Session 6
Financial Regulation: convergence or divergence?

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I. Main Issues of International Financial Regulatory Reform Agenda

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(1) Capital/Liquidity Regulation for Internationally Active Banks (Basel III)

(2) Systemically Important Financial Institutions (SIFIs)

(3) Shadow Banking

(4) OTC Derivatives Markets Reforms

(5) Structural Reform (Volker, Vickers and Liikanen)

(1) Basel III - Overview

Raised minimum capital requirement
Raised minimum Common Equity Tier 1 ratio and Tier 1 ratio

Raised quality of capital
① Applying regulatory adjustment to CET1
② Stricter criteria for Tier1 and Tier2

$$\text{Capital ratio} = \frac{\text{Capital}}{\text{Risk Weighted Asset}}$$

Introducing quantitative liquidity standards
① Liquidity Coverage Ratio（To strengthen buffer against run-off during stress periods）
② Net Stable Funding Ratio（To make sure long and stable funding corresponding to long maturity assets）

Strengthened risk coverage
Revised metric for capital charge to counter party risk

Back stop

Constrain the build-up of exposure

$$\text{Leverage Ratio} = \frac{\text{Capital}}{\text{Non-risk based exposure}}$$

Reducing procyclicality
Constraints on capital distribution
（Constraints on dividend payments, share-backs and staff bonus payments etc. until the bank’s capital reaches the target of Capital conservation buffer）

（For reference） Phase-in Arrangements of Basel III

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Leverage Ratio	Supervisory monitoring		Parallel run : 1 Jan 2013 – 1 Jan 2017 Disclosure starts : 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.5%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Liquidity coverage ratio （LCR）	Observation period begins				Introduction as a minimum standard				
Net stable funding ratio（NSFR）	Observation period begins							Introduction as a minimum standard	

（Note 1） All dates are as of 1 January. Blue shading indicates transition periods.

（Note 2） Green shading indicates new type of quantitative regulations which are introduced in Basel III.

(2) Systemically Important Financial Institutions (SIFIs)

○ To address the problem of "too big to fail", which is associated with bail-out of some large financial institutions using tax-payers money during the financial crisis, following measures are discussed and will be implemented for Systemically Important Financial Institutions (SIFIs): (1) regulatory framework for preventing failure of financial Institutions, (2) framework for orderly resolution, and (3) improving supervisory intensity and effectiveness.

	Global Systemically Important Financial Institutions	Domestic Systemically Important Financial Institutions
Banking	Agreed at the G20 Cannes Summit (November 2011)	Framework was published in October 2012.
Insurance	Work to be completed by April 2013（Consultation document was published on May 2012）	-
Others	Discussions are on-going for market infrastructure and non-bank financial entities	-

(2) Systemically Important Financial Institutions (SIFIs)

Global systemically important banks: assessment methodology and the additional loss absorbency requirement

(1) Assessment methodology of G-SIBs

G-SIBs are selected (and then published), using indicators which reflect 5 risk categories: a) "Cross-jurisdictional activity", b) "Size", c) "Interconnectedness", d) "Substitutability/financial institution infrastructure" and e) "Complexity".（On the list based on end-2011 data, which was published on November 2012 , 28 banks, including 3 mega-banks from Japan, were identified as G-SIBs. The list will be updated on every November.

*A D-SIB(domestic systemically important bank) framework was also published. It is best understood as taking the complementary perspective to the G-SIB regime by focusing on the impact that the distress or failure of banks (including by international banks) will have on the domestic economy. The assessment and application of policy tools should allow for an appropriate degree of national discretion.

(2) Additional capital required

Magnitude

G-SIBs are allocated into following 4 buckets according to their importance. Capital requirement is posed according to the bucket above the Basel III standard.

5th bucket (Empty)	(3.5% Common Equity)
4th bucket	2.5% Common Equity
3rd bucket	2.0% Common Equity
2nd bucket	1.5% Common Equity
1st bucket	1.0% Common Equity

(3) Implementation

The additional loss absorbency requirement will be phased in, starting in January 2016 with full implementation by January 2019.

(This schedule is consistent with the phased-in arrangement of capital conservation buffer of Basel III)

