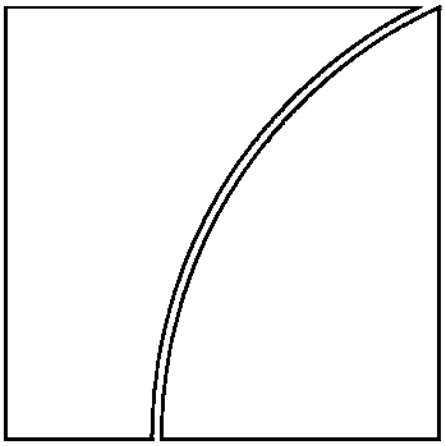
Basel Committee
on Banking Supervision



# Basel III regulatory consistency assessment (Level 2)

## Japan

October 2012

BANK FOR INTERNATIONAL SETTLEMENTS

**Note that this report refers to the RCAP grades prior to October 2025. The grade 'materially non-compliant (MNC)', ie one notch above the lowest grade, has since been renamed to 'partially non-compliant (PNC)' for greater clarity**

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# Foreword

This report presents the conclusions of the Basel Committee's Basel III[1] Regulatory Consistency Assessment ("Level 2") for Japan. It is based on information available at the time it was completed on 22 August 2012. The assessment was conducted over a period of six months from March to August 2012, including an on-site visit in July 2012. The preliminary findings of this assessment were published in a June report to the G20 leaders.[2] The team, led by Ms Sylvie Matherat, Deputy Director General Operations, Banque de France, consisted of six experts, and was coordinated by the Secretariat.

For purposes of this Level 2 assessment of Japan, the Japan Financial Services Agency (JFSA) and the Bank of Japan (BoJ) served as the assessment team's main counterparts. The bank data analysis that forms part of the assessment was coordinated by the JFSA. Representatives from the JFSA, BoJ and from the industry (for specific meetings) participated in the review.

The assessment in this report is based on recently published regulation (as of March 2012) and other rules that implement Basel III in Japan. Hence, the assessment is largely considered final. Nonetheless, there are a limited number of elements which will remain subject to follow-up analysis:

- The assessment excluded certain sections of the Basel rules that are under review or are being finalised by the Basel Committee. In particular, the leverage ratio, the liquidity ratios and the framework for global systemically important banks (GSIBs) have not been assessed. Japan's implementation of these rules will be assessed once they are finalised by the Basel Committee.
- While Japan has already put in place the vast majority of its domestic Basel III rules, specific issues (primarily the rules for capital buffers) are still under final discussion and implementation is envisioned at a later stage but prior to the deadline(s) agreed by the Basel Committee.

The report has been written in accordance with "exception-based reporting", ie it focuses on deviations that could lead to a less robust capitalisation of the banking sector than would otherwise have been achieved if the Basel Framework had been implemented in full. As such, areas of compliance are not explicitly addressed, nor are domestic measures that strengthen the minimum requirements. However, with respect to the latter, assessed jurisdictions were given the option to provide this information in an annex to this report (see Annex G).[3] The information on measures to strengthen the minimum requirements has not been assessed nor is endorsed by the assessment team.

The report outlines where these qualifications apply, and will be subject to updates at a later stage.

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[1] Basel III builds upon and enhances the regulatory framework set out under Basel II and Basel 2.5 (ie the July 2009 enhancements to Basel II), which now form integral parts of the Basel III framework. The assessments thus cover the full set of components, including those introduced by Basel II and Basel 2.5. This full set of requirements is collectively referred to in this document as "Basel III" or the "Basel framework".

[2] The "Report to G20 Leaders on Basel III implementation" is available at www.bis.org/publ/bcbs220.htm.

[3] The Japanese authorities have not listed any areas as super-equivalent compared to the Basel Framework.

This Level 2 assessment report is part of a comprehensive review programme adopted by the Basel Committee, which comprises the following three levels:

- Level 1: ensuring the timely adoption of Basel III

  The objective of the "Level 1" assessment is to ensure that Basel III is transformed into law or regulation according to the agreed international timelines. It focuses on the domestic rule-making processes and does not include the review of the content of the domestic rules. The Level 1 assessment is the foundation for the assessments at the other levels.

- Level 2: ensuring regulatory consistency with Basel III

  The "Level 2" assessment process assesses the compliance of domestic regulations implementing Basel III with the international minimum requirements defined by the Basel Committee. By identifying domestic regulations and provisions that are not consistent with the rules agreed by the Committee and by assessing their impact on financial stability and on the international level playing field, this process will promote full and consistent implementation of Basel III. It will also facilitate an effective dialogue among members and provide peer pressure if needed. The conclusions following each jurisdiction's assessment will be published by the Committee. This assessment programme supports the Financial Stability Board's monitoring of the implementation of the agreed G20/FSB financial reforms and is fully consistent with the "Coordination Framework for Monitoring the Implementation of Agreed G20/FSB Financial Reforms" put in place by the FSB.[4]

- Level 3: ensuring consistency of risk-weighted assets

  The objective of the "Level 3" assessments is to ensure that the outcomes of the new rules are consistent in practice across banks and jurisdictions. It extends the analysis of Levels 1 and 2, which focus on national rules and regulations, to supervisory implementation at the bank level. This work is currently focusing on the review and validation of how banks calculate their risk weighed assets (RWAs).

The Level 2 assessment methodology includes the following key elements:

- The Level 2 assessment is factual in nature and focuses on reviewing the completeness (all required Basel III provisions have been adopted) and consistency (differences in substance) of domestic regulations (ie binding documents that effectively implement Basel III independent of their label).
- When a gap or difference is identified, a key driver for assessing compliance is its materiality and impact.
- To the extent possible, the materiality and impact is quantified using all available data, including those submitted by the jurisdiction being assessed. The assessment, in particular, seeks to measure the significance of any identified difference(s) for internationally active banks. The assessment considers the current impact and consequences, but also the potential impact in the future. The assessment team might also perform its own estimations and analyses, using all available sources of

[4] See the "*Coordination Framework for Monitoring the Implementation of Agreed G20/FSB Financial Reforms*" put in place by the FSB at www.financialstabilityboard.org/publications/r_111017.pdf.

information and including in particular the Basel Committee's Quantitative Impact Study (QIS) and Capital Monitoring Group (CMG) data.

- Specificities and drivers of local implementation are not taken into account when assessing compliance: local specificities are not seen as mitigants for going beyond the scope of national discretion specified within Basel III.
- Domestic measures that strengthen the minimum requirements are not considered to compensate for inconsistencies or gaps identified elsewhere, unless they fully and directly address the identified inconsistencies or gaps.
- The Level 2 assessment is limited to regulatory issues and does not consider supervisory or bank practices. The extent to which Basel III is effectively enforced by supervisors or whether firms are actually complying with the Basel III framework is assessed as part of the Level 3 process.

All level 2 assessments are graded using a four-grade scale[5] - compliant, largely compliant, materially non-compliant and non-compliant:

- *Compliant*: all minimum provisions of the international framework have been satisfied and if no material differences have been identified;
- *Largely compliant*: only minor provisions of the international framework have not been satisfied and only differences that have a limited impact on financial stability or the international level playing field have been identified;
- *Materially non-compliant*: key provisions of Basel III have not been satisfied or differences that could materially impact financial stability or the international level playing field have been identified; and
- *Non-compliant*: Basel III has not been adopted or idifferences that could severely impact financial stability or the international level playing field have been identified.

The assessment team would like to thank the Japan FSA and the Bank of Japan for their cooperation and contribution to this exercise, and in particular the Japan FSA for hosting the on-site visit.

The assessment team leader also thanks the assessment team members, the agencies contributing these staff, and staff from the Basel Committee Secretariat for their valuable contributions.

[5] This four-grade scale is consistent with the approach used for assessing countries' compliance with the Basel Committee's Core Principles for Effective Banking Supervision. The actual definition of the four grades has however been adjusted to take into account the different nature of the two exercises. In addition, components of Basel III that are not relevant to an individual jurisdiction may be assessed as non-applicable.

# Assessment Team

**Team Leader:**

| | |
|---|---|
| Ms Sylvie Matherat | Banque de France |

***Team members:***

| | |
|---|---|
| Mr Mark Ginsberg | US Office of the Comptroller of the Currency |
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# Executive summary

The Japanese Basel III rules were published in March 2012,[6] supplemented by recently published updates (see Tables 1 and 2 in Annex B). From a Level 1 perspective, Japan's rules for implementing the Basel framework have therefore been considered to have been put in place.[7]

The current status of the implementation of Basel II, Basel 2.5 and Basel III in Japan is displayed below.[8]

| Rules | Grade | Next steps – Implementation plans |
|---|---|---|
| Basel II | 4 | |
| Basel 2.5 | 4 | |
| Basel III | 3 | Final rules published on 30 March 2012 – Implementation of final rules (end of March 2013 – In Japan, the fiscal year for banks starts in April and ends in March).<br>Rules covering capital conservation buffer and the counter-cyclical buffer not yet issued. Draft regulations expected in 2014/15. |

1 = draft regulation not published; 2 = draft regulation published; 3 = final rule published; 4 = final rule in force.
Green = implementation completed; Yellow = implementation in process; Red = no implementation.

