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Concerns for Brexit Reveals some Weaknesses in the Japanese Economy, etc.

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

 # Moving from Increased Regulation to Emphasizing Supervision (Koichi Iwai, Senior Manager, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

The issue of how long regulatory reform will continue is still of paramount importance to financial institutions. In this e-Newsletter magazine we referred to the comment by the Financial Stability Board (FSB) Chairman Carney, saying “no Basel IV”, and Japanese Financial Services Agency (FSA) Commissioner’s speech on “ from static regulation to dynamic supervision”. Recently, Bank for International Settlements (BIS) General Manager Caruana directly joined such discussions.

In his speech “Financial regulation: cementing the gains of post-crisis reforms”, Mr. Caruana provided the justification of the regulatory strengthening led by the Basel Committee on Banking Supervision (BCBS) with the following reasoning:

(1) Equity capital is the foundation on which banks base the lending that supports the real economy. BIS research has found that more capital, within a reasonable range, goes hand in hand with more lending. Thus, considerations

on this point should be taken into account in order to strike the right balance in calibrating the overall capital requirements.

(2) In finalising the regulatory reform, a key challenge is to address any excessive variation in risk weights across banks and still maintain the risk sensitivity of capital requirements. Thus, we will not lower the overall capital requirements for banks. Therefore, outlier banks that have stood out with low risk weights should expect to see an increase in their capital requirements.

(3) Regarding the regulatory treatment on sovereign exposures, the preferential treatments of sovereign exposures are currently under review. The timeline for these revisions will most likely extend beyond the finalisation of the other components of the regulatory reform. However, as the drawbacks of the preferential treatment of sovereign exposures are apparent, we expect to weaken the current privileged status of these exposures.

(4) Before the crisis, the excessive leverage and a mispricing of risks resulted in cheap liquidity that market players took for granted. This was eventually exposed in a sudden bust, in which liquidity dried up. Hence the “negative” impact by regulatory reforms on market liquidity is appropriate.

From Mr. Caruana`s stand point, both as being in charge of day-to-day operations at BIS, and also a former head of BCBS, the necessity and legitimacy of regulatory strengthening since the Global Financial Crisis seem to be rather self-evident. At the same time, Mr. Caruana foresees the increasing importance of supervision after finalizing a series of regulatory reforms. As he put it ‘the constant evolution of the financial system and the morphing of risks imply that there is much to be gained from having a prudential policy framework to complement supervision, regulation, and corporate governance’. Frequent regulatory changes are undesirable whilst financial system and risks continue to evolve. Thus, “proactive supervision” could help reduce the need for repeatedly refining and changing regulatory standards.

Caruana’s stance to emphasize supervision seems to coincide with the argument raised recently by the Japanese regulators, and shall be interesting to observe going forward. In Japan, some sort of document is expected to be released by this summer with regards to Commissioner Mori’s comments on “dynamic supervision”. It is clear that both domestic and global financial authorities are already preparing for the post-regulatory reforms environment. As for the financial institutions, they must enhance the forward-looking risk management methods and governance frameworks in order to cope with post-regulation environment, and also to hold beneficial dialogue with the ‘proactive supervisor”. Again, according to Mr. Caruana, “stress tests can provide supervisors with valuable information about the need to go beyond the regulatory minima. Banks' economic capital, derived from internal risk management systems, should take centre stage. This will allow for a mutually beneficial dialogue between banks and supervisors on the assessment of constantly evolving risks.