

Lessons from Bank of Japan's experience during the banking crises of the 1990s and the new dimension to LOLR stemming from the global financial crisis

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Lessons from the Japanese banking crisis of the 1990s

During the Japanese banking crisis of the 1990s, the Bank of Japan (BoJ) extensively exercised its lender of last resort (LOLR) function. Three main lessons emerge from this experience. First, "constructive ambiguity" can become counterproductive, or even destructive. Once a crisis erupts, we should be quite clear about the conditions on which LOLR support is extended. If ambiguity persists, depositors will run and interbank lenders will back away. Thus, ambiguity can fuel market disruptions. This is why the BoJ established principles that guide the provision of LOLR support. One set of principles aims at protecting the central bank as the provider of liquidity support, including the principle that that systemic risk must be imminent when such action is undertaken. Another set of principles reflects the idea that beneficiaries of liquidity support should be penalised in order to contain moral hazard. These latter principles include replacing the management of a failed bank; and wiping out the existing shareholders. The conditions set out in these principles are publicly known and still hold today.

The second lesson is that distinguishing illiquid from insolvent institutions is not easy. Conventional wisdom says that only solvent but illiquid banks should obtain LOLR support. However, in practice, most, if not all, bank failures start with liquidity problems that later develop into solvency problems. We have also learned that it is not only banks that can trigger a systemic crisis. Indeed, we were forced to recognise that non-bank financial institutions, such as security firms and insurers, can be the source of a market-induced systemic crisis.

The third and related point is that the scope of the LOLR function depends on how wide the existing safety net in the financial system is. The safety net arrangements in Japan during the 1990s were underdeveloped and lacked mechanisms to deal with undercapitalised banks and with problematic non-bank systemic institutions. For this reason, the BoJ's responsibility for financial system stability became that much larger and the scope of the LOLR function correspondingly wider. The BoJ provided some ailing banks with capital; it created a bridge-bank on its own; and it provided liquidity to a troubled non-bank security firm. We took these decisions because we judged they were necessary to maintain financial stability. However, the BoJ ended up by incurring credit losses in excess of 200 billion yen (2 billion dollars). Since then, Japan's financial safety net has been

¹ See also "Financial Crises and Central Banks' Lender of Last Resort Function," Remarks by Hiroshi Nakaso, Deputy Governor of the Bank of Japan at the Executive Forum Hosted by the World Bank, 22 April 2013, www.boj.or.jp/en/announcements/press/koen_2013/data/ko130423a1.pdf.

reshaped by a series of legislative measures, so that today the scope of the BoJ's LOLR function has become much narrower.

The global financial crisis and LOLR

Let me now move on to the new dimensions that the recent global financial crisis has added to the LOLR function. Let me focus on two aspects.

The first is the role of what may be called the *market-maker of last resort*. During the crisis, it became clear that systemic risk can be magnified through mutually reinforcing declines in funding and market liquidity. A prime example is the developments in autumn 2008, when money markets become dysfunctional because of heightened concerns among market participants about counterparty credit risk. In response, central banks provided liquidity in key funding markets through various forms of open market operations. These included the Fed's provision of liquidity to issuers of commercial paper (CP) and holders of asset-backed securities (ABS), and the BoJ's outright purchases of CPs and corporate bonds. In the same vein, at the height of the euro area sovereign debt crisis, the European Central Bank (ECB) conducted large-scale long-term refinancing operations (LTROs) on a full allotment basis to address market fragmentation. As these measures substituted for the intermediation function of markets, we can probably say that a central bank's LOLR function has evolved to encompass the role of market-maker of last resort.

The second dimension I would like to highlight is the role of what may be called the *global lender of last resort*. The global financial crisis demonstrated that systemic risk can spill over across national borders. Deepening financial globalisation has been associated with financial institutions broadening their intermediation activities into non-home currencies. During the recent financial crisis, US dollar liquidity shortage became an acute concern, especially among European banks. In response, the ECB and the Swiss National Bank each entered into swap arrangements with the Federal Reserve at the end of 2007 to obtain dollars for onward transmission to financial institutions operating in their respective markets. The BoJ, the Bank of England, and the Bank of Canada joined in after the collapse of Lehman Brothers. With the deepening of Europe's sovereign debt problem, this arrangement was reinforced in 2011 into a network of bilateral swap arrangements that provides the six participating central banks with access to the major currencies other than the US dollar, should a liquidity crunch occur in these currencies. This is now an open-ended arrangement. I think one can say that this provision of non-home currencies under central bank cooperation embodies the role of a global lender of last resort.

Having lived through these eventful years, my observation is that, although the importance and the essential nature of a central bank's LOLR function has remained the same, the ways in which this function is exercised have evolved. Bagehot's principles may well have to be rewritten in the new context. I think the central banking community needs, perhaps more than ever, to work closely together in order to constantly refine their LOLR tools with a view to meeting the potential challenges arising particularly from globalisation and thus better withstanding future shocks.