



# FSA Newsletter July 2007



Minister Yamamoto had a meeting Charlie McCreevy,  
European Union internal market commissioner (June 13)

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### **FY2006 Financial Results of Major Banks**

Following the announcements by the major banks of their financial results for FY2006, the Financial Services Agency (FSA) added up the figures, etc. announced by the respective banks and released them on May 23, 2007.

Below is a summary of the financial results of the major banks for FY 2006.

#### \*Financial Results of Major Banks

##### 1. Profit Status

The major banks' net core business profits totaled 3.4 trillion yen in the fiscal year ending in March 2007, down 0.4 trillion yen from the fiscal year ending in March 2006. The net core business profits declined mainly due to the fact that fee and commission income from sales of risk-involving products such as investment trust funds remained flat while interest income, representing earnings from lending, dropped.

The major banks' net profits amounted to 2.5 trillion yen in the fiscal year ending in March 2007, down 0.5 trillion yen from the fiscal year ending in March 2006. Profits were gained by way of special factors such as improved pension asset management due to the newly-introduced retirement benefit accounting system and an increase in the adjustment amount of corporate tax, etc. related to a change in the number of years in which deferred tax assets are listed in account book. However, profits suffered erosion, presumably due in large part to the absence of profits from the reversal of bad loan allowances that boosted the previous year's earnings and an increase in expenses related to the provision of credit in non-bank operations and stock-related expenses.

Nevertheless, the latest financial results show increases in sales of investment trust funds and lending to overseas customers. Although the expansion of these operations temporarily increases expenses, the major banks are implementing measures to secure profits, such as re-establishing overseas business footholds.

##### 2. Status of Financial Health

The non-performing loan ratio of the major banks stood at 1.5% in the fiscal year ending in March 2007, down 0.3 percentage points from the fiscal year ending in March 2006. Although new non-performing loans arose with regard to some large-lot borrowers, including customers of non-bank affiliates, the overall balance of non-performing loans declined, presumably due to the fact that economic recovery has put a lid on new non-performing loans and because the classification of some borrowers previously in the non-performing category were upgraded due to improvements in their business performance.

The capital adequacy ratio, calculated in accordance with Basel II beginning with the fiscal year ending in March 2007, stood at 13.1%, up 0.9 percentage points from the fiscal year ending in March 2006. The rise was presumably attributable to profits stemming from an improvement in the business performance of borrowers as well as the fact that the effects of a decrease in the amount of credit risk assets were reflected in the calculation of the capital adequacy ratio under a new standard.

As shown in the continued decline in the non-performing loan ratio and the rise in the capital adequacy ratio, the financial conditions of major banks continue to improve.

## **FY2006 Financial Results of Regional Banks**

Following the announcements by regional banks of their financial results for FY2006, the Financial Services Agency (FSA) added up the figures, etc. announced by the respective banks and released them on June 11, 2007.

Below is a summary of the financial results of regional banks for FY2006.

### 1. Profit Status

Regional banks' net core business profits in the fiscal year totaled at 2,002.8 billion yen in March 2007, a result almost unchanged from the fiscal year ending in March 2006, as increases in lending and fee and commission income were offset by a decline in the profit margin on interest, which resulted from the fact that interest rates for deposits had been raised prior to interest rates for loans.

Regional banks' net profit in the fiscal year ending in March 2007 dropped by around 20% from the fiscal year ending in March 2006 to 805.2 billion yen due to increased losses related to the disposal of non-performing loans.

### 2. Capital Adequacy Ratio

Regional banks' average capital adequacy ratio continued to rise, standing at 10.4% for the fiscal year ending in March 2007, up 0.6 percentage points from the fiscal year ending in March 2006. This was the first time that regional banks' average capital adequacy ratio exceeded 10%.

