

**NEAEF**

**The Cause and the Cure  
of  
the Current U.S. Financial Crisis**

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**Two Largest Economies of the World  
(Japan & the U.S.)  
both experienced Bursts of Real Estate Bubbles**

**International Spread of the Financial Crisis**

**What's Wrong?  
What to Change?**

**The Cause:  
BIS International Banking Regulation**

**The Cure:  
Use the Free Market Mechanism**

1988: The Bank of International Settlement (BIS) introduced a Regulation for international banks to keep their own capital ratio more than 8% of the total assets.

(2004: introduced revised version, Basel II)

Assets (loans, securities, etc.) are limited to less than 12.5 times of its own capital.

Limits the profit size.

Bank Loan, Capital Markets, Real Estate Markets

- A Single, Unified, & un-separable Market
- Only Banks are regulated
- Technical Progress in the Financial Markets

Bank's natural reaction      **Regulatory arbitrage**

Securitization, new financial commodities, etc.

# **BIS Capital Regulation Changed the Global Financial Markets**

**BIS Regulation = Focuses only on the soundness of banks in a single consolidate financial and capital markets**

**Bank's Reaction**  
||  
**Regulatory Arbitrage**

**Financial Unbundling**  
**Securitization**  
**Off balancing Assets**  
**Establish unconsolidated SIVs**  
**Growth of Investment Funds**

**Benefited banks in countries with large capital markets**

**Created International Competitive Inequality**

Bank's risks spread to the whole financial system  
True Risks have been covered up

## Theoretical Expectation

### Securitization

Isolating Risks from Banks  
Raise the BIS Ratio  
Specialize High Return Business

Enhanced  
Bank Soundness

## Reality

- Risk Isolation Impossible**      **Un-separable & Complex**  
**Relationship between Banking and Capital Markets**
- **Banks gave large loans to buyers of Securitized loans**
  - **Banks established SIVs that hold Securitized loans**
  - **Vague SIV Consolidation Standard**  
**Cover up the Deteriorated Own Capital Ratio**
  - **Accurate Valuation of Securitized loans Impossible**  
**Un-transferable Risk Information**  
**Poor Traceability to Original Assets**

## Defects of the BIS Regulation:

Regulates only banks

in a consolidated single & larger financial market

No Theoretical Rationale for enhancing bank soundness

No Evidence for enhancing bank soundness

Actual Implementation diverts from the theoretical  
concept

Bank Management = To find the best mix of

- Rate of return
- Bad loan ratio
- **Own capital ratio**      **Only this index is regulated**
- Many other management indices

**Pro-cyclicality** (enlarges business fluctuations)

an unchanged & unique risk level of the financial market

Aggravates an economy at a time of macro-shock

## Reality of the BIS Regulation

**BIS Capital** =  $\left\{ \begin{array}{l} \text{Tier I (Globally uniform basic items)} \\ \text{Tier II (Each country can define arbitrarily} \\ \text{up to the amount less than Tier I)} \end{array} \right.$

- **Measures taken to keep the 8% capital ratio:**

Definition of Tier II has been kept enlarged

- 1988: 45% of unrealized profit from held equities,
- 1990: Subordinate debts
- 1998: 45% of revaluation of real estate properties
- 1999: Deferred tax assets (effective tax rate times the future expected taxable income for over 5 years)

1998-1999: Public money Injection

This effort deserves credit.

- **Otherwise, Japanese economy must have been**

**Much Worse!**

Same with the successive bailouts in the U.S. now

- **BIS Capital ratio**

- Impossible for outsiders to know
- Too complex
- Use of own internal model are allowed for large banks
- Does not reflect true bank soundness

**Hard for regulators to assess the correct value**



Fig. 1

# Ratio of Tier I and Tier II: Major Banks Average

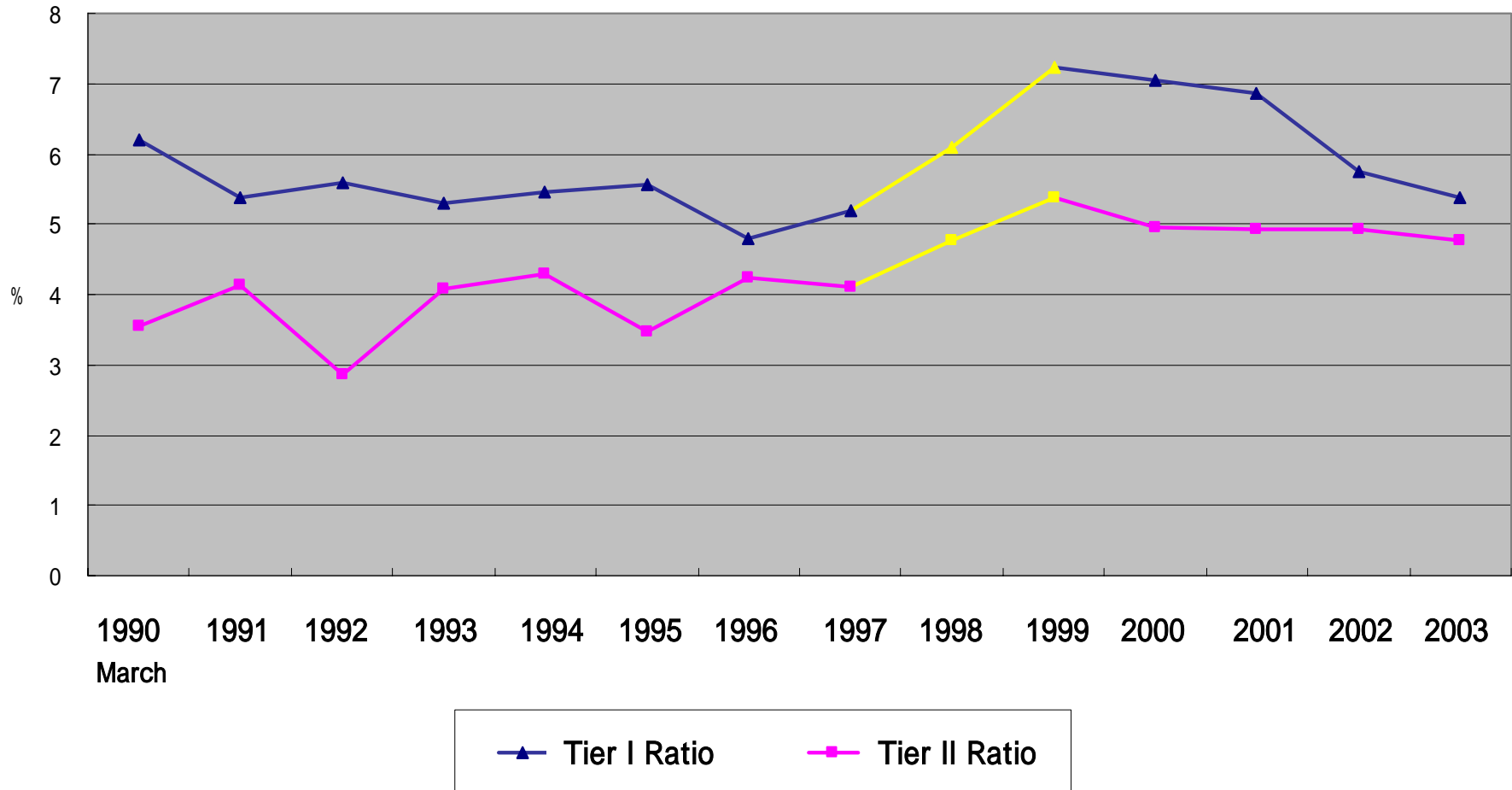
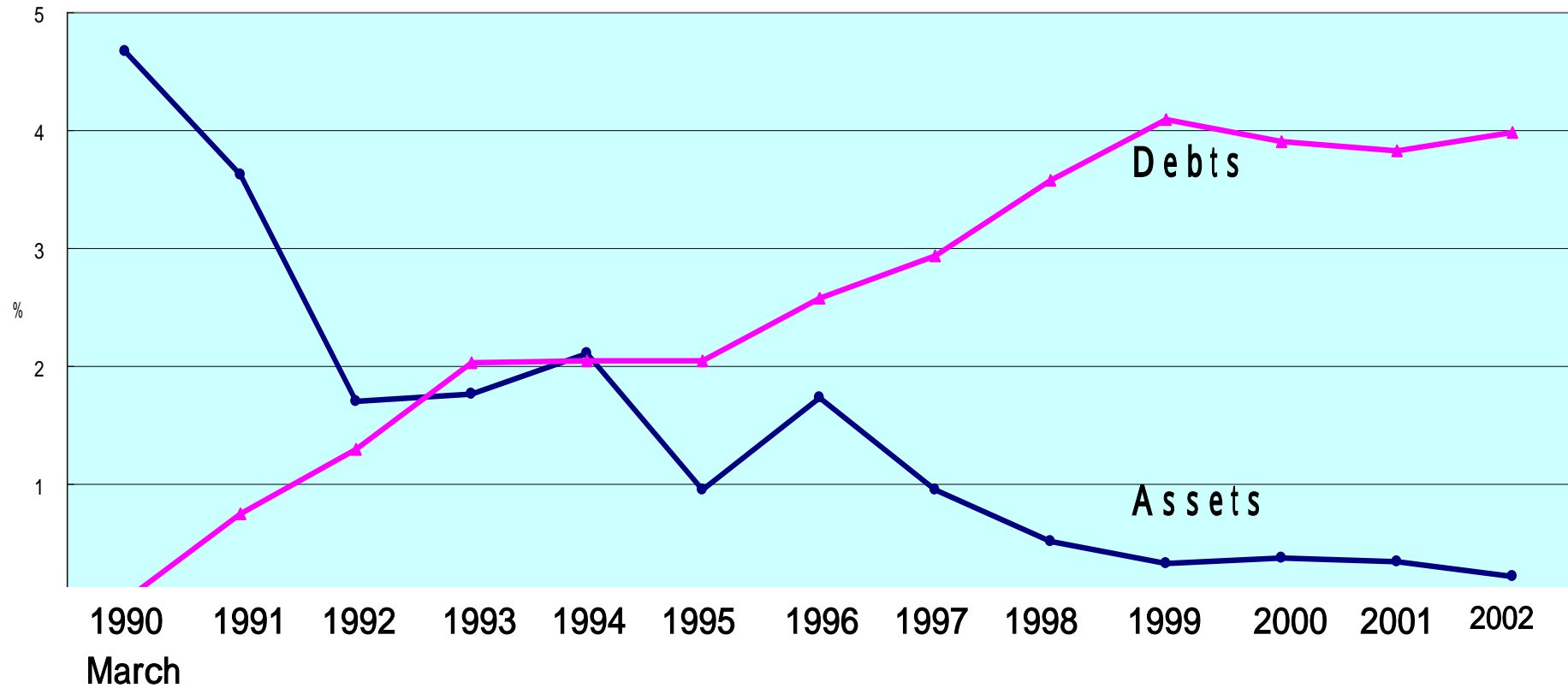


