2006 KDI Conference on Adopting the New Basel Accord

organized by KDI in collaboration with FSS

# Challenges for Cross-border Bank Supervision under Basel II (Cases of Japan)

July 6, 2006

Shunsuke Shirakawa
Director for International Banking
FSA, Japan

# Outline

1. Basel II Implementation Framework in Japan
   - Timetable
   - Rulemaking
   - Validation/approval process
   - Recognition of ECAIs
   - Pillar 2 framework

2. Preliminary Analysis of QIS5 Results in Japan
   - Changes in minimum required capital (MRC) for Japanese banks
   - Contribution to overall change in MRC by portfolio

3. Challenges for Cross-border Application of Basel II
   - Divergence in implementation timelines
   - Global level playing field vs. local rules
   - Possibility of mutual recognition of domestic rules

4. Cross-border Supervisory Cooperation
   - Promotion of home-host information exchange
   - Multilateral approach to cross-border cooperation

5. Conclusions

# Implementation Timetable

## Available Basel II Approaches and their Implementation Dates in Japan

| Applicable Approaches: Credit Risk | Applicable Approaches: Op. Risk | Y2006 (End-Mar, Jun, Sep, Dec) | Y2007 (End-Mar, Jun, Sep, Dec) | Y2008 (End-Mar, Jun, Sep, Dec) | Y2009 (End-Mar, Jun, Sep, Dec) | Y2010 (End-Mar, Jun, Sep, Dec) | End-Mar |
|---|---|---|---|---|---|---|---|
| RSA | BIA or TSA | | Implementation of Basel II | | | | |
| FIRB | – | Parallel Calculation | Floor 95% | Floor 90% | Floor 80% | * | |
| AIRB | AMA | Parallel Calculation | | Floor 90% | Floor 80% | * | |

* Banks adopting IRB/AMA after year 2008 will be subject to one-year parallel calculation and comparable floors (90% and 80%).

# Current Status of Basel II Rule-making in Japan

October 2004 ‘Draft FSA Ordinance on the New Capital Adequacy Regulation’

- Draft rule text on Pillar 1 and disclosure items under Pillar 3 were published for public consultation.

March 2005 Revised ‘Draft FSA Ordinance’

- Revised draft rule text on Pillar 1 and disclosure items under Pillar 3 were published for public consultation.
  - Answers to the Comments issued in June 2005

October 2005 ‘Comprehensive Guideline for Supervision of Major Banks’

- Emphasized the importance of integrated risk management, corporate governance etc.

November 2005 FSA’s Implementation Framework of Pillar 2

December 2005 Third ‘Draft FSA Ordinance’

- Third draft rule text on Pillar 1, including the application of Basel II to trading activities and the treatment of double default effects, were published for public consultation.

March 2006 FSA Ordinance and ‘Comprehensive Guideline’ were published

- The Pillar 1 rule text was finalised.
- The revised ‘Comprehensive Guideline’ incorporates the Pillar 2 implementation framework.
- The draft rule text on Pillar 3 was published for public consultation.

# Approval Process for Advanced Approaches (IRB/AMA)

**Field Test/ QIS5**

- Assessing the impact of Basel II on banks' capital
  - Adjustment of overall minimum capital requirement at the global level
- Facilitating the preparation for Basel II implementation at banks that intend to adopt IRB/AMA from inception
  - QIS Spreadsheet + Questionnaire & Self-assessment Gap Analysis