The Japanese Basel rules are mandatory for the 16 internationally active banks, which account for about 56% of the Japanese banking sector assets (see Table 4 in Annex B for a list of these banks), and voluntary for two large broker-dealers. The other domestic banks are subject to domestic rules, which are, overall, similar to the Basel III standard (but use a different minimum capital adequacy ratio).[9]

The team's Level 2 assessment consisted of a comprehensive comparison of Japan's Basel rules with the global Basel standard. With the exception of a limited number of non-material gaps, the assessment team found that the Japanese rules meet the Basel standards. Additional secondary rules recently issued by the JFSA helped to close some of the gaps, and have generally been recognised by the review team in its assessment.

The gaps identified relate to the scope of application, capital, credit risk and market risk and were considered by the assessment team as not material. The materiality assessment was based on bank-specific data for each of the 16 internationally active banks affected by a specific gap (see Figures 2 and 3 in Annex E) and was undertaken for all quantifiable gaps.

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6 See www.fsa.go.jp/en/news/2012/20120330-1.html

7 The Japanese Basel II and Basel 2.5 regulations had been transposed into domestic rules in March 2007, and December 2011, respectively (Tables 1 and 2 in Annex B).

8 See also Appendix 1 of the Report to G20 Leaders on Basel III implementation available at www.bis.org/publ/bcbs220.pdf (p.24, 26 and 28) for the status as of May 2012.

9 The rules applicable for the domestic banks deviate (mainly) in terms of the minimum capital ratio adequacy ratio (4 percent instead of 8 percent) and the recognition of capital.

The team also assessed whether potential gaps were influenced by inaccurate translation. It concluded that this was not the case.

The assessment team observed that a number of the standards were implemented through "secondary" legislation (eg guidelines and inspection manuals as well as published questions and answers) rather than primary regulation, reflecting the more informal legal tradition in Japan. While some of the secondary legislation is not necessarily binding in formal terms, the assessment team, based on detailed discussions with the authorities on specific issues, still considers them to be generally binding and thus eligible to meet Basel standards. This is supported by evidence, in some instances, of supervisory action based on these rules that were established through secondary legislation. Nevertheless, in order to meet Basel standards in full and to be consistent with other legislations (especially those with a formal legal background), the authorities might consider adding primary legislation (eg by moving part of the secondary legislation to the March 2012 Basel III notice), in order to further strengthen banks' commitment to the regulation.

Overall, the review team considers the current scope of the Japanese Basel III rules as "compliant" with Basel standards.

## Assessment findings

### Overall grading

Using a standardised assessment format, the assessment team has provided compliance ratings for 13 components of the Basel framework (out of a total of 20) and an overall rating of compliance. One component, relating to the manner in which the capital buffers will operate in practice, remains subject to a follow-up assessment once further guidance is established (using the remaining time for implementation until 2015), and another six components will be assessed once the Basel III standards are finalised. Detailed information on the findings and compliance ratings for each of the 13 assessed components is set out in greater detail later in this report.

The assessment team's overall finding is that the Japanese Basel framework is *compliant* with the global standard agreed by the Basel Committee. This is based on three facts/observations: (1) the number of gaps identified by the assessment team was relatively low; (2) all gaps were found to be non-material, both in isolation (ie as single issues) and in aggregate terms (for single banks and/or the group of internationally active banks as a whole); and (3) the review team has noted that a notable portion of Japan's rules are based on secondary legislation, reflecting the legal tradition in Japan, and has generally recognised these rules as binding. As such, none of the above issues was assessed as likely to have a material impact on financial stability or on the international playing field.

### Overarching Issues

The review team has made the following observations, some of which will be re-assessed at a later stage:

- In terms of scope (ie the possibility to use different options/approaches under Japanese rules), a few options (eg the maturity ladder approach for commodity risks, the internal model method – IMM – for counterparty credit risk) are not specified by the Japanese rules and are therefore not available to Japanese banks,

but these do not constitute instances resulting in inappropriate capital treatment and are expected to be made available if needed;

- There are some deviations from Basel's definition of capital, Pillar 1 market risk (exception for small trading books, commodity risk) and Pillar 1 securitisation, which also applies, to a lesser degree, to Pillar 1 credit risk, but these are not considered material;
- The Pillar 2 rules are generally stipulated as secondary legislation, and there are some gaps in terms of the granularity of the rules (ie some specific issues are not stipulated in the Japanese rules). However, the JFSA and the BoJ have established a comprehensive Pillar 2 framework, and are, in general legal terms, in a position to take action, if needed, and have done so in the past;
- The capital buffers remain to be implemented at a later stage and will be subject to follow-up analysis, together with the standards yet to be established by the Basel Committee.

**Main specific Issues**

The key issues identified by the assessment team are discussed below, and the corresponding rating is shown in the compliance table. The authorities' response to the assessment follows the compliance table.

***Definition of Capital and Capital Buffers***

While most of the rules concerning the definition of capital had been established with the March 2012 Basel III notice (see Tables 1 and 2 in Annex B), some additional secondary legislation in the form of more detailed guidelines and Q&A's were published in June[10] and August.[11] This filled the majority of gaps that had previously been identified.[12]

The two remaining issues are with respect to the loss absorption for Additional Tier 1 and Tier 2 instruments and the divergent cutt-off date for state aid instruments. With respect to the cut-off date for the grandfathering of state aid instruments, the Japanese rules allow for a window of opportunity until early 2013 (unlike the September 2010 cut-off date in the Basel rules), but this opportunity has not been used by banks for now and the assessment team understands (based on discussions during the on-site visit) that there is no intention to do so going forward.

As for the PON rules, based on discussions with the JFSA, its staff informed the assessment team that it intends to implement the contractual approach rather than the statutory approach (as originally envisaged). Supervisory rules are foreseen to be implemented in the near future, whereby no gaps would be identified.[13] Some additional questions as to how the

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[10] See the following link (in Japanese only) for the Q&A's published on 6 June 2012.

[11] See www.fsa.go.jp/news/24/ginkou/20120807-3/05.pdf (Japanese only), for the revised supervisory guidelines, published on 7 August 2012 and www.fsa.go.jp/news/24/ginkou/20120807-3/08.pdf (Japanese only) for additional Q&A's, also published on 7 August 2012.

[12] Specifically, recent regulation has filled the previously identified gaps with respect to the recognition of stock acquisition rights as regulatory capital, the deduction of deferred tax assets and most of the missing recognition criteria for additional Tier 1 instruments.

[13] Provided that the rules were to be implemented as envisaged.

contractual approach will work with the current legislation will have to be discussed and potentially addressed, and will be part of follow-up analysis.[14]

For the capital buffers (capital conservation, countercyclical), the domestic rules are not yet in place, but the Basel III rules leave more time for implementation, which is intended to be used by the authorities. The Japanese authorities plan to issue the rules by 2015, ie one year ahead of the international schedule for implementation (2016).

### *Pillar 1 - Minimum Capital Requirement*

For securitisation, a gap has been identified in terms of the treatment of exposure (being part of a nationwide investment scheme)[15] as securitisation rather than re-securitisation. This gap has been found to be non-material for the time being, though, as none of the internationally-active banks exhibits such exposure. One other gap relates to the general treatment of securitisation exposure but similarly is not considered material.

In terms of counterparty credit risk and cross-product netting, Japan has not implemented the IMM but implementation could become relevant in the future and the authorities have indicated being ready to issue the relevant rules. In the assessment team's view, this issue is not considered a case of inappropriate capital treatment.

Concerning market risk, the team has identified areas of non-compliance with respect to (i) the exemption of the regulatory treatment of smaller trading books (<100 billion JPY and no larger than 10% of the bank's total assets) and (ii) the treatment of commodity risk, where Japanese legislation only allows banks to use the simplified approach (for those banks that choose the Standardised Measurement Method, SMM). In the former case, banks with trading activities slightly below the materiality threshold benefit from this exception, but the issue has not been found to be material. Banks' commodity risk is very limited, as is the materiality of the gap.

With regard to operational risk, some of the details with regard to the Advanced Measurement Approach (AMA) are not specified in the March 2012 notice implementing Basel III but instead supplement bank inspection manuals. In line with other areas, these secondary rules are publicly available, and discussions during the on-site visit with the JFSA and BoJ indicate that each of the detailed requirements in the Basel framework is validated during the process of supervisory assessment as necessary, ie that the rules are binding and will be enforced, if applicable.