Fig. 2  
Major Components of Tier II:  
Ratios from Hidden Assets and from Debts  
Major Banks Average



## What is a Better Measure?

- **A Market-Valued Own Capital Ratio**  
**= (Total market value of the bank/Total asset)**

A better & more transparent measure

Reflects true bank soundness

Markets see through true bank soundness

A bank fails when it drops to 2%

Negatively correlated with bad loan ratio

Let's take a look of the data

Fig. 3 BIS Ratio of City Banks

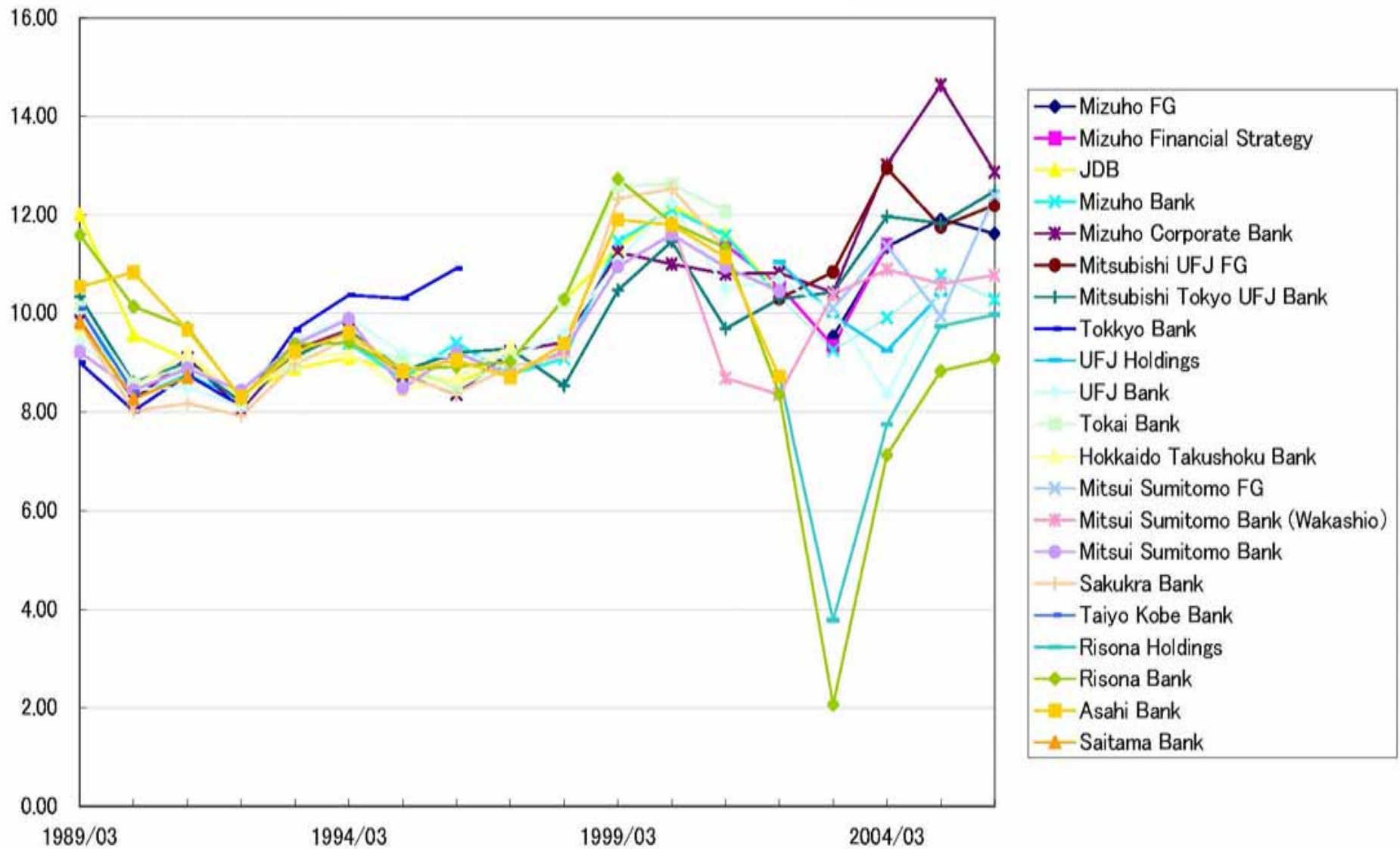


Fig. 4  
Market Valuation of Capital Ratio: City Banks

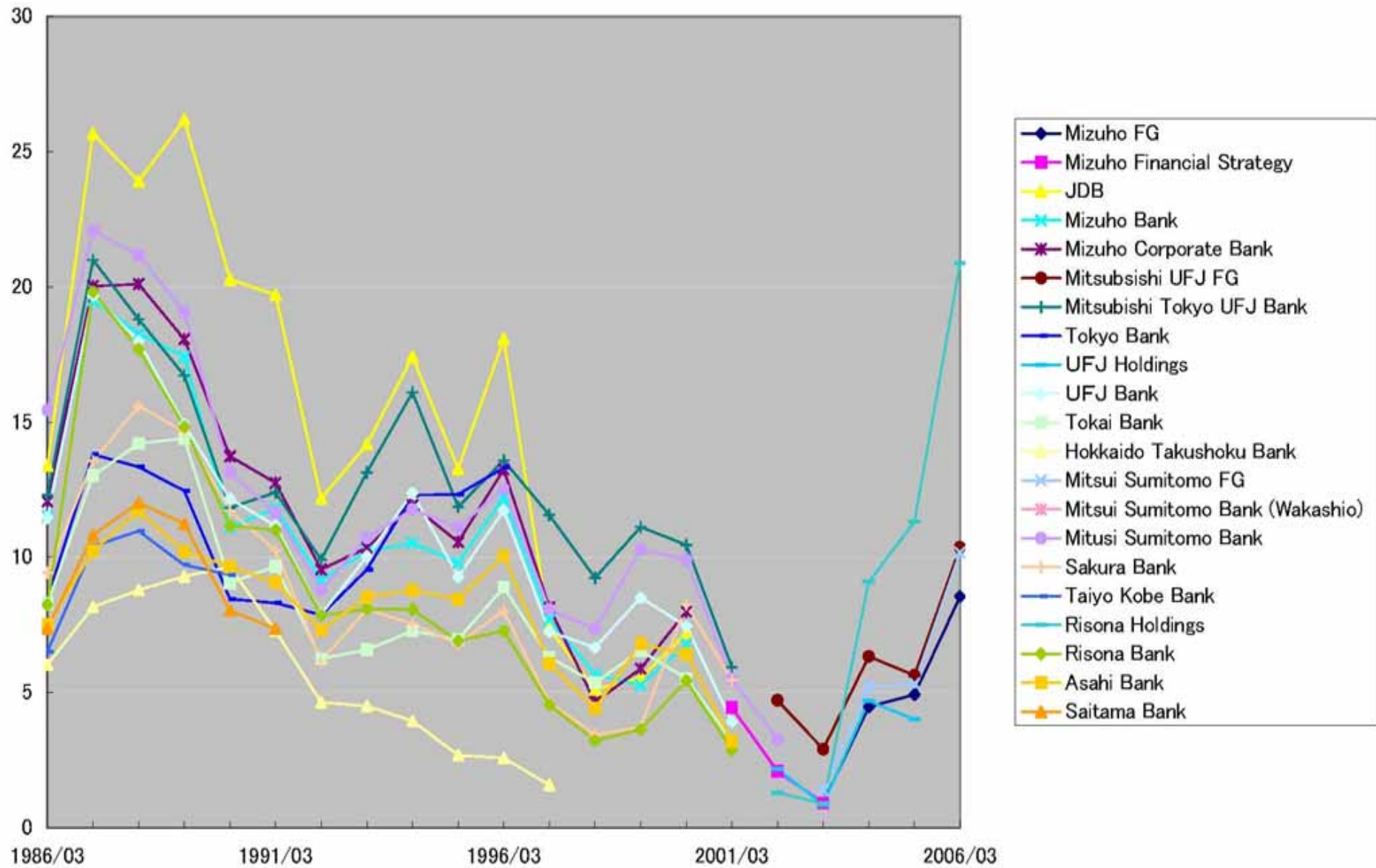


Fig. 5 BIS Ratio and Market Valuation of Capital Ratio:  
