12th Asia-Pacific High Level Meeting on Banking Supervision
Session 2: "The role of micro- and macroprudential policy in an era of unconventional monetary policy"
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The challenges of microprudential supervision in an exceptionally low interest rate environment

Thank you very much for the kind introduction. It is my great pleasure to participate in this panel and to share our experience to tackle an exceptionally low interest environment. This topic is attracting a lot of attention around the world because both short- and long-term interest rates have continuously declined even to negative numbers in advanced economies. Near zero or negative interest rates were still exceptional in 2011 but have expanded across the yield curve and almost all the advanced economies (See slides No.2 and 3). While the US Fed is showing a clear sign to turn around its extraordinary loose monetary policy, it is not certain when and how other central banks will follow suit. In addition to the changes in interest rate levels, the shape of the yield curve has also flattened significantly in recent years (See slide No. 4). I guess nobody would disagree with the statement that Japan has the longest and probably the toughest experience in this area. So, I would like to focus on challenges faced by the JFSA under the long lasting low interest and low growth environment and explain the directions we are aiming at through regulatory and supervisory reforms.

If you look back at history, the JFSA's supreme mission at its inauguration around the year 2000 was to resolve non-performing loan problems and to end the ensuing financial crisis. In order to regain trust in the financial administration, we emphasized rule-based ex-post checking for our supervisory activities. Asset quality reviews and compliance checks conducted by on-site inspectors were the primary policy tools employed. I would like to claim that objectivity, transparency and self-responsibility principles of our activities have contributed to the restoration of public confidence in banking supervision and regulation in Japan as well as the stability of the Japanese financial market.

This successful business model for the JFSA, however, may not necessarily work forever. If we mechanistically continue the past modus operandi, we may create unintended consequences or fail to address emerging risks. That's why the JFSA established the "Advisory Group on Supervisory Approaches" last year to have our supervisory approaches reviewed by prominent outside experts. The group published its report last week and pointed out that there can be three types of deficiencies in continuing current approaches. The first one is the obsession with form rather than substance. For instance, we tend to put too much emphasis on guarantee or collateral in credit assessment and fail to properly assess the profitability or future prospects of a borrower's business. The second problem is the obsession with the past. For instance, we tend to focus on the soundness of a bank's balance sheet based on point-in-time information in the past rather than its business sustainability in the future. The final problem is the obsession with individual elements. For instance, we tend to focus on the classification of each asset rather than holistically assessing material risks as a threat to a bank's entire management.

The Japanese economy has undergone a long period of very low interest rates, some of which have even entered into negative territory. This macro-economic condition implies two different types of risk scenario for Japanese banks. One is a textbook case in which a sudden rise of interest rates significantly affects asset prices and causes material losses for banks. As global markets are becoming more volatile and interconnected, we need to be vigilant to catch signs of such risk and be prepared for the worst scenario.

On the other hand, we also need to consider the possibility that the current extremely low interest rate environment will continue for a long time. This trend has squeezed the margin between deposit rates and lending rates for Japanese banks, as retail deposit rates are constrained by the de facto zero lower bound.

(Please look at slides No. 5 and 6)

Japanese banks have tried to compensate for the narrowed margin by increasing lending volumes despite the depopulation trend in Japan, intensifying competition and further accelerating the margin squeeze. Moreover, a flat yield curve squeezes term spreads between short-term funding and long-term investments, also putting pressure on bank profitability.

(Please look at slide No. 7)

The decreasing and aging population in Japan would put more pressure on Japanese banks sticking to the current business models. The JFSA conducted a simulation analysis regarding how continued low interest rates and decline in working age population would affect the future profitability of regional banks, based on the projection of market interest rates as well as the size of the regional economy and population in each prefecture. It is estimated that more than 60% of regional banks will suffer negative profit in lending and fee businesses in 2025.

On the other hand, there is a variety of customer needs that are not sufficiently satisfied by Japanese banks. One example is the Japanese services industry, mainly composed of a large number of SMEs, whose productivity has remained relatively low. Another example is Japanese household financial assets, the majority of which are held in cash or deposits and are not sufficiently diverse. Japanese banks are expected to improve the quality of their consulting functions or asset management services by addressing each customer’s needs properly.

(Please look at slide No. 8)

In 2015, the JFSA conducted interviews with more than 700 borrower companies and sent written surveys to 15,000 firms, from which it received some 2,500 responses, to find out how banks can create shared value with customers. According to the results of those interviews and surveys, corporate customers tend to prefer an offer of lending based on a deep understanding of their businesses and/or support for business improvement, compared to lending at lower interest rates.

In short, Japanese banks need to seek sustainable business models under the changing environment by pursuing win-win solutions with customers. In particular, for regional banks, the viability of the regional economy where each of them is operating is an important prerequisite for their sustainability. Against this backdrop, the JFSA has begun to shift its focus from backward-looking asset quality review to forward-looking monitoring of emerging risks and the sustainability of each bank's soundness.

(Please look at slide No. 9)

This slide (No. 9) summarizes the evolutions of our supervisory tasks and approaches in accordance with changes in the environment surrounding the Japanese economy and financial markets. Although ex-post asset quality review has been effective in cleaning up the legacy of what happened in the past, it does not necessarily prevent the creation of a portfolio susceptible to losses in a future case of unexpected economic and market downturns.

In addition, the persistent low interest rate environment seems to be creating new types of sustainability risk for banks: the risk of compressed margins, the risk of traditional business models becoming non-viable, and the risk of a vicious cycle caused by impaired credit intermediation capabilities. Existing prudential toolkits, which are designed to curb excessive risk-taking, would largely be ineffective in dealing with this new threat of weakened financial intermediation.

