

Update on the Global Financial Turmoil and Regulatory Response

7 January 2009
Masamichi Kono
Financial Services Agency



**Any views expressed in this presentation are those of the author, and not necessarily the official views of the FSA.*

I. Update on the Global Financial Turmoil

Origin of the Current Turmoil

- **What started out as losses for financial institutions stemming mainly from US sub-prime loans and related securitized products such as residential mortgage backed securities(RMBS) has rapidly grown into huge and cumulating losses across a broad spectrum of securitized products and loan portfolios.**

Extent of Losses at Global Financial Institutions

- **IMF estimated total losses for the global financial system amounted to 1.405 trillion US dollars (October 2008).**
- **Major global financial groups each posted cumulative losses of several trillions of yen (tens of billions of dollars).**
- **Japanese financial institutions have collectively lost around 3 trillion yen (30 billion dollars).**

Current Status

- **Severe stress and loss of confidence in the global financial markets have created market paralysis and caused a global credit crunch.**
- **Such a situation in the financial markets has led the entire economy into a steep recession.**
- **Urgent need has arisen for a quick policy response.**

Current Status (cont.)

- **In recent months, government measures have been implemented/announced by the US, Europe and other countries/regions to restore market confidence and stabilize the financial system.**
- **However, conditions in the credit markets remain extremely tight.**
- **Such tight credit conditions (credit crunch) may continue for some time.**
- **Governments and central banks have been working in close coordination to address the situation and secure financial stability.**

Current assessment for Japan

- **The effect of the recent global financial market turbulence on Japanese financial institutions and markets has been relatively limited so far.**
- **This has been due to factors such as:**
 - 1. The health of Japanese financial institutions has improved, as shown, for example, in lower NPL ratios and higher capital ratios.**
 - 2. Exposures of Japanese financial institutions to sub-prime loans and related products have been limited. (Total exposure at less than ¥1.0 trillion or \$10 billion for sub-prime loans and related products.)**
 - 3. Implementation of Basel II for all deposit-taking institutions as of end-March 2007.**

Current assessment for Japan (cont.)

- **Recent incidents in global markets have not had major systemic impacts for Japan, so far.**
- **However, we need to stay extremely vigilant as the effects of an economic slowdown, rising currency, real estate market correction etc. have started to affect the Japanese financial sector. Sharp fall in stock prices also had major impact.**
- **Despite adverse conditions, some Japanese financial institutions have found an opportunity to invest abroad, and expand their overseas operations.**

II. Lessons from Japan's experience in financial crisis management

Lessons from Japan's experience in financial crisis management

- 1. Prompt and accurate recognition of losses is essential***
- 2. Toxic assets need to be taken off the balance sheet.***
- 3. Undercapitalization of financial firms needs to be addressed, if necessary, by injecting public funds as capital.***
- 4. Exceptional measures, such as a blanket guarantee of bank deposits and temporary nationalization of troubled banks, can be useful in times of serious crises.***

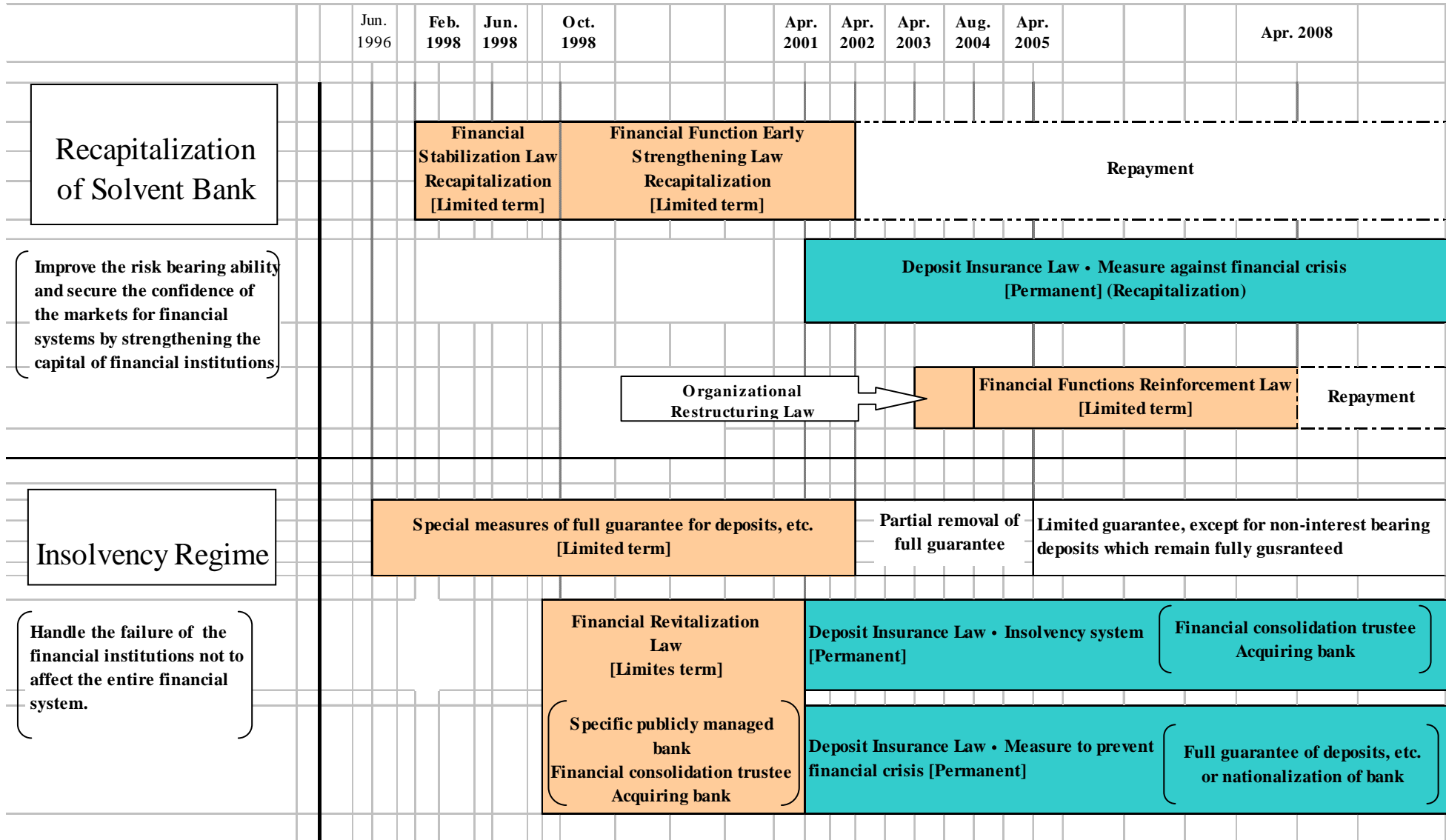
Lessons from Japan's experience in financial crisis management (cont.)

