

***Financial Innovation and Global Market Turmoil  
~Preparing for the Post-Subprime World of Finance~***



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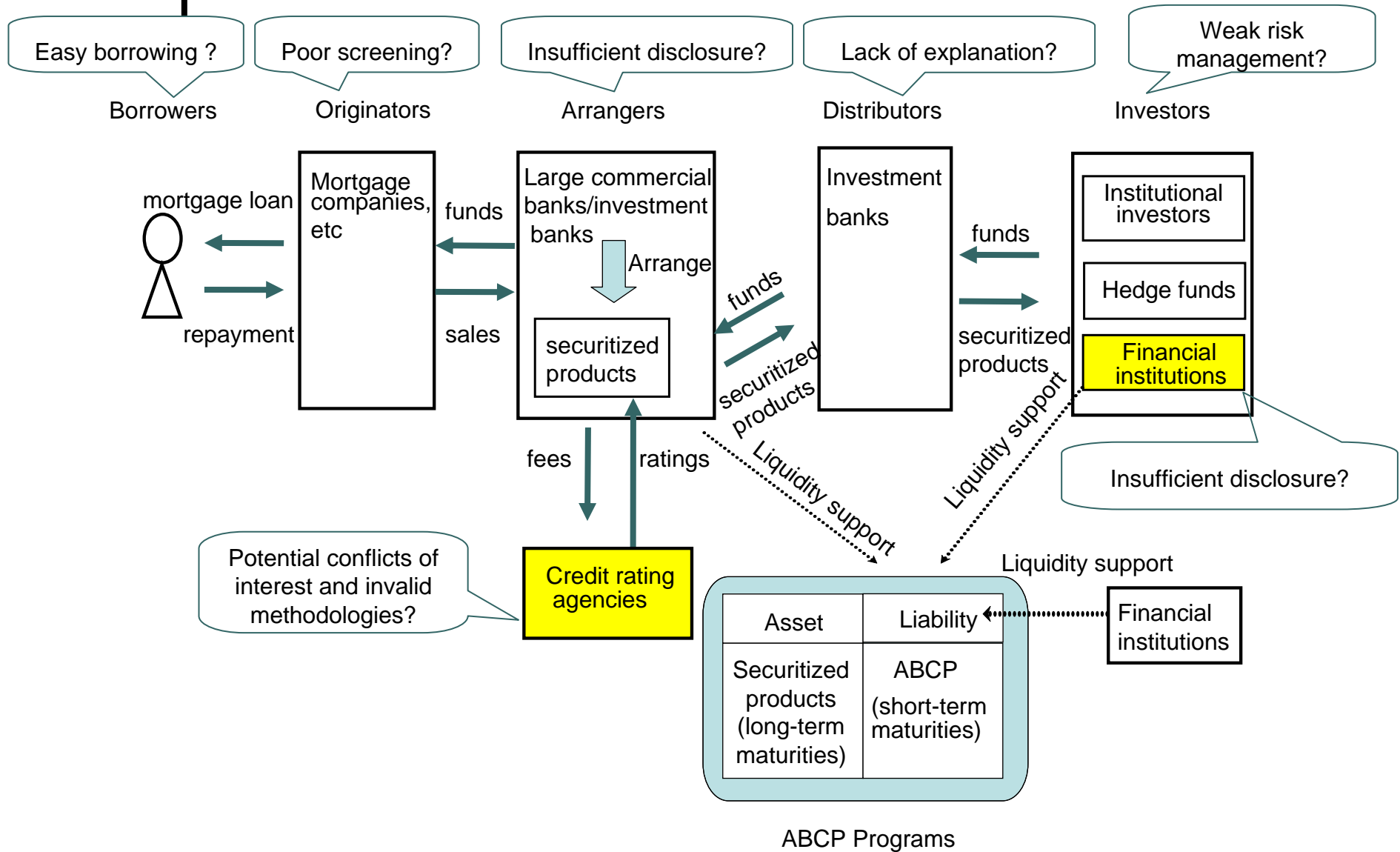
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# 1. Overview of the Subprime Loan Crisis



## 2. Underlying Causes behind the Market Turmoil

“Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience” (April 2008)

### **An exceptional boom in credit growth and leverage in the financial system**

- A long period of benign economic and financial conditions; historically low real interest rates and abundant liquidity

### **Poor underwriting standards in the US subprime mortgage sector**

- The OTD model allows mortgage lenders to disperse credit risks of underlying assets to investors.
- Rapidly rising house prices lead originators and mortgage brokers to lower their underwriting standards.

