markets innovation and growth in Japan. From a two-person office in 1970, today the Firm has more than 1,500 people in Tokyo and is a leading provider of investment banking, sales & trading, research, securitization, real estate and investment management services. For further information about Morgan Stanley, please visit www.morganstanley.com.

NAGASHIMA OHNO & TSUNEMATSU
長島·大野·常松 法律事務所

Nagashima Ohno & Tsunematsu, established in 2000, is widely known as a leading law firm in Japan and a foremost provider of international and commercial legal services. We represent domestic and foreign companies and organizations involved in every major industry sector and legal service area in Japan. We have successfully structured and negotiated many of Japan's largest and most significant corporate and finance transactions, and have deep litigation strength spanning key commercial areas, including intellectual property and taxation. As of September 30, 2008, we have 313 lawyers (inclusive of 12 foreign-licensed lawyers) capable of providing our clients with practical solutions to meet their business needs.

For more information, please visit: http://www.noandt.com/.

[1]

Nikko Asset Management Co., Ltd. has almost 50 years of history and received the Reuters' Lipper Award for Best Fund Group in Japan in 2005.[2] Since the new management embarked on major corporate reform in 2003, the firm has gained world-class financial investors like Warburg Pincus and the Government of Singapore Investment Corporation (GIC), and a mostly new and highly motivated workforce. Under its new leadership, Nikko AM has created a new culture and now offers customers a diverse range of asset classes, including traditional and alternative investments, while enjoying its fastest growth ever.

Nikko AM provides in-house funds, investing mainly in Japanese equities, fixed income, and REITs, as well as China A-shares and Indian equities, Through its sub-advisory platform, "World Series," Nikko AM gains access to top-performing global asset managers.

Nikko AM has assets under management totaling 12 trillion yen[3] and employs over 550 people in Tokyo, New York, London and Singapore.[4]

[1] "Nikko AM" stands for Nikko Asset Management Co., Ltd. and its overseas subsidiaries.
[2] This rating is not indicative of the investment adviser's future performance.
[3] Nikko AM's assets under management as of June 30, 2008 (includes advised assets).
[4] As of June 30, 2008.

NOMURA

Nomura (the Group) is a global financial services group that provides financial services for individual, corporate and government clients. Founded in 1925, by Tokushichi Nomura, the Group presently employs more than 18,000 people worldwide.

Nomura offers financial and advisory solutions through its global headquarters in Tokyo, more than 150 branch offices in Japan, and an international network, doing business in more than 30 countries with regional headquarters in New York, London and Hong Kong. In the U.S., Nomura offers investment banking and securities brokerage services through its broker-dealers, Nomura Securities International, Inc., Instinet, Inc. and Harborview, which are members of SIPC.

The Group's business activities include investment consultation and brokerage services for retail investors in Japan and, on a global basis, brokerage and trading, underwriting, investment banking, merchant banking and asset management.

For additional information on Nomura, please visit our web site at www.nomura.com.

The Norinchukin Bank

The Norinchukin Bank (the "Bank") was established in 1923 as a quasi-governmental financial institution. Privatized in 1959, the Bank is one of Japan's largest and most distinguished banks.

The Bank is the central bank for Japan's agricultural, forestry and fishery cooperative systems. Based on constant funds procurement from member cooperatives, the Bank carries out efficient and flexible asset management by investing in various financial products. This is carried out on a global scale. The profits from these activities are then continuously passed on to its members.

The Bank has branches in the world's major financial centers, including New York, London and Singapore. Coupled with its head off life insurance operations, The Prudential Life Insurance Company, Ltd (POJ) and The Gibraltar Life Insurance Company, Ltd (Gibraltar Life). POJ focuses on need-based selling services by Life Planners, who are insurance professionals. POJ has achieved 20 years of consecutive growth in policies in force. Gibraltar Life serves the broad middle-income market through Life Advisors. Gibraltar Life's strength is in its close long time relationships with associations such as Kyoko (Teachers' Association) and Shoko (Small Business Owner's Association).

Prudential Financial, Inc. companies include The Prudential Insurance Company of America, one of the largest life insurance companies in the U.S. Leveraging our heritage of life insurance and asset management expertise, Prudential is focused on helping approximately 50 million individual and institutional customers grow and protect their wealth. Coupled with its head office life insurance operations, The Prudential Life Insurance Company, Ltd (POJ) and The Gibraltar Life Insurance Company, Ltd (Gibraltar Life). POJ focuses on need-based selling services by Life Planners, who are insurance professionals. POJ has achieved 21 years of consecutive growth in policies in force. Gibraltar Life serves the broad middle-income market through Life Advisors. Gibraltar Life's strength is in its close long time relationships with associations such as Kyoko (Teachers' Association) and Shoko (Small Business Owner's Association). Prudential's businesses offer a variety of products and services, including life insurance, annuities, retirement-related services, mutual funds, investment management and real estate services.

