International Conference on A Perspective of Asian Financial Sector under the Global Financial Crisis
January 21, 2010

The Publication of Consultative Documents by the Basel Committee on Banking Supervision and Future Challenges

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Background and Progress to Date

- Aiming to prevent the occurrence of another financial crisis and to strengthen the capital base of banks, the basis for future loans, the G20 countries at the London Summit in April 2009 agreed to strengthen the standards of the prudential regulations for banks, after the economic recovery is assured.
- Subsequently, in September 2009 at the Pittsburgh Summit, in order to improve both the quality and the quantity of the bank capital and to discourage excessive leverage, the G20 leaders agreed to establish internationally-agreed rules by end-2010 and to phase in the new rules as financial conditions improve and the economic recovery is assured, with the aim of implementation by end-2012.
- Between these two summits, the Basel Committee made an announcement in July 2009 that it would implement strengthened regulations related to higher risk weights for re-securitization products and rigorous treatment of trading books ahead of the above measures. These reforms are intended to resolve the sub-prime loan problem and other causes of the recent financial crisis and will be implemented by end-2010.
- The proposal that has been made public for consultation this time is a comprehensive package of regulatory reform measures other than those for re-securitization products and trading books that the Basel Committee has reviewed.

Overview of the Consultative Documents (Regulatory Reform Package)

The regulatory reform package for internationally-active banks which has been made public for consultation by the Basel Committee includes the following elements.

○ Strengthening the resilience of the banking sector

- Strengthening of the quality of capital
- Strengthening of the risk coverage (strengthening of the treatment of counterparty credit risk, etc.)
- Introduction of a leverage ratio (supplementary measure)
- Mitigation of procyclicality

○ International framework for liquidity risk measurement, standards and monitoring

- Introduction of Regulatory Standards for Liquidity

The Position of the Consultative Documents and How the New Regulations will be Brought into Force

- The regulatory proposals presented in the consultative documents are just ones among various options being debated in the Basel Committee.
- Taking into account comments received through the consultation period and results of the comprehensive "quantitative impact studies (QIS)" planned for the first half of 2010, there will be a further review in the second half of 2010 regarding how the final regulations should be.
- The new standards will be phased in as financial conditions improve and the economic recovery is assured, with the aim of implementation by end-2012, to ensure the consistency with the stability of the financial markets and "sustainable economic growth."
- Moreover, the Basel Committee has clearly stated that when it brings the new regulations into force, it will put in place appropriate "grandfathering arrangements" (allowing the existing treatment for a fixed period even after the new regulations have been brought into force) and "phase-in measures" (bringing a part of the new regulations into force at a later date).

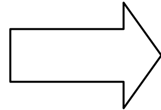
Strengthening of the Quality of Capital

The aim is to improve quality by clarifying the definitions for the elements of the capital structure.

Constitute of Capital (Current)

Predominant form of the core capital (Tier 1)	・Common shares (including preferred shares with conversion rights to common shares) and retained earnings
Tier 1 other than the above	・Preferred shares other than the above ・Preferred investment securities
Supplementary capital (Tier 2)	・Subordinated bonds, subordinated loans ・An amount equivalent to 45% of the revaluation reserve for land ・An amount equivalent to 45% of the evaluation reserve for other marketable securities ・The general allowance for doubtful loans (to a maximum of 1.25% of risk assets), etc.
Items deducted from Tier 1 (or capital overall)	・Loss on evaluation of other marketable securities ・Goodwill, trading rights ・Deferred tax assets (net amount) (portion in excess of 20% of Tier1)* ・Treasury stock ・Investment in other financial institutions (Depositary financial institutions in the domestic market) and non-consolidated subsidiaries, etc. (Double gearing)

Ensuring the loss absorbency on a going-concern basis



Assumes the loss absorbency on a gone-concern basis

Constitute of Capital (New Treatment Proposal)

