Opening Keynote Presentation at the Japanese Regulatory Summit 2017
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"Pursuing the Dual Goals of Financial Stability and Sustainable Growth through Regulatory and Supervisory Reforms"

Thank you very much for the kind introduction. It is a great pleasure to deliver my remarks at the Japanese Regulatory Summit again. Last year, I talked about international discussions on regulatory reforms after the financial crisis and challenges faced by both regulators and banks around the globe.

Today, I would like to focus on challenges faced by the JFSA under the rapidly changing environment and explain the directions we are aiming at through regulatory and supervisory reforms.

Then, I will touch upon our thoughts regarding recent developments of international discussions on regulatory reforms and possible next steps.

Changing environment surrounding Japanese banking business and JFSA

JFSA's original missions around Year 2000

If you look back at the history, the JFSA's supreme mission at its inauguration around Year 2000 was to resolve non-performing loan problems and to end the ensuing financial crisis. In order to regain trust in the financial administration, we emphasized rule-based ex-post checking for our supervisory activities. Asset quality review and compliance check conducted by on-site inspectors were the primary policy tools employed. I would say objectivity, transparency and self-responsibility principles of our activities have significantly contributed to the restoration of public confidence in the financial administration as well as stability of the Japanese financial market.

Limitation of current supervisory approaches

This successful business model for the JFSA, however, may not necessarily work for ever. If we mechanistically continue the past modus operandi, we may create unintended consequences or fail to address emerging risks. That's why the JFSA established the "Advisory Group on Supervisory Approaches" last year to have our supervisory approaches reviewed by prominent outside experts. The group points out that there can be three types of deficiencies in continuing the current approaches. One is the obsession with form rather than substance. For instance, we tend to put too much emphasis on guarantee or collateral in credit assessment and fail to properly assess the profitability of a borrower's business. The second problem is the obsession with the past. For instance, we tend to focus on the soundness of a bank's balance sheet based on point-in-time information in the past rather than its business sustainability in the future. The final problem is the obsession with individual elements. For instance, we tend to focus on the classification of each asset rather than holistically assessing material risks for a bank's entire management.

Changing environment surrounding Japanese banking business

As global markets are getting more volatile and can quickly and significantly affect Japanese banks, we need to be vigilant and respond swiftly to various emerging risks, including geopolitical factors.

In addition, the Japanese economy has undergone a long period of very low interest rates, some of which have even entered into the negative territory. This trend has squeezed the margin between deposit rates and lending rates in Japan, because retail deposit rates are constrained by the de facto zero lower bound. Japanese banks have tried to compensate the narrowed margin by increasing lending volumes despite the depopulation trend in Japan, intensifying competition and further accelerating the margin squeeze. Moreover, a flat yield curve squeezes term spreads between short-term funding and long-term investments, also putting pressure on bank profitability.

On the other hand, there is a variety of customer needs that are not sufficiently satisfied by Japanese banks. One example is the Japanese services industry, mainly composed of a large number of SMEs, whose productivity has been remaining relatively low. Another example is Japanese household financial assets, the majority of which are held in cash or deposits and are not sufficiently diversified. Japanese banks are expected to improve the quality of their consulting functions or asset management services by addressing each customer’s needs properly. In short, Japanese banks need to seek sustainable business models under the changing environment by pursuing win-win solutions with customers. In particular, for regional banks, the viability of the regional economy where each of them is operating is an important prerequisite for their sustainability.

Review of supervisory approaches

New challenges for JFSA

Against this backdrop, the JFSA has begun to shift its focus from backward-looking asset quality review to forward-looking monitoring of emerging risks and sustainability of each bank’s soundness. Although ex-post asset quality review is effective in cleaning up the legacy of what happened in the past, it does not necessarily prevent the creation of a portfolio susceptible to losses in a future case of unexpected economic and market downturns.

In addition, the persistent low interest rate environment seems to be creating a new type of risks for the sustainability of banks: the risk of compressed margins, the risk of traditional business models becoming non-viable and the risk of a vicious cycle caused by impaired credit intermediation capabilities. Existing prudential toolkits, which are designed to curb excessive risk-taking, would be hardly effective in dealing with this new threat of weakened financial intermediation. In this respect, the aforementioned advisory group argues that, while JFSA’s primary missions are the stability of the financial system, protection of bank customers and so on, its ultimate goal in pursuing these missions should be sustainable economic growth.