### **Shortcomings in firms’ risk management practices**

- Weak controls over balance sheet growth and over off-balance sheet risks
- Risks underestimated under the value-at-risk model, with insufficient input data used.

### **Poor investor due diligence**

- Excessive reliance on credit ratings

### **Poor performance by the CRAs in respect of structured credit products**

- Weaknesses in rating models and methodologies
- Conflicts of interest in the rating process

### **Incentive distortions**

- Moral hazards at each stage of the OTD model (shortcomings in underwriting standards, risk management, and information transmission)
- The pre-Basel II capital framework encouraged banks to securitize assets.

### **Weaknesses in disclosure**

- Weaknesses in public disclosure by financial institutions

### 3. Consequences of the Subprime Loan Crisis

Risk transfer through securitization → Uncertainties about risks → Rising counterparty risks

(Transferred risks return to financial institutions through on-balancing)

Confidence lost in ratings and prices for securitized products → Deals fail to be completed (Evaporation of market prices) → Growing uncertainties about prices and loss estimates

US and European money markets depend on central banks' liquidity provision  
(Term instrument providers are absent from interbank markets)

#### Flight to Quality

Investment money moves across national borders to and from different markets (equities, bonds, currencies and commodities) Volatility increases in various markets.



## 4-1. Outline of the FSF Recommendations (1)

*“Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience” (April 2008)*

### I. Strengthened prudential oversight of capital, liquidity and risk management

#### ➤ **Capital requirements**

- The Basel II capital framework needs timely implementation.
- Supervisors will strengthen the Basel II capital treatment of structured credit and securitization activities (Proposals will be issued in 2008).

#### ➤ **Liquidity management**

- Supervisors will issue for consultation sound practice guidance on the management and supervision of liquidity by July 2008.

#### ➤ **Supervisory oversight of risk management, including of off-balance sheet entities**

- Supervisors will use Pillar 2 (supervisory review) to strengthen banks' risk management practices, to sharpen banks' control of tail risks and mitigate the build-up of excessive exposures and risk concentrations.

#### ➤ **Operational infrastructure for OTC derivatives**

### II. Enhancing transparency and valuation

#### ➤ **Risk disclosures by market participants**

- Financial institutions are encouraged to make robust risk disclosures using the leading disclosure practices in their mid-year 2008 reports.
- The BCBS will issue further guidance by 2009 to strengthen disclosure requirements under Pillar 3 of Basel II.

#### ➤ **Accounting and disclosure standards for off-balance sheet entities**

#### ➤ **Valuation**

- International standard setters should enhance accounting, disclosure and audit guidance for valuations.

#### ➤ **Transparency in securitization processes and markets**

- Securities market regulators should work with market participants to expand information on securitized products and their underlying assets.

## 4-2. Outline of the FSF Recommendations (2)

### III. Changes in the role and uses of credit ratings

#### ➤ Improvement of rating process quality and management of conflicts of interest

- IOSCO will revise its Code of Conduct Fundamentals for Credit Rating Agencies by mid-2008.
- CRAs should quickly revise their codes of conduct to implement the revised IOSCO CRA Code of Conduct Fundamentals.

#### ➤ Differentiated ratings and expanded information on structured products

- CRAs should differentiate ratings on structured finance from those on bonds.
- CRAs should expand the initial and ongoing information provided on the risk characteristics of structured products.

#### ➤ CRA assessment of underlying data quality

- CRAs should enhance their review of the quality of the data input and of the due diligence performed on underlying assets by originators, arrangers and issuers involved in structured products.

#### ➤ Uses of ratings by investors and regulators

- Investors should address their over-reliance on ratings.
- Authorities will review their use of ratings in the regulatory and supervisory framework.

### IV. Strengthening the authorities' responsiveness to risks

#### ➤ Supervisors, regulators and central banks will translate their risk analysis into actions more effectively

#### ➤ Improving information exchange and cooperation among authorities

- The use of international colleges of supervisors should be expanded so that, by end-2008, a college exists for each of the largest global financial institutions.