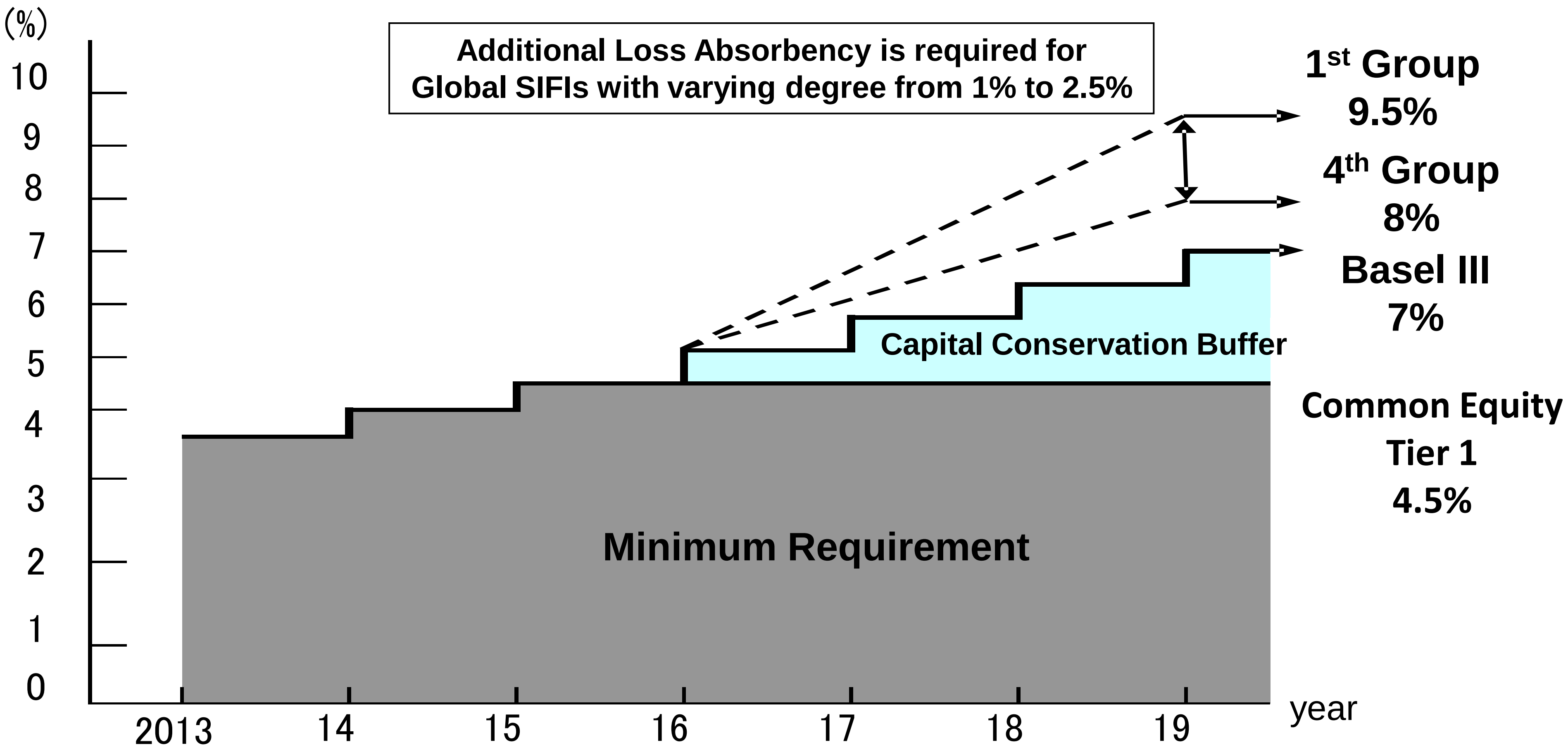
（For reference）List of G-SIBs

Financial Institutions identified as G-SIBs based on end-2011 data (Published in November 2012)	
【5th bucket（3.5% ※）】	【1st bucket（1.0% ※）】
–	**Bank of China**
【4th bucket（2.5% ※）】	BBVA (New)
Citigroup	Group BPCE
Deutsche Bank	Group Crédit Agricole
HSBC	ING Bank
JP Morgan Chase	**Mizuho FG**
【3rd bucket（2.0% ※）】	Nordea
Barclays	Santander
BNP Paribas	Société Générale
【2nd bucket（1.5% ※）】	Standard Chartered (New)
Bank of America	State Street
Bank of New York Mellon	**Sumitomo Mitsui FG**
Credit Suisse	Unicredit Group
Goldman Sachs	Wells Fargo
Mitsubishi UFJ FG	(Alphabetical order in each bucket)
Morgan Stanley	
Royal Bank of Scotland	
UBS	
Total 28	

※ G-SIBs are required to accumulate equity capital over regulatory standards of the Basel III according to each bucket.

（For Reference）SIFIs Framework

Additional Loss Absorbency



(2) Systemically Important Financial Institutions (SIFIs) Recovery and Resolution Plans: RRPs

Key Attributes of Effective Resolution Regimes for Financial Institutions（FSB）

11.2. Jurisdictions should require that robust and credible RRPs (…) are in place for all G-SIFIs and for any other firm regarding which its home authority judges it could have an impact on financial stability in the event of its failure.

- **Recovery Plans by Financial Institutions:**

  The plans which identify options to restore financial strength and viability when the firm comes under severe stress.