**Parallel Calculation**

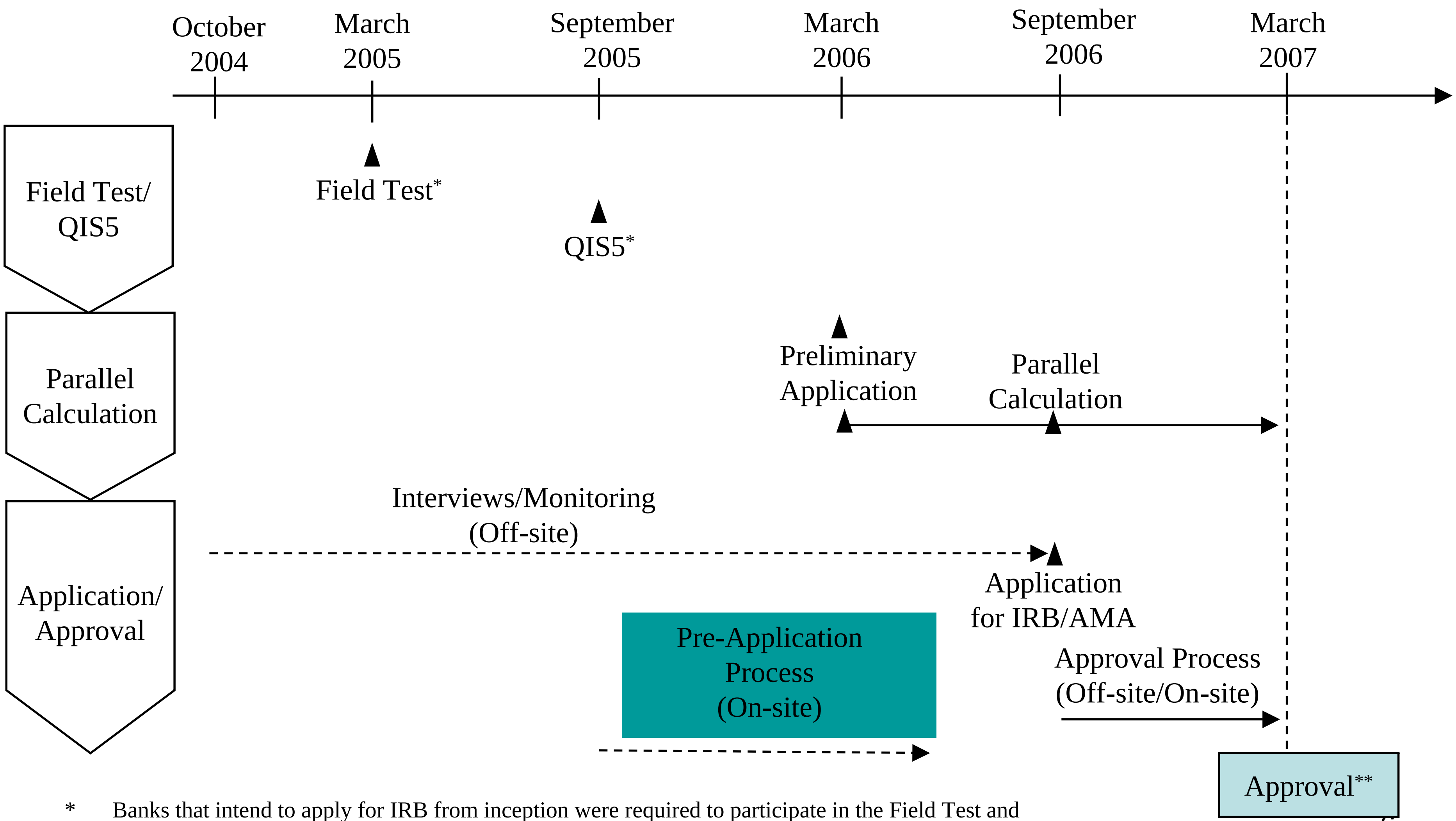
- Assessing the impact of Basel II on banks' capital
- Assessing the preparedness of banks in adopting IRB/AMA from inception
- Facilitating the preparation for Basel II implementation at banks

**Application/ Approval**

- Assessing and judging whether banks satisfy requirements set out in the FSA Ordinance, etc.
  - On-site/Off-site assessment
- Assessing the appropriateness of banks' roll-out plans
  - Supported by constant monitoring of banks' Basel II implementation plans

Approval process for advanced approaches will be a 3-stage process

# Approval Process for Advanced Approaches (IRB/AMA) (continued)




* Banks that intend to apply for IRB from inception were required to participate in the Field Test and QIS5 .