Ramius is a privately owned global alternative investment firm with approximately $11 billion(*1) in assets under management. More than anyone, we understand the value of a long-term approach. For nearly a decade and a half we have focused on building an institutional quality firm with a comprehensive platform of alternative investments to match the needs of serious investors. But what sets us apart is the unparalleled experience and unique industry insight we apply to deliver superior, uncorrelated, absolute returns over the long term.

For more information please visit our website: http://www.ramius.com

(*1) as of July 1, 2008.

Rating and Investment information, Inc.(R&I) is the most recognized credit rating agency in Japan and the broader Asian markets. R&I is a respected independent source of financial information among overwhelming majority of broker-dealers and institutional investors throughout Japan and U.S.

R&I provides a variety of credit rating services for publicly issued instruments, structured finance products, senior long-term financial obligations of incorporated schools and hospitals and creditworthiness of borrowers of syndicated loans.

R&I in Bloomberg and Reuters.

On May 21, 2007, the Division of Market Regulation of US SEC provided R&I with written assurance that it will not recommend enforcement action to the SEC if R&I is considered by broker-beakers to be a “nationally recognized statistical rating organization (NRSRO) for the purpose of applying the relevant provisions of Exchange Act Rule 15c3-1.

Rockefeller

Rockefeller & Co., Inc.

Headquartered in New York and with offices in Boston and Washington, DC, Rockefeller & Co., Inc. is a leading global wealth management firm that provides comprehensive wealth and investment management services to a large and diverse client base of high net worth individuals, families, trusts, foundations and endowments. The firm has three wholly owned subsidiaries: The Rockefeller Trust Company, a New York limited "

Ropes & Gray LLP provides comprehensive legal services to leading businesses and individuals around the world. Clients benefit from our unwavering standards for integrity, service, and responsiveness. In collaboration with our leading practice areas—health care, life sciences, intellectual property, investment management, litigation, private equity, and tax and benefits—our public finance practice has been representing key sectors of the marketplace since 1890. In recent years, we have placed among the top 10 bond counsel firms nationwide for short-term issues, and among the top 40 firms for long-term issues. Our list of "firsts" in public finance is extensive, and we have been instrumental in the drafting of public finance legislation in at least 10 states. With offices in preeminent centers of finance, technology and government, including our recent expansion in Tokyo, we are ideally positioned to address today's most pressing legal and business issues.

To learn more, visit ropesgray.com.

新日本有限責任監査法人
ERNST & YOUNG
Quality In Everything We Do

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 130,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young ShinNihon LLC is a member firm of Ernst & Young. We are the leading audit firm in Japan, with the largest number of people, and with offices throughout the country. We are committed to providing the highest quality audit and assurance services, and to offering a range of other financial advisory services.

Together with the Ernst & Young global network, we strive to ensure trust in our capital markets and improve their functioning to achieve the potential of the global economy and our wider communities, which surround Japan.

For more information, please visit www.shinnihon.or.jp

Shinsei Bank (TSE: 8303)

Shinsei Bank is a leading diversified Japanese financial institution providing a full range of financial products and services to both institutional and individual customers. The Bank has total assets of 12.5 trillion yen (US$118 billion) on a consolidated basis (as of June 2008) and a network of 36 outlets that includes 34 Shinsei Financial Centers and 2 Platinum Centers in Japan. Shinsei Bank demands uncompromising levels of integrity and transparency in all its activities to earn the trust of customers, staff and shareholders. The Bank is committed to delivering long-term profit growth and increasing value for all its stakeholders.

For additional information on Shinsei Bank, please visit us at shinseibank.com

西川シドリーオースティン
法律事務所・外国法共同事業

SIDLEY AUSTIN NISHIKAWA
FOREIGN LAW JOINT ENTERPRISE

Established in 1866, Sidley is a truly global law firm, with more than 1800 lawyers in 16 office. The firm offers a comprehensive, multi-jurisdictional legal service.

In 2002, partners of Sidley Austin Gaikokuho Jimu Bengoshi Jimusho entered into a joint enterprise with Nishikawa & Partners (Sidley Austin Nishikawa Foreign Law Joint Enterprise since October, 2007) . Led by Tomoo Nishikawa, a prominent Japanese lawyer (bengoshi) and a former government policymaker who was actively involved in matters at the central government and at the Diet as a member of the House of Representatives, we offer clients the unique services of a Japanese team of bengoshi supported by the diverse skills of a global firm which represents major participants in the global markets. We have expertise in and focus on areas such as Lobbying/Regulatory Advice, Internal IP Litigation and HR for Foreign Companies. We also have unique expertise in Pharmaceutical and Insurance industries. In the financing areas we focus on Securitization, Structured Financing and Real Estate Financing.

STEEL PARTNERS JAPAN

Steel Partners Japan Strategic Fund (SPJSF) is a long-term relationship/active value investor that seeks to work with the management of its portfolio companies to increase corporate value for all stakeholders and shareholders. SPJSF has made over 30 investments in Japan since 2002 and is the largest shareholder in several world-class companies, including Sapporo Holdings, Brother Industries, Nissin Food Products, and Aderans Holdings.