- **Resolution Plans by Authorities:**

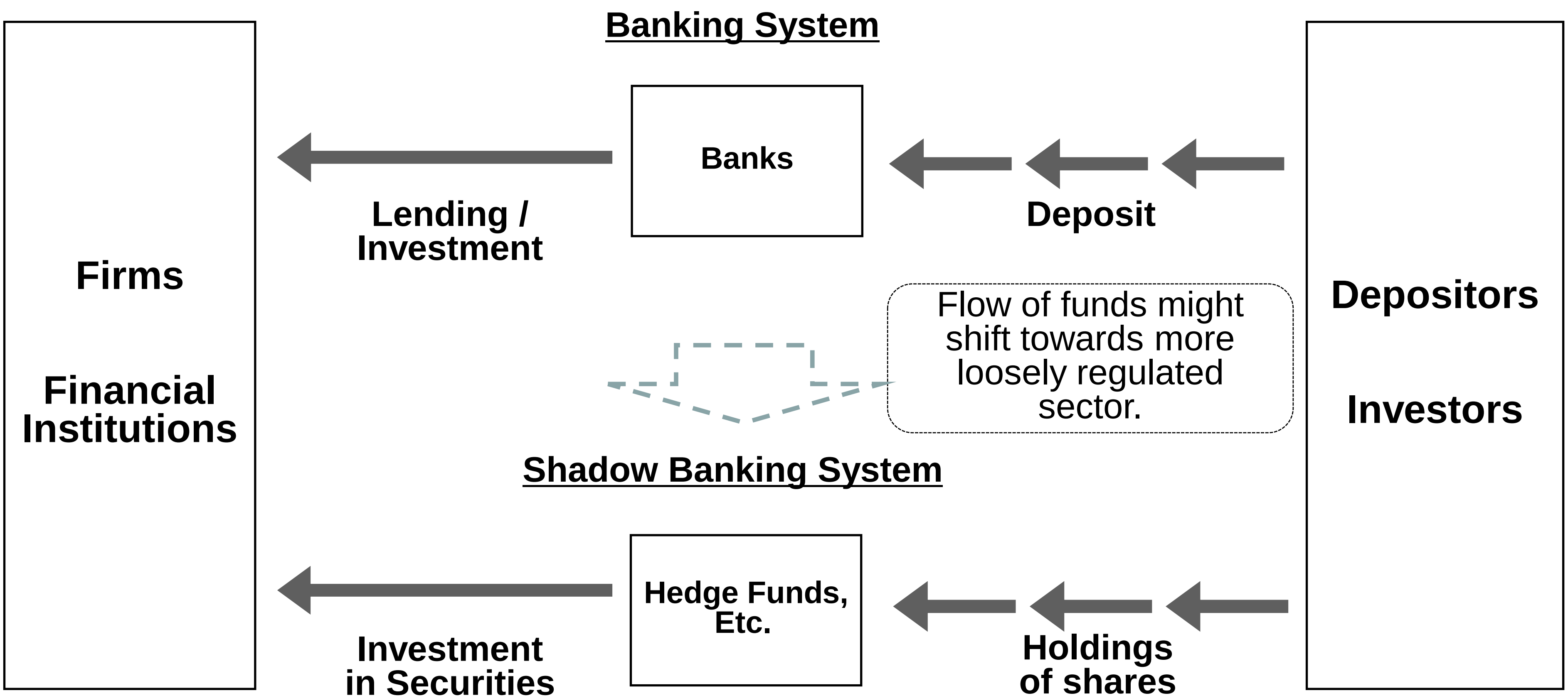
  The plans which facilitate effective use of resolution powers to protect systemically important functions, with the aim of making the resolution of any firm feasible without severe disruption and without exposing taxpayers to loss.

(2) Systemically Important Financial Institutions (SIFIs)
- Increasing the intensity and effectiveness of SIFI supervision

What to do

1. Corporate Governance (Self-discipline)
   (1) Engagement with the Board
   (2) Assessing firm's senior management
   (3) CRO and internal audit functions
   (4) Succession planning
2. Risk appetite and culture
3. Operational risk
4. Follow the money (business model)
5. Stress testing

(3) Shadow Banking (Credit intermediation which occurs outside of banking system)



(3) Shadow Banking (Credit intermediation which occurs outside of banking system)

- After the financial crisis, it has been recognized that entities which conduct credit intermediation like banks, and such activities themselves, are not subject to capital / liquidity regulation and prudential supervision, and hence regulation and supervision on shadow banking need to be strengthened.

- At the G20 Cannes Summit (November 2011), Financial Stability Board (FSB) was asked to build recommendations for regulation and oversight of shadow banking system in the course of 2012.

- Regulation and oversight of following areas are being examined by the FSB etc.
  ① The indirect regulation of shadow banking through banking entities
  ② Money Market Fund（MMF）
  ③ Securitization
  ④ Securities lendings and repos
  ⑤ Other shadow banking entities

(4) OTC Derivatives Market Reforms – G20 Pittsburgh Summit

G20 Pittsburgh Summit

1. All standardized OTC derivative contracts:
   a) should be traded on exchanges or electronic trading platforms, where appropriate; and
   b) cleared through central counterparties.

2. OTC derivative contracts should be reported to trade repositories.

Based on the G20 Summit Statement, regulatory reforms for OTC derivatives markets are being implemented in major jurisdictions

(G20 Summit Deadline: end-2012)

(5) Structural Reform

- **Volcker Rule (October 11, 2011) prohibits the following two activities of banking entities.**
  1. Engaging in short-term proprietary trading
  2. Having certain relationships with a hedge fund or private equity fund

- **UK government (October 12, 2012) published draft Banking Reform Bill to separate retail and investment banking through a “ring-fence”.**
  1. Ring-fenced banks should offer simple products such as deposits from individuals and SMEs.
  2. The lowest level of primary loss absorbing capacity is 17% of risk-weighted assets in the case of UK headquartered G-SIBs.

- **Liikanen group (October 2, 2012) has concluded that it is necessary to require legal separation of certain particularly risky financial activities from deposit-taking banks within the banking group. The activities to be separated would include proprietary trading of securities and derivatives, and certain other activities closely linked with securities and derivatives markets.**

II. Reform implications for East Asia community and Japanese Financial Crisis in late 1990s and early 2000s

Experience and lessons learned

Implications of the reform for East Asian community

1. Basel III and Volker rule

- bank centric financial system
- utility banking business model

⇒ Higher capital requirement and strong liquidity regulation may just result in deleveraging, adverse effects on bank lending, and ultimately a slower growth?

2. SIFIs

- There are no SIFIs in east Asia except Japan and China
- However, there are a home/host issue, and D-SIBs.