Elements of sustainable banking business

Last year, Mr. Nobuchika Mori, Commissioner of the JFSA, delivered a speech in Tokyo calling for a shift from static regulation to dynamic supervision, and pointed out three types of balance for a bank’s sustainability: the risk-return balance, the return-capital balance and the risk-capital balance. The argument in the speech is that the last one of the three, risk-capital balance, is the most immediate indicator of a bank's soundness and viability, but that it is just a point-in-time ratio and does not give any assurance on its sustainability without the other two balances.

As the environment surrounding banking business is getting less favorable due to demographic and structural changes in some advanced economies, we cannot ensure the soundness of a bank by merely controlling its excessive risk-taking in relation to its capital. If a bank's profit is not matched to its capital or its risk-taking, it cannot accumulate retained earnings in a stable manner and may face difficulties in capital-raising when necessary. Therefore, the JFSA intends to carefully monitor these three types of balance through dialogues with banks and to detect potential weaknesses for the sustainability of each bank. Though banks have started their efforts to reduce costs, increase fees to their customers and/or consider consolidation with other banks, they have not yet made sufficient efforts to grow together with their customers.

In order to facilitate such dialogues, the JFSA published simulation results of the combined effects on banks' profitability of continued low interest rates and decline in working age population in regional economies. We have also conducted interviews with more than 700 borrower companies and written surveys with more than 2000 firms to find how banks can create shared value with customers. In addition, the JFSA started the use of some fifty indicators which capture characteristics of and changes of direction in a bank's business model, such as numbers of customers with improved performance, as a tool for better dialogue. We would like to deepen our dialogues with banks over their profitability and business models by utilizing these data and information.

JFSA's approach to macro-prudence and stress-testing

These dialogues with banks would also help supervisors to identify macro-prudential risks. Supervisors are in a better place than banks in grasping a precise picture of interactions in the market through their access to the information on each bank's risk positions and internal incentive structures. Supervisors can also detect signs of deterioration of each bank's underwriting standards. In addition, supervisors can assess the collective second-round effects of possible reactions by banks to a potential shock. In short, supervisors should be able to give a warning on anomalies individual banks may fail to notice.

But this task would not be so simple. Macro-indicators traditionally used to detect anomalies, such as credit-to-GDP ratio or asset price movements, would surely help us, but would not let us distinguish between a healthy boom and irrational exuberance. So, the JFSA is paying attention to micro-symptoms as well and trying to analyze interactions between the activities of individual banks and movements of the market.

In this connection, the JFSA considers stress-testing as a useful tool to identify material risks in a forward-looking manner for individual banks as well as the entire financial system. We put greater emphasis on stress-testing conducted by each bank based on its own scenario tailored to fit respective weaknesses. Through the dialogue over appropriately tailored stress-testing, the JFSA and each bank will have a common recognition of emerging risks and of each bank’s resilience against them. This exercise will also help us assess systemic risks on the financial markets and the entire economy, and deepen our macro-prudential analysis as well.

Next steps for global regulatory reforms

G20’s commitment to attain both financial stability and sustainable growth

Let us turn now to international discussions on regulatory reforms. As you may know, the JFSA, together with other like-minded colleagues, has been advocating that the global regulatory reform efforts should aim to attain not only financial stability but also sustainability of economic growth while minimizing their unintended side-effects. In response, the G20 Leaders have proclaimed that sustainable economic growth is the ultimate goal and that they would address any material unintended consequences caused by the financial regulatory reforms. Accordingly, the FSB has initiated the exercise to review both the effects and side-effects of the reform measures, and the Basel Committee is committed to finalizing Basel III without a significant increase in overall capital requirement. We will continue our efforts to ensure that these commitments are fulfilled by each standard-setter, including the Basel Committee. They should thoroughly review the possibility of unintended consequences of their reform measures and, if necessary, should not hesitate to make adjustments.

Though I cannot comment in detail on the current status of negotiations at the Basel Committee, I would dare to say that the remaining issue is, in essence, the balance between simplicity/comparability vis-a-vis risk sensitivity of the capital framework. From Asian perspectives, the importance of risk-sensitivity is high in light of the dominance of a commercial banking model in the region. Loan commitment, trade finance and project finance are notable cases in which capital costs need to be sensitive to their underlying risks. Therefore, we will continue to make every effort to achieve a well-balanced capital framework.

From static regulation to dynamic supervision

Except for Basel III, most of the post-crisis regulatory reforms have been completed and need to be implemented in accordance with the agreed schedule. As the reform package is so huge and complicated, we need to concentrate on domestic rule-making processes for some time and then need to establish a supervisory framework for each measure. Therefore, whether we want to or not, international fora have to shift their focus from rule-making to implementation and supervision.