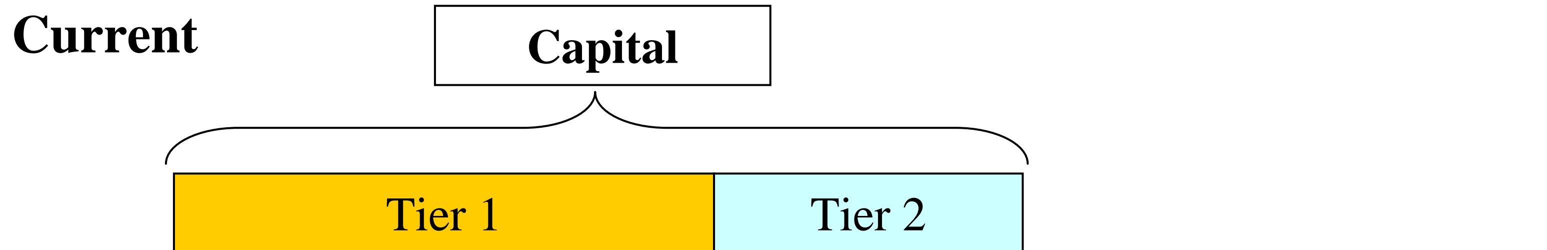
Predominant form of the core capital (Tier 1)	・Common shares and retained earnings (including other comprehensive income)
Tier 1 other than the above	・Preferred shares ・Other products are limited to those with strong loss absorbency (Clarification of entry criteria) ※ Aiming to improve quality while implementing transitional measures
Supplementary capital (Tier 2)	・Some preferred investment securities, subordinated bonds, and subordinated loans (Limited to those items that are clearly subordinated to depositors and general creditors to absorb losses when the bank is a gone concern) ・The general allowance for doubtful loans ※Aiming to improve quality while implementing transitional measures
As a general rule, items deducted from the major parts of Tier 1	・Loss on evaluation of other marketable securities ・Goodwill, trading rights + other intangible fixed assets ・Deferred tax assets (net amount) ・Treasury stock ・Strengthening of the treatment of investment in the common shares of other financial institutions (double gearing), expansion of the deduction items, etc. ※Deduction items will be finalized based on the results of impact studies including those on alternative proposals.

* Applicable to the major banks

Calibration of Capital Levels

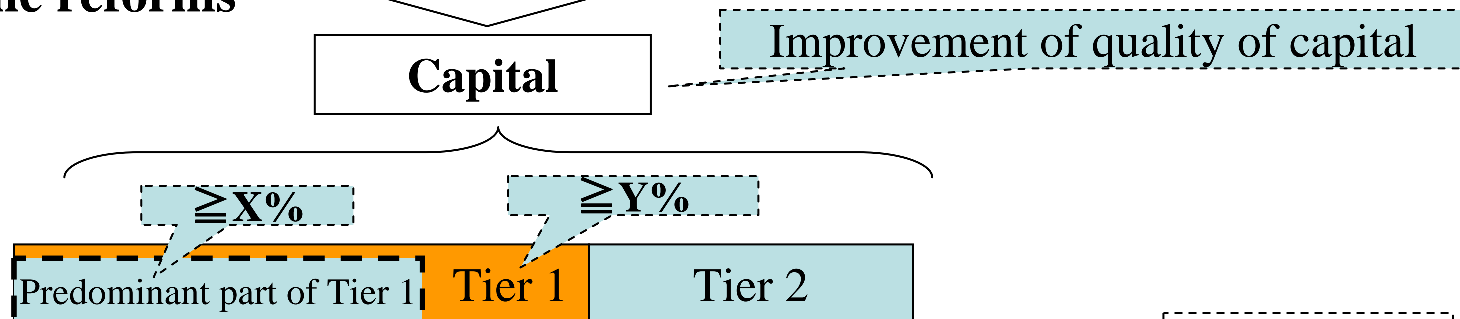
Determine levels of capital requirement by the end of 2010, taking into account the results of impact studies.

Current



≧ 8%

After the reforms



≧ Z%

Review of securitization, trading books, counterparty risk, etc.

Strengthening of Risk Coverage

(Strengthening of the capital requirements for counterparty credit risk (CCR), etc.)

1. Background

- During the recent financial crisis, insufficiency of the risk capture of CCR in relation to OTC derivative transactions and repurchase transactions, etc. has come to light.
  (Note) This has been seen particularly in the internal model method for capturing CCR.
- In addition to strengthening the risk coverage for re-securitization products and trading books which will take into force by the end of 2010, the Basel Committee will also plan to strengthen the risk coverage further.

2. Overview

- Strengthening of methods of estimating exposure to counterparties
  - Additionally capture the market risk due to the movement of the credit quality of counterparties
- Review of asset value correlations among large financial institutions
  - In the internal ratings-based approach, raise the value of the asset value correlation among large financial institutions to 1.25 times, because the asset value correlation among these financial institutions has been higher than that among other firms.
- Review of the treatment of exposures to central counterparties (CCPs)
  - Review the Basel II treatment in order to encourage settlements through CCPS that meet international standards set by CPSS/IOSCO.
- Review of the way external ratings are used in the framework of Basel II
  - Review the Basel II treatment in order to correct the excessive dependence on external ratings

Introduction of Leverage Ratio (Supplementary Measure)

1. Background

• At the London Summit in April 2009, the G20 leaders agreed to supplement risk-based capital requirements with a simple, transparent, non-risk based measure which can help contain the build-up of leverage in the banking system.