### *Pillar 2 – Supervisory Review Process*

In terms of Pillar 2, significant portions of this part of the Basel framework are not implemented through primary legislation and are therefore based entirely on secondary rules. In addition, in some areas the rules are less detailed than foreseen by the Basel standards. However, supervisory action in the past (5–10 cases from 2009–2011) demonstrates that the

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[14] The Japanese authorities have already developed a special resolution scheme for failing/failed and/or insolvent banks under the Deposit Insurance Act. However, the existing scheme does not necessarily equip authorities with the power to require bank's Additional Tier 1 and Tier 2 capital to be written off upon the trigger event defined in "Final elements of the reform to raise the quality of regulatory capital issued by the Basel Committee" (see www.bis.org/press/p110113.htm) or to require such instruments to absorb losses before tax payers are exposed to losses.

[15] The scheme is run by the Japan Finance Corporation.

authorities are willing to act. Likewise, Japan's Banking Act[16] generally enables the authorities to impose additional capital charges.

At the same time, the authorities have established a comprehensive Pillar 2 assessment framework, including a three-tier supervisory approach to cover the four Pillar 2 principles as established by the Basel rules.

The assessment team has also evaluated the materiality of some key Pillar 2 risks (eg interest rate risk in the banking book, concentration risk), and found that banks' capital levels reflect (ie are related to) the level of Pillar 2 risks (IRBB, concentration risk), where applicable (see Figure 3 in Annex 2).

**Follow up work**

The team recommends a follow-up assessment on the capital buffers once further Basel Committee guidance on this topic has been implemented in Japan. Implementation is envisaged by 2014/15 (see Annex F). Likewise, any other areas in which the domestic rules will be updated, be it to finalise the existing rules (as is foreseen for the definition of capital) or to address findings outlined in this report, will be subject to follow up analysis.

Other follow-up work will include the areas of the Basel standards that have not yet been implemented (liquidity, leverage and G-SIB, as shown below).

[16] See www.fsa.go.jp/en/refer/legislation/index.html

# Overview table of compliance grading

| Key components of the Basel framework (and number of elements) | Grade |
|---|---|
| **Overall Grade:** | C |
| **Capital requirements** | |
| Scope of application | C |
| Transitional arrangements | C |
| Definition of capital | (LC) |
| **Pillar 1: Minimum capital requirements** | |
| Credit Risk: Standardised Approach | C |
| Credit risk: Internal Ratings-Based approach | C |
| Credit risk: securitisation framework | LC |
| Counterparty credit risk rules | C |
| Market risk: standardised measurement method | LC |
| Market risk: internal models approach | C |
| Operational risk: Basic Indicator Approach and Standardised Approach | C |
| Operational risk: advanced measurement approaches | C |
| Capital buffers (conservation and countercyclical) | "Not yet assessed" |
| G-SIB additional loss absorbency requirements | (1) |
| **Pillar 2: Supervisory Review Process** | |
| Legal and regulatory framework for the Supervisory Review Process and for taking supervisory actions | C |
| **Pillar 3: Market Discipline** | |
| Disclosure requirements | C |
| **Liquidity standards** | |
| Scope of application | (1) |
| Transitional arrangements | (1) |
| Liquidity Coverage Ratio | (1) |
| Net Stable Funding Ratio | (1) |
| **Leverage ratio** | |
| Leverage ratio | (1) |

Compliance assessment scale (See foreword for more information): C (compliant), LC (largely compliant), MNC (materially non-compliant) and NC (non-compliant). (1) To be assessed after the Committee concludes its review on any revisions or final adjustments of these elements of Basel III. Ratings that are based on draft or proposed rules are indicated within parentheses. Ratings based on final rules are indicated without parentheses.

# Response from the Japanese authorities

The Japanese authorities appreciate the detailed and holistic assessment conducted by the assessment team.

We have made our utmost efforts for timely implementation of Basel III, which resulted in the publication of our final rules in March 2012, the earliest publication among BCBS members only next to that of Saudi Arabia. Highly committed to the Level 2 assessment process, we have submitted full English translations of our domestic rules/guidance and the results of self-assessment both in March 2012, and provided quantitative data in accordance with the team's request.

After the cut-off date of the June interim report by the BCBS, we have published draft supervisory guideline and final Q&A's in June. We had the opportunity to discuss about these additional publications as well as notices with the team on the occasion of the on-site visit in July. The supervisory guideline was subsequently finalised in August.

The Level 2 assessment is only a starting point for the proper implementation of Basel III. The major challenge remains in securing the internationally-active banks implement the rules properly at the bank level. The FSA intends to conduct effective supervision and inspections. The Bank of Japan will provide any necessary cooperation and contribution to this end.

# Assessment

Below, the report details the structure of the banking sector along with some basic information on financial soundness, after which details of the assessment are given by category.

## 1. Introduction

***Overview of the Japanese Banking Sector***[17]

The Japanese banks dominate the financial system, holding about 55 percent of the system's assets. Relative to GDP (320 percent, Table 3), the Japanese financial sector is larger than most of its G-7 peers, except for the U.K. and France.

There are 123 banks in Japan (and 445 cooperatives), but the sector is highly concentrated:

- The banking sector is dominated by *three megabanks* (and their related entities), which account for 41 percent of the banking sector assets (Table 4).
- 13 other banks are internationally active,[18] most of which fall into the category of regional banks and account for 15 percent of the sectoral asset.
- The other banks, including foreign-owned banks account for a total of about 44 percent of the banking sector assets.

In total, there are 16 banks that are classified as *internationally active*, as shown in Table 4 in the Annexes. The three megabanks are among the G-SIFIs.[19]

The capital adequacy ratios of Japanese banks and the subset of internationally active banks alike have increased in recent years (Figure 1). For the internationally active banks, the total risk-based capital ratio by end of 2011 was at 16.3 percent and the tier 1 risk-based ratio at 12.9 percent (Table 3, figures based on current Basel rules).

Risk-weighted Assets have slightly declined in recent years, and are predominantly held for credit risk (above 91 percent), with market risk accounting for 3 percent and operational risk for about 6 percent. With the introduction of Basel 2.5 and III, the portion for market risk will increase moderately given the limited degree of banks' activities in this area.

Capital increased slightly in recent years and its quality has increased markedly[20] (79% of total capital is tier 1), but the phase-in of Basel III will make part of capital ineligible, alike for other countries.

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[17] See Bank of Japan, 2012, Financial System Report, April (www.boj.or.jp/en/research/brp/fsr/data/fsr120419a1.pdf) and the Japan Financial Sector Stability Assessment Update, IMF 2012 (www.imf.org/external/pubs/cat/longres.aspx?sk=26137.0), for further information.

[18] Internationally active banks include bank holding companies and credit cooperatives which have one or more foreign branches or subsidiaries.

[19] For a list of G-SIFIs see www.financialstabilityboard.org/publications/r_111104bb.pdf, p.4.

[20] From 2006 till 2011, the portion of tier 1 capital on total capital increased from about 58 percent to 79 percent.

The sizeable increase of capital ratios since 2008 was predominantly driven by sizeable capital raisings of the larger banks.[21]

Total assets in the banking system have increased slowly, in line with contained GDP growth rates. Loans account for about 55 percent of total assets, which is broadly in line with most peer countries. Bank profitability has been moderate and stable (return on equity was at 5-10 percent during recent years), alike the level of non-performing loans. Bank's profitability is rather low compared to peers, and could challenge the build-up of capital buffers in the future. The basic liquidity ratios are sound, with banks benefiting from solid customer deposit funding, but do not necessarily reflect the liquidity situation of banks more generally.[22]

### *Broader context of the Level 2 assessment*[23]

The regulatory consistency assessment (Level 2) assessment for Japan is part of the Financial Stability Board's (FSB) mandate of monitoring the implementation of the agreed G20/FSB financial reforms.[24] The assessment for Japan, along with the European Union and the United States, was part of the first "wave" of Level 2 assessments undertaken by the Basel Committee.

The Level 2 assessment seeks to assess regulatory consistency with Basel II/III. Specifically, the Level 2 process is meant to:

(i) identify the domestic regulations and provisions that are, in terms of content (ie, scope and substance), not consistent with the standards agreed by the Committee and

(ii) to assess the gaps potential impact on financial stability and on the international level playing field.

It should also be noted that the Basel Committee's implementation assessment programme and the Financial Sector Assessment Program (FSAP), which is conducted by the International Monetary Fund and the World Bank,[25] have different scopes and focuses and will complement each other. In particular, the Basel III Level 2 assessment programme provides a narrower but deeper focus on the regulatory consistency with Basel III, while the assessment of the Core Principles considers the full range of the regulatory framework and supervisory practices.

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[21] For the total capital adequacy ratio, 26 percent (ie three quarters) of the total increase of 38 percent (from 11.4 in 2008 to 15.7 percent in 2011) resulted from higher capital, and the remainder from a decrease in RWAs. For the tier 1 ratios, the increase by 65 percent (from 7.5 percent in 2008 to 12.4 percent 2011) was predominantly (51 percent) driven by an increase in capital.

