



Financial Services Agency  
Government of Japan

# Financial Stability Analysis in Japan

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*Note: the views expressed in this presentation are those of the presenter and do not necessarily reflect those of the FSA.*



# Today's Presentation

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1. Off-site monitoring conducted by the FSA
2. Examples of macro-prudential analysis
3. Challenges to a greater emphasis on macro-prudential elements in Japan's supervisory framework



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# Off-site monitoring by the FSA

- ◆ *Continuous and quantitative monitoring of conditions of financial institutions in the intervals between on-site inspections*
  - Profitability
  - Market Risk
  - Liquidity Risk
  - Credit Risk
  
- ◆ *Processes*
  - Regular reporting from banks on a number of figures and issues that relates to the soundness of financial institutions
  - Simulations and analyses
  - Feedbacks to and regular consultations with financial institutions, and additional reporting and consultations on the FSA's request whenever necessary



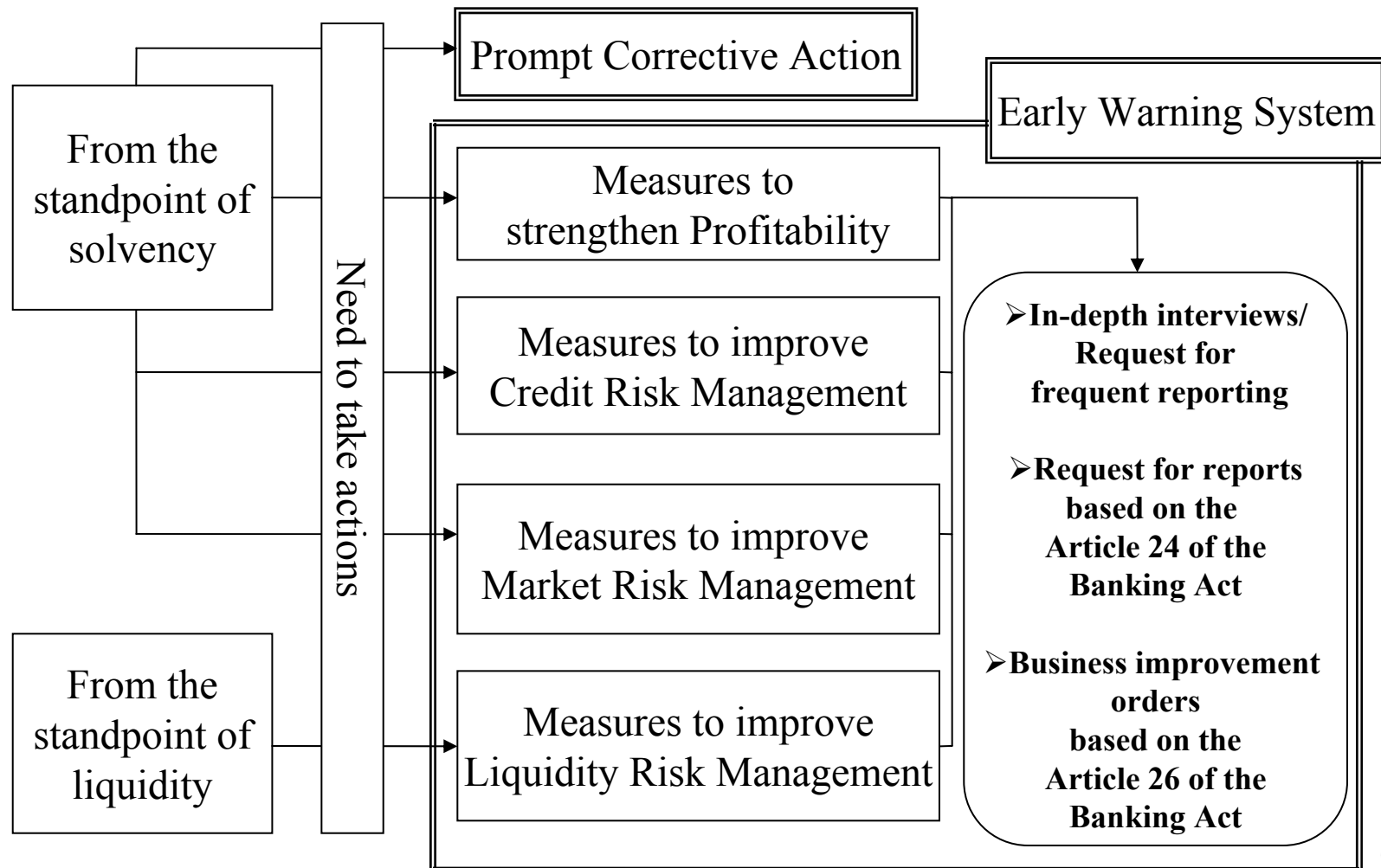
## Early warning system

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- ◆ Introduced in December 2002 to monitor the soundness of banks and to identify vulnerabilities that may not be reflected in the deterioration of capital adequacy
- ◆ The monitoring focuses on:
  - *Profitability*
    - Profit breakdowns and their projections
  - *Credit risk management*
    - Concentration of major credit exposures, etc.
  - *Market risk management*
    - Impact of fluctuations in securities prices, etc.
  - *Liquidity risk management*
    - The level of reserves, trends of deposits, etc.
- ◆ The FSA conducts in-depth interviews based on this monitoring, and may order more detailed reporting and/or corrective measures as necessary