All City Banks Average

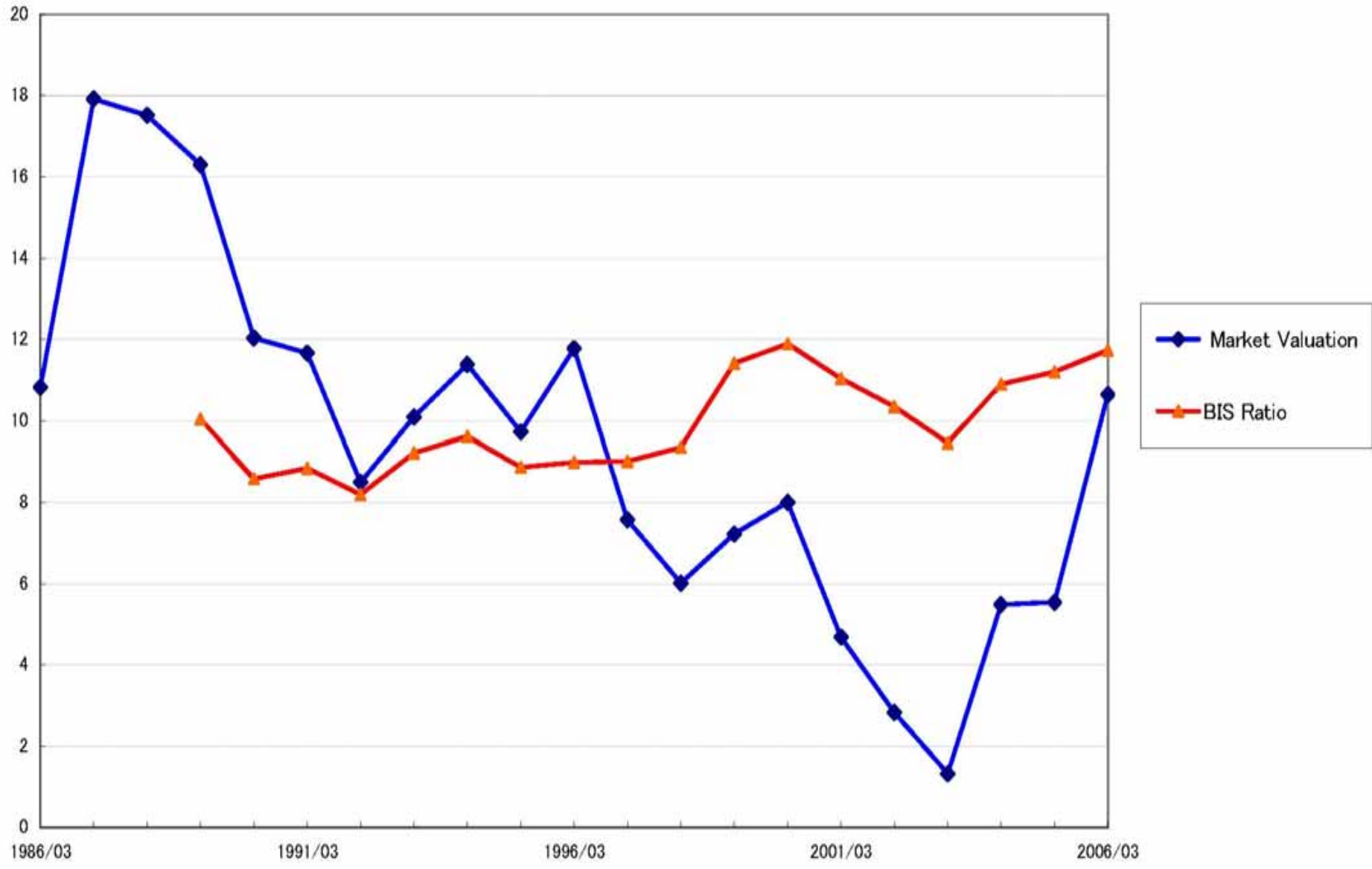


Fig. 6 Mizuho

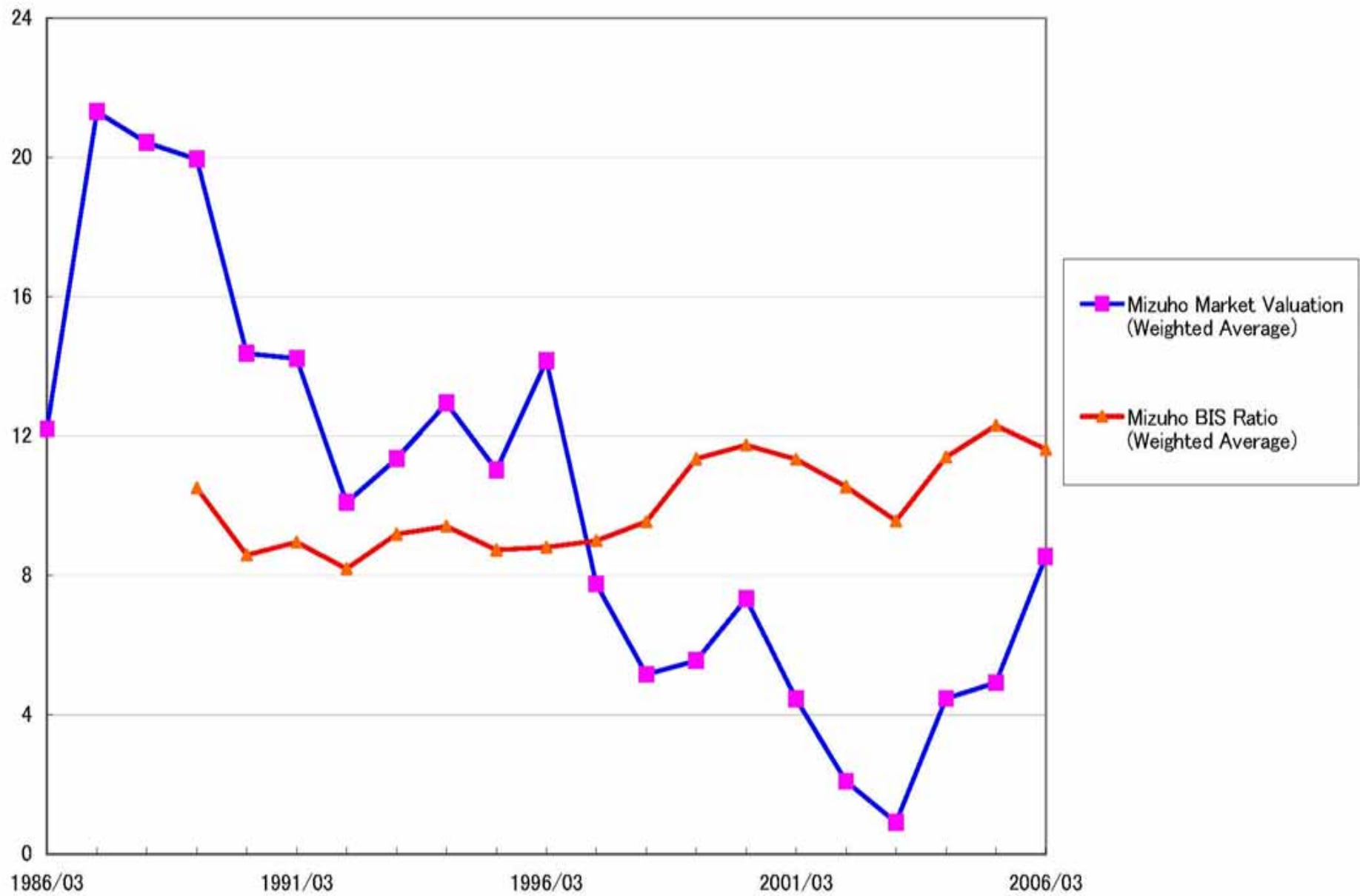


Fig. 7 Mitsubishi UFJ

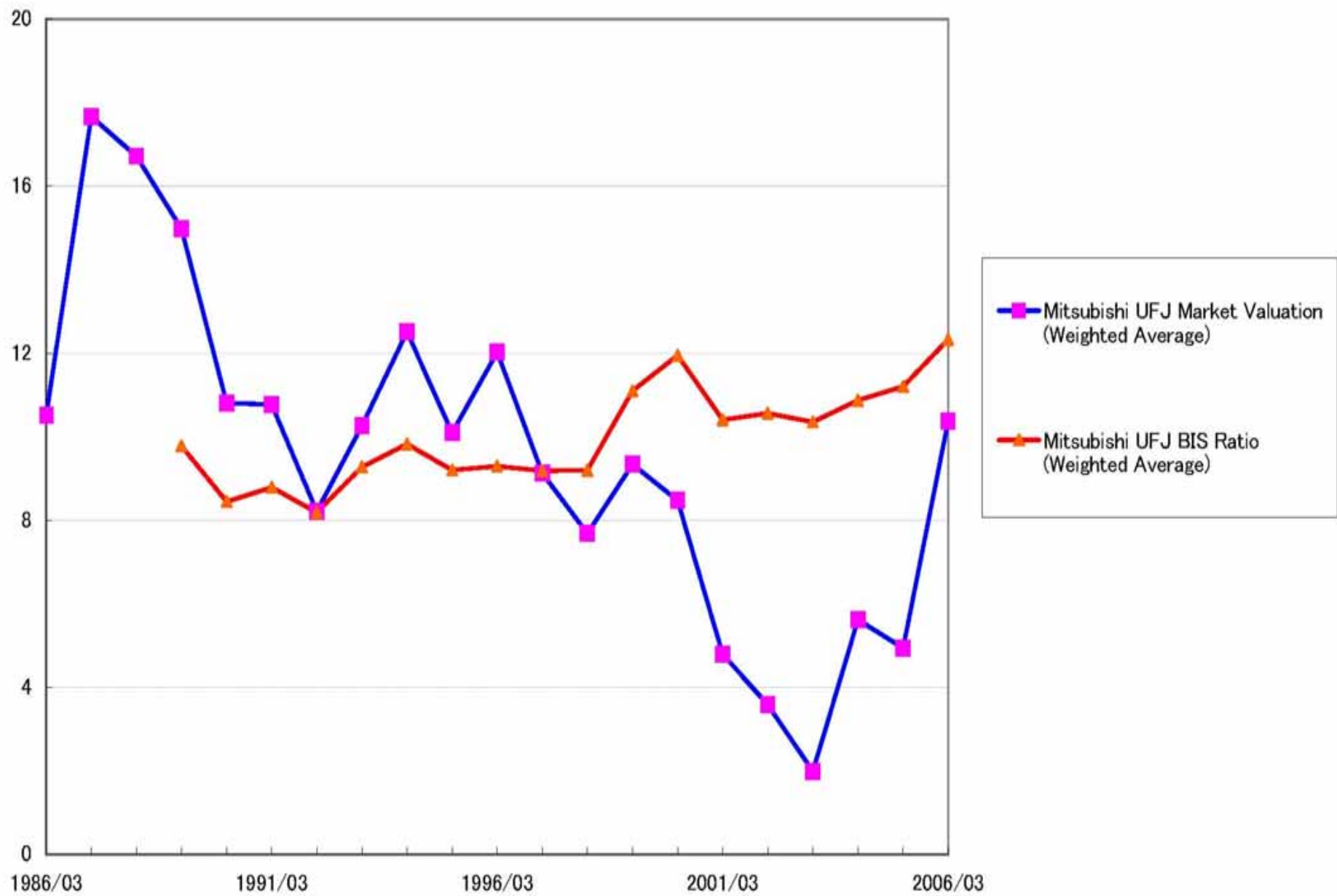




Fig. 8 Mitsui Sumitomo

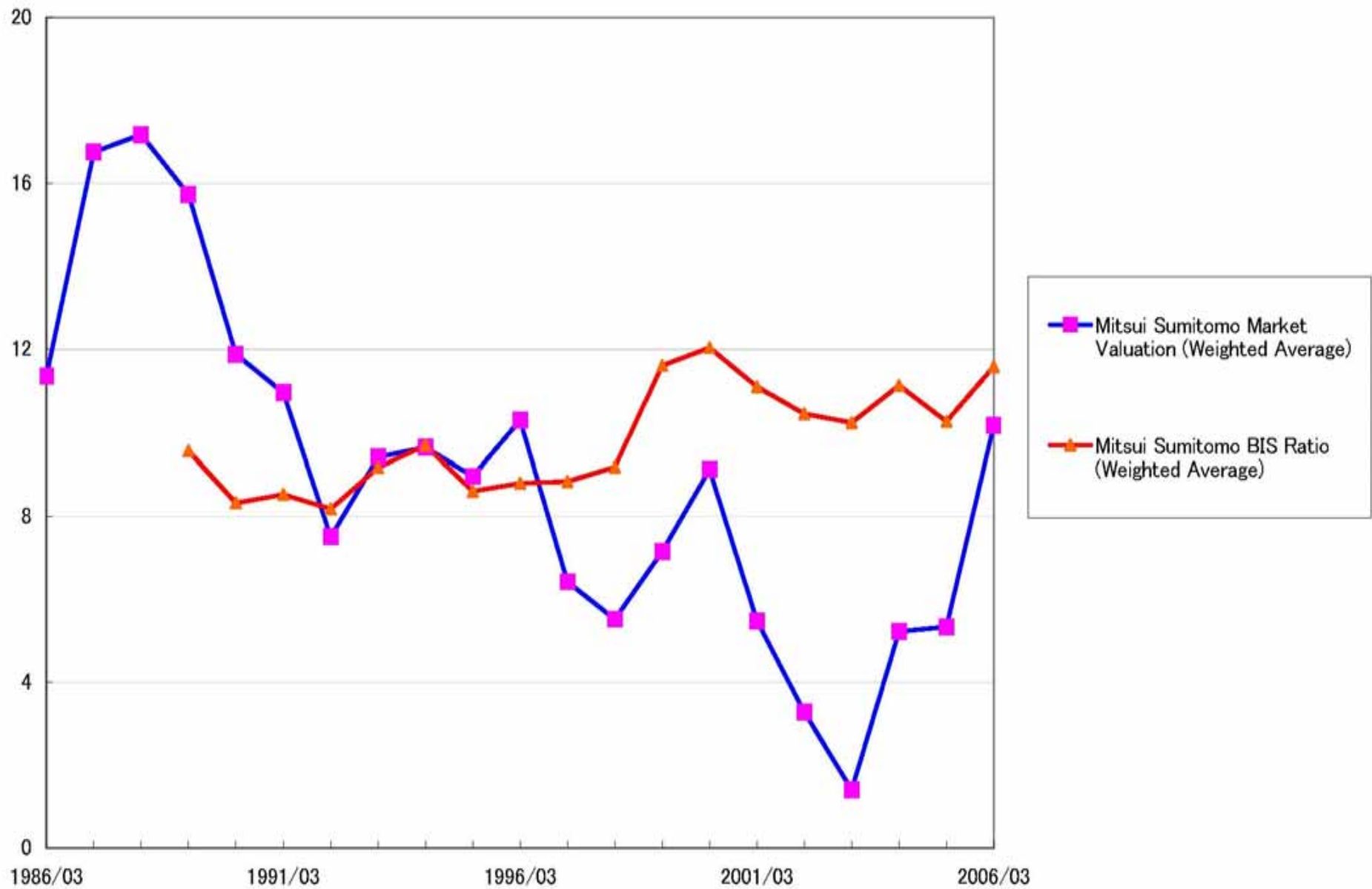


Fig. 9 Risona

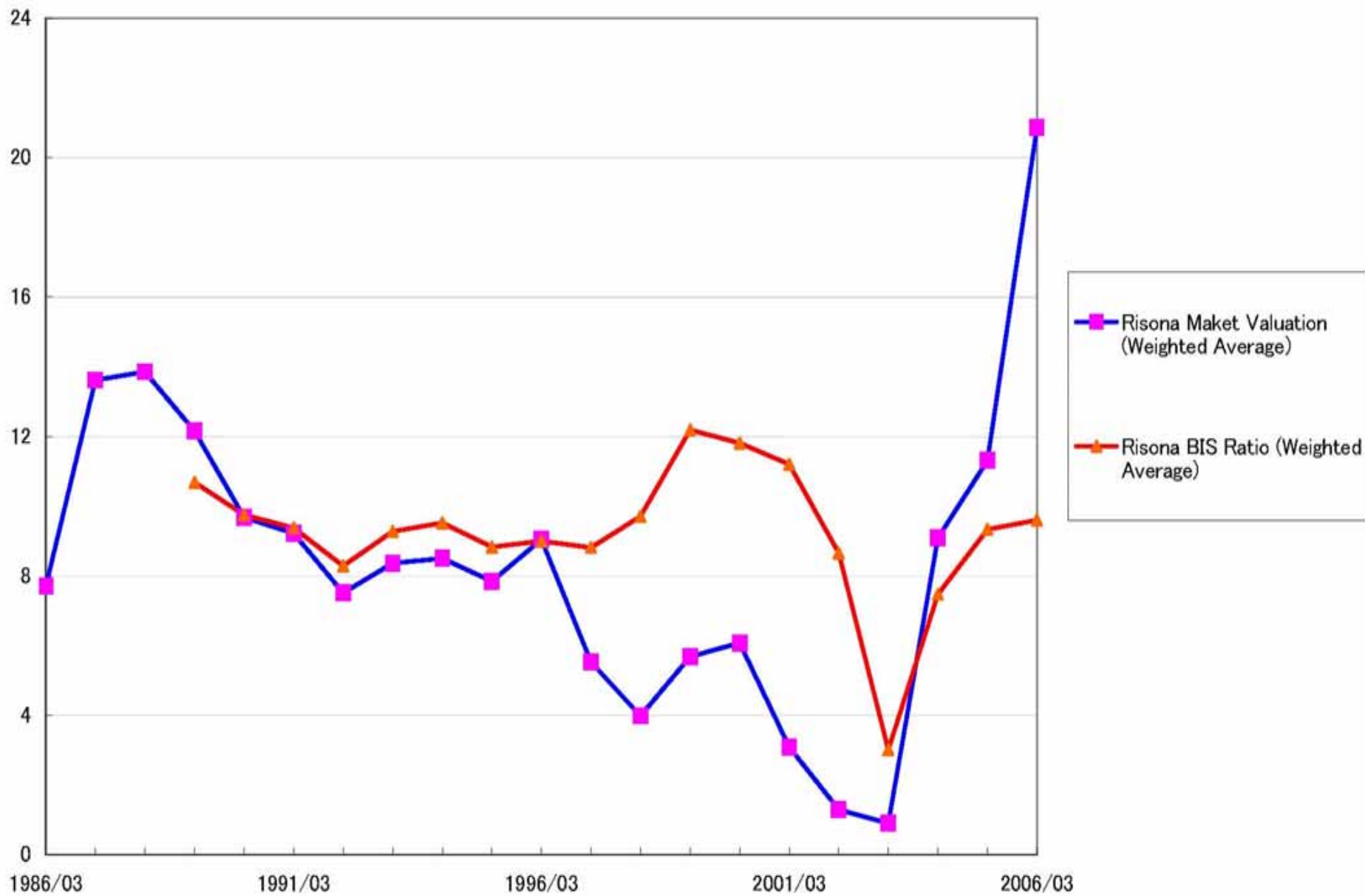