[22] The crisis has shown that liquidity risks need to be assessed in a holistic manner.

[23] See www.bis.org/publ/bcbs216.pdf for further information.

[24] As such, it is consistent with the "*Coordination Framework for Monitoring the Implementation of Agreed G20/FSB Financial Reforms*" put in place by the FSB.

[25] The FSAP assesses country's compliance with the Basel Committee's Core Principles for Effective Banking Supervision (BCPs). See www.imf.org/external/pubs/cat/longres.aspx?sk=26163.0 for the recently published BCP assessment (in August 2012) as part of the Japan FSAP update.

### *Basel rules used for the assessment*

The Level 2 assessment undertaken at this stage was benchmarked against most Basel II and 2.5 standards, while Japan will finalise some of Basel III standards, such as those applying to the G-SIBs, liquidity, provisions on leverage, and, to some degree to the rules on capital buffers at a later date after the Committee concludes its review on any revisions or final adjustments, consistent with the agreed phase-in arrangements.[26]

The report explicitly indicates which Basel Accord standards will be included in follow up analysis (see the executive summary and the overview on compliance grading), and lists all documents used for the assessment in Annex B.

### *Japanese Basel rules used for the assessment*

The assessment is based on the latest rules published in Japan: By end March 2012, the Japanese authorities published final rules implementing Basel III with respect to the definition of capital and risk-weighted assets (RWA), while the Basel II and Basel 2.5 standards had already been transposed into domestic rules previously (Tables 1, 2 in Annex B).

The Japan level 2 assessment was based on a variety of elements related to the Japanese Basel rules: (i) the universe of Basel rules considered relevant, namely notices, supervisory guidelines, inspection manuals and Q&As issued by the FSA to spell out the detailed interpretation;[27] (ii) meetings with the authorities and selected industry representatives (during the on-site visit in July); and (iii) a self-assessment by the Japanese authorities.

The degree of formality of the rules (and the implications on whether they are binding) was discussed both with the authorities and the private sector. The team also compared them with general principles and took into account the country's legal tradition. The conclusions are discussed in the respective sections, but overall the review team considers the majority of primary and secondary rules in Japan as binding. More information on the rules used for the assessment and their hierarchy (in terms of formality) is given in Annex B.

The team has also assessed the appropriateness of the English translation of the Japanese rules through comparison with the original text in Japanese based on a number of examples. For the specific sections the review team has looked at, it was found that the translation is robust and only minor issues were identified and subsequently clarified.

Finally, the Basel schedule for Japan is slightly different from other countries due to the difference in terms of the fiscal year, which ends on 31 March rather than 31 December. The review does not consider this difference to be a deviation from the Basel rules.

### *Data for materiality assessment*

For all issues that were quantifiable,[28] the Japanese authorities have provided data for all internationally active banks subject to the specific gaps. A list of the internationally active

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[26] See www.bis.org/publ/bcbs216.pdf, p.8/9.

[27] The notices constitute a formal part of the Banking Law. The FSA's supervision and inspection is conducted based on the supervisory guidelines and inspection manuals. The Q&As represent the FSA's official interpretation of notices. Corrective action is taken and administrative sanctions are imposed in line with these guidance documents.

[28] Except for issues that are apparently very minor.

banks that are subject to the Basel standards is shown in Table 4. The internationally active banks constitute close to 60 percent of the banking sector assets. The largest, internationally active broker-dealers also comply with the Japanese Basel rules on a voluntary basis. It should also be noticed that the other banks in Japan are subject to local rules that are more or less congruent with the rules for the internationally active banks, except for the minimum capital level and the treatment of unrealised gains for capital purposes (see section 2.1 on scope).

***Preliminary report***

On 11 June, the assessment team revealed the preliminary findings of its work as part of the Basel Committee's "Report to G20 Leaders on Basel III Implementation".[29] The initial assessment in June highlighted the same areas of potential gaps (definition of capital, Pillar 1 and 2) as identified by now and outlined that these areas would be subject to follow-up analysis (including during the on-site visit). The report concluded that the rules were in "broad consistency with the majority of the sections of the Basel rules".

***On-site visit***

From 4 to 6 July 2012, the assessment team held an on-site visit at the premises of the JFSA in Tokyo. The team met with various representatives of the FSA and the BoJ. In addition, the assessment team met with representatives of the industry (see Annex C for further information).

# 2. Detailed findings

In the next sections, the detailed assessment findings are presented together with an assessment of their materiality. The sections correspond with the sections in the overview table of compliance grading above.

As remarked in the foreword, only deviations that could lead to a less robust capitalisation of the banking sector are reported. Areas of compliance are not explicitly addressed (and discussed), nor are areas where the Japanese approach would be super-equivalent vis-à-vis the Basel standards. Areas where the domestic rules strengthen the minimum requirements have also not been taken into account in the section gradings.

The following findings are not in order of importance, but in the order of assessment through the relevant Basel rules texts.

## 2.1 Scope of application

| | |
|---|---|
| **Section Grading** | Compliant |
| **Summary** | In terms of scope, the team has observed one finding, namely in terms of the definition of internationally active banks. Discussions with the |

[29] See www.bis.org/publ/bcbs220.htm, pages 10 to 13.

| | |
|---|---|
| | authorities on materiality (which included data) indicate that the issue is not material. |
| **Overview of findings by Basel paragraph:** | |
| Basel paragraph no | **Paragraph 20–24, revised framework** |
| Reference in the domestic regulation | Articles 1, 2 and 3 of FSA Notice "Internationally active bank: a bank which calculates the capital adequacy ratio (...) in article 2"<br>Art 2 : "(...) a bank that has overseas business locations" |
| Findings | The 2006 Basel Agreement (Basel 2) foresees that Basel rules apply to internationally active banks, without however defining the concept. In the JFSA's Administrative notice, an internationally active bank is restrictively defined as a bank that has one or more overseas business locations.<br>Although such a definition does not explicitly contradict Basel rules – which do not provide any specific definition, it may seem in contradiction with the spirit of the Basel agreement. A purely domestic bank with no establishment abroad may still compete with foreign banks in foreign markets – it is not necessary to own a branch or a subsidiary in a foreign country to be internationally active and provide financing on a global scale, such as by means of cross-border lending.<br>In the case of Japan, the impact of this rather restrictive definition is not material, at least for now, as banks with noteworthy oversees operations are the internationally active banks, who own at least one subsidiary or branch abroad. More generally, the sample of banks with oversees activities has been stable (while their activities have been growing in recent years) and cross-border lending usually constitutes intra-group lending. Cross-border lending activities of domestic banks are monitored on a quartely basis by the authorities. These appear to be very limited.<br>The rules for local banks and internationally active differ in terms of the minimum capital ratio (which is significantly lower for local banks at 4 percent) and in terms of the recognition of unrealised gains. Hence, there would, in principle, be some potential for a gap for now (although it appears highly unlikely that a bank would establish business overseas based on cross–border lending only). |
| Materiality | The review team has discussed and assessed the finding (which is not a formal gap) and found that it is not material. |

## 2.2 Transitional arrangements

| | |
|---|---|
| **Section Grading** | Compliant |
| **Summary** | No deviations vis-à-vis the Basel framework have been found. However, due to differences in the fiscal year the implementation in Japan deviates from the one in other countries by 3 months (due to the year end being on 31 March rather than 31 December).[30] |

[30] The transitional arrangements do, in principle, also comprise the grandfathering of capital instruments (Para. 94f), see section 1.2.3, but have been assigned to the rules on capital (consistent with the other Level 2 analysis).

## 2.3 Definition of capital

| | |
|---|---|
| **Section Grading** | (Largely Compliant) |
| **Summary** | The review team identified two deviations from the Basel standards, while a few other issues identified earlier in the assessment process (the treatment of additional tier capital; detailed rules for netting for some elements of capital; some additional issues related to the definition of capital) have been implemented based on secondary legislation in June 2012.<br><br>While the team recognises the fact that the recently issued secondary legislation appears to be binding, they are less formal than primary regulation.<br><br>The team has discussed the materiality of the identified gaps with the authorities. One issue (grandfathering of state–aid instruments) is not relevant for any bank for now, but leaves a potential window of opportunity for the coming months till end March 2013. The gap in terms of the loss absorption of additional tier 1 capital and tier 2 capital (related issues pertinent to paras 55 and 58) is not considered material.<br><br>The implementation of the rules related to the PON will be assessed at a later stage. |
| **Overview of findings by Basel paragraph:** | |
| Basel paragraph no | **Paragraph 55** |
| Reference in the domestic regulation | Art. 6 para 4<br><br>Q&A's (as of June 2012) |
| Findings | The Japanese legislation (Art. 6 para 4 (v)) allows redeeming instruments "in cases where, considering the purpose of the issuance, unavoidable reasons are found for the redemption before the date on which five years have passed from the issuance". The only exemptions from five year minimum non-call period are a tax or a regulatory call as set out in FAQ No. 15 for AT 1-instruments. The FSA clarified in the Q&As that in addition to a regulatory or a tax call, a call in case of delisting of issuer will be considered as "unavoidable reasons".<br><br>As regards the triggering of the loss absorption mechanism of Additional Tier 1 instruments, the Japanese Supervisory Guidelines give banks the possibility to avoid the write down or the conversion of the instrument, if the bank submits a plan to the FSA, which contains measures that are considered reasonable for ensuring that the CET 1-ratio will exceed the trigger level of the instrument going forward. Where, based on such a plan, a bank obtains approval from the FSA, it may stop the write down or conversion from becoming effective.<br><br>While the possibility to avoid the write down or the conversion of a capital instruments once the trigger is hit by submitting a plan which sets out remedial actions to the relevant supervisor is not foreseen in Basel III, the assessment team was not made aware that the authorities intend change the approach currently chosen with respect to this issue. |
| Materiality | The review team has not explicitly quantified the gap but has discussed the issue in detail with the authorities and considers it as insignificant and thus not material. |
| Basel paragraph no | **Paragraph 58** |
| Reference in the domestic regulation | Art. 7 para 4 (v)<br><br>Q&A's (as of June 2012) |