Implications of the reform for east Asian community (cont'd)

3. Shadow Banking

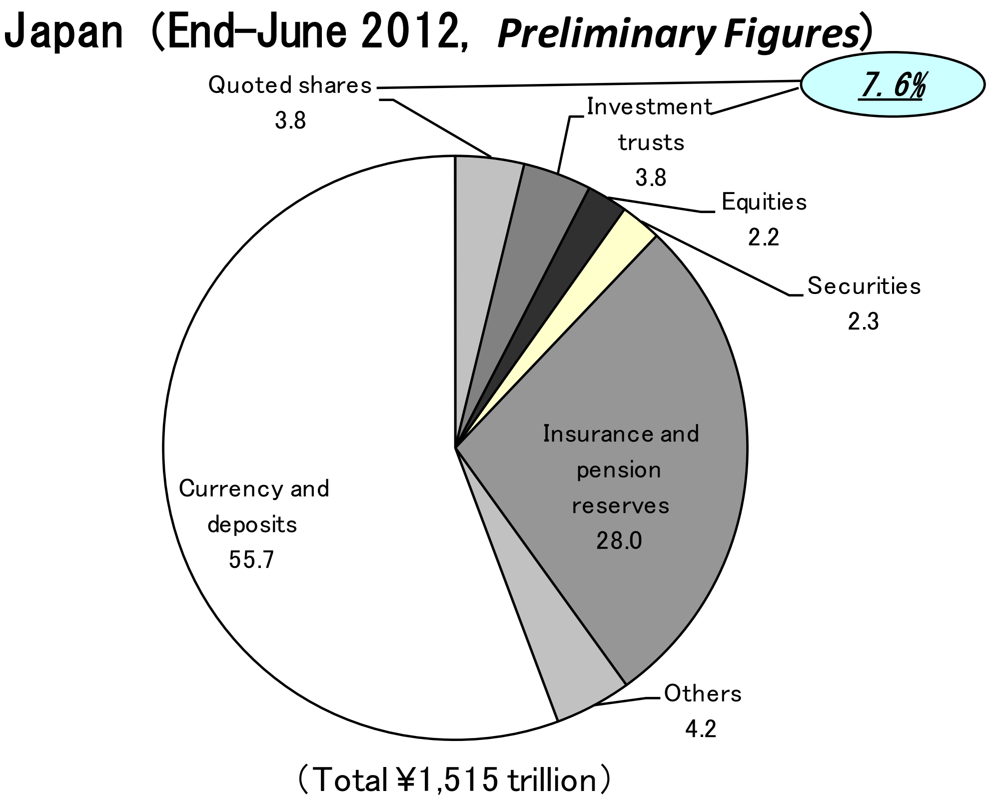
- US (35%), Euro area (33%), and UK (13%) make more than 80%.

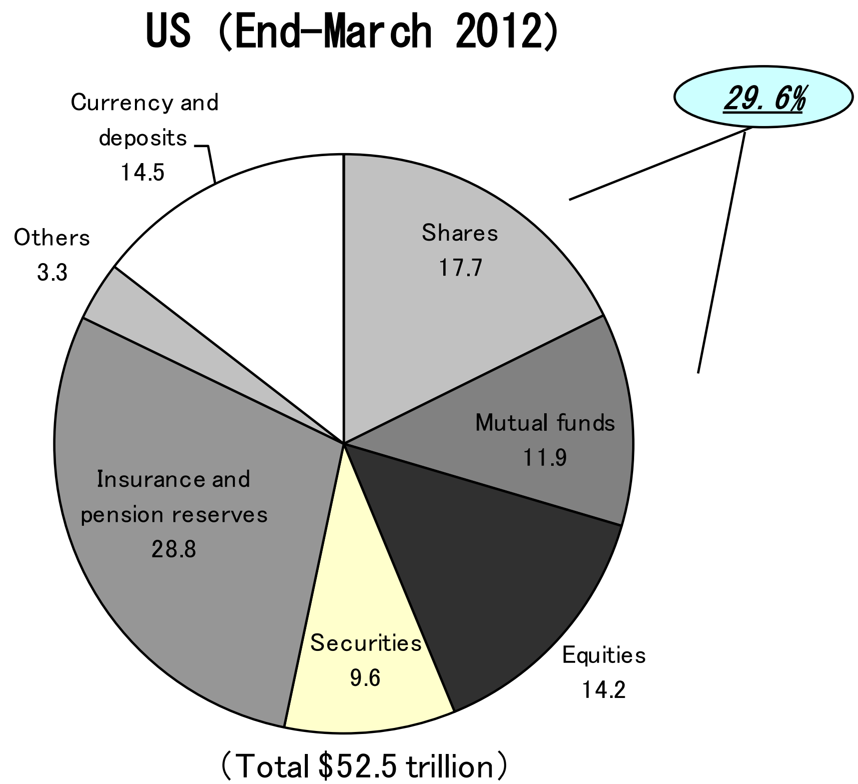
4. OTC derivatives

- not much complex transactions in east Asia?

Financial Asset Allocation of Households, etc.（Japan, Germany, US, UK, France）

In Japan, half of the household asset, relatively higher proportion than other countries, is allocated to currency or deposits.





