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2. Overview of Development in Financial Regulations (Trends & Topics)

 # Towards the enhanced Pillar 2 (Shiro Katsufuji, Director, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

In global financial regulation, as Basel III was finalized at the end of 2017, focus is shifting away from the "Pillar 1" requirements towards "Pillar 2." In Pillar 1, convergence of the international standards for capital requirements have made progress. However, risk management area for financial institutions is expanding into new territory outside of conventional risk categories (namely credit risk, market risk, and operational risk).

Various financial institutions are addressing these risks through a more sophisticated approach to the Internal Capital Adequacy Assessment Process (ICAAP). For instance, the interest rate risk in the banking book (IRRBB) is not subject to the Pillar 1 international standards of the Basel Accords. However, many financial institutions calculate IRRBB using methodologies such as Value at Risk (VaR) or net interest income (NII), which are both managed under the buffer of the Pillar 1 capital requirements. The same goes for stock volatility risk - Basel Pillar 1 treats risks in equities as part of credit risks and measures unexpected losses as risk assets, based on the probability of default (PD) and the loss given default (LGD). However, the actual risk in shareholding lies more heavily in price volatility rather than an issuer's potential default, thus a number of Japanese banks control this risk (i.e. cross-shareholdings) by including price risk in required capital.

In the UK and Europe, the structure for capital requirements based on Pillar 2 is being enhanced. The Prudential Regulation Authority (PRA) requires financial institutions to maintain Pillar 2 capital in a two-tiered framework made up of Pillar 2A and Pillar 2B. This is capital add-on requirement to address risks that are not adequately covered by the EU's Capital Requirement regulation, which is based on the Basel Accords. The PRA imposes additional Pillar 2 capital rules mainly for risks to which the Basel's methods do not allocate sufficient risk amount (i.e. standardized approach for operational risk). Conventionally the PRA utilized its unique method to supervise the Pillar 2 requirements in the UK. However, from January 1, 2018, the regulation has been upgraded to a statutory requirement under the Financial Services and Markets Act. In Europe, the European Banking Authority published the "Pillar 2 Roadmap" in April 2017, and launched public consultations to strengthen the Pillar 2 framework in October 2017. These propose to set the result of the bank stress tests as the pillar 2 guidance (P2G) for supervisory authorities in the EU jurisdiction.

Among the risks that Pillar 1 does not cover, some are difficult to capture by quantitative measurement. Those that are not suited to quantitative measurement (i.e. conduct risk, reputational risk) as well as those utilized in event-driven scenarios (i.e. issues around North Korea, or a possible earthquake that devastates Tokyo) require supplementary control beyond Pillar 1. In order to assess the capital level in relation to these risks, it is effective to develop stress scenarios and evaluate their impact, instead of waiting for the arrival of quantitative measurement methodologies. In the US, the supervisory stress tests (i.e. CCAR, DFAST) have already been serving as a basis for capital requirements for domestic financial institutions. The Basel Committee on Banking Supervision (BCBS) published a report titled "Supervisory and bank stress testing: range of practices" where it compares and analyzes regulatory stress testing and industry practice in different countries. The report will be a momentum for the authorities to move forward with further sophistication in stress testing.

In Japan, supervisory stress tests are less prominent than in other jurisdictions. However, Japanese banks are expected to further develop ICAAP or internal stress testing as an internal control method to maintain the capital adequacy. The economic downturn in the US began in 2007 when subprime mortgage loans triggered the global financial crisis. 10 years on from the last recession, it is necessary to prepare for the next economic downturn with forward-looking risk management that is not driven by regulatory requirements.