| | |
|---|---|
| Findings | The recognition criteria for Tier 2 instruments as transposed in Art. 7 para 4 (v) of the Japanese legislation allow a call option "in cases where, considering the purpose of the issuance, unavoidable reasons are found for the redemption before the date on which five years have passed from the issuance". The FSA clarified in the Q&As that in addition to a regulatory or a tax call, a call in case of delisting of issuer will be considered as "unavoidable reasons". |
| Materiality | The gap is insignificant and thus not material. |
| Basel paragraph no | **Paragraphs 94f** |
| Reference in the domestic regulation | Art. 1, Art. 2 para 1 and Art. 4 of the Supplementary Provisions for Basel III |
| Findings | Para 96 of the Basel III text stipulates that only those capital instruments will qualify for grandfathering, which were issued before 12 September 2010. However, as regards state aid instruments, the treatment of which during the transitional period is set out in para 94 (f), Art. 4 of the Supplementary Provisions for Basel III allows for inclusion of all instruments issued "prior to the Application Date" into the grandfathering, with the Application Date defined in Art. 2 para 1 in conjunction with Article 1 as being 31 March 2013 (ie, end 2012, in principle).<br><br>This postpones the cut-off date for state aid instruments to be included in the grandfathering by 2.5 years and might give room for banks to meet the new capital requirements by frontloading state aid capital instruments, which, according to the Japanese legislation, would only have to meet the pre-Basel III recognition criteria for Tier 1 in order to be eligible as CET 1 until 31 March 2018.<br><br>Based on follow-up discussions with the Japanese authorities no bank has used the window of opportunity for now to issue such instruments, and this is not foreseen to be the case in the remaining period until 31 March 2013. |
| Materiality | The gap provides banks with a potential window of opportunity, but as it is not expected that this opportunity will be used in the remaining time the gap is not material. |

Loss absorbency at the point of non-viability (PON)

| | |
|---|---|
| Reference in the domestic regulation | Rule not yet implemented |
| Findings | According to the discussions with the JFSA during the on-site visit and follow up discussions more recently, the JFSA intends to implement the contractual approach rather than the statutory approach as originally envisaged. Provided that the rules are implemented as currently foreseen, no gaps are identified. A final judgement on this matter will be subject to follow-up analysis. |

## 2.4 Pillar 1: minimum capital requirements

### *2.4.1 Credit risk: standardised approach*

| | |
|---|---|
| **Section Grading** | Compliant |
| **Summary** | In terms of the standardised approach for credit risk, the assessment team has identified two minor issues. Both issues are not material. |
| **Overview of findings by Basel paragraph:** | |
| Basel paragraph no | **Paragraph 65, revised framework[31] (Claims on securities firms)** |
| Reference in the domestic regulation | Article 64 |
| Findings | The risk weight to be applied to the exposures to a Type 1 Financial Instruments Business Operator (securities firm) that is supervised on a solo basis is foreseen to be treated as exposures to Deposit Taking Financial Institutions under Article 63, and not a corporate exposure.<br>However, the impact of the deviation is minor. |
| Materiality | The team has not explicitly quantified the impact, but the discussions and clarifications during the on-site visit indicate that the gap is not material. |
| Basel paragraph no | **Paragraphs 189–201 as amended by the revised framework[32] (Guarantees and credit derivatives)** |
| Reference in the domestic regulation | Articles 118,119,120,121,122,124,125,126,127.128, 129,130(1) and 251(2) |
| Findings | The Japanese Basel rules miss the provision in Accord paragraph 191(d), which says credit derivatives allowing for cash settlement are recognised for capital purposes insofar as a robust valuation process is in place in order to estimate loss reliably. |
| Materiality | The team has not explicitly quantified the impact, but the discussions and clarifications during the on-site visit indicate that the gap is not material. |

### *2.4.2 Credit risk: internal ratings-based approach*

| | |
|---|---|
| **Section Grading** | Compliant |
| **Summary** | The implementation of the IRB is closely aligned to the Basel framework. The only gap identified during the assessment is that the Japanese rules do not explicitly require human judgement and oversight for the use of models. The issue is not quantifiable, but not considered material. |

[31] New paragraph 689(iv) introduced by Basel II.5.

[32] Paragraph 195 amended by Basel III (paragraph120).

| Overview of findings by Basel paragraph: | |
|---|---|
| Basel paragraph no | **Paragraphs 394–421 as amended by the revised framework[33] (Rating system design)** |
| Reference in the domestic regulation | Articles 149,179,180,181,182,183,184,185,186,187, 188,189,190 and 191 |
| Findings | The Basel Accord says sufficient human judgment and oversight is necessary for use of models, while the Japanese rules do not mention "human judgment" per se, but rather point to the quantitative validation processduring the IRB model approval.<br><br>Based on the discussion with the authorities, some degree of human judgment is part of the process and the authorities validate it's appropriateness through the IRB model approval process, but not explicitly outlined in the rules. |
| Materiality | While the issue is not quatifiable, the team considers the issue non-material. |

### *2.4.3 Securitisation framework*

| **Section Grading** | Largely Compliant |
|---|---|
| **Summary** | In terms of securitisation the team identified two differences. Based on evidence received by the authorities, there is no impact fo the sample of internationally active banks for the issue on re-securitisation, and a very minor impact for other banks. However, the issue has some potential to be more material, which is also the case of another general issue that is not quantifiable. |
| **Overview of findings by Basel paragraph:** | |
| Basel paragraph no | **Paragraph 538–552 as amended by the revised framework[34] (Scope and definitions)** |
| Reference in the domestic regulation | Articles 1(ii),(ii–ii), (xvi), (lxv), (lxvi), (lxvii), (lxviii), (lxix), (lxx), (lxxi), (lxxii), (lxxv), (lxxvi) and (lxxvii) |
| Findings | The review team found that certain type of exposure is excluded from the definition of re-securitisation exposures provided under Japanese rules (see definitions, Article 1, (ii)–2(b), a portion of which is copied below for reference), which appears to be a deviation from the Accord paragraph 541(i).<br><br>Specifically, the exception applies to exposure that falls under article 1, (ii)–2 (b)–"Securitization Transaction conducted by the government of Japan, Japanese local governments or the Japanese Government-Affiliated Organizations prescribed in Article 61, paragraph (1) (collectively referred to as the "State" in 1. to 3. below) with the main purpose of facilitating the smooth functioning of financial services for small and medium sized enterprises, and which satisfies all of the |

[33] New paragraph 415(i) added by Basel III (paragraph 112).

[34] New paragraph 541 (i) as amended by Basel II.5

| | |
|---|---|
| | following requirements:<br>1. the State retains the first loss position for the relevant Securitization Transaction, as an Originator;<br>2. the State is to keep the accounts of the relevant Securitization Transaction separately from other accounts based on laws and regulations;<br>3. the State periodically publishes the default information of the Underlying Asset of the relevant Securitization Transaction."<br>Based on data provided by Japanese Authorities the impact is zero for the internationally active banks. All banks that are affected are smaller ones, and also for those banks the potential impact is very limited at present (equivalent to 0.0002% of the total RWAs in the system). |
| Materiality | The data analysis show that the finding is not material. |
| Basel paragraph no | **Paragraphs 566–576 as amended by the revised framework[35][36] (Standardised approach scope; risk weights; and exceptions to general treatment)** |
| Reference in the domestic regulation | Articles 249 and 250 |
| Findings | While Japanese Authorities' rules do not require that the risk associated with unrated commitment or credit enhancement in a second loss or higher position be investment grade (or better), given the level of overcollateralisation provided by originators, nearly all such commitments and enhancements likely would meet the investment grade requirement. The few instances where the associated risk may be below investment grade are not considered material. |
| Materiality | While the issue is not readily quatifiable, the team considers the issue non-material. |

### *2.4.4 Counterparty credit risk rules*

| | |
|---|---|
| **Section Grading** | Compliant |
| **Summary** | In terms of counterparty credit risk, the review team has found an issue (non-implementation of the IMM), which is not a "real" gap as the current treatment of risks using the standardised approach is appropriate. If the IMM were to be adopted at a later stage, it would be subject to a follow-up review. |
| **Overview of findings by Basel paragraph:** | |
| Basel paragraph no | 10–19, Annex 4<br>20–68, Annex 4 (as applicable to the IMM) |
| Reference in the domestic regulation | Not implemented |
| Findings | In terms of the treatment of counterparty credit risk and cross-product |

[35] Paragraph 567amended by Basel III (paragraph 90).