(Note) Japan: including “households” . US: including “households and “non-profit organizations”
(Sources) Japan: BOJ “Flow of Funds”, US: Federal Reserve Board “Flow of Funds Accounts”

Japan's Experience of Financial Crisis (1)

1970's Two Oil Crunches ⇒ Industrial structural change in Japan
Funding demand by the heavy industry declined ⇒ Bank lending shift from heavy industry to (1) the real estate through home-loan financial institutions
(2) finance and loan companies (shadow banking sector)

1980's Land and equity bubble

1990's Onset and increasing seriousness of the non-performing loan problem
(The authorities did not get the current picture of the size and seriousness of NPLs)
⇒ Patchwork measure on the problems were surfaced

1995 Injection of \680 billion in public funds to deal with bankrupt home-loan financial institutions

1996 Blanket protection of all deposits (pay-offs frozen)

1997 Bankruptcies of Hokkaido Takushoku Bank, Yamaichi Securities
⇒ Inter-bank market was frozen (liquidity)

1998 Intensive inspections of major banks
Nationalization of the Long Term Credit Bank of Japan
(← OTC derivatives market concern)

1999 Financial inspections manual published

Japan Experience of Financial Crisis (2)

2000 Financial Services Agency (FSA) was established
Amendment of the Deposit Insurance Law
- introduction of permanent measures for recovery and orderly resolution of the Japanese SIBs (Article 102)

2001 Write down of non-performing loans was promoted
Special inspections were implemented to major banks

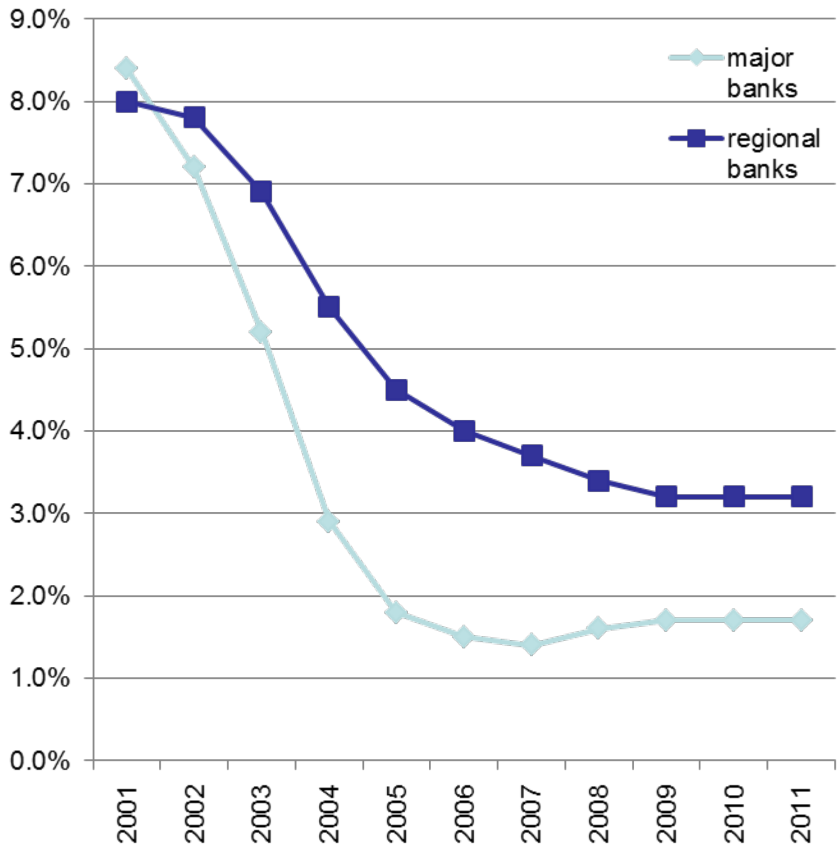
2003 Capital injection into a major bank (Resona Bank) under Article 102
Temporary nationalization of a major regional bank (Ashikaga Bank) under Article 102

2005 End of the blanket deposit protection
(NPL ratio dropped from 8.4% at March 2002 to 2.9% at March 2005)

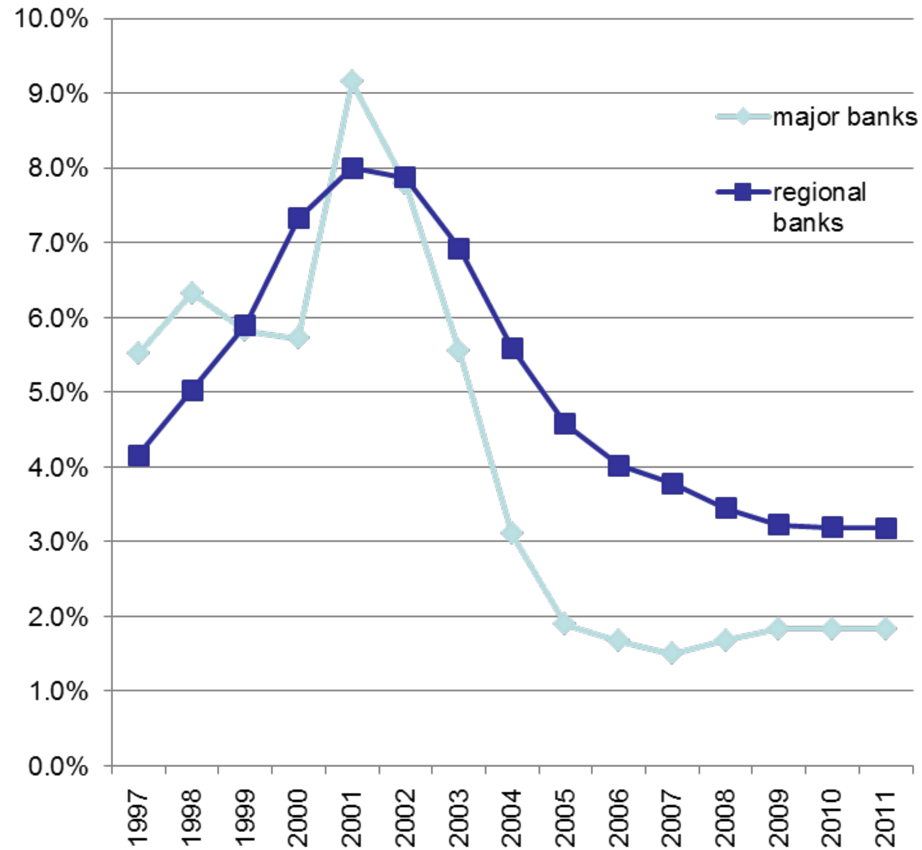
2007 FSA launched the "Better Regulation" initiatives

