

Remarks by  
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Thanks are owed first to Jim McDonald for doing so kindly by me in his introduction and then, of course, to the Japan Society for asking me to be with you today. My deepest gratitude to the Society, however, is for the heroic work it's done over nearly a century in support of U.S. – Japanese friendship – a friendship that has produced so much of lasting value for all the world's people, but especially for the people of our two countries.

Last year, as you know, the U.S. – Japan relationship marked its 150<sup>th</sup> anniversary. When Commodore Perry's fleet entered Edo Bay, under sail and steam, a new era in world history began. It's a history that's seen tragedy and misunderstanding, to be sure. But on the whole, the relationship between our countries has been eminently satisfactory -- and enormously constructive. The late Akio Morita, with his physicist's eye, used to observe astutely that, in the world of nations as in the world of matter, a certain amount of friction was inevitable when two bodies came into close and interactive contact. The challenge has been to manage that friction in a constructive way – a responsibility that has fallen to diplomats and businesspeople, as well as to well-intentioned private citizens and organizations like the Japan Society.

The excellent state of our relations today attests in a large degree to your success in promoting the free and open exchange of views and information and to our willingness to learn from each other. I offer my remarks today in that spirit.

My most recent personal experience in international diplomacy has been as a member of the Basel Committee on Banking Supervision, which was already well engaged in the process of revising the 1988 framework – Basel I – for setting minimum regulatory capital when I became Comptroller of the Currency six years ago. As you probably know, the Committee recently brought the negotiating phase of this effort to a close with agreement on Basel II -- the risk-based capital rules that will not only guide the internationally active banks of the 13 Basel member countries, but also the many other financial institutions and governments that will undoubtedly subscribe voluntarily to those rules.

Basel II was a product of compromise. The Committee and its staff spent months debating multitudinous and arcane technical issues, such as whether capital levels should cover both expected and unexpected losses – ultimately agreeing that the former should be addressed through reserves -- and how much capital ought to back mortgages and unused credit card lines. We spent months more pondering such existential issues as the meaning of operational risk. And we agonized until nearly the final moment over what not all of us are yet convinced is an achievable cross-border implementation schedule for the new accord.

But at the end of the day, what I like to call the spirit of Basel – the spirit of cooperation and compromise – prevailed. Without anyone bargaining away fundamental

national differences and interests, we produced an agreement that met each of the broad goals that were established when the process began.

Those goals were embedded in three “pillars” upon which the Basel approach was built. The first was a set of formulas for calculating regulatory capital requirements. The second was a set of principles for the exercise of supervisory oversight; and the third, a set of disclosure requirements intended to enhance market discipline. Whatever else the Committee has disagreed upon, there has always been a strong consensus that financial markets have an enormously important role to play as a barometer of the financial condition and risk profile of regulated institutions – as well as a reality check on the job we do as regulators. That’s why Basel II requires that financial institutions improve the quality and quantity of the information they make public, so that financial markets have the ability to make accurate and informed judgments on the health of each institution – and on the degree to which the accord itself is being observed and applied in each country.

We – the central bankers and bank supervisors who negotiated Basel II – drew on our own recent experience in hope of building a sustainable, stable global financial order. Recent history has taught us that where supervisory rigor has slipped -- and where financial markets have been unable to make informed judgments, based on full and accurate disclosure, about the true condition of financial institutions -- the consequences for the international financial system can be severe.

Both the United States and Japan can speak to this outcome from first-hand experience. Indeed, for Japan, that experience is still unfolding today.

I don't know whether anyone else noticed the anniversary that passed earlier this year. In March 1984 – 20 years ago -- the Empire Savings Bank of Mesquite, Texas failed. It turned out to be the first of many U.S. savings and loan failures. Empire wound up costing taxpayers \$300 million to resolve – a small drop in the ocean of red ink that's now up to \$132 billion – the Government Accountability Office estimate of what the failure of the thrift industry has cost taxpayers. And even that number does not include the potential cost to taxpayers from the so-called “net worth” cases still pending in the courts today. Twenty years later, and Americans are still paying!