2. Overview

$$\text{Leverage ratio} = \frac{\text{Capital (Tier 1 or Predominant form of Tier 1)}}{\text{Total assets on the balance sheet + Off-balance-sheet items, etc.}} \geqq ?\%$$

• The regulatory level of a leverage ratio will be set after the impact assessment, by the end of 2010.

• A leverage ratio will be introduced with a view to migrating to a Pillar I treatment based on appropriate review and calibration.

• The treatment of liquid assets (cash, government bonds, etc.) will be reviewed with results of the impact assessment, taking account of interaction of a leverage ratio and liquidity framework requirements.

Mitigation of Procyclicality

1. Background

- At the London Summit in April 2009, the G20 leaders agreed to promote measures to mitigate procyclicality, including a requirement for banks to build buffers of capital, etc. in good times that they can draw down when economic conditions deteriorate.

2. Overview

Specific proposals have not yet been made for any of the measures below.

(i) Mitigation of the cyclicality of the minimum required capital (MRC)

- For banks adopting the internal ratings-based (IRB) approach, mitigate the cyclicality of the amount of MRC that arises from economic cycles by using the probability of default (PD) which is estimated using longer-term data.

(ii) Encouragement of forward-looking provisioning

- Encourage banks to build provisions for loan losses in good times under the expected loss approach which is currently studied by the International Accounting Standards Board (IASB)

(iii) Capital conservation by restricting distributions such as dividends

- Restrict the amount of capital distributions to a certain percentage of earnings in accordance with the level of capital to encourage the building up of capital buffers

(iv) Adjustment of the capital buffer level in accordance with macroeconomic conditions

- Adjust the capital buffer level in accordance with macroeconomic conditions, in order to mitigate the credit crunch

Introduction of Regulatory Standards for Liquidity

1. Background

- At the London Summit in April 2009, the G20 leaders agreed to develop a global framework for promoting stronger liquidity buffers at financial institutions.

2. Overview

(1) Liquidity coverage ratio (standard on a stress scenario over a 30-day period)

- The regulatory standard that requires banks to hold sufficient liquid assets (cash, government bonds, etc.) to meet its liquidity needs over a 30-day period in the specified stress scenario on both institution-specific difficulties (deposit outflows, etc.) and systemic shocks (greater difficulty in funding from the money market, etc.) .
- Liquid assets / Net cash outflows over a 30-day period ≧ 100%

(2) Net stable funding ratio (longer-term standard over a one-year time horizon)

- The regulatory standard that requires banks to maintain stable funding (deposits, longer-term borrowing, capital, etc.) in relation to the sum of the liquidity risks for each held asset (the risk of being unable to monetize it within one year).
- Available amount of stable funding / Required amount of stable funding > 100%

Future Challenges - Calibration of Capital Levels

1. Objectives

- To ensure that the new standards introduce greater resiliency of individual banks and the banking sector to periods of stress, while promoting sound credit and financial intermediary activities.

2. Bottom-Up Impact Studies

Cumulative impact of the following regulatory changes on required capital will be assessed in the first half of this year.

- Strengthening of the quality of capital
- Strengthening of the risk coverage (including the reforms related to re-securitization transactions and trading books.)
- Introduction of a leverage ratio

3. Calibration of Capital Levels

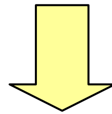
Calibration of capital levels should be determined based on the impact assessment of the proposed new standards on the flow of credit by the banking sector and the economy as a whole in addition to the soundness of individual banks.

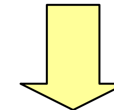
- Appropriate levels of minimum capital
- Appropriate level of capital buffer above the minimum standard
- Appropriate level of a leverage ratio

Future Schedule

Dec 17, 2009: *Publication of consultation documents for public comments*

Around Feb 2010: Commencement of QIS





Apr 16, 2010: *Deadline for the submission of public comments*

Around end-Apr, 2010: Deadline for the submission of QIS

The middle of 2010: Commencement of reviews taking into account the public comments and the results of QIS

By end-Dec, 2010 Completion of the calibration of the capital levels

End-2012: The target for the implementation of the new standards