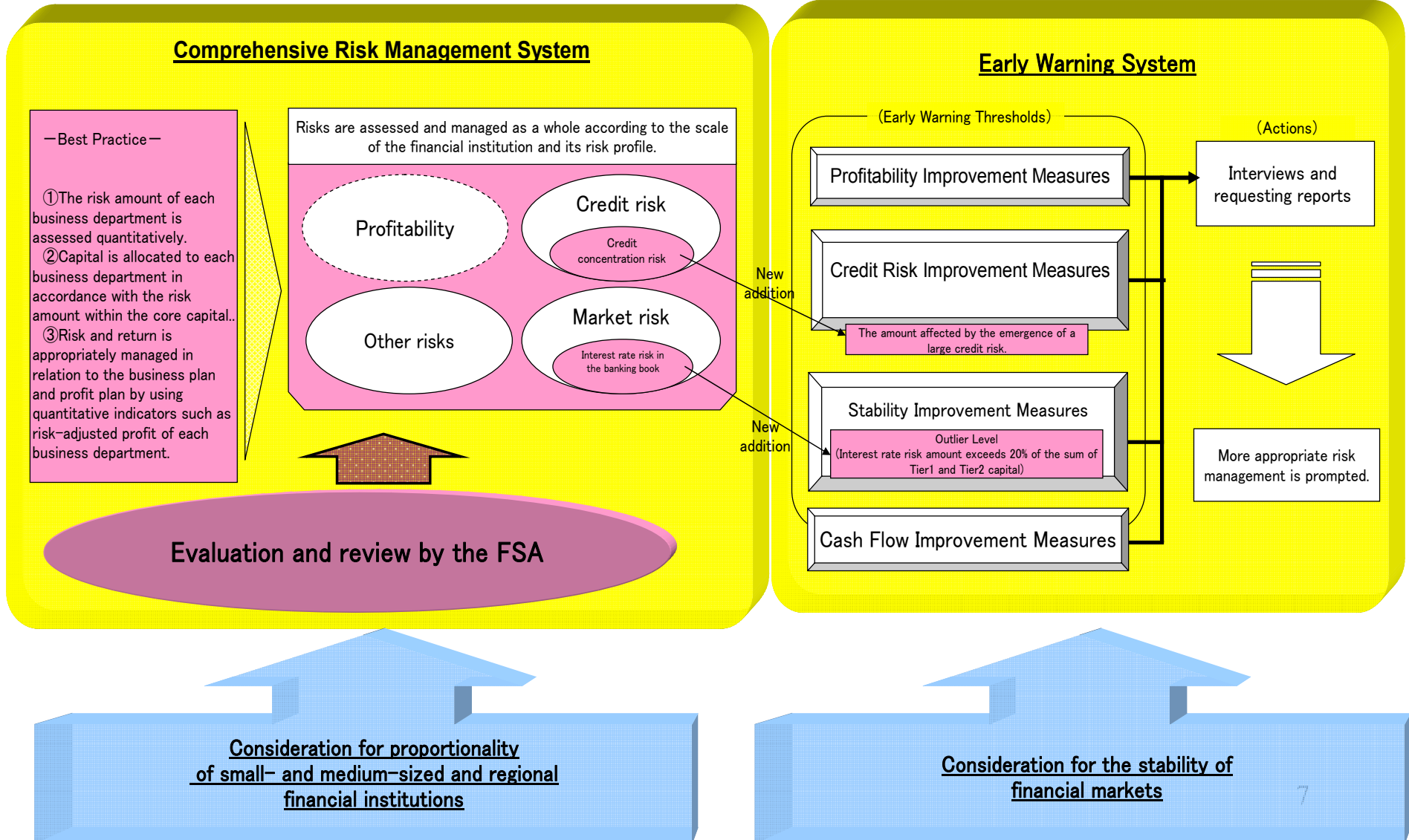
# Framework of the early warning system



# Enhancing the early warning system: implementing Basel II (Pillar 2) in Japan

## (1) Assessment of Comprehensive Risk Management System

## (2) Enhancement of the Early Warning System





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# Elements of macro-prudential analysis are (being put) in place

## *Off-site monitoring system*

- Data and information necessary for macro-prudential analysis are already available
  - ⇒ VaR analysis and/or stress testing at the aggregate level has been conducted as needed

## *Early warning system*

- Impact of fluctuations in securities prices on balance sheets is analysed

## *Implementing Basel II*

- IRB banks: regular conduct of stress testing is a requirement for approval
- Pillar 2: stress testing is or will be conducted with respect to credit concentration risk, and interest rate risk in the banking book



## However, one might characterise this analysis as...

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- Essentially a bottom-up approach
- Mainly micro-prudentially oriented, particularly regarding credit risk  
(greater emphasis is placed on the circumstances specific to individual banks and/or local economies)
- Being conducted on a confidential basis



# Macro-prudential analysis by the Bank of Japan

## *Examples of areas analysed*

- Potential impact on capital adequacy ratio of banks arising from macroeconomic shocks (economic downturn, higher interest rates,...)
- Cyclical impact on banks' credit costs

## *Techniques employed*

- VaR analysis
  - Scenario analysis and stress testing
  - Structural modelling
- ⇒ *The results of these analyses are incorporated in the Bank's Financial System Reports and other documents*



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# Hurdles standing in the way of the shift towards macro-prudential supervision

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*Mr Malcolm Knight of the BIS in Merida, 5 October 2006:*

- Limited knowledge of the workings of the economy, especially of interactions between the financial sector and the real sector
- Complications arising from institutional set-ups
- Political economy considerations, including resistance to tighter rules at good times