[36] Updated table on page 5 of Enhancements to the Basel II framework (July 2009).

| | |
|---|---|
| | netting, the Internal Model Method (IMM) has not been implemented in the Japanese ruleset. However, none of the Japanese banks has so far adopted the approach. If this were to change (a few large banks have indicated that they will adopt the IMM within two to five years), the JFSA would have to conduct the necessary validation for IMM approval in the future, and this item be re-discussed.<br><br>While not subject to quantitative anaylsis, the team does not expect that capital would change materially in the future if banks were to use the IMM. |
| Materiality | The issue does not constitute a "real" gap and has therefore not been subject to materiality analysis. |

### *2.4.5 Market risk: scope and standardised method*

| | |
|---|---|
| **Section Grading** | Largely Compliant |
| **Summary** | For the standardised method for market risk, the team has identified two gaps, none of which has been found to be material, and both issues only apply for a limited number of the internationally active banks (3 and 8, respectively). |
| **Overview of findings by Basel paragraph:** | |
| Basel paragraph no | Paragraph 683(i)–689(iii), revised framework[37] (Scope of the Computation of RWAs for Trading Book Assets) |
| Reference in the domestic regulation | Articles 1, 3, 4, 10(2)(i), 11, 123, and 271<br><br>Supervisory Guideline III–2–1–2–3<br><br>Inspection Manual, Risk Management Section, Checklist for Market Risk Management II 2. (1), and III 8 |
| Findings | According to the Japan FSA Administrative notice, banks may be exempted from calculating their capital requirements for market risk if the size of their trading book remains below a certain threshold. Specifically, where the size of the trading book is no larger than 100 billion JPY and no larger than 10 % of the bank's total assets, the bank is exempted from measuring market risk capital requirement. Only the credit risk of the positions held in the trading book is taken into account.<br><br>Based on the data provided by the Japanese authorities, such an exemption has no material consequences with respect to the overall impact on the capital adequacy ratio (see Figure 2). Moreover, given that the size of the trading book is measured on a monthly basis and banks lose their exceptional status if they are once above the floor the exemption is well contained in terms of materiality. |
| Materiality | The gap has been quantified for the eight banks that are subject to the issue. Figure 2 clearly shows that the impact is limited, including for the bank being most affected. |
| Basel paragraph no | **Paragraphs 718(xLiii)–718(Lxix), revised framework (Commodity Risk)** |
| Reference in the | Articles 293–302 |

[37] New paragraph 689(iv) introduced by Basel II.5.

| | |
|---|---|
| domestic regulation | |
| Findings | The Japan FSA Administrative notice only foresees the calculation of capital requirement for commodities risk according to the simplified approach, for those banks that use the Standardised Measurement Method. The use of the more sophisticated method (under the Standardised Measurement Method), the maturity ladder approach, is not allowed, while use of internal models is eligible.<br><br>According to the Basel Framework, using the simplified approach is appropriate only if banks conduct a limited amount of commodity business (See article 718(xLvi) of the Basel 2 framework of June 2006). Hence, banks with a more significant commodity portfolio are expected to adopt the internal model approach. Market risk RWA data collected by the FSA on a semi-annual basis (provided to the assessment team) are used to monitor banks' materiality of commodity risk to some extent. While this data indicates that commodity risk is small, at least presently and in particular for small-sized banks, this risk could be scrutinised more by the Japanese authorities.<br><br>The quantification of the upper bound[38] for the impact of this gap has revealed that it is immaterial (see Figure 2 in Annex E). |
| Materiality | The gap has been quantified for the three banks that use the standardised approach for commodity risk, based on a conservative approximation (by establishing an upper bound). Figure 2 clearly shows that the impact is very limited, including for the bank being most affected. |

### *2.4.6 Market risk: internal models approach*

| | |
|---|---|
| **Section Grading** | Compliant |
| **Summary** | No deviations vis-à-vis the Basel framework have been found. |

### *2.4.7 Operational risk: Basic Indicator Approach and Standardised Approach*

| | |
|---|---|
| **Section Grading** | Compliant |
| **Summary** | No deviations vis-à-vis the Basel framework have been found. |

### *2.4.8 Operational risk: advanced measurement approach*

| | |
|---|---|
| **Section Grading** | Compliant |
| **Summary** | No deviations vis-à-vis the Basel framework have been found. However, some of the details in the Basel accord are specified by secondary legislation (inspection manuals) rather than in the notice. |

[38] The approximation is an upper bound because the figure of commodity risk does not represent the gap but another count of the entire commodity risk capital requirement under the simplified method. Accordingly, the actual gap would be much smaller than the figure.

### *2.4.9 Capital buffers (conservation and countercyclical)*

| | |
|---|---|
| **Section Grading** | Not yet assessed |
| **Summary** | The rules for the capital buffers have not been implemented yet, but the authorities intend to finalise the rules by 2015, and implement them in accordance with the schedule. |

## 2.5 Pillar 2: Supervisory Review Process

| | |
|---|---|
| **Section Grading** | Compliant |
| **Summary** | The majority of the rules on Pillar 2 are specified in guidelines, Q&A's and inspection manuals and are entirely missing in the primary rules (ie the notice) for some risk types (residual risk, operational risk, market risk).<br><br>Likewise, for a few areas,[39] the domestic rules are less detailed than the international rules.<br><br>Nonetheless, supervisory action in the past (5–10 cases from 2009–2011) demonstrates that the authorities are in a position to act and will do so if necessary. While the authorities have not imposed Pillar 2 add-ons in the past, the Banking Act does enable them to be in a position to impose additional capital charges (from a more general perspective related to the risk profile of a bank).[40] At the same time, the authorities have established a comprehensive Pillar 2 assessment framework, including a three-tier supervisory approach to cover the four Pillar 2 principles as established by the Basel rules.<br><br>The assessment team has also looked into the relevance of some key Pillar 2 risks (Interest Rate Risk in the Banking Book, Concentration Risk) in quantitative terms, and found that banks' capital levels reflect (ie, are related to) the level of Pillar 2 risks (IRRBB, concentration risk), where applicable, while being contained the vast majority of banks at the same time (Figure 3).<br><br>Overall, given the authorities' discretion of application of Pillar 2 rules (and the less prescriptive nature of the Basel Pillar 2 issues more generally) on the one hand and the magnitude of risks for the internationally active banks on the other, the review team does not consider the issue to be material. |

[39] For instance, paragraph 63 under the section Valuation practices in the Basel document "Enhancements to the Basel II framework" is not implemented in the Japanese notice, but is, on a general level, stipulated in supervisory guidelines.

[40] The BCP assessment notes that "Although the FSA has the legal power to impose higher capital requirements on individual banks that are commensurate with their risk profiles, the FSA's implementation of Pillar 2 of Basel II does not provide for setting extra capital charges in case the supervisory review process would indicate that not all material risks would have been captured." (www.imf.org/external/pubs/cat/longres.aspx?sk=26163.0, p.22)

## 2.6 Pillar 3: Market Discipline

| | |
|---|---|
| **Section Grading** | Compliant |
| **Summary** | No deviations vis-à-vis the Basel framework have been found. |

# Annexes

## A. Glossary

| | |
|---|---|
| AMA | Advanced Measurement Approach |
| AT | Additional Tier (Capital) |
| BCBS | Basel Committee on Banking Supervision |
| BCP | Basel Core Principles |
| BIS | Bank for International Settlements |
| BoJ | Bank of Japan |
| CET | Common Equity Tier 1 Capital |
| (J)FSA | Japanese FSA (Financial Services Agency) |
| FSAP | Financial Sector Assessment Program |
| FSB | Financial Stability Board |
| GDP | Gross Domestic Product |
| IAA | Internal Assessment Approach (for Securitisation Exposure) |
| IMM | Internal Model Method (for Counterparty credit risk) |
| IRB | Internal Ratings based Approach (for Credit Risk) |
| IRRBB | Interest Rate Risk in the Banking Book |
| JPY | Japanese Yen |
| PD/LGD | Probability of default / Loss given default approach for equity exposures |
| PON | Point of non-viability |
| RWA | Risk-weighted Assets |
| SMM | Standardised Measurement Method (for Market Risk) |
| TSA | The Standardised Approach (for Operational Risk) |

