

From static regulation to dynamic supervision

Keynote address by
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Thank you, Scott, for the kind introduction. Good morning, everyone. Welcome to Japan. It is my great pleasure to deliver my remarks at ISDA's 31st Annual General Meeting.

The last time ISDA had its Annual General Meeting in Tokyo was in April 2003. In the same month, the Basel Committee on Banking Supervision published the third consultative paper of the Basel II framework. The Basel committee explained what they wanted to attain by Basel II in the following way:

“[Basel II] builds on and consolidates the progress achieved by leading banking organizations and provides incentives for all banks to continue to strengthen their internal processes. By motivating banks to upgrade and improve their risk management systems, business models, capital strategies and disclosure standards, the Basel II Framework should improve their overall efficiency and resilience.”¹

What a different world it was then! What we can see in the statement is regulators' trust in bankers, risk management and innovation.

Since the Global Financial Crisis, such sentiment of trust seems to have become a thing of the past. Today, some even proclaim that the more the regulators distance themselves from Wall Street, the better they can police bankers, and a few even argue that dialogue with bankers entails

¹ Basel Committee on Banking Supervision, “G10 central bank governors and heads of supervision endorse the publication of the revised capital framework,” June 2004

the risks of regulatory capture. The global regulatory community's preoccupation shifted from bettering risk management to enhancing capital adequacy. Less confidence is given to supervisory processes adapted to specific institutions and more hope is placed on the effectiveness of uniform rules. It is sometimes argued that the room for innovation in risk management can be abused by arbitrage and that regulators need to intervene deeper into banks' risk management processes. Recently we see some signs of change, but I believe the balance is still tilted in the way I described.

It goes without saying that weaknesses that existed in the pre-crisis framework have to be rectified. Yet, the aspirations the global regulatory community had in pursuing Basel II included some valuable elements. After all, regulators cannot run the banks themselves and regulation can work only by providing bankers with the right incentives.

Today, we have many regulations based on banks' latest balance sheet numbers. Capital adequacy standards include the minimum ratio, the capital conservation buffer, the G-SIB surcharge, and the countercyclical buffer. We have the CET1 ratio, Tier 1 ratio, total capital ratio, and the TLAC ratio. We are also implementing the leverage ratio and the TLAC ratio using the leverage ratio denominator, and are currently considering introducing a G-SIB buffer for the leverage ratio. To secure liquidity, we have the Liquidity Coverage Ratio and the Net Stable Funding Ratio. In addition, banks are tested if they can satisfy these standards under stressed conditions. It looks as if a bank's safety and soundness were surrounded and protected by many layers of thick, defensive walls.

Yet, we had better think carefully whether thick walls are enough to attain our dual goal of financial stability and growth. The Japanese heavy battleships *Yamato* and *Musashi* had the thickest walls, but we know that they were not resilient against air power. Instead of blindly trusting the thickness of the walls, we need to assess and strengthen the entire framework of prudential regulatory and supervisory policy.

From A to G

Today I would like to propose that such assessment should incorporate the following perspectives: from A to G, in alphabetical order.

“A” stands for aggregate. We should aggregate the cumulative impact of the different regulatory measures taken. For example, we have liquidity ratios and margin requirements, which encourage banks to hold high quality bonds, and the leverage ratio, which discourages banks from holding such assets. What would be the aggregate impact of these apparently conflicting requirements?

“B” stands for behavioral. For example, if regulatory capital requirements are set at a level higher than economic capital, banks may start to behave differently: They may focus more on meeting the uniform regulatory parameters rather than apply their own divergent views of risks in allocating their investment, and thereby increase the risk of herd behavior.

“C” is for cross-sectoral. For example, prudential regulation on banks such as the leverage ratio requirement may have cross-sectoral impacts, through affecting market liquidity in fixed-income and derivative markets. Banking regulation can affect the capital market in many ways.

“D” is for dynamic. A tightening of capital adequacy rules may force banks to issue new equities and reduce risk-taking upon the introduction of the new rules. Subsequently, the change will alter their dividend payouts and affect their returns on equity, which would then result in changes in the bank’s business strategy in the following periods. Changes in banks’ risk-taking behavior will also affect the state of the market and, and through changes in bank lending and other activities, impact the real economy, resulting in changes in the banks’ future business environment. We should take such dynamic effects into account, to the extent possible.