#### ➤ Enhancing international bodies' policy work

### V. Robust arrangements for dealing with stress in the financial system

#### ➤ Central bank operations

#### ➤ Arrangements for dealing with weak banks



## 5-1. FSA Actions in Response to Market Turmoil (1)

- Direct administrative resources to the response measures against the market turmoil in view of the depth and breadth of the crisis
- Assess and analyze impact of the crisis on Japan's financial system. (Release of financial institutions' exposures to subprime related products)
- Proactively identify and address risks by monitoring financial institutions
- Reorganize the FSA for timely and accurate monitoring of global market developments (Establishment of Market Monitoring Office in February 2008 and Risk Analysis Office in July 2008)
- Brainstorm future challenges based on the Financial Market Strategy Team's First Report (November 2007) and the Second Report (June 2008)





## 5-2. FSA Actions in Response to Market Turmoil (2)

- Update the supervisory guidelines for financial product traders to secure the traceability of securitized products and introduce an early warning system
- Update the supervisory guidelines for banks, etc. to strengthen risk management and disclosure
- Verify the risk management structure that addresses various financial products accordingly
- Consider a framework for supervision of credit rating agencies



## **6. The Better Market Initiative – Four Pillars**

- (1) Reliable and Vibrant Markets**
- (2) Enhanced Business Environment**
- (3) Better Regulation**
- (4) Supportive Market Infrastructure**



## **7. Reliable and Vibrant Markets**

- Making transactions among professionals more vibrant**
- Expanding the scope of disclosure in English**
- Diversification of ETFs and J-REITs**
- Establishment of a framework for alliances between stock and commodity exchanges**



## **8. Enhanced Business Environment**

- **Relaxation of firewall regulations**
- **The scope of business permitted for banking and insurance groups will be broadened**
  - **Permitting sister companies of banks and insurance companies to provide new businesses, such as commodity spot trading**
  - **Permitting banks and insurance companies to engage in emissions trading**
  - **Permitting subsidiaries of banks and insurance companies to engage in Islamic finance**



## 9. Better Regulation

- **Trying to share key principles and enhance dialogue with the industry**
- **Striving to enhance the transparency and predictability of regulation and supervision**
- **Strengthening cooperation with fellow authorities overseas**
- **Close monitoring and accurate analysis of market developments for effective regulatory and supervisory responses**
- **Improving the skills of FSA staff**



## **10. Supportive Market Infrastructure**

- **Developing and accumulating internationally competitive human resources in the areas of finance, law, and accounting**
- **Enhancing urban functions to levels suitable for an international financial center**
  - **Development plan to enhance Japan's role as an international financial center**
  - **Two areas in Tokyo have been designated as priority areas**



# Annex 1. Exposures of Japanese Deposit-taking Institutions to Subprime-related Products

Figures in brackets are as of the end-March 2008 (Billion Yen)

	Tier1 capital (end-March 2008)	Operating profits from core businesses (end-March 2008)	Valuation profits/losses for equity holdings (end-June 2008)	Exposures to subprime-related products						Subprime-related ABCP programs
				Exposures to subprime-related products			Subprime-related businesses			Exposures
				Book value (end-June 2008)	Valuation profits/losses	Realized profits/losses (profits/losses on sales, impairment, etc. from April 1,2007 to June 30, 2008)	Book value (end-June 2008)	Valuation profits/losses	Realized profits/losses (profits/losses on sales, impairment, etc. from April 1,2007 to June 30, 2008)	
Major Banks, etc.	25,987	3,499	4,962 (3,570)	876 (933)	-138 (-123)	-679 (-652)	65 (107)	0 (0)	-305 (-288)	—
Regional Banks	12,862	1,799	2,782 (2,217)	50 (54)	-2 (-1)	-46 (-46)	—	—	—	—
Cooperative Financial Institutions	11,222	795	78 (-6)	32 (32)	-2 (-1)	-29 (-28)	—	—	—	—
<b>Total</b>	<b>50,071</b>	<b>6,093</b>	<b>7,823</b> (5,781)	<b>958</b> (1,019)	<b>-142</b> (-125)	<b>-754</b> (-725)	<b>65</b> (107)	<b>0</b> (0)	<b>-305</b> (-288)	<b>—</b>

Apart from the above figures, there are valuation/realized losses at some Japanese financial institutions for securitized 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 (ABSs) backed by subprime loans or collateralized debt obligations (CDOs) and other financial products referencing these ABSs. "Subprime-related businesses" are the businesses in which firms produce subprime-related products. 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, Resona Bank, Chuo-Mitsui Trust Bank, and Sumitomo Trust Bank), Norinchukin Bank, Shinsei Bank, Aozora Bank, Citibank Japan, banks of new type, 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, etc., 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.