** Approval for Advanced IRB approach (AIRB) and AMA will be at end-March 2008.

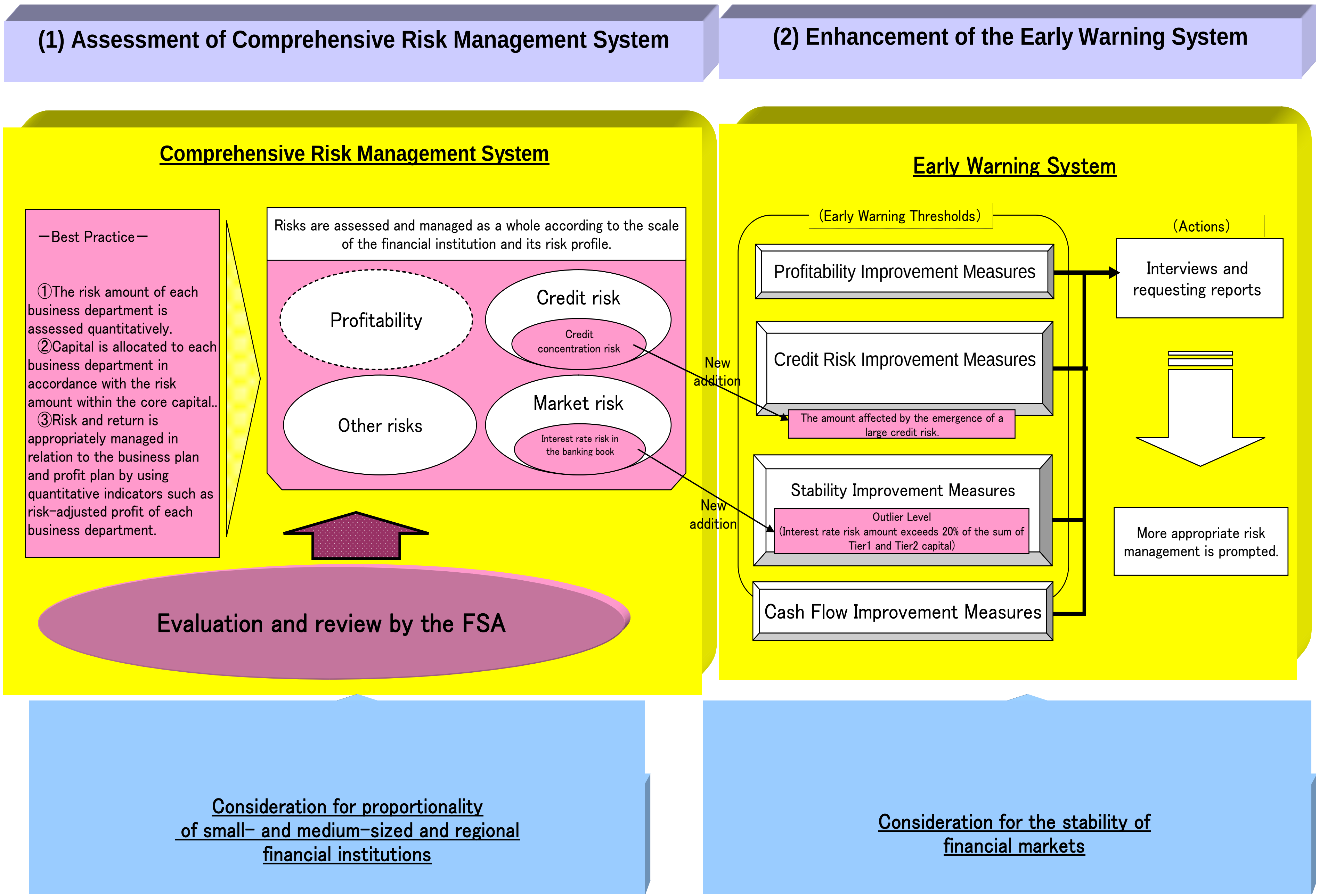
# Preliminary recognition of ECAIs under Basel II in Japan

