March 31 2005
Financial Services Agency

The Outline of Draft Rules for the New Capital Adequacy Framework

1. Schedule

June 26, 2004 — Basel Committee on Banking Supervision published "International Convergence of Capital Measurement and Capital Standards: A Revised Framework".

October 28, 2004 — FSA published a consultation paper on draft rules for the new capital adequacy framework.

March 31, 2005 — Revised draft rules were published.

Forthcoming

Around the year end of 2005 — Revised rules for the new capital adequacy framework will be published in the official gazette.

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- The new framework will become effective at the end of FY2006 (March 31, 2007). AIRB/AMA will be available from the end of FY 2007 (March 31, 2008).

2. The Outline of the New Capital Adequacy Framework

(1) The First Pillar (Minimum Capital Requirements)

$$\frac{\text{Regulatory Capital}}{\text{Credit Risk} + \text{Market Risk}} \geqq 8\%^{※} \Rightarrow \frac{\text{Regulatory Capital (same as the current)}}{\text{Credit Risk} + \text{Market Risk} + \text{Operational Risk}} \geqq 8\%^{※}$$

Unlike the current framework, the new framework allows banks to choose from the following two methods; the Standardized Approach, which is the revision of the current framework, and the Internal Ratings-Based Approach, which allows banks to use their internal estimates of risk components subject to supervisory approval.

Operational risk is the risk of loss resulting from failure in internal processes, system failures or fraud behaviors etc. Banks are allowed to use a method based on banks' internal estimates of risk components subject to supervisory approval.

※ Minimum capital ratio of 8% is for internationally active banks.

(I) Credit Risk

Credit Risk Weighted Assets ＝ Σ(Exposures × Risk Weights)

(Exposures include off-balance sheet transactions such as guarantees.)

(i) The Standardized Approach

The risk weights of the Standardized Approach will be more risk sensitive than those of the current framework.

(a)The risk weights for exposures to SMEs (small and medium sized enterprises) and individuals will be lowered, reflecting the diversification effects.

(b)The risk weights for past due loans could be adjusted according to the provisions.

(c)The risk weights for exposures to corporates reflect the credit qualities of the borrowers.

Entities	Current	New
Japanese Governments (including local governments)	0%	**0% (claims in JPY)**
Japanese PSEs (Public Sector Entities)	10%	**10% (20% for some entities) (claims in JPY)**
Banks and Securities Firms	20%	**20%～150% (dependent on the credit ratings of the sovereigns of incorporation)**
Corporates (excluding SMEs)	100%	**20%～150% (dependent on their credit ratings)※ or 100%(for all corporate claims)**
SMEs, Individuals	100%	**75%**
Residential Mortgage Loans	50%	**35%**
Past due loans	100%	**150% ※※ (could be lowered according to the level of provisions)**
Equities	100%	**100%**

※ Only solicited ratings will be allowed.

※※ Past due loans are the loans to those whose payments are past due for more than three months.

(ii) The Internal Ratings-Based Approach (IRB)

The Internal Ratings-Based Approach (IRB) allows banks to use the internal estimates of risk components for the determination of required capital for a given exposure.

Required capital shall be calculated by the risk-weight functions with the parameters of probability of default (PD), loss given default (LGD) etc.

	Foundation IRB	Advanced IRB
PD	Banks' estimates	Banks' estimates
LGD	Supervisory value※	Banks' estimates

※ e.g.45% LGD will be assigned to unsecured corporate exposures.

（Note）Treatment of equity exposure in the IRB.

Equity investments acquired after the end of September 2004

Banks can choose approaches for the calculation of risk-weighted assets out of several alternatives. (subject to minimum risk weights as follows; 200% to publicly traded equities, 300% to private equities and 100% to the investment in equities as part of a long-term customer relationship under the PD/LGD approach.)

Equity investments acquired before the end of September 2004

Equity investments held before the end of September 2004 may be exempted from the treatment above and applied a risk weight of 100% for ten years.

(II) Operational Risk (newly introduced)

Operational risk is the risk of loss resulting from failure in internal processes, system failures and fraud behaviors, etc.

Three methods are available for the calculation of operational risks.

①The Basic Indicator Approach (BIA)

②The Standardized Approach (TSA)

③Advanced Measurement Approaches (AMA)

(Calculation of ① and ② is based on gross income and calculation of ③ is based on historical data of realized losses and other relevant factors.)

(2) The Second Pillar（Supervisory Review Process）

The supervisory review process intends not only to ensure that banks have adequate capital to support all the risks in their businesses, but also to encourage banks to improve risk management techniques.

・The treatment of interest rate risk in the banking book

Supervisors are particularly attentive to the sufficiency of capital of 'outlier banks' where economic value declines by more than 20% of the sum of Tier 1 and Tier 2 capital as a result of a standardized interest rate shock. (However, outlier banks will not immediately face automatic add-ons of capital charge.)

(3) The Third Pillar（Market Discipline）

Pillar Ⅲ aims at strengthening market discipline through enhanced disclosure.

Banks will be required to disclose information on capital adequacy ratios, components of capital, exposures of each risk, risk assessment techniques, etc.

In principle, banks are required to disclose quarterly, and cooperative-type financial institutions are required to disclose semi-annually.