### 3. Status of Non-Performing Loans

The balance of non-performing loans (loans subject to disclosure under the Financial Reconstruction Law) decreased by 0.9 trillion yen from the fiscal year ending in March 2006 to 7.8 trillion yen. The non-performing loan ratio dropped 0.5 percentage points from the fiscal year ending in March 2006 to 4.0%, less than half the level of the peak of 8.3% registered in the interim term ending in September 2002, indicating that the status of the non-performing loans has been steadily improving.

### ※ Composition of regional banks:

As of the fiscal year ending in March 2007, there were a total of 111 regional banks, including 64 regional banks, 46 second-tier regional banks and Saitama Resona Bank. As of the fiscal year ending in March 2006, there were a total of 112 regional banks, including 64 regional banks, 47 second-tier regional banks and Saitama Resona Bank.

[Featured]

## Implementation of Basel II

### Introduction

A new capital adequacy regulatory framework known as Basel II was introduced at the end of March 2007<sup>1</sup>. The Financial Services Agency (FSA) has addressed issues related to Basel II in this newsletter several times. Now that the new regulatory framework has been implemented, we will again provide an overview of the contents thereof while citing recent movements related to the implementation of Basel II in Japan

### 1. First Pillar (Minimum Capital Requirements)

The new Basel II framework aims to measure risks faced by financial institutions for the purpose of calculating capital adequacy ratios more precisely than the previous regulatory framework (Basel I) and, by doing so, seeks to encourage financial institutions to ensure appropriate risk management. Basel I focused mainly on measuring credit risks, and in doing so used a simple measurement approach, applying the five prescribed risk weightings (0%, 10%, 20%, 50% and 100%) to broad categories of assets held by financial institutions, classified according to the level of their relative risks. Under Basel II, however, the minimum level of capital required of financial institutions (minimum capital requirement) for their loan claims on corporations, for example, varies in accordance with the creditworthiness of the borrower companies. While Basel II reduces the burden of capital requirement regarding loans to small- and medium-size enterprises compared with Basel I, capital requirement burdens may increase or decrease in relation to nonperforming loans according to the ratio of loan loss provision to said loans. As a result, Basel II has a higher level of risk sensitivity than Basel I. As explained below, Basel II introduces for the first time operational risk into the calculation of capital requirements.

For regulatory purposes, Basel II recognizes sophisticated risk measurement techniques in relation to new types of financial products and transactions, such as credit derivatives and securitization, in addition to traditional risk mitigation techniques such as collateral and guarantees, in light of the advance in financial engineering techniques in recent years. In this regard, the FSA has recently amended a set of rules concerning the calculation of capital adequacy ratios (released as a regulatory notice) in order to enable the recognition of credit risk mitigation effects regarding movables used as collateral that meet certain conditions under the foundation Internal Ratings-Based (IRB) Approach.

Measurement of the credit risks involved in financial products backed by multiple assets such as investment trusts (generally known as “funds”) should in principle be conducted by way of calculating the aggregate of the values of all of the underlying credit risk assets. Regarding specific ways of treating funds under Basel II, the FSA published additional FAQs on Basel II (which provide a set of interpretations) in December 2006 and May 2007.

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<sup>1</sup> For the outline of Basel II, please refer to FSA Newsletter No. 41

Unlike Basel I, which required that all financial institutions use the same methodology for credit risk measurement, Basel II allows them to choose the one most suited to them from among three methodologies: the Standardized Approach, the foundation Internal Ratings-Based (IRB) Approach and the advanced IRB Approach. The standardized approach, which represents a partial modification of the methodology used under Basel I, differs from the previous approach in that it uses external ratings for the evaluation of the creditworthiness of borrower companies. Meanwhile, under the foundation and Advanced IRB Approaches, financial institutions apply techniques used for their own internal controls to the calculation of the capital adequacy ratio. Financial institutions themselves are allowed to estimate the parameters used for their credit risk measurement, such as probability of default (PD) and loss given default (LGD), on condition that they possess sophisticated credit risk management systems, solid internal control functions, and so on. If financial institutions are to adopt the IRB Approaches, they must meet the minimum requirements specified by the regulatory notice regarding capital and obtain prior approval from the regulatory authorities. At the end of March 2007, the FSA had approved the adoption of the foundation IRB Approach by a total of 23 groups and 19 financial institutions. The adoption of the advanced IRB Approach, which allows for the estimation of all parameters by financial institutions themselves, is scheduled for approval from the end of March 2008.

