Basel II and Recent Market Development

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Nobuyoshi Chihara
Deputy Commissioner for International Affairs
Financial Services Agency, Japan

Strengthening of Basel II framework in Japan

1. Rigorous application of look-through approach

2. Disclosure requirement for eligible securitisation ratings

3. Prompt implementation of Pillar 3

1. Rigorous application of look-through approach

- Treatment of Investment Funds under the Standardised Approach -

In cases where the asset composition of the fund can be "looked-through"

- As with Basel I, the risk-weighted asset of each underlying asset is calculated and summed up.

In cases where it is difficult to look-through the asset composition of the fund

- As with Basel I, the maximum risk weight of the underlying assets will be applied to the unknown portion of the underlying assets.
  - Claims on sovereigns（Rated AAA～AA） = 0%
  - Claims on banks and corporates（Rated AAA～AA-） = 20%
  - Secured by residential property = 35%
  - Claims on banks and corporates（Rated A+～A-） = 50%
  - Claims on banks and corporates（Rated: BBB+～BB-） = 100%
  - Past due loans for more than 90 days（if specific provision are less than 20%） = 150%
  - Securitisation exposures（Rated BB+～BB-: for investors) = 350%
  - Securitisation exposures (Unrated, subordinated portion) = Deducted from the regulatory capital

（Example 1) A 150% risk weight will be applied to the unknown portion of a fund if a bank can demonstrate that no securitisation exposures are included in the underlying assets.

（Example 2) A 100% risk weight will be applied to the unknown portion of a fund if a bank can demonstrate that no securitisation exposures and/or non performing loans are included in the underlying assets.

- Treatment of Investment Funds under the IRB Approach -

Criteria for determining a calculation method

Calculation of capital requirements

Possible to "look-through" the asset composition of the fund? — Yes →

1) The Look-Through Approach

- As with Basel I, the risk-weighted asset of each underlying asset is calculated and summed up.

No ↓

Majority of the underlying assets composed of equities? — Yes →

2) The Adjusted Simple Majority Approach

- The fund is deemed to be composed of equity exposures and 300% (where the Fund is composed exclusively of listed equity holdings) or 400% risk weight is applied.

No ↓

Mandate of the fund available? — Yes →

3) The Mandate Approach

- The asset composition of the fund is conservatively assumed and the risk weighted asset of each underlying asset is summed up according to the investment criteria (mandate).

No ↓

Market value of the fund available on a daily/weekly basis? — Yes →

4) The Internal Models (VAR) Method

- In cases where supervisory approval has been obtained to use the Internal (VAR) Models, the required capital is calculated from the volatility of the market price of the fund satisfying certain requirements.

No ↓

High risk instruments excluded from the fund? — Yes →

5) The Simple Risk-weight Method (A)

- In cases where it can be confirmed that no securitisation instruments (mezzanine portion, subordinated portion) nor high risk instruments such as non performing loans are included, 400% weight risk is applied.

No →

6) The Simple Risk-weight Method (B)

- 1250% risk weight is applied to the fund.

2. Disclosure requirement for eligible securitisation ratings

- External Ratings of Securitization Exposures -

- As with securitization exposures, it is difficult for external third parties .....

  - to have access to the details of each transaction (irrespective of being publicly offered or privately placed);

  - to test the reliability of ratings based on default experience data (*e.g.* three-year cumulative default rates) as past default experiences are extremely limited.

➡ Market discipline may be less workable compared to regular corporate ratings.

- In order to reinforce the Basel II operational criteria for the use of external credit assessments for securitization exposures (paragraph 565), FSA established its own "disclosure requirements" for ECAIs' ratings of securitization exposures, and included it in the guidance of Pillar1 rules (*i.e.* "Basel II FAQs").

- Disclosure Requirements for External Ratings of Securitisation Exposures -

< An Outline >

1. General Information

i) Ratings criteria
ii) Transition matrix

2. Transaction Information

i) Name of transaction
ii) Rating
iii) Issued amount
iv) Currency
v) Types of underlying assets
vi) Subordination ratio
vii) Date/Month of issue
viii) Statutory redemption date/month
ix) Coupon type (fixed/floating)
x) Interest rate
xi) Reports by each ECAI stating the outline of schemes, etc.
xii) Reasons for rating changes

Rating agencies (ECAIs) are expected to disclose the above information on their website free of charge so as to be exposed to ‘market discipline’.