Japanese Banks non-performing loan rate

Non-performing loan rate disclosed based on the Financial Reconstruction Law

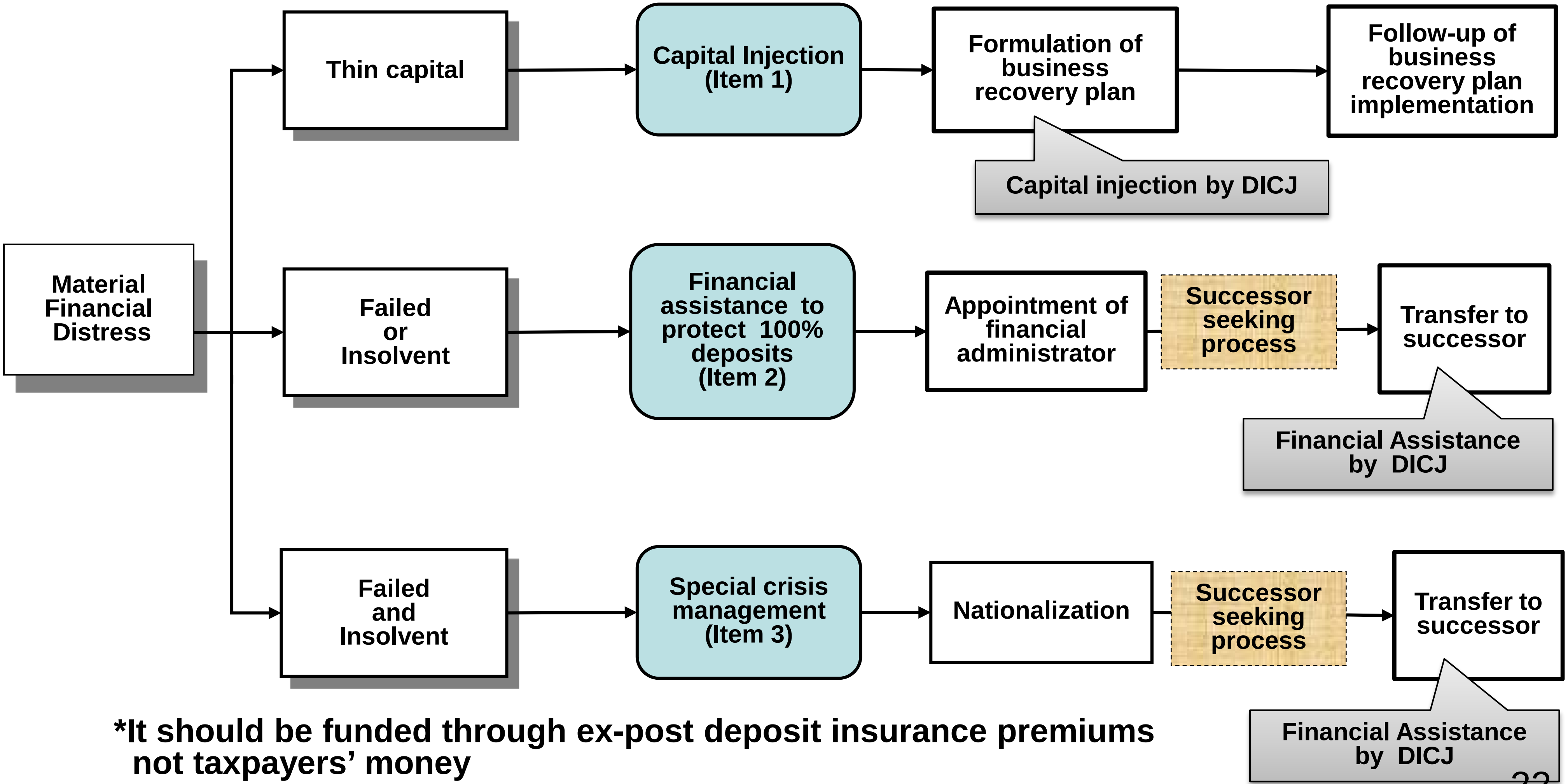


Non-performing loan rate disclosed based on the Banking Law



Deposit Insurance Law (Article 102.)

◆ The measures stipulated in the Deposit Insurance Law, Article 102 can be taken when an extremely serious threat is posed to the maintenance of the credit system in Japan or region where financial institutions are conducting operations.