On 31 March 2006, the FSA published its preliminary decision to recognise two Japanese and three foreign credit rating agencies as eligible external credit assessment institutions (ECAIs) under Basel II in Japan. The results of preliminary mapping that set out the corresponding risk weight to each rating grade assigned by each ECAI were also issued. The following is an illustration of such mapping results for long-term corporate exposures under the standardised approach:

| Basel II Framework | AAA | AA+ ~ AA- | A+ ~ A- | BBB+ ~ BBB- | BB+ ~ BB- | B+ and lower |
|---|---|---|---|---|---|---|
| (Corresponding Risk Weights) | (20%) | | (50%) | (100%) | | (150%) |
| Rating and Investment Information, Inc. (R&I) | | | | | | |
| Japan Credit Rating Agency, Ltd. (JCR) | | | | | | |
| Moody's Investors Service, Inc. | | | | | | |
| Standard & Poor's Rating Services (S&P) | | | | | | |
| Fitch Ratings, Ltd. | | | | | | |

The published list of eligible ECAIs and their mapping results are not only for long-term credit risk exposures but also for short-term and securitisation exposures. The mappings made no difference in determining risk weights for individual ECAIs, except for the case of long-term corporate exposures indicated above. It must be noted, however, that these results are tentatively prepared for the purpose of parallel calculation that will start as from end-March 2006. Therefore, there still exists a possibility that the FSA would need to change the recognition and mapping decisions before the formal implementation of Basel II in Japan from end-March 2007.

