'This newsletter is translated from the Japanese edition distributed on April 25th
Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

Japan's Economy Struggling in the Phase of Global Risk-Off Holidays, etc.

Global Risk Watch Vol.13 (1 year anniversary)
28 April 2016

==

≪index≫

==

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

 # Perhaps the Financial Regulation Strengthening has Gone Too Far? (Koichi Iwai, Senior Manager, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

In the Basel Committee on Banking Supervision (BCBS), regulatory development work has become somewhat hurried. Only within the past one month, several important papers have been published, including consultative document on "Reducing the variation in credit risk-weighted assets – constraints on the use of internal model approaches" and "Regulatory consistency assessment programme(RCAP)-Analysis of risk-weighted assets for credit risk in the banking book" in the area of credit risk internal rating approaches, and also consultative document on "Revisions to the Basel III leverage ratio framework" regarding leverage ratio.

These regulatory reform documents did not give out any surprises as it was widely expected prior to the announcement. Moreover, in these BCBS documents above, the committee has indicated that the intention of concurrent reform proposals are not to raise the overall capital requirements, which could be somewhat comforting news for the banking sector.

However, in the above documents, some proposals have potentially major impacts on banks that use internal ratings-based approach (IRB approach). Specifically, the proposal not only limits the scope of exposure to which the IRB approach can be applied, but also to set a floor (lower limit) on the model parameters themselves. In addition, the document also indicated consideration for setting "capital floor" to be applicable for internal model approaches to be 60% - 90%. If a 90% capital floor is adopted, the incentives for banks to use internal model approaches should be reduced significantly. As the consultative document "Standardised Measurement Approach for operational risk" published on March, 2016 stated to abolish Advanced Measurement Approaches (AMA), BCBS has maintained a fairly strict stance with respect to internal model approaches. Therefore, the outcomes of BCBS's regulatory reforms seem to have substantial impact on banks' incentives to enhance risk management framework and measurement approaches.

Meanwhile, it is noteworthy that the Japanese Financial Services Agency (FSA) has once again stated its cautious stance toward global financial regulatory developments. For example, during the interview with Mr. Kano, Vice Minister for International Affairs of JFSA, stated that when analyzing effects of regulatory reform, regulators should consider the combined effect of various regulations, and should not hesitate to fix the problems by the regulatory reforms that has already been implemented. Furthermore, Mr. Mori, Commissioner of the agency, stated in his speech on April 13th that while banks' safety and soundness are now protected by a number of thick defensive walls due to a series of regulatory strengthening, the authority should carefully consider whether these walls are sufficient to achieve two goals, financial stability and growth. Commissioner Mori also stated that JFSA is set to transform its approach from regulatory focused framework to a framework that is supplemented by dynamic supervisory.

Considering these discussions, the Japanese supervisory authority seems to consider that the outcomes of regulatory strengthening have actually diminished the financial intermediary abilities, which also induce adverse impacts and risks on the real economy and capital market. Certainly, although there is not guarantee that the JFSA's stance will immediately change the policy stance of BCBS and supervisory authorities in the US and Europe, the effects of regulatory reforms will be validated by supervisors domestically and internationally going forward. What kinds of validated results can be confirmed, and whether it is necessary to revise regulatory strengthening are bound to gain more attention.