*It should be funded through ex-post deposit insurance premiums not taxpayers' money

Better Regulation: Outline

I. Four Pillars of Better Regulation: Direction to Take for Further Evolution of Our Supervisory Approach

1. Optimal combination of rules-based and principles-based approaches.
2. Risk-focused, forward-looking approach: prompt & effective response to high-priority issues.
3. Encouraging voluntary efforts by financial institutions and placing greater emphasis on incentives for them.
4. Improving the transparency and predictability of regulatory actions.

II. Specific Areas to Focus on

1. Enhanced dialogue with financial institutions and other relevant parties.
2. Effective dissemination of information.
3. Further cooperation with fellow authorities abroad.
4. Enhanced research functions for prompt recognition of market developments.
5. Human resource development.

Japanese lessons learned

1. **Macro-prudential supervision is important.**
   - macroeconomic development, holistic view on the financial system including the shadow banking sector.

2. **Solid capital requirement is not a panacea, but very important.**
   - pre-requisite for a financial system stability
   - risk buffer for future risk taking

⇒ foundation of economic growth

Japanese lessons learned (cont'd)

3. Measure the size of the hole, and then fix it.

- other than that, the market would not be reassured.

4. Need for <u>supervisory</u> focus more on banks' business model, sustainability and risk appetite

5. Special <u>resolution regime for SIFIs</u>.

⇒ The <u>current internationally agreed reform agenda</u> for the ongoing financial crisis may <u>have relevance</u> even to bank centric financial systems <u>in East Asia</u>

Subprime Loan Crisis and Early implementation of Basel II in Japan

1. Impact of Subprime Loan Crisis on Japan

- **Severely affected by deterioration of the real economy and market volatility**
- **However, the Japanese economy is relatively sound compared with US, Europe**
  - Smaller losses incurred from securitized products
  - Smaller exposure to toxic assets

2. Reasons for relative soundness

- **Japanese firms: not strongly innovation-oriented**
- **Final stage of resolving NPL problems coincided with spread of "originate-to-distribute" model**
- **<u>Improvement in firms' risk management, early implementation of Basel II</u>**

<u>Implementation of Basel II</u>

Japan	**Mar. 2007**
Canada	**Oct. 2007**
Europe	**Dec. 2008**
U.S.	**-**

2008 Sep. Lehman Shock

Early implementation of the Basel II framework encouraged Japanese financial institutions to improve their rigorous risk management and to make more prudent investment decision.

・The exposure of Japan's financial sector to securitization products was significantly smaller
・Losses from these assets were limited compared with the US and Europe

Status of Basel III Adoption

Status of Basel III Adoption (as of 14 December 2012)	Jurisdictions
Final Rule Published (11)	Australia, China, Canada, Hong Kong SAR, India, Japan, Mexico, Saudi Arabia, Singapore, South Africa, Switzerland
Draft Regulation Published (7)	Argentina, Brazil, the European Union, Indonesia, Korea, Russia, the United States
Draft Regulation Not Published (1)	Turkey

Source: BCBS Press Release (14 December 2012)

Examples

Some of the issues that may be considered:

- How to ensure the level playing field between the state banks and private banks.
- Caution may be needed on the potential drive of the private banks to recover the market shares by aggressive lending in the future.
- Liquidity regulation may favor the government bond, and the private sector borrowing may be crowded out.

III. Structural Reform

Structural Reform (1)