SMBC SUMITOMO MITSUI BANKING CORPORATION

Strong domestic business base, speed in implementing strategies, and sector-leading group companies are Sumitomo Mitsui Banking Corporation's strengths. We leverage these strengths to provide comprehensive financial services to our customers. Operating under the umbrella of Sumitomo Mitsui Financial Group, a holding company, SMBC and other member companies, such as Sumitomo Mitsui Card Company, Ltd., work as one to create new value for our customers.

We provide global services not just to our domestic customers but also to overseas Japanese and non-Japanese companies, sovereigns, and government agencies. Building on our strong business platform in Japan, we are proactively developing business in Europe, the Americas, and East Asia, tailoring our products and services to meet local needs.

We will continue to develop and provide leading-edge products and services that answer our customers' increasingly diversified and sophisticated needs, wherever they may be, in order to remain their bank of choice.

The Sumitomo Trust & Banking Co., Ltd. (Sumitomo Trust) is a trust bank established in 1925. We currently have approximately 5,800 employees working in 62 domestic branches and 8 overseas offices. Sumitomo Trust's management model is an indispensable financial institution providing real estate related services, asset management and custody services based on commercial banking. This model guides the operations of Sumitomo Trust's five business groups and divisions, and enables the company to actively carry out our unique strategies. We will keep our focus firmly on our characteristics as a trustee ("Trustee-ness") and the specific merits of Sumitomo Trust ("STB-ness"). We aim to become an "essential partner "with our customers and society, as an independent and unique "asset management-oriented financial intermediary services group.

TOKIO MARINE NICHIDO

With customer trust at the base of all our activities, we are committed to the promotion of affluent and comfortable society and economic progress through providing safety and security.

- By offering customers the highest quality products and services, we will contribute to their richer lives and sustained development of business.
- For fulfilling our responsibility to shareholders as the core company of the Tokio Marine Group, we will pursue a global development of world's excellent business in terms of soundness, growth potential and profitability.
- By establishing a close rapport with the agents who are reliable partners, we will work hard together to realize mutually beneficial goals.
- For encouraging the creativity of each and every employee, we will foster a corporate culture which stimulates free and open communications.
- While performing our social responsibility as a good corporate citizen for conservation of the global environment, respect for human rights, compliance and contribution to society, we will make positive and extensive efforts for the development of society and local communities.

Tokyo Stock Exchange Group, Inc. (TSE Group) is a holding company of the Tokyo Stock Exchange, Inc., one of the leading global exchanges and the largest securities market in the Asia-Pacific region. The TSE Group is best known for its equities market, valued at US$4 trillion as of the end of June 2008. It also boasts the largest market for Japanese securities derivatives such as Japanese Government Bond (JGB) and TOPIX (Tokyo Stock Price Index) futures.

Unison Capital is a pioneer of private equity investment in Japan, operated by a handful of seasoned Japanese professionals with no ties to large corporate groups. We help portfolio companies devise strategies to enhance their value from a long-term perspective without any conflicts of interest.

Unison Capital has invested more than ¥700 billion in corporate value, accumulating in-depth experience and expertise in business management. This strength is reinforced by a global network of financial institutions, non-financial firms, corporate managers and a variety of professional service firms. We invest only in promising companies - those operated by enthusiastic managers and employees with potential to keep increasing corporate value. By working in unison with management teams and employees, we help companies realize new levels of growth.

WHITE & CASE

Operating 35 offices in 23 countries, White & Case is distinguished by the depth and scope of our global legal services. Wherever our clients do business, our entire global resources are available to help solve the most challenging business and legal issues promptly and efficiently. We move quickly, effectively and with expert knowledge of global and local legal environments to mitigate problems, resolve complexities and close deals simultaneously across multiple borders.

Our Tokyo office has been a leading law firm in Japan for over 20 years. Our foreign and Japan-qualified lawyers work seamlessly together to deliver integrated foreign and Japanese legal and tax advice to domestic and international clients. White & Case has consistently been rated as a leading firm in Japan in Capital Markets, Banking, Corporate, Asset and Project Finance, Mergers and Acquisitions, Tax, Dispute Resolution, Regulatory and Intellectual Property. We have advised clients on some of the most innovative and challenging transactions in the Japanese market during the past twenty years. Robert Grondine and Chris Wells have been leading figures in the international legal and business community in Japan through their leadership in the American Chamber of Commerce in Japan, Bob as President and Chairman and Chris Wells as Co-Chairman of the Financial Cervices Committee, which has brought major positive changes to the Japanese financial system for the benefit of all players in the past decade. From September 3, 2007, they will also be joined by Arthur Mitchell upon his retirement as General Counsel to the ADB, bringing his well known breadth of experience in Japan and Asia to the White & Case team.