Last year, Mr. Nobuchika Mori, commissioner of the JFSA, delivered a speech in Tokyo calling for a shift from static regulation to dynamic supervision, and pointed out three types of balance for a bank's sustainability: the risk-return balance, the return-capital balance, and the risk-capital balance.

(Please look at slide No. 10)

Mr. Mori argued that risk-capital balance, which is at the bottom of the figure, is the most immediate indicator of a bank's financial soundness and viability, but that it is just a point-in-time ratio and does not give any assurance on its longer-term sustainability without the other two balances. As the environment surrounding banking business is becoming less favorable due to demographic and structural changes in industrialized countries, we cannot ensure the soundness of a bank by merely controlling its excessive risk-taking in relation to its capital. A capital buffer is effective in meeting sudden unexpected loss, but cannot withstand a prolonged period of structural low profitability. Also, if a bank's profit is not matched to its capital or its risk-taking, it cannot accumulate retained earnings in a stable manner and may face difficulties in capital-raising when necessary. Therefore, the JFSA intends to carefully monitor these three types of balance through dialogues with banks and to detect potential weaknesses for the sustainability of each bank. Though banks have started their efforts to reduce costs, increase fees to their customers and/or consider consolidation with other banks, they have not yet made sufficient efforts to grow together with their customers.

In order to facilitate such dialogues, the JFSA published the results of the afore-mentioned simulation analysis regarding combined effects on banks' future profitability of continued low interest rates and decline in working age population in regional economies. The JFSA also conducted interviews and written surveys with borrowers as I already mentioned and initiated another survey round this year by sending a new questionnaire to 30,000 firms. In addition, the JFSA started to use some fifty indicators designed to capture the characteristics of, and changes in the direction of a bank's business model, such as the number of customers with improved performance, as a tool for better dialogues. We would like to deepen our dialogues with banks about their profitability and business models by utilizing these data and information.

(Please look at slide No. 11)

This slide (No. 11) illustrates our new supervisory approaches for prudential policies. Based on our assessment of risks including those not covered by Pillar 1 for each bank, we will take appropriate corrective actions or other supervisory responses if necessary. To be specific, we assess the probability of each bank falling below the Pillar 1 minimum requirements from viewpoints including its balance of return, risks and capital, as well as the sustainability of its business model. The closer a bank is to the Pillar 1 minimum requirements, the more intense our monitoring and communication activities towards the bank would be.

These dialogues with banks would also help us to identify macro-prudential risks. For instance, in 2006, the JFSA identified the signs of overheating in the real estate sector through active dialogues with banks. We responded to the signs by amending our supervisory priority document, by publishing analytical articles and by conducting on-site inspections on banks with large exposures to the real estate sector. Our message seems to have been clearly understood by banks and an asset price bubble was aborted without causing significant side effects.

Similarly, we are now carefully monitoring property markets in local cities. Bank loans to the real estate sector, especially loans to apartment owners mainly for tax savings, are rising due to the recent increase of inheritance tax as well as persistent low interest rates in Japan. Consequently, constructions of apartments are showing a dramatic increase at an apparently unsustainable pace even in local cities with diminishing population. Borrowers of such apartment loans could face difficulties in their future repayment due to lower than expected rent incomes, and thus their lenders could suffer as well. Against this backdrop, the JFSA is intensifying dialogue with banks which have increased such exposures.

I believe supervisors are in a better place than banks in grasping a precise picture of interactions in the market through their access to the information on each bank's risk positions and internal incentive structures. Supervisors can also detect signs of deterioration of each bank's underwriting standards.

In addition, supervisors can assess the collective second-round effects of possible reactions by banks to a potential shock. In short, supervisors should be able to give a warning on anomalies individual banks may fail to notice.

But this task would not be so simple. Macro-indicators traditionally used to detect anomalies, such as credit-to-GDP ratio or asset price movements, would surely help us, but would not let us distinguish between a healthy boom and irrational exuberance. So, the JFSA is paying due attention to micro-symptoms as well and trying to analyze interactions between the activities of individual banks and movements of the market.

In this connection, the JFSA considers stress-testing as a useful tool to identify material risks in a forward-looking manner for individual banks as well as the entire financial system. We put greater emphasis on stress-testing conducted by each bank based on its own scenario tailored to fit respective weaknesses. Through the dialogue over appropriately tailored stress-testing, the JFSA and each bank will have a common recognition of emerging risks and of each bank's resilience against them. This exercise will also help us assess systemic risks on the financial markets and the entire economy, and deepen our macro-prudential analysis as well.

Finally, let me briefly touch upon international discussions on regulatory reforms. As you may know, the JFSA, together with other like-minded colleagues, has been advocating that the global regulatory reform efforts should aim to attain not only financial stability but also sustainability of economic growth while minimizing their unintended side-effects. In response, the G20 Leaders have proclaimed that sustainable economic growth is the ultimate goal and that they would address any material unintended consequences caused by the financial regulatory reforms. Accordingly, the FSB has initiated the exercise to review both the effects and side-effects of the reform measures, and the Basel Committee is committed to finalizing Basel III without a significant increase in overall capital requirement. Needless to say, we should finalize Basel III as soon as possible in order to remove regulatory uncertainty and have banks fully exercise their credit intermediary functions for the entire economy.

Once Basel III is finalized, we need to concentrate on domestic rule-making processes for some time and then need to renew our supervisory framework in each jurisdiction. In addition, I believe that bank supervisors need more discussions on the sustainability of a bank's soundness under the prolonged low interest rates and flat yield curve environment in advanced economies. Existing prudential regulations largely focus on the balance between capital held by banks and risks taken by them and do not directly address issues of profitability. It may be worthwhile for the Basel Committee or the FSB to share experiences among bank supervisors and to discuss possible tools to cope with this new type of regulatory and supervisory challenges.

Thank you.