# The Implementation Framework of the Second Pillar of Basel II in Japan

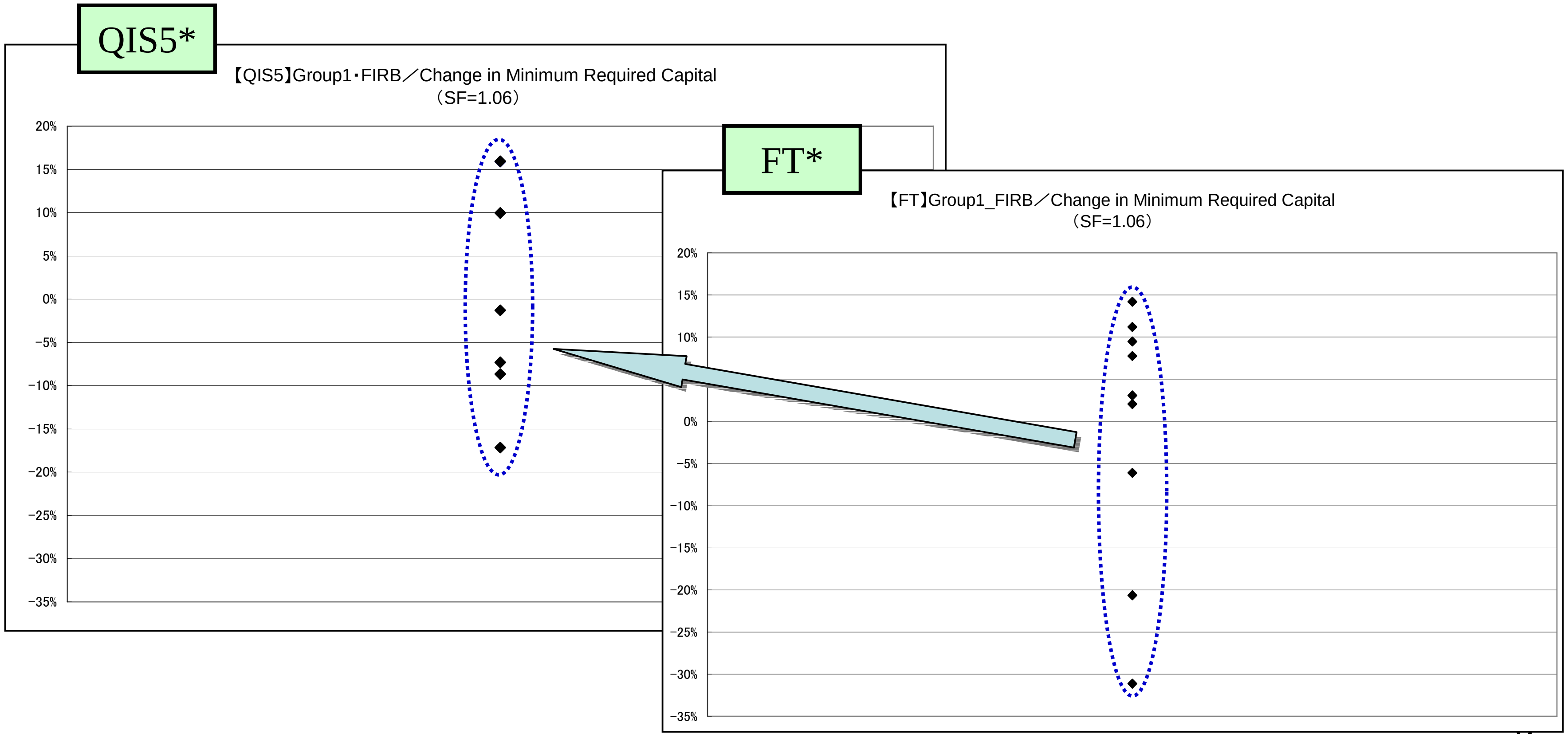


# QIS5 Results for Japanese Banks

## (Changes in MRC (Minimum Required Capital) for **Group1 FIRB**)

- The overall change in MRC for Japanese Group 1 FIRB banks (simple average) is ＋1%.
- The dispersion observed in QIS5 results is compressed compared with Japanese Field Test (FT)

⇨ The changes in MRC range from +15% to -20% in QIS5 (c.w. +15% to -30% in FT)