Moreover, I believe, bank supervisors need more discussions on the sustainability of a bank’s soundness under the prolonged low interest rate and flat yield curve environment in some advanced economies. Existing prudential regulations largely focus on the balance between capital held by banks and risks taken by them and do not directly address issues of profitability. A capital buffer is effective in meeting sudden unexpected loss, but cannot withstand a prolonged period of structural losses. Given the possibility of continuation of the unprecedented very low rate environment, it may be warranted for the Basel Committee or the FSB to share experiences and discuss possible tools to cope with this new type of supervisory challenge.

Importance of international regulatory framework

Despite the change in focus, the importance of the international regulatory framework will not change at all. It provides internationally active banks with a stable foundation and a level-playing-field for cross-border operations. Without such an international framework, such banks would face duplicative or conflicting regulations in each jurisdiction where they operate and their global operations would become far more inefficient and costly. This is why we need to finalize Basel III as soon as possible to remove regulatory uncertainty. It is also imperative for each major regulator to implement the internationally agreed framework faithfully in a timely manner in its jurisdiction. Otherwise, global banks would face competitive inequality and lose confidence in the international regulatory framework. In order to avoid such an unfortunate situation, I believe, the international regulatory framework itself should have some degree of flexibility to deal with specificities in local markets or diversity in business models, while being mindful of simplicity and comparability.

More harmonized implementation and supervisory cooperation

For the benefit of smooth implementation of global regulatory reforms, authorities around the globe need to implement regulations in a harmonized manner and to enhance cross-border supervisory cooperation. I would like to take the example of implementation of the margin requirements for non-centrally cleared derivatives. This new international framework based on the G20 agreement came into force on 1 September 2016, but only in 3 jurisdictions - US, Canada and Japan.

Authorities from four additional jurisdictions – EU, Australia, Hong Kong and Singapore – followed suit by finalizing their rules after 1 September 2016 and started implementation no later than 1 March 2017, though a 6-month transition period has been granted by the authorities of the last 3 jurisdictions.

The gap in implementation timing posed significant challenges for jurisdictions abiding by the internationally-agreed schedule because counterparties, particularly those located in jurisdictions of delayed implementation often seek to avoid incurring costs associated with them. Nevertheless, the phase 1 banks, including Japanese large financial groups, which became subject to the initial margin requirements on 1 September

2016 made tremendous efforts to complete legal documentations and operational preparations, thereby achieving a high level of compliance with the requirements. This is commendable given the situation they were faced with.

Behind this successful implementation on 1 September 2016, I would also like to mention, relevant authorities also played an important role to coordinate supervisory approaches for addressing difficulties involved in cross-border transactions. The so-called T+1 issue related to the timing for the exchange of margins is the most notable example, which might have affected banks in the Asian-pacific region most seriously. The JFSA raised this issue at the Basel Committee and the IOSCO at an early stage and contributed to building awareness among regulators on the necessity to take a flexible and coordinated approach. In addition, the JFSA and the US CFTC have issued comparability determinations for allowing each other's rules to be applied to cross-border transactions. We are still in the process of enhancing our cross-border supervisory cooperation to address bigger challenges associated with the implementation of the VM big-bang that came into force last week. Again, thanks to tremendous efforts made by Japanese banks, we have not heard any major problems so far in our jurisdiction.

I think we need to learn important lessons from this episode. Differences in implementation timing of international regulations together with the resulting complexities have raised operational challenges and level-paying-field concerns for market participants, which could increase the risk of market fragmentation and hinder the functions of financial markets to support the broader economy. Cross-border supervisory cooperation is essential to avoid such an undesirable outcome.

Conclusions

To sum up, the JFSA is pursuing both the stability of the financial system and the sustainability of economic growth through regulatory and supervisory reforms. In order to achieve these dual goals under the current macro-economic and demographic environment, we need to shift our focus from static regulation to dynamic supervision and to encourage banks to improve financial services for the best interest of their customers.

Considering low profitability of banks due to persistent low interest rate and flat yield curve environment, the JFSA enhances dialogue with each bank on the sustainability of its business model, paying due attention to the balance between risk, return and capital.

With regard to global regulatory reforms, the JFSA continues to be committed to the international regulatory framework and supervisory cooperation among authorities to avoid market fragmentation and undue costs for banks' cross-border activities. In particular, the JFSA will make the utmost effort to finalize Basel III to remove regulatory uncertainty, while advocating a balance between simplicity/comparability and risk-sensitivity.

Thank you.