Basel II introduces for the first time operational risk into the calculation of minimum capital requirements. Operational risk refers to the risk to financial institution of incurring losses due to incidents such as administrative errors, computer problems and illegal activities. For the measurement of operational risk, financial institutions are also allowed to choose the approach best suited to them from among three options: the Basic Indicator Approach, the Standardized Approach and the Advanced Measurement Approach. Financial institutions wishing to adopt the Standardized Approach or the Advanced Measurement Approach must obtain prior approval from the regulatory authorities. Regarding the Standardized Approach, the FSA granted approval for the use thereof to 22 groups and 45 financial institutions in March 2007, after conducting a self-assessment questionnaire survey, in which financial institutions were asked for their own assessment of their status of compliance with the requirements for approval as specified in the relevant notice, twice over a one-year period. Like the Advanced IRB Approach regarding credit risk, the Advanced Measurement Approach regarding operational risk is scheduled for introduction from the end of March 2008.

As described above in regards to the above-mentioned credit and operational risks, the financial institutions in question should choose one of the three measurement approaches allowed under Basel II. If financial institutions are to adopt an advanced measurement approach like the IRB Approach, they must have a certain level of risk management systems and internal control functions in place and meet the minimum requirements as specified by the relevant notice, as is outlined hereabove. However, not all financial institutions will necessarily have as their ultimate goal the adoption of the most advanced approach available. It goes without saying that financial institutions focusing on the traditional banking business centered around loans and deposits do not necessarily require risk management techniques with the same levels of complexity and sophistication as those engaged in a diverse range of businesses with the use of complex and sophisticated risk measurement techniques. The important thing is for financial institutions to choose the techniques best suited to them in light

of the scale and nature of their own business and to establish the risk management systems best suited to them regardless of how the capital adequacy ratio is to be calculated. At the same time, regulatory authorities, for their part, should consistently review and revise their supervisory methods in accordance with the evolution of financial institutions' risk management operations.

## **2. Second Pillar (Financial Institutions' Self-Control and Supervisory Review Process)**

The second pillar of Basel II is a framework aimed at encouraging financial institutions to develop self-control processes that enable them to appropriately assess and manage all the risks involved in their business as a whole, including risks not captured by the First Pillar process (the calculation of minimum capital requirements) and to determine the amount of capital required for their business management. For their part, regulatory authorities should examine and assess the risk management techniques devised by the financial institutions themselves through their own creativity and resourcefulness and take appropriate supervisory measures as necessary. For the implementation of the second pillar of Basel II, the Comprehensive Guidelines for the Supervision of Major Banks, etc. and the Comprehensive Guidelines for the Supervision of Small- and Medium-Sized and Regional Financial Institutions have been amended in accordance with the Implementation Framework of the Second Pillar of Basel II<sup>2</sup>, which was published in November 2005.

To be more specific, the FSA is required to assess financial institutions' comprehensive risk management systems in light of the scale and nature of their business and to conduct off-site monitoring under the early warning system with regard to important risks such as interest rate risk and credit concentration risk involved in the banking book (those which are not captured by the first pillar). Regarding comprehensive risk management systems, the FSA intends to conduct assessments through its inspections and supervision with the use of the Checklists for Comprehensive Risk Management, Capital Management, etc., which are included in the amended version of the "Inspection Manual for Deposit-Taking Institutions," which was published in February 2007 and was to take effect in April 2007.<sup>3</sup>

Among the important risks covered by the second pillar is the interest rate risk involved in the banking book. Regarding this risk, the FSA intends to conduct monitoring within the framework of the early warning system so as to check whether or not economic value declines by more than 20% of the sum of Tier 1 and Tier 2 capital (known as the outlier criteria) as a result of standard assumptions concerning interest rate fluctuations (a standardized interest rate shock). However, even if a financial institution fits the outlier criteria, this alone would not automatically mean that this institution's management should be deemed as unsound and that the regulatory authorities should immediately move to urge the institution to take specific corrective measures. The FSA will urge financial institutions that fit the outlier criteria to conduct risk management more appropriately through hearings with them under the early warning system.