In Empire's case, criminal misconduct compounded the underlying economic problems that ultimately would nearly doom a whole industry. S&Ls in the late 1970s were trapped in a classic interest-rate mismatch. Locked into long term, fixed-rate mortgage contracts, thrifts had to pay volatile market rates for funding. When interest rates moved into the high teens in the late 1970s, the real economic value of thrift assets plummeted. Regulators sat by, taking no effective action to force thrifts to restore their disappearing capital, pretending that book values, representing original acquisition costs of mortgages, had meaning. By 1980, the industry as a whole was insolvent on a mark-to-market basis. Yet hundreds of “zombie” institutions were allowed to remain in business.

The legislative response did not help. Congress thought the industry could “earn” its way out of insolvency, so it eliminated interest rate controls and raised the deposit insurance limit from \$40,000 to \$100,000, thus allowing thrifts to attract larger- and higher-rate deposits. They then used these funds to make questionable loans and exotic investments. Since insolvent institutions have no incentive to avoid risk, thrifts threw prudence to the winds, hoping to earn their way back to solvency with high returns on

risky ventures. Congress cooperated further with this strategy by significantly expanding the asset powers of the insolvent industry.

Just as damaging – and even more relevant to today’s discussion – were the policies pursued by thrift regulators. Capital requirements for thrifts were dramatically reduced; loan-to-value ratios were eliminated; generous provisions were made for supervisory good will in the acquisition of troubled S&Ls; and accounting rules for thrifts were given the most liberal interpretation possible.

Although forbearance and forgiveness seemed initially to work, those policies merely contributed to a postponement of the day of reckoning, making it infinitely pricier in the end. The thrift crisis taught U.S. supervisors a most painful and costly -- but necessary -- lesson: the importance of acting with independence and rigor and dispatch when the safety and soundness of the institutions under our jurisdiction are in jeopardy. It taught us to resist the temptation to view those institutions through rose-colored glasses, as we would wish them to be rather than as they truly are, no matter how unpleasant that reality may be.

And the S&L debacle spoke to the importance of resisting the inevitable pressures to subordinate lending and bank supervision to politics or to macroeconomic policy. Over the years such interference has taken many forms. Central governments may compel banks to make loans in defiance of good credit practices in order to promote certain policy goals, such as protecting inefficient industries. Governments may take an ownership interest in the banking system to facilitate such policies. In some cases, government pressure has forced financial institutions to lend to weakened, but politically powerful, companies or industries.

Pressure may also be brought to bear on supervisory authorities to forbear – to “look the other way” – when a bank’s condition has deteriorated and supervisory action would be warranted. In some cases, court decisions, legislative action, or other informal influences have undermined supervisors. Where supervisors are removed from office without cause – and appointed to office without regard to their professional competence – the quality of bank supervision inevitably suffers, as we’ve seen in some countries. What may be worse, the ability of financial institutions to support an economy’s growth – to take on sound credits that lead to business expansion, job creation, rising living standards – may suffer, too.

Japan is certainly no stranger to these pitfalls. Virtually every analysis of the Japanese banking crisis points to the same regulatory failures we experienced in the U.S. during the S&L crisis -- lax accounting and disclosure requirements, regulatory forbearance, a compromised regulatory independence, and various policy missteps that prevented regulators from coming to grips with the magnitude of the crisis -- as factors of scarcely lesser magnitude in bringing on that banking crisis than falling asset values and mismanagement on the part of Japanese financial institutions themselves.

A taste of this literature is instructive. The “failure to create a prudential regulatory system” to replace Japan’s postwar system of regulated interest rates and constrained competition, according to Hugh Patrick of Columbia University, was “the first cause of [Japan’s] banking crisis.” A year 2000 IMF Working Paper points to weak corporate governance and regulatory forbearance as the two factors that, “by contributing to what might have been an unnecessary prolongation of the crisis, inevitably raised the cost of the final resolution.” And even more saliently, in an essay entitled “Japan Now

and the United States Then: Lessons from the Parallels,” Harvard’s Benjamin Friedman observes how Japanese supervisors in the Ministry of Finance not only repeated but exceeded the misguided forbearance policies of their U.S. counterparts, permitting Japanese banks to defer charging off credits that the market viewed as patently valueless. By the late 1990s, Friedman notes, the situation had reached the point of farce: every official pronouncement of the capital position of Japanese banks was dismissed as fiction and private analysts viewed all Japanese banks as essentially insolvent, no matter what the banks and the government – or the actual facts -- said.