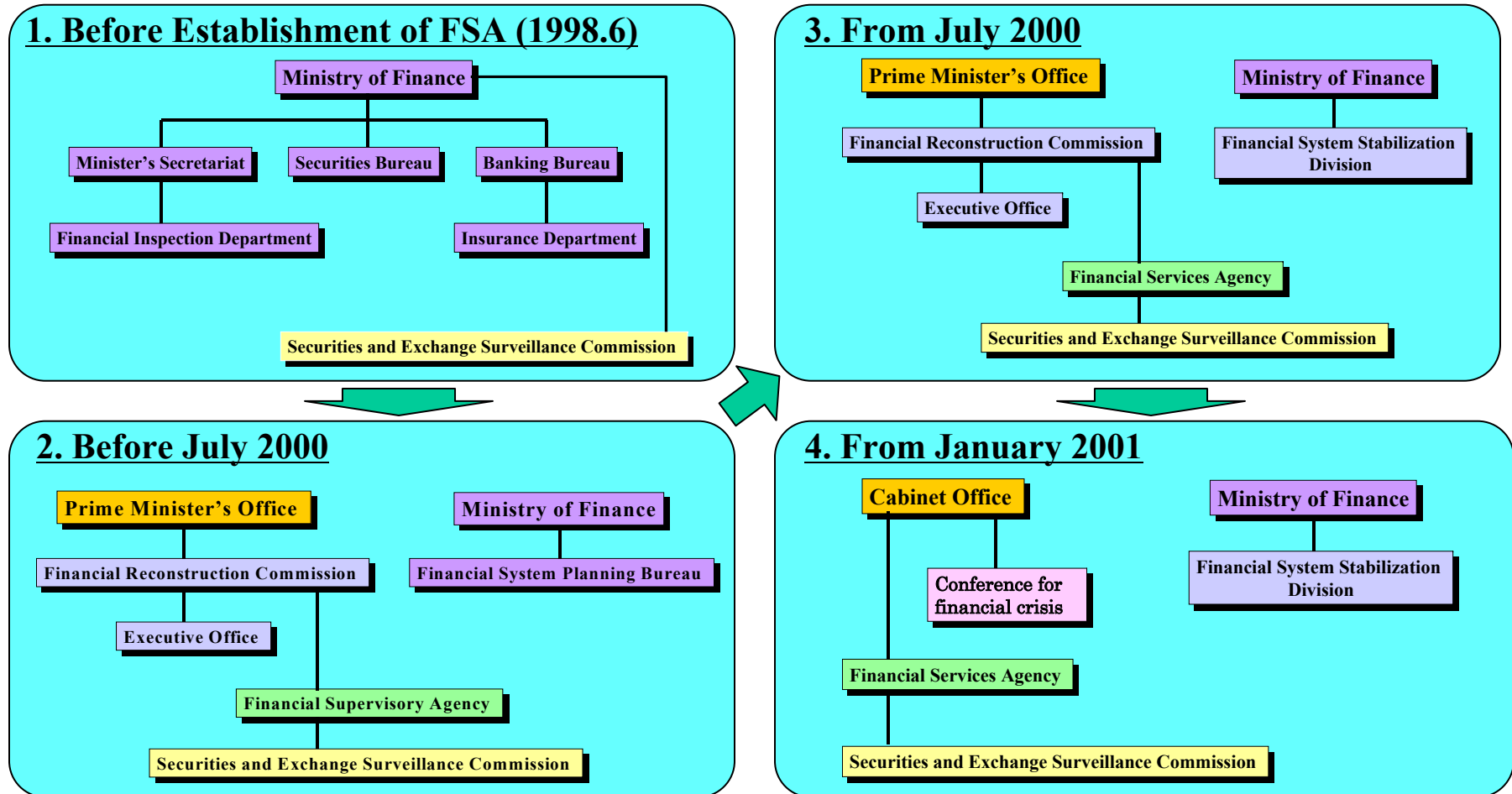
## The FSA was established with the aim to specialise in financial supervision

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- Supervisory functions were hived off from the Ministry of Finance (MoF) in 1998, in the midst of a financial crisis in the country
- Regulatory functions were transferred from the MoF in 2000
- This re-organisation followed the criticism that fiscal and other macroeconomic functions had adversely affected the conduct of the MoF's financial supervision
- Partly due to the circumstances in which it was established, greater emphasis has tended to be placed on depositor/investor protection, ruled-based supervision, and compliance, in the FSA's work



# Changes in organisational structure regarding financial regulation and supervision in Japan



\*1 FRC was established in December 1998.

\*2 Certified Public Accountants and Auditing Oversight Board (CPAFOB) was established under the FSA in April 2004.

\*3 The Financial System Stabilization Division of the MOF is concurrently responsible for planning and policymaking the system for handling the bankruptcies of financial institutions and concerning financial risk management.



## This historical background may be affecting the nature of the FSA's supervision

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*In Mr Knight's words,*

- Strong depositor/investor protection elements are more consistent with a focus on individual institutions as opposed to systemic risk *per se*
- The comparative advantage a supervisor may have in legal and accounting issues coexists uneasily with macro-prudential orientation





## Macro-prudential supervision: perceived analytical weaknesses

*Furthermore,*

- The macro-prudential analysis may not be robust enough, while the analytical framework for macro-financial linkages is still underdeveloped
- Assumptions in scenario analysis or stress testing could well be arbitrary  
*“What are the criteria for determining whether the proposed shock is ‘exceptional but plausible?’”*
- ⇒ *Under these circumstances, it may be hard to convince supervised institutions and the public of the validity of macro-prudential analysis as well as the measures based on such an analysis, particularly if these measures were to include tightening of rules and standards*



## To conclude...

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- Macro-prudential analysis is a useful tool for supervisory authorities in complementing traditional micro-prudential supervision
- In Japan, too, some elements of macro-prudential analysis have been or are being incorporated in the supervisory framework
- At the same time, strong depositor/investor protection elements, partly due to the historical background of the FSA's establishment, could constitute hurdles for further shift towards macro-prudential supervision in Japan
- Macro-prudential surveillance tools need to be strengthened and tested further in order to obtain the confidence of practitioners as well as the public with respect to supervisory measures to be taken based on this analysis



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*Thank you.*

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