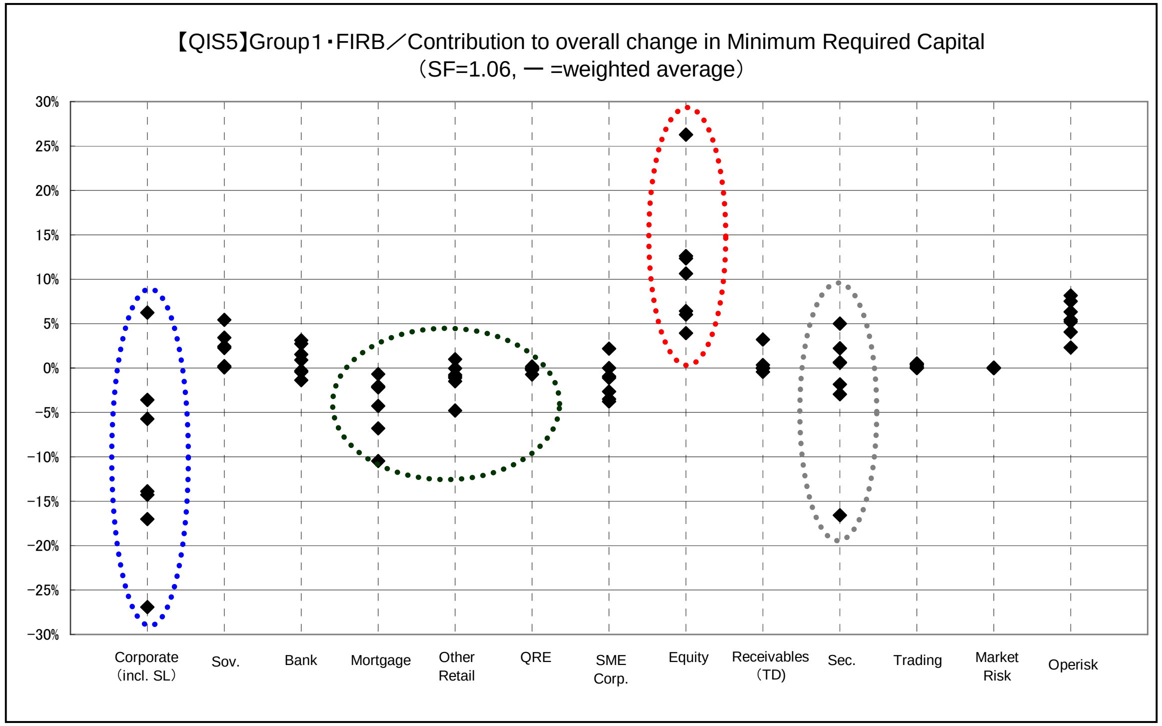



* Data basis date: **QIS5 (as of end-September 2005), FT (as of end-March 2005)**

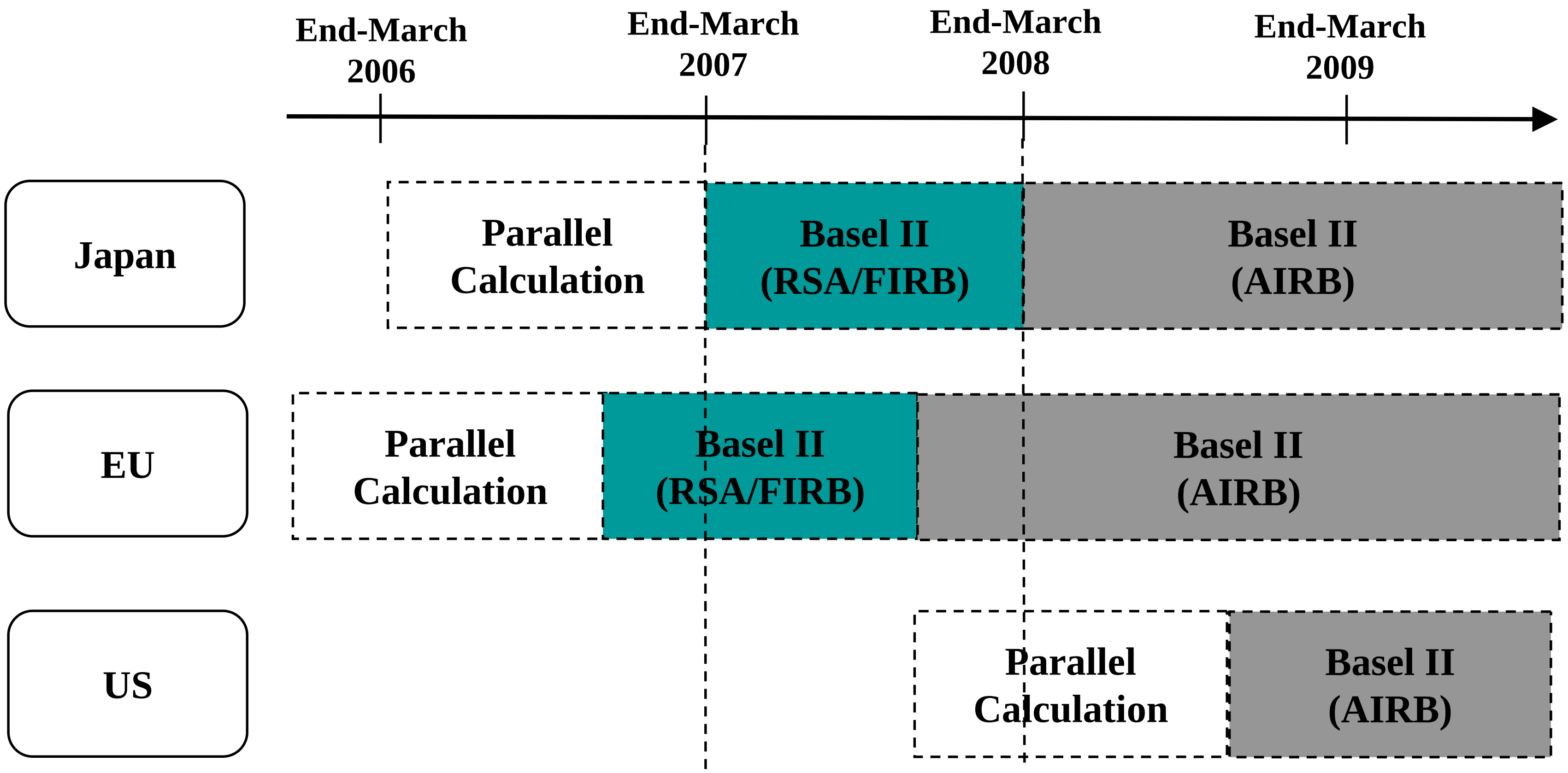
# Contribution to Overall Change in MRC by Portfolio