“E” represents the ecosystem. A financial system is comparable to an ecosystem where many forms of life have competitive, symbiotic, or other relationships with each other. If new regulations induce financial institutions to withdraw from business activities such as market-making, client-clearing, repo-market financing, or correspondent banking, it could

result in a change in the entire system through various interconnective channels, just as the extinction of a certain species of the plankton could change the entire ecosystem of a lake.

“F” stands for feedback loop. Various feedback loops exist within banks, between banks, between the banking system and the capital market, and between the financial system and the real economy. The existence or the emergence of a pro-cyclical feedback loop might not be unveiled till the next crisis materializes.

The message I wanted to convey by talking about those elements under A to F is similar to what we learn at Economics 101. To know how the world works, a partial equilibrium analysis, which looks only at a specific sector or market in question, is not enough and can even be misleading, which points to a need for conducting a general equilibrium analysis which incorporates interactions and interdependencies within and across various sectors and markets.

So “G” stands for general equilibrium. I am not proposing to use the concept exactly in the way economists use. Please be assured that no complex equations or Greek letters appear in my following slides. Rather, the point I want to make here is that, in assessing the system of our prudential policy, we should take into account such interactions and interdependencies as the perspectives A to F would suggest.

True, it is by no means easy to analyze the effects of regulatory reform from the perspectives A to G, but it should not be an excuse for not addressing them. Interactions and interdependencies are key elements in the real world. Formulating our policy on assessments using partial equilibrium-type analyses is easier but can be dangerously misleading.

An alternative approach to prudential policy

The above considerations have prompted us at the JFSA to think about an alternative approach to prudential policy. Current prudential policy is centered on a static regulatory approach focusing on the most recent, point-in-time balance-sheet figures. Let me cite three reasons why this can be problematic.

First, when we design and implement regulation, we ideally should follow a Plan-Do-Check-Act, or PDCA-cycle, designing regulation, implementing it, assessing its effects upon implementation, and making modifications, if needed. Doctors do not prescribe medicine – particularly strong medicine – without assessing its effects and side-effects on the overall health of the patient. But, in the case of prudential policy, it is not easy to assess the effects and side-effects on the overall functioning of the financial system incorporating the perspectives A to G.

Can there be, then, any alternative approach other than imposing a set of static regulation and let it stay till we know its dynamic effects long after introduction? If supervisors have closer dialogue with individual banks based on the perspective A to G, it would most probably help implement the PDCA cycle in an appropriate and timely manner.

Second, the safety and soundness of a bank cannot be captured by a point-in-time assessment of its balance sheet alone. They are ensured through dynamic interactions between the bank and the markets, and affected by various elements in the entire economy. A vicious cycle among elements can even break layers of thick protective walls.

Then, instead of relying exclusively on static rules calibrated on the basis of point-in-time figures of the bank's balance sheet, we should try to complement them by close supervision, which incorporates the perspectives A to G.

Third, regulation, or application of uniform rules, has an advantage of being more objective and transparent, and comparable across countries, but tends to focus on the point-in-time condition of a limited number of the elements of bank soundness, and entails the risk of inviting regulatory arbitrage and creating market distortions.

Supervision, or monitoring of banks' conditions and measures taken according to their individual conditions, on the other hand, entails the risk of being less predictable and transparent, and also difficult to compare across jurisdictions, but it enables the adoption of a more holistic approach to ensuring the safety and soundness of the bank, while not

impairing its financial intermediation function. Such an approach could help identify any undue accumulation of risks, and deal rapidly with new or unexpected risks, which are not captured by static regulation.

Would there be a better division of labor between regulation and supervision to leverage the strengths and complement the weaknesses of each?

These are the questions we at the JFSA are asking of ourselves. Though we do not have complete answers yet, today I would like to share our current thinking with you to solicit your reactions and seek your inputs to deepen our thoughts.

Elements of dynamic supervision

Ideally, we would like to monitor a bank with particular attention to the following three relationships:

- First, the relationship among the risk taken, the returns earned and the capital retained by the bank.
- Second, the relationship among the bank, the capital market, and the real economy.
- Third, the relationship between the bank and its customers.

Let me discuss the three aspects referring to the *Mandala*-like diagram.

Elements of sustainable banking business



The first of the three aspects is the relationship between risk, return and capital. The green part of the *Mandala* depicts this relationship. There are three balances, each of which is essential for the bank's sustainability: the risk-return balance, the return-capital balance, and the risk-capital balance.

Please look at the upper half of the diagram. If the bank does not attain the right balance between risk and return, it cannot be profitable in a sustainable manner. The bank needs to have a business plan which can attain the balance.