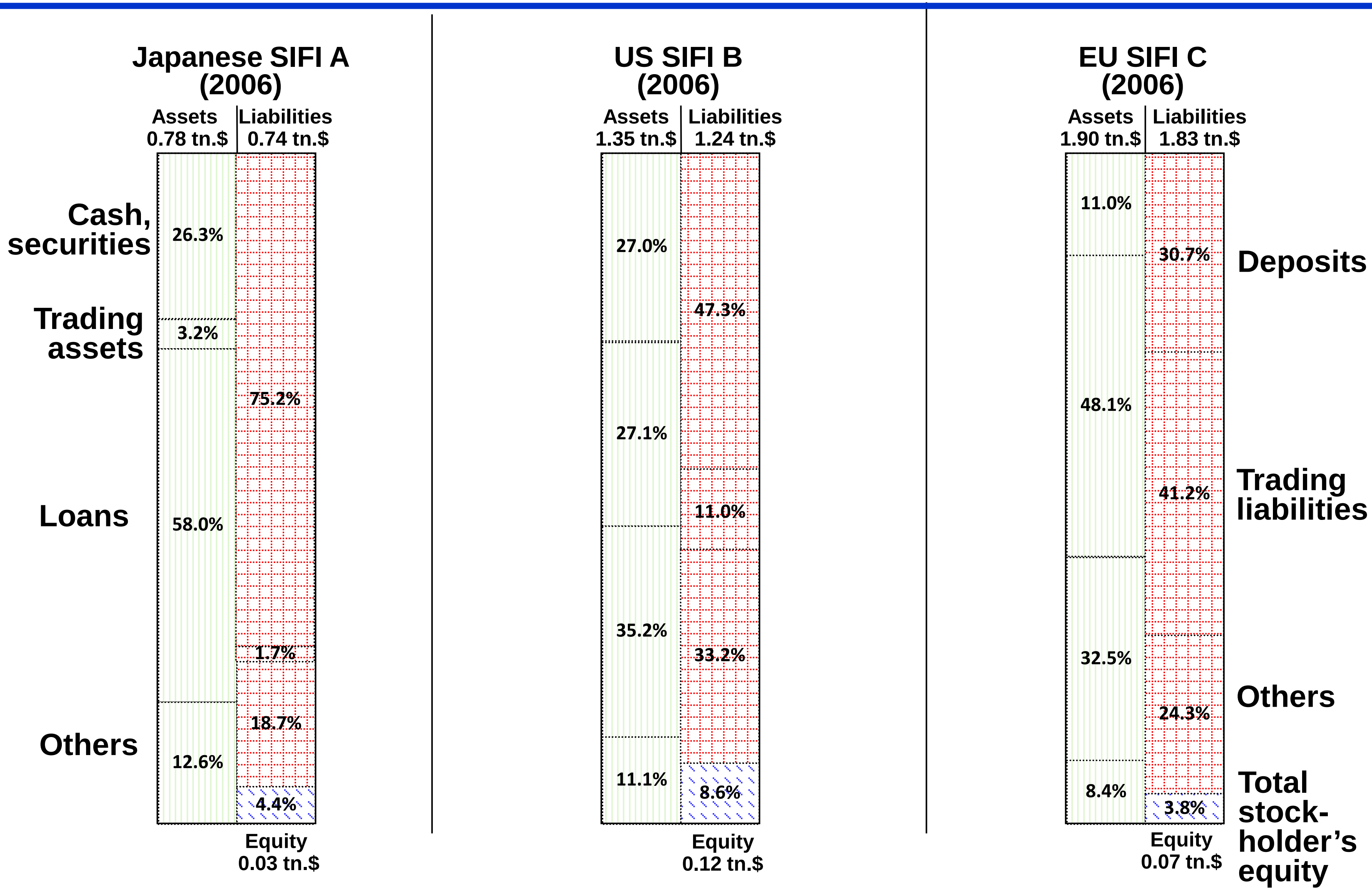
- The background thought of the structural reform
  - Commercial Banking + Investment Banking
    - ⇒ Interconnectedness & Complexity ↑
    - ⇒ Difficulty in an orderly resolution
  - Too important to fail ⇒ Moral hazard ⇒ Social cost
- However, the structural reform may sacrifice to some extent, for example,
  - One-stop shop convenience to the customers
  - Diversification benefits for banks (protection for banks against idiosyncratic shocks to individual lines of business)
- Due attention should also be paid to
  - Concerns are somewhat addressed by the internationally agreed reform agenda (G-SIFIs etc.)
  - Migration of risk to an unregulated shadow banking sector

Structural Reform (2)

- The structural reform should be based on
  ① Existing differences in financial structure,
  ② Bank business models, and
  ③ Crisis experience

- East Asian countries have
  - Bank-centric financial structure
  - Basic commercial banking business model with a simple organizational structure

Peer Comparison of SIFIs and Japanese Major Financial Institutions (1)



Peer Comparison of SIFIs and Japanese Major Financial Institutions (2)

($ mm. %)

Company	Banking	Trading	$\frac{\text{Trading}}{\text{Banking}+\text{Trading}}$	Total Asset
Japanese SIFI A	1,746,461	331,096	16%	2,394,786
Japanese SIFI B	1,222,694	377,355	24%	1,895,290
Japanese SIFI C	1,137,947	124,628	10%	1,472,088
Japanese Largest Investment Bank	13,519	181,114	93%	410,488
US SIFI D	996,538	475,515	32%	2,141,595
EU SIFI E	416,931	1,718,357	80%	2,676,826
US SIFI F	118,408	379,171	76%	891,301
US SIFI G	33,822	348,781	91%	841,372

Japanese Firms: as of the end of March, Others: as of September 2010

Banking book consists of loans and securities, and trading book consists of trading asset including derivatives.

Structural Reform (3)

○ <u>In some of the Asian countries</u>,

- <u>Security markets are not deep</u>, and the dominant players of financial sector, <u>banks are expected to play a large role to develop the markets</u>
- There are <u>supervisory resource constraints</u>, and it would be efficient to focus the resources on bank supervision

⇒ <u>One-size-fits-all approach will not be warranted</u> in the area of structural reform

Example: Japan's view on the Volcker Rule

- **In December 2011, the BOJ and the FSA sent a joint comment letter to the US authorities, expressing concerns that the rule could have negative effects on the stability and liquidity of the world-wide markets and financial institutions.**

Requests in Japan's comment letter

(1) Exemption of Japanese financial institutions from extraterritorial application

In order to avoid adverse effect on liquidity and stability of world-wide financial markets and financial institutions, as long as the groups are subject to appropriate group-wide supervision by foreign supervisors, such foreign entities should be exempted from the requirements.

(2) Exemption of Japanese Government Bonds (JGBs)

In light of the recent financial market developments and the liquidity and transparency of JGBs, they should be exempted from extraterritorial application, as is the case of U.S. Government Bonds.

(3) Exemption of short-term FX swaps

Short-term foreign exchange swaps play significant role as the US-dollar funding tools and therefore should be exempted from the restrictions, like long-term foreign exchange swaps.

(4) Clarification of criteria for application to non-U.S. asset management funds

It is difficult in practice to make judgment whether a fund is exempted or not (e.g. whether or not it has U.S. investors). The U.S. authorities should set an objective and concrete definition of funds subject to the application.

Thank you very much for your kind attention.

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