3. Prompt implementation of Pillar 3

- FSA published a list of the disclosure items under Pillar 3 in October 2004, and it was finalized as a separate FSA Ordinance at the end-March 2007.
- In line with the Basel II Framework Document, banks (especially internationally-active banks and IRB banks) are expected to disclose their Basel II capital ratio and Tier1 ratio, etc. on a quarterly basis. (See below)
- The Frequency and the contents of information to be disclosed are in line with those required by the Basel II Framework Document.

  (1) Quarterly
  - Tier1 ratio, Total capital adequacy ratio, Amount of Tier 1 capital, Amount of total capital, Amount of required capital.

  (2) Semi-annually
  - Quantitative disclosures on credit risk, Credit risk mitigation, Securitization, Market risk, Operational risk, Equities, and IRRBB, etc.

  (3) Annually
  - Qualitative disclosures that provide a general summary of bank's risk management objectives and policies, Reporting systems, etc.

- Pillar 3 requirements will equally be applicable to subsidiaries of foreign financial institutions operating as a bank in Japan (not applicable to branches).

Exposures of Japanese deposit-taking institutions to subprime-related products (As of end-December 2007)

※ Figures in the brackets are as of the end-September 2007 （**Billion USD [rate: 1USD/110Yen]**）

	Tier1 capital (end-March 2007)	Operating profits from core businesses (end-March 2007)	Valuation profits/losses for equity holdings (end-December 2007)	Exposures to subprime-related products: Book values (end-December 2007)	Exposures to subprime-related products: Valuation profits/ losses	Exposures to subprime-related products: Realized profits/losses (profits/losses on sales, impairment, etc; from April 1 to December 31, 2007)	Subprime-related businesses: Book values (end-December 2007)	Subprime-related businesses: Valuation profits/ losses	Subprime-related businesses: Realized profits/losses (profits/losses on sales, impairment, etc; from April 1 to December 31, 2007)	Subprime-related ABCP programs: Exposures
Major Banks, etc.	230	34	58 (73)	13 (11)	▲1.3 (▲1.1)	▲3.6 (▲1.1)	1.8 (1.3)	0 (0)		— (1.4)
Regional Banks	115	18	32 (39)	0.7 (1.0)	▲0.1 (▲0.1)	▲0.3 (▲0.1)	—	—	—	—
Cooperative Financial Institutions	105	8.8	2 (3)	0.5 (0.4)	▲0.1 (▲0.1)	▲0.1 (▲0.1)	—	—	—	—
Total	449	61	92 (114)	14 (13)	▲1.4 (▲1.2)	▲4.0 (▲1.3)	1.8 (1.3)	0 (0)	▲0.8 (▲0.2)	— (1.4)

Apart from the above figures, there are valuation/realized losses at some Japanese financial institutions for securitization products not directly related to subprime loans, as global market turmoil has been broadly affecting financial markets, especially in the U.S. and Europe.

Note 1: "Subprime-related products" are asset-backed securities (ABS) backed by subprime loans, and/or collateralized debt obligation (CDOs) of those ABS. The above figures do not include the exposures to subprime-related products through investment trusts.

Note 2: "Major Banks, etc" include major banks (Mizuho Bank, Mizuho Corporate Bank, Mizuho Trust Bank, Bank of Tokyo-Mitsubishi UFJ, Mitsubishi UFJ Trust Bank, Sumitomo Mitsui Banking Corporation, Risona Bank, Chuo-Mitsui Trust Bank, and Sumitomo Trust Bank), Norinchukin Bank, Shinsei Bank, Aozora Bank, Citibank Japan, banks of new types, foreign trust banks and others.

Note 3: "Cooperative Financial Institutions" include Shinkin Banks including Shinkin Central Bank, Credit Cooperatives including The Shinkumi Federation Bank, Labour Banks including The Rokinren Bank, Prefectural Banking Federations of Agricultural Cooperatives, and Prefectural Banking Federations of Fishery Cooperatives. This does not include Japan Agricultural Cooperatives, etc.

Note 4: The above figures are based on interviews with individual institutions, and thus can be further revised in the process of examination by each institution.

Note 5: Subprime-related exposures at some securities firms are included in the figures for "Major Banks, etc." as those figures are on a consolidated basis.