## Annex 2. Exposures of Japanese Deposit-taking Institutions to Securitized Products Based on the Leading Practices in the FSF Report

As of the end-June 2008 (Figures in brackets are as of the end-March 2008) (Billion Yen)

	Exposures to subprime-related products												CLOs, CDOs <sup>※</sup>			RMBS <sup>※</sup>			CMBS			Leveraged Loans		Total		
	CDOs			RMBS			Others			Subtotal			Book value	Valuation profits/ losses	Realized profits/ losses	Book value	Valuation profits/ losses	Realized profits/ losses	Book value	Valuation profits/ losses	Realized profits/ losses	Book value	Realized profits/ losses	Book value	Valuation profits/ losses	Realized profits/ losses
	Book value	Valuation profits/ losses	Realized profits/ losses	Book value	Valuation profits/ losses	Realized profits/ losses	Book value	Valuation profits/ losses	Realized profits/ losses	Book value	Valuation profits/ losses	Realized profits/ losses														
Major Banks, etc.	209	-27	-548	504	-112	-74	163	1	-57	876	-138	-679	6,411	-572	-349	3,888	-89	-203	2,323	-76	-9	5,911	-96	19,410	-875	-1,337
	(246)	(-24)	(-528)	(513)	(-99)	(-70)	(174)	(0)	(-53)	(933)	(-123)	(-652)	(6,164)	(-573)	(-328)	(3,988)	(-66)	(-191)	(2,338)	(-71)	(-10)	(5,178)	(-64)	(18,602)	(-833)	(-1,243)
Regional Banks	10	-1	-46	0	-0	0	39	-1	0	50	-2	-46	320	-30	-87	971	-4	17	432	-3	6	15	0	1,788	-38	-110
	(11)	(-1)	(-46)	(0)	(-0)	(0)	(43)	(-1)	(0)	(54)	(-1)	(-46)	(340)	(-34)	(-84)	(1,030)	(-0)	(14)	(457)	(-2)	(4)	(17)	(0)	(1,897)	(-37)	(-111)
Cooperative Financial Institutions	4	-1	-30	0	0	0	28	-1	1	32	-2	-29	1,205	-114	-73	830	-2	4	213	-2	3	26	1	2,305	-119	-94
	(4)	(-0)	(-30)	(0)	(-0)	(0)	(28)	(-1)	(1)	(32)	(-1)	(-28)	(1,261)	(-111)	(-82)	(762)	(-0)	(9)	(222)	(-1)	(3)	(16)	(0)	(2,294)	(-113)	(-98)
Total	223	-29	-625	504	-112	-74	230	-1	-55	958	-142	-754	7,936	-715	-509	5,689	-95	-182	2,968	-80	-0	5,953	-95	23,503	-1,033	-1,541
	(261)	(-24)	(-604)	(513)	(-99)	(-70)	(245)	(-1)	(-51)	(1,019)	(-125)	(-725)	(7,766)	(-718)	(-495)	(5,780)	(-67)	(-167)	(3,017)	(-74)	(-2)	(5,211)	(-63)	(22,793)	(-983)	(-1,453)
(Reference) Loss Ratio	-75.32% (-70.83%)			-31.25% (-28.19%)			-25.48% (-22.35%)			-52.10% (-48.33%)			-14.14% (-14.40%)			-4.55% (-3.90%)			-3.00% (-2.75%)			-1.48% (-1.22%)		-9.94% (-9.79%)		
	-15.02% (-15.68%)			-22.45% (-19.09%)			-11.60% (-11.86%)			-1.60% (-1.53%)		-15.34% (-15.56%)														

Figures in inner columns represent the underlying assets of which were originated abroad.

※Excluding subprime-related products

Note 1: 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 2: "Depreciation Ratio" is the percentage of sum of valuation profits/losses (as of the end-June), additional provisions and impairment (from April 1, 2007 to June 30, 2008) to the book value as of the beginning of the period.

Note 3: CDOs include the exposures to SIVs.

Note 4: RMBS does not include GSE MBS.

Note 5: While the definition of leveraged loans can vary depending on each financial institutions, it generally refers to loans to low-rated companies, including loans made for mergers and acquisitions.

Note 6: Apart from above figures, losses on CDS transactions with monoline insurers (about 31.5 billion yen) have been reported.