## (Group1 FIRB)

- Corporate portfolio has a major contribution to downward change in MRC.
- Equity portfolio has a major contribution to upward change in MRC.
- The impact of retail portfolio is relatively limited to overall change in MRC.
- The impact of securitisation portfolio is neutral to overall contribution on average but some dispersion exists.



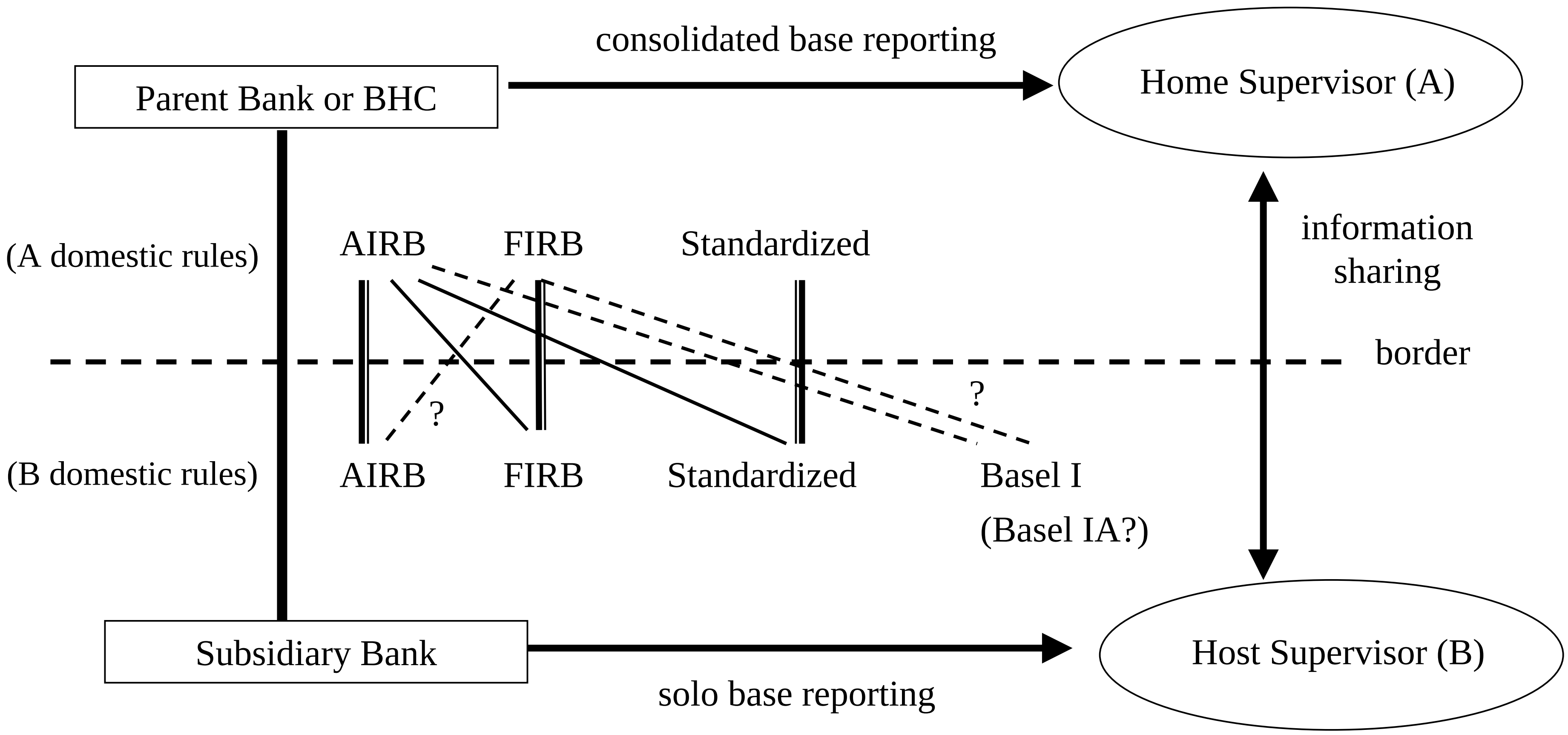
# Divergence in Implementation Timelines