Fig. 10 Hokkaido Takushoku Bank

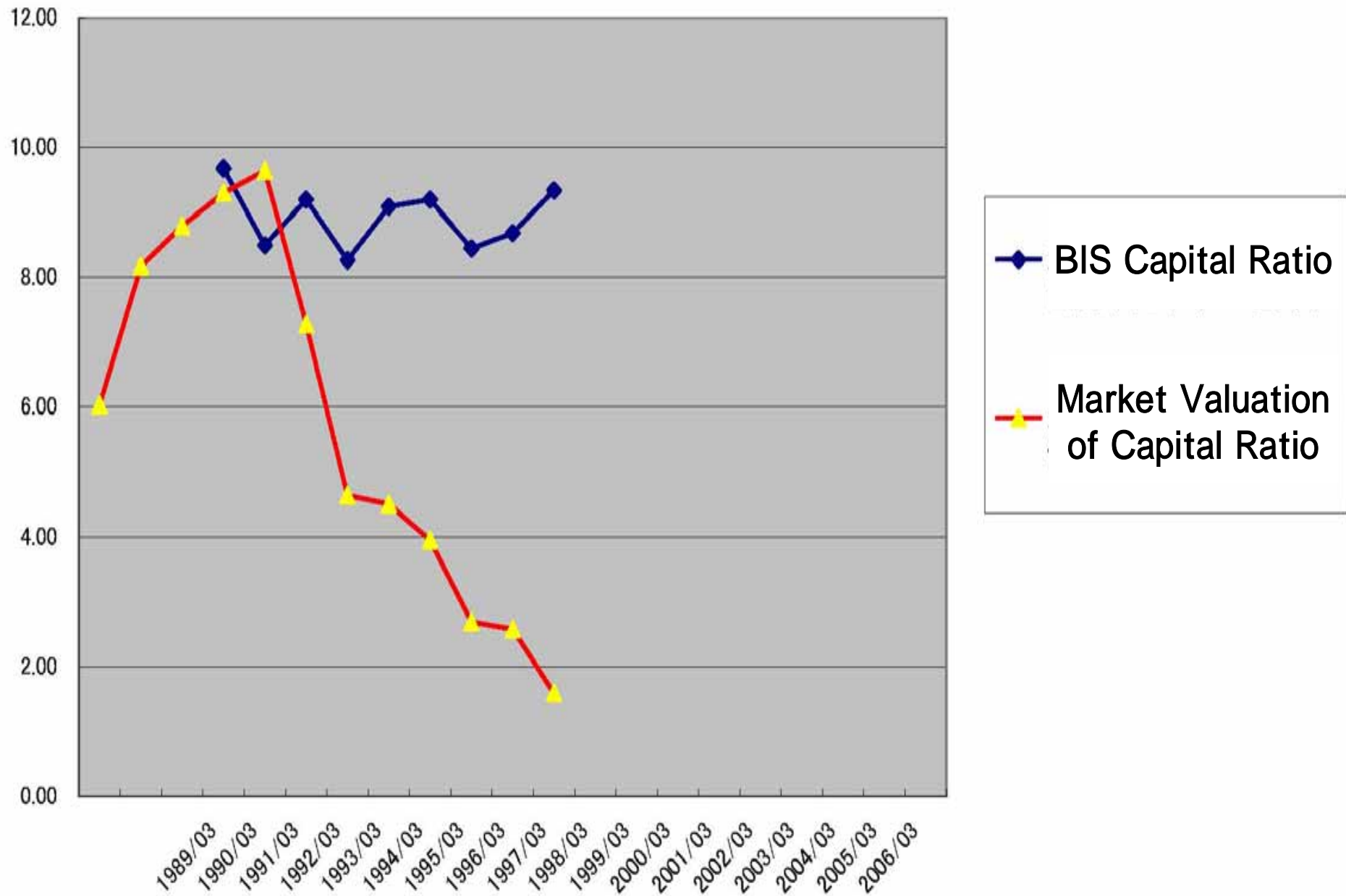


Fig. 11 Japan Long-term Credit Bank

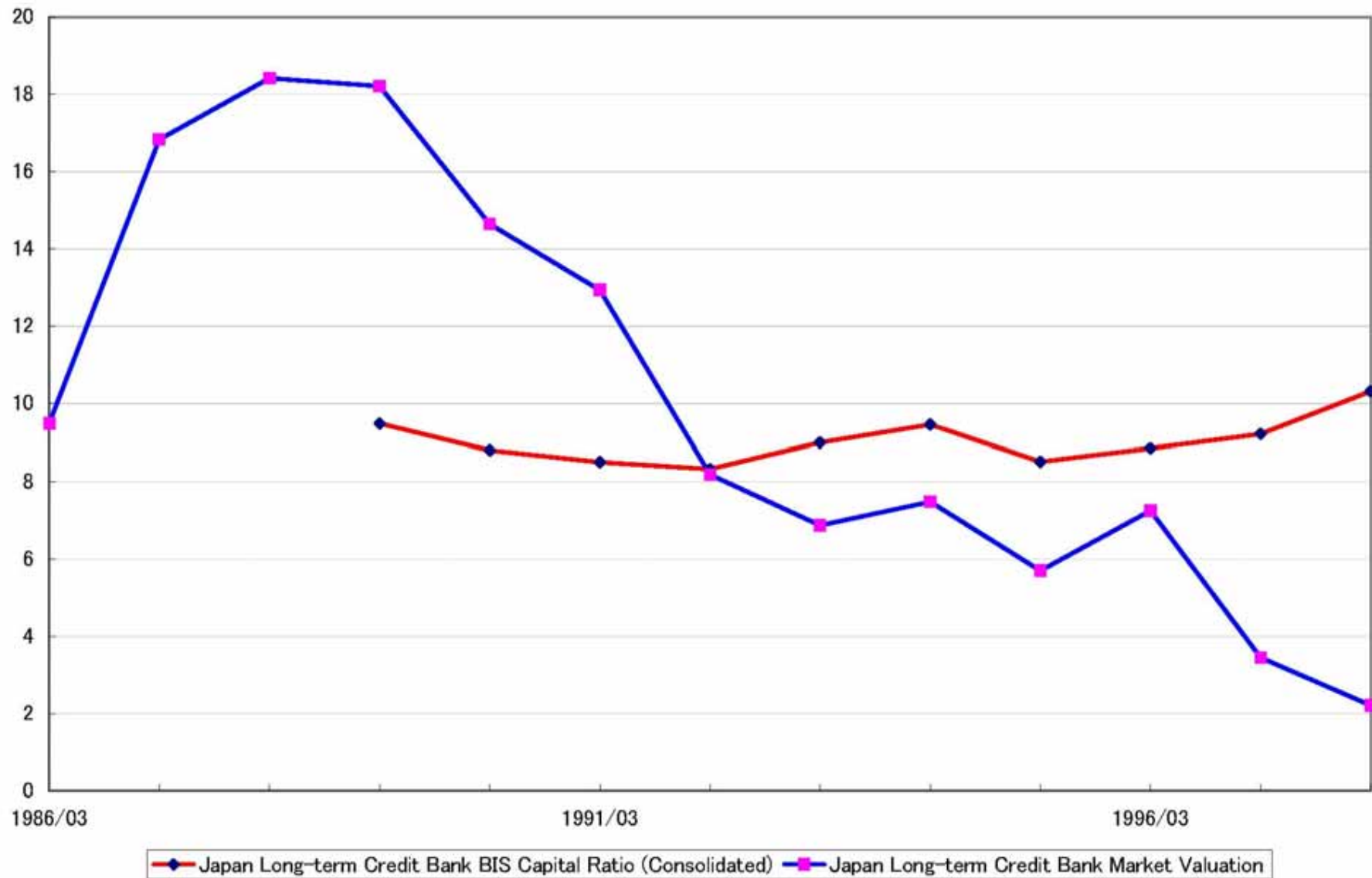


Fig. 12 Japan Credit Bank

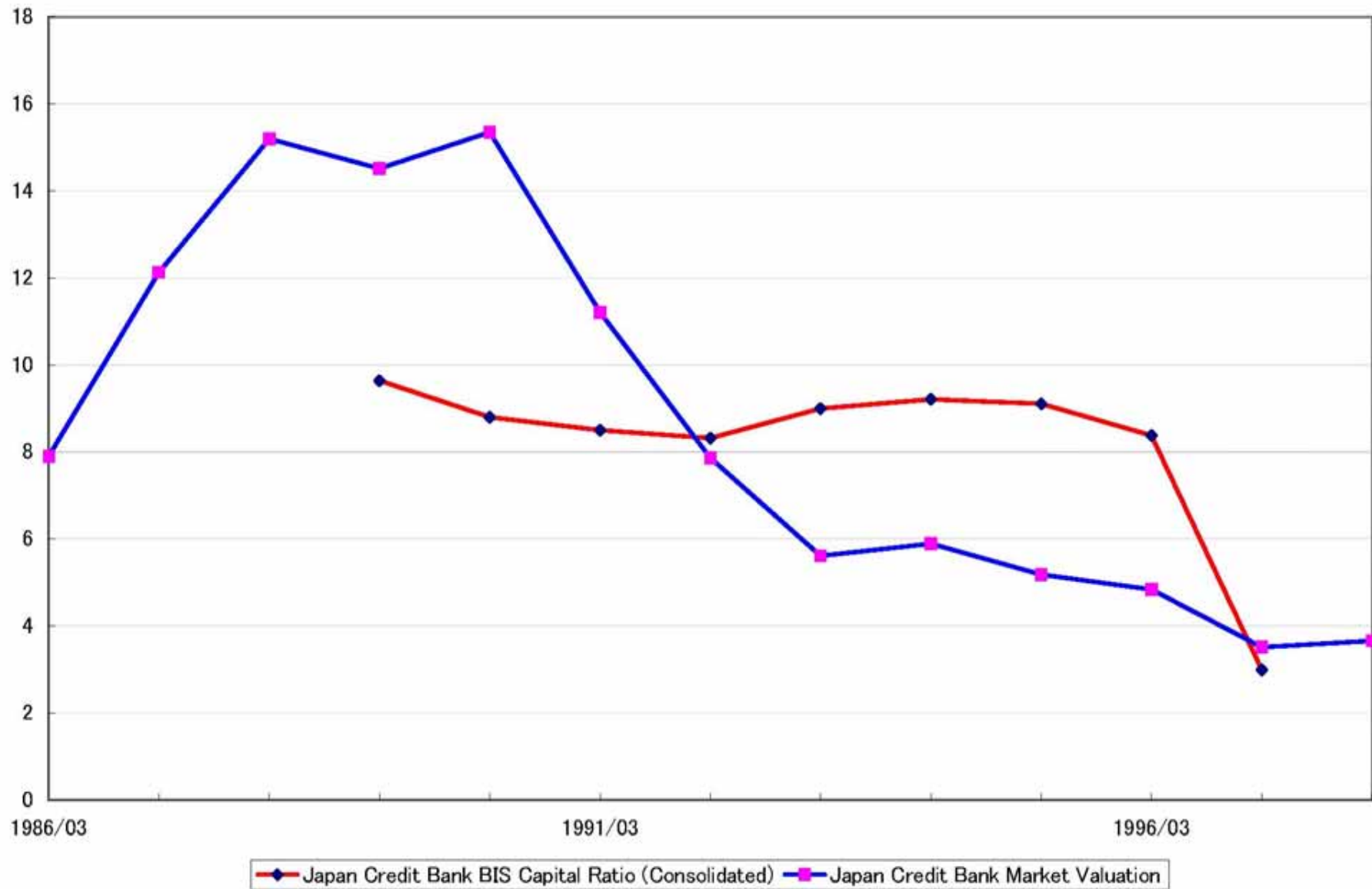


Fig. 13 Ashikaga Bank

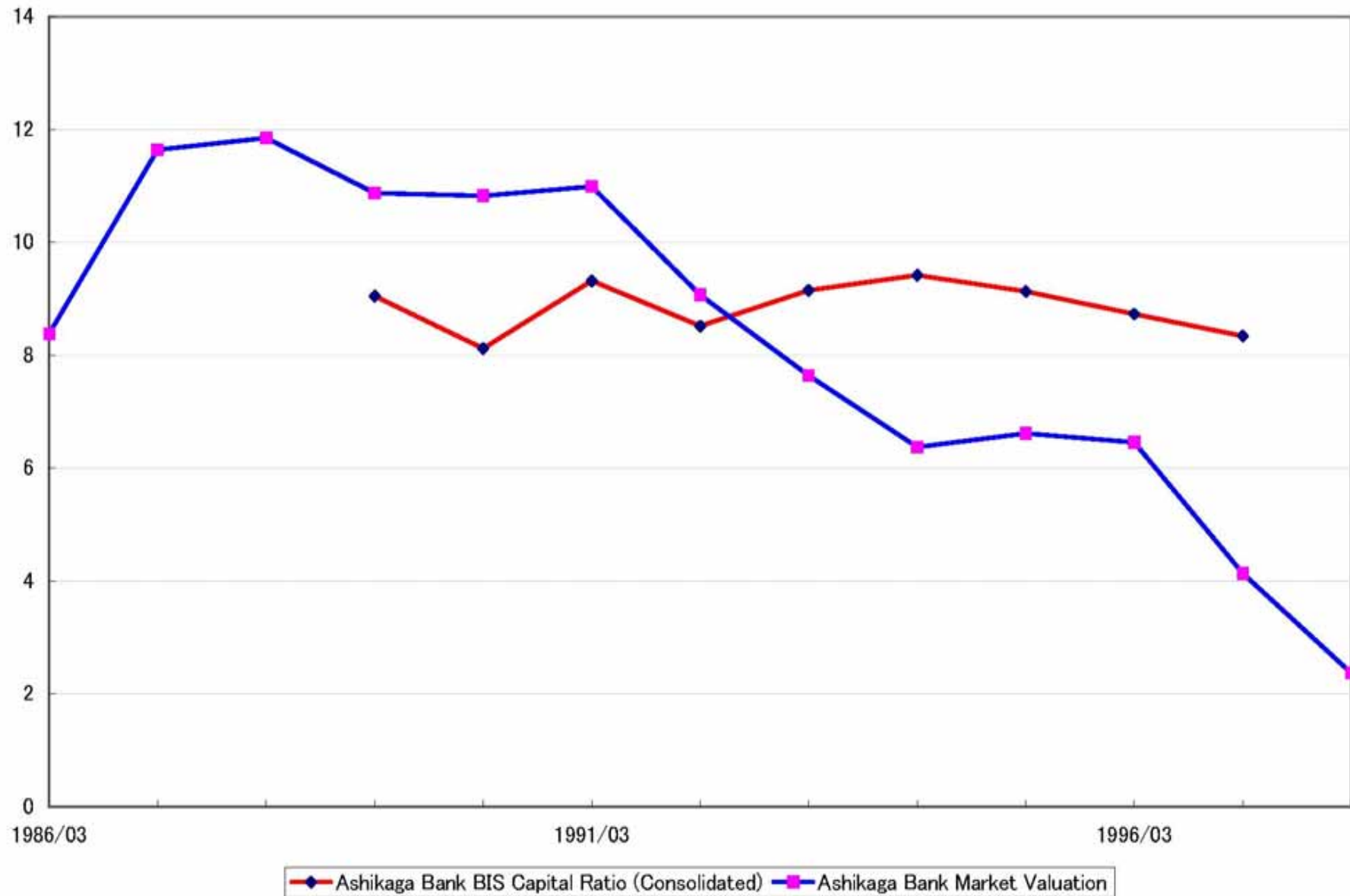


Fig. 14 Bad Loan Ratio: City Banks