The second pillar is a new regulatory framework of a type that was not included in Basel I, and the risks covered thereby are not reflected in the calculation of minimum capital requirements under the first pillar.

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<sup>2</sup> For details concerning the implementation policy for the second pillar of Basel II, please refer to FSA Newsletter No. 37.

<sup>3</sup> For details concerning financial inspections after the start of the implementation of Basel II, please refer to FSA Newsletter No. 50.

However, these are not risks that are emerging for the first time because of the implementation of Basel II. In principle, financial institutions themselves are supposed to ensure the soundness of their own business management by appropriately managing various risks, including interest rates risk. The second pillar is a framework for issuing a reminder of the importance of voluntary efforts in this regard.

### **3. Third Pillar (Market Discipline)**

The third pillar is a framework for strengthening the self-control of financial institutions by enhancing information disclosure requirements as a way to exert market discipline. Under the provisions of the Banking Act, banks are obligated to disclose information concerning the status of their assets and business activities at least twice a year (once a year in the case of cooperative-type financial institutions). Disclosure items under the third pillar concern the status of capital buildup. Specifically, such items include the capital adequacy ratio, the breakdown thereof, risk measurement techniques and information concerning quantitative risks. The FSA published the final version of the notice concerning disclosure items under the third pillar in an official gazette in March 2007 and amended the guidelines for supervision accordingly. With regard to important disclosure items such as the capital adequacy ratio and the Tier 1 capital ratio, the Ordinance for the Enforcement of the Banking Act requires financial institutions to endeavor to make quarterly disclosure (semiannual disclosure in the case of cooperative-type financial institutions). Internationally active financial institutions and financial institutions adopting the IRB Approach (for credit risk measurement) and, in particular, the Advanced Measurement Approach are required to make semiannual and quarterly disclosures in an appropriate fashion. Such disclosure is one of the criteria that must be met for the approval of the adoption of those approaches.

### **Conclusion**

As explained above, Basel II is intended to encourage financial institutions to ensure appropriate risk management by promoting more precise measurement of the risks faced by financial institutions than Basel I. The first pillar of Basel II, for example, provides financial institutions with the option of adopting a method for calculating the capital adequacy ratio based on techniques used for their own internal control. In addition, the second pillar serves as a framework for encouraging self-control on the part of financial institutions and the third pillar serves as a framework for exercising market discipline.

Meanwhile, the objective of Basel II is neither to strengthen nor relax capital adequacy ratio regulations. Because of the increased risk sensitivity of Basel II in comparison with Basel I, the impact of the implementation of the new regulation varies from institution to institution. However, the overall effect is that the average capital requirement burden under Basel II is similar to the burden level under Basel I<sup>1</sup> as the addition of capital requirements for operational risk is offset by the reduction of the capital requirement burden related to credit risk pertaining mainly to loans to small- and medium-size enterprises and residential mortgage loans. In principle, financial institutions should conduct appropriate risk management on their own initiative and ensure sound business management, and the FSA believes that the implementation of Basel II will provide them with a good opportunity to be reminded of this principle. The FSA hopes that financial institutions will

proactively take advantage of Basel II so as to enhance their risk management, rather than simply respond to it as a regulatory requirement.

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<sup>i</sup> In the fiscal year ending in March 2007, the average capital adequacy ratio of major banks stood at 13.1%, up 0.9 percentage points from the previous year, and the average capital adequacy ratio of regional banks stood at 10.4%, up 0.6 percentage points.