- For non-G10 countries, the Basel Committee explicitly acknowledges that moving toward an early adoption of Basel II may not be a first priority in terms of what is needed to strengthen their supervision. Each national supervisor should consider carefully the benefits of Basel II in the context of its domestic banking system when developing a timetable and approach to implementation.

# A Global Level Playing Field vs. Local Rules

Internationally active banks are eager for a global level playing field to avoid regulatory burden of double calculation while each supervisor minds differences in local practices.



# Possibility of Mutual Recognition of Domestic Rules and Add-up Consolidation Methods

Double calculation can be avoided, to some extent, through mutual recognition of each domestic rules by home/host supervisors.

Besides, banks may be allowed to apply different approaches to subsidiary banks and to aggregate the results of these approaches (i.e. add-up consolidation) based on such criteria as follows:

1. Are Basel II approaches not available in host jurisdictions?

2. Is the add-up consolidation method applied on a temporary basis?

3. Is the subsidiary a non-significant business unit?

4. Is it possible to prevent regulatory arbitrage?

# Promotion of Home-Host Information Exchange

## Background

### Industry

Concerns on regulatory burden

- Need for multiple reporting/approval requirement
- Dependence on centralized systems and business-line management across legal entities

### Supervisors

Concerns on efficient allocation of supervisory resources

- Substantial increase of validation /approval work
- Scarce human resources (experts)

**Need for home-host information sharing**

## Tools

### Multilateral

- Supervisory college meetings
  - ➢ Kick off of home-host information sharing process and general review of bank's implementation plans

### Regional

- Regional supervisory cooperation
  - ➢ Mutual understanding of Basel II implementation framework of neighboring countries

### Bilateral

- Case study exercises
- Regular bilateral contacts
  - ➢ In-depth information sharing on banks' implementation plans

# Multilateral Approach to Cross-border Cooperation on Basel II

## Supervisory College Meeting in Tokyo on 10 June 2005

- Invitation sent out to all BCBS member countries + jurisdictions where major Japanese banking groups have subsidiaries/branches.

- 29 participants from 21 Supervisory Agencies of 16 jurisdictions
  - AIG member jurisdictions (Belgium, Canada, France, Germany, Luxemburg, Netherlands, Switzerland, UK, US)
  - EMEAP member jurisdictions (China, Hong Kong, Indonesia, Korea, Malaysia, Singapore, Thailand)

- An overview of the Basel II implementation framework in Japan was presented by FSA.

- Cross-border Basel II implementation plans at three major Japanese banking groups were presented by each banking group.
  - SMFG, MTFG/UFJ Groups and Mizuho FG

# Conclusions

- Japan has almost finalized the domestic rules for Basel II implementation from the end of Fiscal Year 2006.
- Validation/approval process for Japanese banks is in progress assisted by the QIS5 exercise.
- Divergence in Basel II implementation timelines and domestic rules among jurisdictions pose significant challenges for internationally active banks and their supervisors.
- Cross-border supervisory cooperation such as home-host information exchange is essential for supervision of internationally active banks under Basel II.