Of course, as I’ve noted, while the United States is still paying dearly for the S&L crisis, we’ve recognized the folly of the supervisory behavior that contributed to it, and taken steps, both legislative and regulatory, to prevent a recurrence of that outcome. The FDIC Improvement Act -- FDICIA -- with its provisions for Prompt Corrective Action, virtually foreclosed the possibility that institutions will be allowed to continue racking up loan losses after they become technically insolvent.

Regulators – and I can certainly speak for the OCC in this regard – have, I think, demonstrated in recent years by our actions as well as our words, that we too are determined not to repeat the mistakes of the past – at least to the extent that those mistakes owe to wishful thinking and failures of nerve.

No one can promise a future free of conflict or crisis. Indeed, we would be far safer to assume that such crises will come. But I feel confident enough to say that the lessons of the past – and the commitment to an independent, muscular, proactive brand of supervision that flows from them -- will not be soon forgotten. At the OCC, we’re doing everything in our power to assure that these lessons are being studied, memorialized, and

passed down to the next generation of bank supervisors, to be incorporated into our training materials and our supervisory folklore.

The fact that the principles of supervisory rigor, transparency, and market discipline have received the global recognition implicit in their incorporation into the Basel framework, I think, offers additional reason for hope.

Just as we cannot know what crisis may lie ahead for the U.S. banking system, neither can we predict the outcome of the Japanese government's courageous efforts to resolve its still ongoing banking crisis – a crisis now well into its second decade. What we do know is that this painfully protracted crisis has taken a profound toll – not only on Japan's productive capacity and on the standard of living of her people, but also on the credibility of her governing system, both domestically and internationally.

But with the steps that have been taken, especially of late, Japan and the world finally have reason for optimism. I take heart that Japan has looked not only within itself but also to its friends and partners in the global economy for assistance and inspiration in addressing its problems. In this context, perhaps the most important step forward that Japan has taken – an indispensable step -- was the creation of the Financial Supervisory Agency (FSA) as an independent regulatory body outside of the Ministry of Finance, in 1998. And while many market analysts greeted the FSA's Financial Revival Program with a certain skepticism when that program was first announced two years ago, it has gone on to produce impressive results. Nonperforming loans are down dramatically, by as much as 50 percent since 1998, as banks continue to liquidate bad loans. The share prices and profits of leading banks have risen, in some cases dramatically. And banks are



taking action against the country's own corporate "zombies," regardless of how politically connected they might be.

Going forward, that should mean that good borrowers, having been so long starved for capital, will once again be in a position to obtain credit, fueling innovation, productivity, and employment growth. That will obviously be of huge benefit to the entire Pacific economy and to the world.

But while many of the most glaring shortcomings in Japan's pre-crisis supervisory system have now been addressed, the crisis itself is still with us. There remains a considerable residue of distrust and cynicism in the marketplace – a cynicism born of years of misinformation and mistrust about goals stated but unmet and then abandoned. Japanese bank supervisors will need to dip deep into their reservoir of professionalism and independence to persist in the actions they know are imperative to bring genuine reform to Japan's banking system – and genuine hope to Japan. Some of those actions will undoubtedly carry a heavy political cost. I do not underestimate for a moment the hard choices the FSA will be called upon to make.

But the past decade teaches us – all of us -- that forbearance and turning away from the facts are not the answers. After 15 years, Japan knows this better than anyone. It is past time for Japan to put its problems behind it and move on to a brighter future. There is no other way.

In taking these actions, courageous and forthrightly, Japanese supervisors will have the support of the community of their international peers.

If there is a single purpose in my being here today, it is to express that support.