# B. Reference documents

## B.A. List of Basel standards used as a benchmark

(i) Basel II, A revised framework, June 2006

(ii) Enhancements to the Basel Framework (July 2009)

(iii) Guidelines for computing capital for incremental risk in the trading book (July 2009)

(iv) Final elements of the reforms to raise the quality of regulatory capital issued by the Basel Committee (13 January 2011)

(v) Revisions to the Basel II market risk framework – updated as of 31 December 2010 (February 2011)

(vi) Basel III: A global regulatory framework for more resilient banks and banking systems –revised version (rev June 2011)

(vii) Pillar 3 Disclosure Requirements for Remuneration (July 2011)

(viii) Interpretive issues with respect to the revisions to the market risk framework (November 2011)

(ix) Treatment of trade finance under the Basel capital framework (October 2011)

(x) Final Elements of the Reforms to increase the quality of capital raised by the BCBS 13 January 2011

(xi) Basel III definition of capital – Frequently asked questions (December 2011)

## B.B. List of key Japanese rules

**Table 1: List of key Japanese rules assessed by the team**[41]

| Type and Descriptions | Time of implementation |
|---|---|
| **Regulation** | |
| FSA Administrative Notice on the capital adequacy rules for internationally active banks pursuant to Article 14–2 of Banking Act (March 2006) | 31 March 2007 |
| Amendment to Notice based on Basel 2.5 (May 2011) | 31 December 2011 |
| Amendment to Notice based on Basel 3 (March 2012), with respect to "Strengthening the capital" and "Enhancing the risk coverage" | Published on 30 March 2012<br>In place from 31 March 2013 |
| Consultative document of the amendments to the notice for Pillar 3 and CCP to be issued by the BCBS in the second half of 2012 | Envisaged for second half of 2012 (once BCBS rules are final) |
| **Q&A's** | |
| Final Q&A's related to the notice on Basel III | 6 June 2012 |
| Additional Q&A's to clarify the netting rules of own capital instruments and capital instruments of other financial institutions | 7 August 2012 |
| **Supervisory Guidelines** | |
| Amendment to the supervisory guidelines disclosed for public consultation | Published on 7 August 2012<br>In place from 31 March 2013 |

Source: JFSA

[41] See www.fsa.go.jp/en/refer/legislation/index.html for further information. Part of the documents are only available in Japanese.

**Table 2: Timetable of Basel standards implementation**

| | Publication date of proposed rules | Publication date of final rules | Rules effective as of |
|---|---|---|---|
| **Basel II** | Oct 2004, March, Sep and Dec 2005 | March 2006 | March 2007 |
| **Basel 2.5** | Feb 2011 | May 2011 | Dec 2011 |
| **Basel III** | Feb 2012 | March 2012 | March 2013 |

Source: JFSA; Note: The fiscal year in Japan begins in April

### *Hierarchy of rules*[42]

The Japanese Basel III rules are implemented through four types of rules:

- **Regulation,** comprised of Acts, Cabinet Orders, Ministerial Orders and FSA notices; The key element of regulation is the banking act, which gives the FSA power to issue business improvement orders, including the imposition of additional capital.
- **Q&A's pertinent to the FSA notices (for detailed interpretation),**
- **Supervisory Guidelines:** Supervisory guidelines are meant for FSA staff, but are public documents, which are expected to be followed by the banks. Banks are consulted for the establishment and any amendments of the guidelines. Supervision is conducted based on the supervisory guidelines, and the FSA will take formal actions, if necessary; and

  **Inspection Manuals:** are manuals for FSA staff that are publicly available and are meant to guide banks in the development of their internal management (banks are consulted while establishing and amending the manuals). If any deficiencies are identified based on the manual (through the inspection) banks will be asked to apply changes accordingly.

Regulation constitutes fully binding formal rules, while the Q&A's, guidelines and, particularly inspection manuals are less formal in nature, but publicly available and expected to be met by banks.

### *Other References*

Bank of Japan (BoJ), 2012, Financial System Report, April
(www.boj.or.jp/en/research/brp/fsr/data/fsr120419a1.pdf)

IMF, 2012, Japan Financial Sector Stability Assessment Update,
(www.imf.org/external/pubs/cat/longres.aspx?sk=26137.0)

[42] Based on information received by the FSA during the on-site visit. See also www.imf.org/external/pubs/cat/longres.aspx?sk=26163.0, para. 35, for complementary information.

## C. List of Japanese institutions met during the on-site visit

***Japanese regulatory agencies***

- Japanese Financial Service Agency (FSA)
- Bank of Japan

***Private sector***

- Japanese Bankers Association
- Sumitomo Mitsui Financial Group, Inc.
- Mitsubishi UFJ Financial Group, Inc.

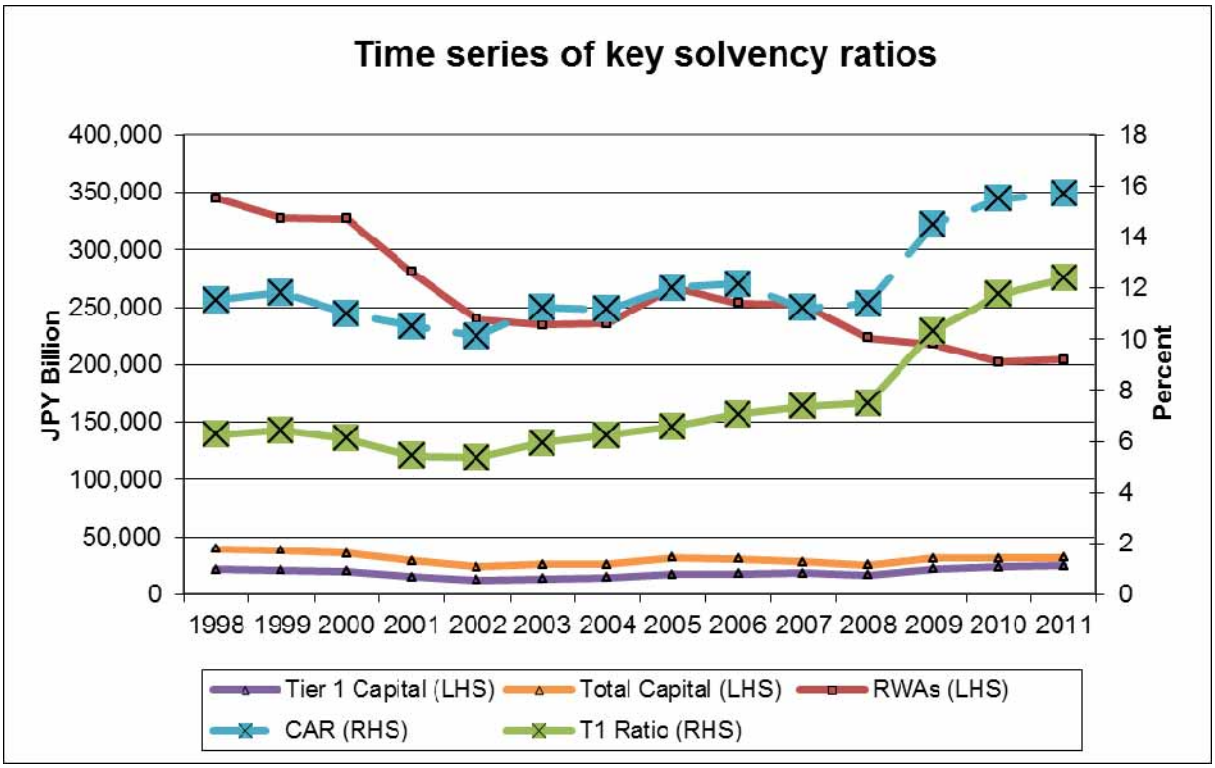
## D. Data on the Japanese banking Sector

**Table 3: Overview of Financial Soundness of the Japanese Banking Sector**

| **Size of banking sector** | |
|---|---|
| Banking system assets/Total Financial System Assets | 55% |
| Total assets all Japanese banks (JPY, bn) | 1,279,298 |
| Total assets of internationally active banks (JPY, bn) | 721,524 |
| Total capital of internationally active banks (JPY, bn) | 44,030 |
| **Number of banks** | |
| Number of banks | 123 |
| Number of internationally active banks | 16 |
| Number of Global Systemically Important Banks (G-SIBs) | 3 |
| **Basel rules** | |
| Number of banks required to implement Basel standards | 16 |
| Year when first bank moved to IRB (or when this is foreseen) | 2007 |
| Percent of internationally active banks under the IRB | 87.5% |
| Year when first bank moved o IMA (or when this is foreseen) | 1998 |
| Percent of internationally active banks under the IMA | 31.3% |
| Year when first bank moved to AMA (or when this is foreseen) | 2008 |
| Percent of internationally active banks under the AMA | 18.8% |
| **Capital adequacy (internationally active banks)** | |
| Total capital (JPY, bn) | 44.030 |
| Total Tier 1 capital (JPY, bn) | 34,827 |
| Total CET1 capital (JPY, bn) | N/A |
| Total risk-weighted assets (JPY, bn) | 270,807 |
| RWAs for credit risk (Percent of total RWAs) | 91.3% |
| RWAs for market risk (Percent of total RWAs) | 2.9% |
| RWAs for operational risk (Percent of total RWAs) | 5.8% |
| Capital Adequacy Ratio (weighted average) | 16.3% |
| Tier 1 Ratio (weighted average) | 12.9% |
| CET1 Ratio (weighted average) | N/A |