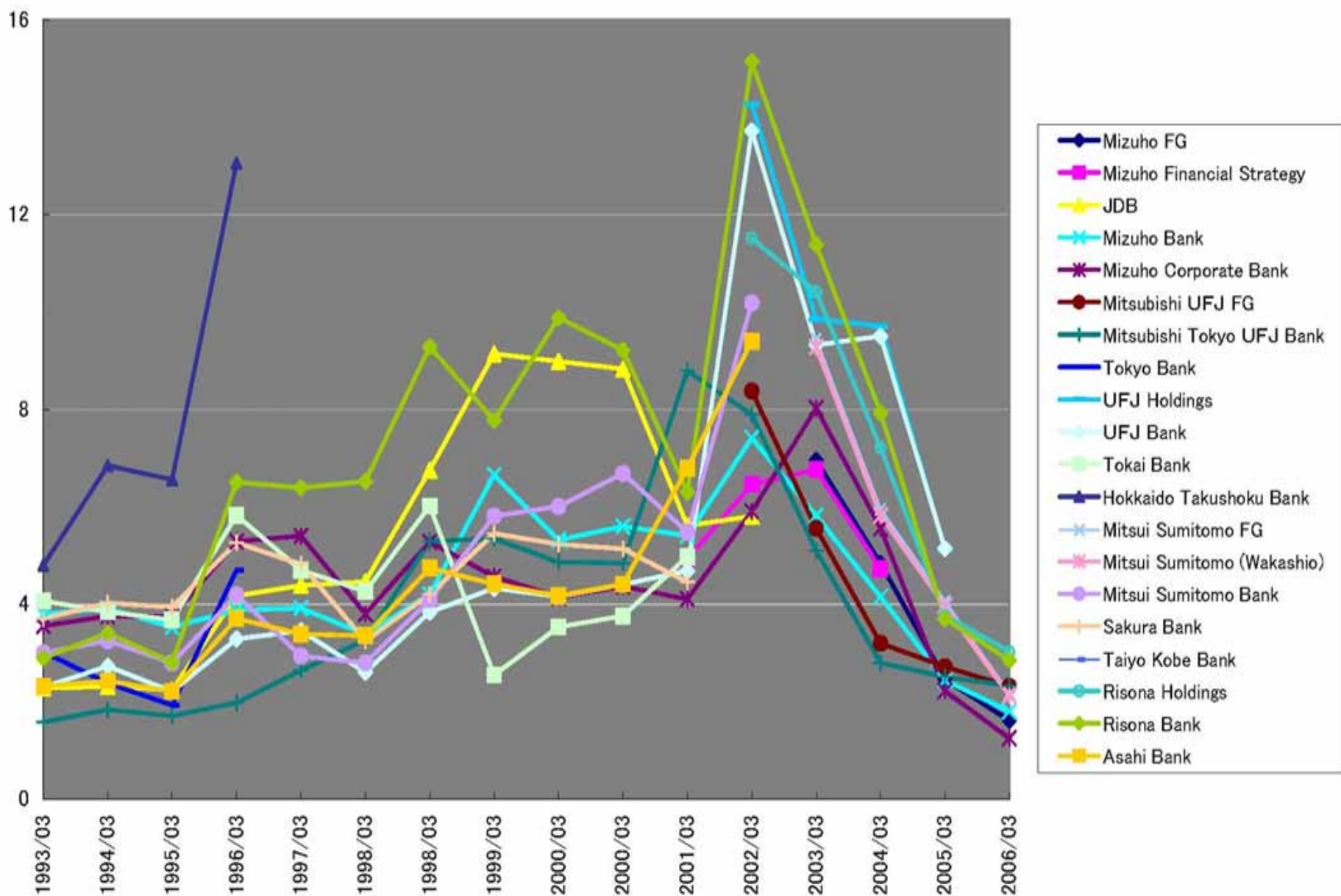
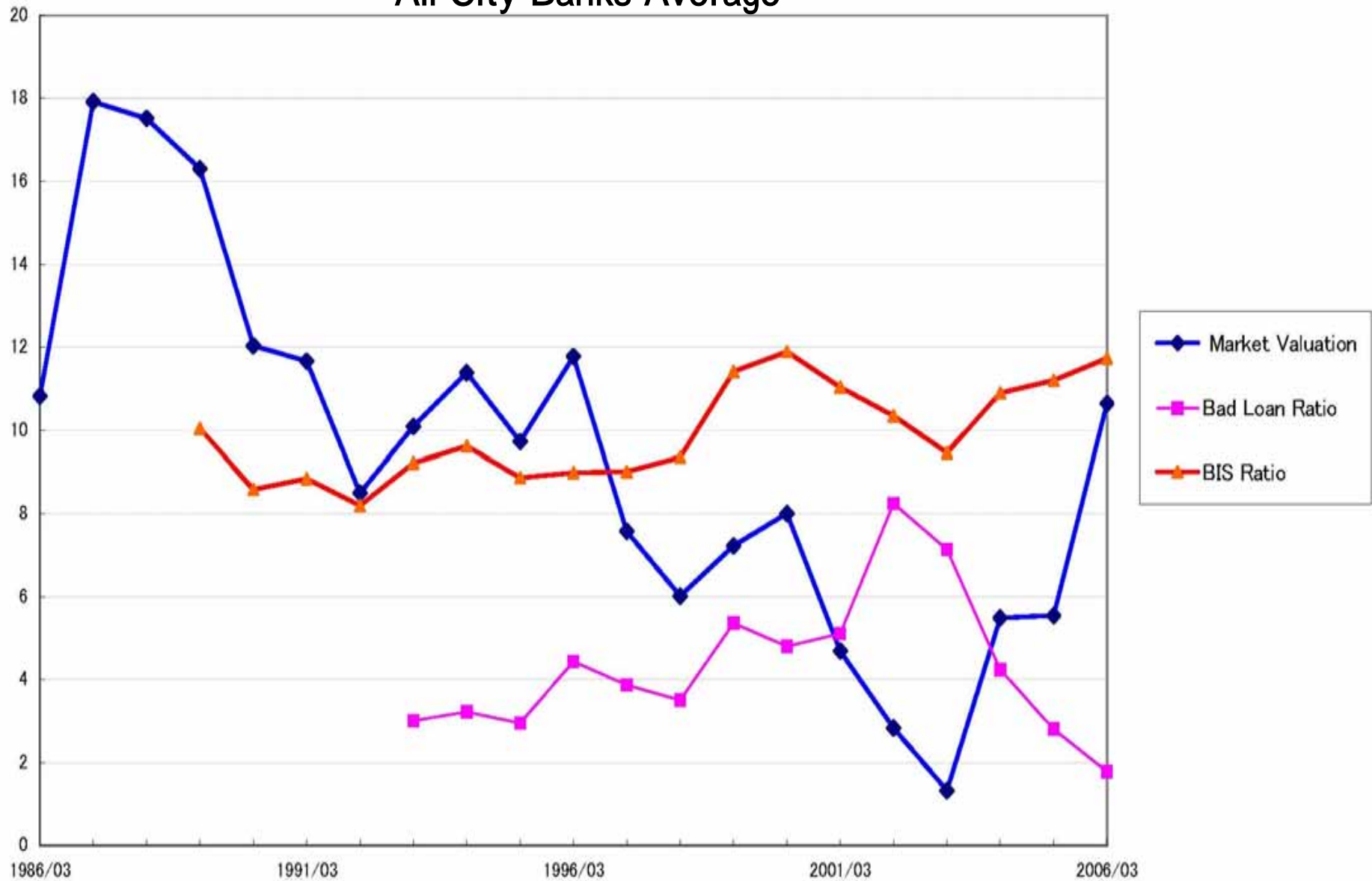




Fig. 15

BIS Ratio, Market Valuation of Capital Ratio, and Bad Loan Ratio:  
All City Banks Average





## Conclusion

### The BIS capital regulation

has been obsolete through technical progress in the last 20 years

has facilitated number of financial innovations that led to

international consolidation of financial markets

(Bank loan markets, Capital markets, Real estate markets, etc.....)

has introduced a greater volatility to the global economy due to its pro-cyclicality.

has facilitated international spread of financial risks

has obscured the real risks

### The Market-valued own capital ratio

is a more accurate & more transparent measure of bank soundness

**Let banks free to choose their own capital ratio**

**Once regulates, governments are captured**

**Let markets free to evaluate & control bank's behavior**

**Moral Hazard is ubiquitous!**

**Need to create global financial system free from moral hazard**