The lower right part of the diagram is meant to indicate that the bank needs to attain the right balance between return and capital in order to be a viable listed company in the capital market. The bank's capital strategy should ensure the balance.

The bottom left part of the diagram depicts the balance between risk and capital. If the level of capital is not commensurate with the risks taken, depositors and creditors cannot have confidence in the bank. The risk management process of the bank should ensure the balance.

If the bank can maintain the right balance between risk, return and capital, then it may benefit from a virtuous cycle: Gaining a reasonable return on risk will enhance its capital through retained earnings, and strong earnings and capital will make it possible for the bank to make investments and risk-taking needed to provide better value to its customers. Creating value shared with its customers will solidify its business model and further improve the risk-return balance. The opposite, or a vicious cycle, can also happen.

Capital adequacy requirements focus only on the left bottom part of the diagram, or the risk-capital balance. The risk-capital balance is the most immediate indicator of the bank's soundness and viability, but it is point-in-time, and we cannot have confidence in the sustainability of the bank if we ignore the other two balances.

Second, we intend to supervise banks by paying particular attention to banks' relationship with the capital market and the real economy, or the relationship between the green and orange parts in the diagram.

The feedback loop existing between the banking sector, the capital market and the real economy can form both virtuous and vicious cycles. For example, a recession can increase non-performing loans on the books of banks and market turmoil can result in capital losses for banks, and the resultant malfunctioning of the banking sector can further exacerbate the recession and market turmoil.

In our pursuit of stability and growth, it is pivotal to avoid the occurrence of such a vicious circle and to foster a virtuous cycle. Our aim therefore should not be limited to the minimization of the risk of failures of individual banks: We should make sure that the financial system effectively functions to support business activities and the overall economy, even in the conditions of market turmoil or economic downturn.

To be sustainable, banks need to keep transforming themselves adapting to the rapid changes in the market and the economy. In 1988, Japanese banks were considered to be among the strongest in the world. It was a false sense of strength resulting from their strategy to pursue larger size

in a deregulated environment, even as size ceased to be a key source of strength. Five years later, they found themselves deep in trouble. Misguided responses to changes in the business environment can indeed be fatal.

Our dialogue with banks will emphasize the banks' responses to changes in the business environment such as credit cycles over the longer term, technological innovations, emergence of new risks, demographic changes, changes in social value, and changes in regulation.

Third, we intend to supervise banks with particular attention to the relationship between banks and their customers. Please revert to the upper half of the *Mandala* diagram.

Michael Porter and Mark Kramer argued in their 2011 paper titled "Creating Shared Value" that companies can find new markets and establish competitive advantages by creating shared value with their customers, community and the society, instead of pursuing business performance and social responsibility separately.²

In many countries, notably in Japan, the population is aging, and local communities have started to shrink. Consumption has matured, and room for economic growth is limited. Low interest rates have prevailed and the yield curve has become flat. In this environment, it will become more and more difficult for banks to achieve balances between risk, return and capital, by the pursuit of the merits of scale through price competition. The pursuit of the merits of scope through mergers and acquisitions may not always bring the right balance, unless customer value is enhanced as a result. The sustainability of a bank would ultimately hinge upon what shared values it creates with their customers.

We at the JFSA is in the process of interviewing one-thousand borrower companies of different sizes, industries and regions, and have found that many borrowers think that banks do not provide the values borrowers are most keen to obtain from a bank's services. We believe such findings

² Michael E. Porter and Mark R. Kramer, "Creating Shared Value," *Harvard Business Review*, January-February 2011

can help banks find better ways to create values shared with their customers.

Conclusion

I have briefly sketched how the JFSA intend to design its prudential policy. In short, we intend to move from a framework dominated by static regulation to that complemented by dynamic supervision. Though I did not have time today to discuss how the new framework should function more specifically, we hope to publish a consultative paper laying out a more complete picture before the summer, both in Japanese and in English. We look forward to receiving your inputs.

As I mentioned at the beginning, at the time of the last ISDA Annual General Meeting in Tokyo, the global regulatory community aspired to maintain financial stability and enable sustainable growth by providing banks with incentives to enhance their risk management practices, capital strategies and business models. The JFSA is hoping to explore the potential benefits of such an approach once again.

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. I hope that the discussions scheduled later today and tomorrow will form an important step towards a world where efforts by bankers and regulators complement each other's roles and jointly contribute to the goals of financial stability and sustainable growth.

Thank you very much.