Source: JFSA; Figures as of end 2011

**Figure 1: Time series for Financial Soundness of the internationally active banks**




Source: JFSA

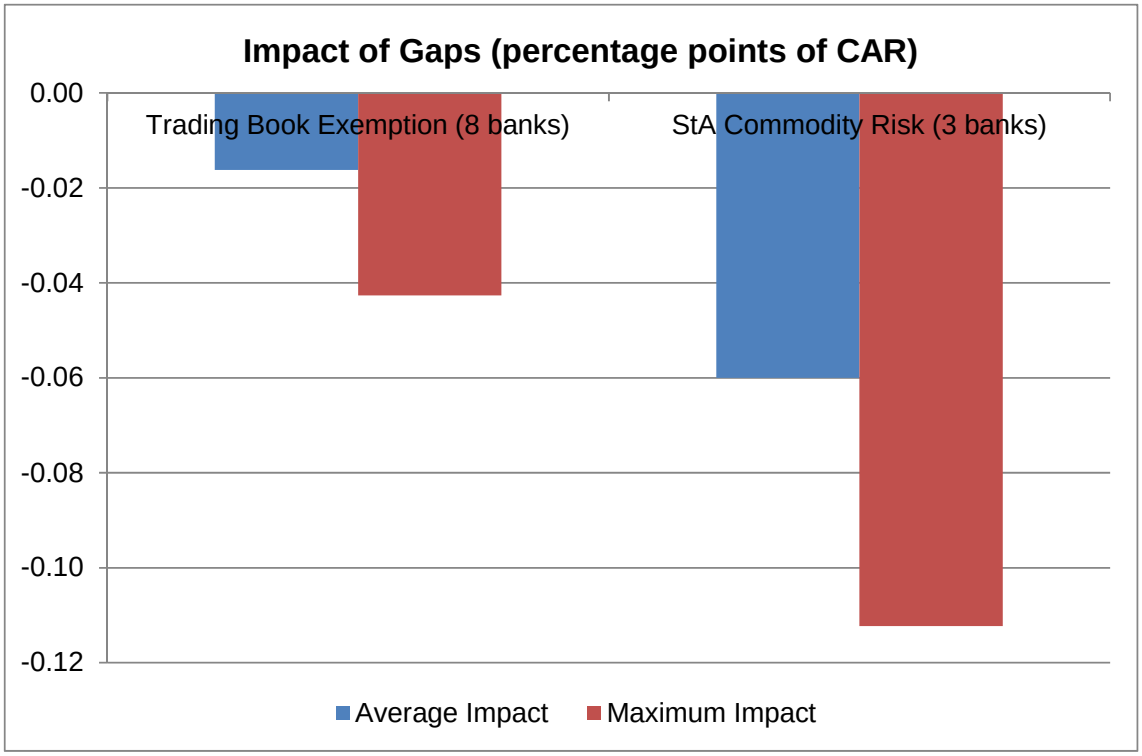
**Table 4: List of internationally active banks**

| No. | Bank | Percent of Assets in Banking System | Percent of Assets in Financial System |
|---|---|---|---|
| 1 | Mitsubishi UFJ Financial Group, Inc. | 17.4 | 10.4 |
| 2 | Mizuho Financial Group, Inc. | 13 | 7.8 |
| 3 | Sumitomo Mitsui Financial Group, Inc. | 10.7 | 6.4 |
| 4 | The Norinchukin Bank | 5.6 | 3.4 |
| 5 | Sumitomo Mitsui Trust Holdings, Inc. | 2.9 | 1.7 |
| 6 | The Bank of Yokohama, Ltd. | 1 | 0.6 |
| 7 | The Shoko Chukin Bank, Ltd. | 1 | 0.6 |
| 8 | The Chiba Bank, Ltd. | 0.8 | 0.5 |
| 9 | The Shizuoka Bank, Ltd. | 0.8 | 0.5 |
| 10 | Yamaguchi Financial Group, Inc. | 0.7 | 0.4 |
| 11 | The Hachijuni Bank, Ltd. | 0.5 | 0.3 |
| 12 | The Gunma Bank, Ltd. | 0.5 | 0.3 |
| 13 | The Chugoku Bank, LTD. | 0.5 | 0.3 |
| 14 | The Iyo Bank, Ltd. | 0.4 | 0.2 |
| 15 | The Shiga Bank, Ltd. | 0.4 | 0.2 |
| 16 | The Bank of Nagoya, Ltd. | 0.2 | 0.1 |
| | **Total** | **56.4** | **33.8** |

Source: JFSA

## E. Outcome of Materiality Analysis

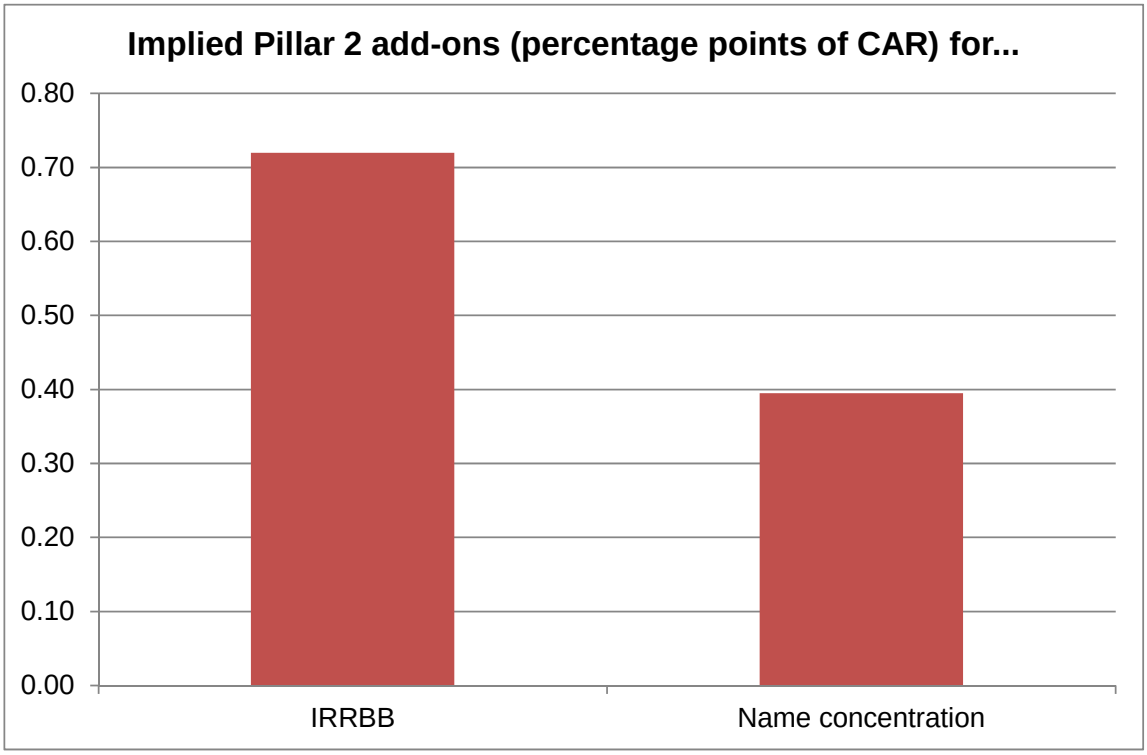
**Figure 2: Impact of Gaps**




Source: JFSA

Note: The figures of commodity risk do not represent the gap but another count of the entire commodity risk capital requirement under the simplified method. Accordingly, the actual gap would be much smaller than the figure.

**Figure 3: Materiality of key Pillar 2 risks**




Source: JFSA Estimation according to the method provided by assessment team)

Note: The figures represent the median (IRRBB) and average (name concentration)[43]

[43] The add-ons for name concentration have been computed based on Schmieder, Puhr and Hasan (2011), www.imf.org/external/pubs/ft/wp/2011/wp1183.pdf.

## F. List of issues for follow-up assessment

The assessment team recommends the subsequent follow-up assessments:

- Finalisation of the assessment for the section “Definition of capital” (once the domestic rules have been implemented)
- Assessment of the section on capital buffers (once the domestic rules have been implemented)

## G. Statement of the Japanese authorities on areas of super-equivalence

The Japanese authorities have not listed any areas as super-equivalent compared to the Basel Framework.