- 5. Short-term measures, and,
Re-designing of the regulatory framework
in the medium-term
need to be implemented simultaneously and
in a balanced manner.***

**Important to strike an appropriate balance
between these two strands of policies.**

**(Japan in the 1990s may not have been a
success story in this respect.)**

Safety Net for the Financial System



Some Results

- ✓ **181 deposit-taking institutions failed between 1991 and 2003, with 144 failing in the 1998~2001 period. 3 banks were nationalized, and subsequently resold to the private sector.**
- ✓ **Average capital adequacy ratio of major banks rose from 9.4% in March 2003 to 12.3% in March 2008. (11.7% in September 2008)**
- ✓ **Average NPL ratio of major banks declined from 8.4% in March 2002 to 1.4% in March 2008. (1.5% in September 2008)**
- ✓ **Number of deposit-taking institutions declined from 1007 in 1995 to 618 in 2006, with the largest decline in the number of credit associations and credit cooperatives.**

The status of implementation of financial assistance and collection by the Deposit Insurance Corporation

(As of the end of September, 2008)

The status of the implementation of financial assistance and collection from April 1992 (when the Deposit Insurance Corporation first implemented the financial assistance scheme) until the end of September, 2008.

(Note 1) 10.4326 trillion yen, disbursed in the form of JGBs which were used to settle the excess of actual cost for full deposit guarantee over the estimated cost of payoff, has been determined to be borne by the national treasury. The residual amount is to be recovered by the insurance premiums collected by the Deposit Insurance Corporation from financial institutions, the surpluses recovered from assets purchased from failed financial institutions including shares taken over from financial institutions etc., and by other revenues. Therefore, the final cost to the national treasury is not determined as of now.

(Note 2) "Cumulative amount of collection, etc." includes recovery of book value, collections beyond book value, gains from disposal of securities and real estate etc., as well as price adjustments on purchased property. It does not include interests and dividends received etc., however.

	[Amount for the implementation of assistance, etc.]	[Cumulative amount of recovery, including surplus etc.]
(1) <u>Monetary grants</u> to protect depositors, etc.	<u>18.8677 trillion yen</u>	--
(2) <u>Purchase of assets</u> from failed financial institutions etc.	<u>9.7775 trillion yen</u>	<u>9.6722 trillion yen</u>
(3) <u>Recapitalization</u> implemented to stabilize the financial system	<u>12.4274 trillion yen</u>	<u>10.5392 trillion yen</u>
(4) <u>Other financial assistance</u> , etc	<u>5.9950 trillion yen</u>	<u>4.8614 trillion yen</u>

III. Measures to ensure financial stability and to prevent financial crises

Measures to ensure financial stability and to prevent financial crises

- **Early warning system and prompt corrective action (PCA) scheme based on capital adequacy and other indicators of risk**
- **Public administration in case of insolvency or liquidity shortage (including the use of a bridge bank scheme)**
- **Deposit insurance system and other safety net provisions to protect depositors**
- **Possibility to use public funds in recapitalizing banks or to nationalize a bank**

Measures to ensure financial stability and to prevent financial crises (cont.)

- ✓ **The aforementioned measures require :
budgetary allocations and,
the setting up of independent and competent
entities for the administration of the deposit
insurance system, the management of public funds,
and the recovery of non-performing loans.**
- ✓ **The DIC (Deposit Insurance Corporation) and its
subsidiary RCC (Resolution and Collection
Corporation) play those essential roles in Japan.**

Early Warning System (EWS)

✓ EWS

Introduced in December 2002 to detect early signs of problems at financial institutions before they fall below adequately-capitalized level.

FSA to conduct intensive hearings and, if deemed necessary, take necessary administrative action, based upon indicators of profitability, credit risk, market risk, and liquidity risk

Prompt Corrective Action (PCA)

✓ PCA

Introduced in April 1998 to issue timely administrative orders to correct the management of weak financial institutions.

Measures to be ordered are strengthened in stages, in line with a decline in the capital adequacy ratio (CAR) of the institution

Prompt Corrective Action (PCA) (cont.)

✓ For internationally active banks:

CAR 4~8 % Submit and immediately implement business improvement plan

CAR 2~4 % Suspend dividend payout, suspend or restrict executive bonuses

CAR 0~2 % Either raise additional capital, drastically cut down businesses, merge with other institution, or suspend business

CAR ~0% Order to cease business entirely or partially

Deposit Insurance System

Full protection of all deposits and liabilities of failed banks was implemented between 1996 and 2001 as a temporary measure. This was subsequently extended until March 2002.

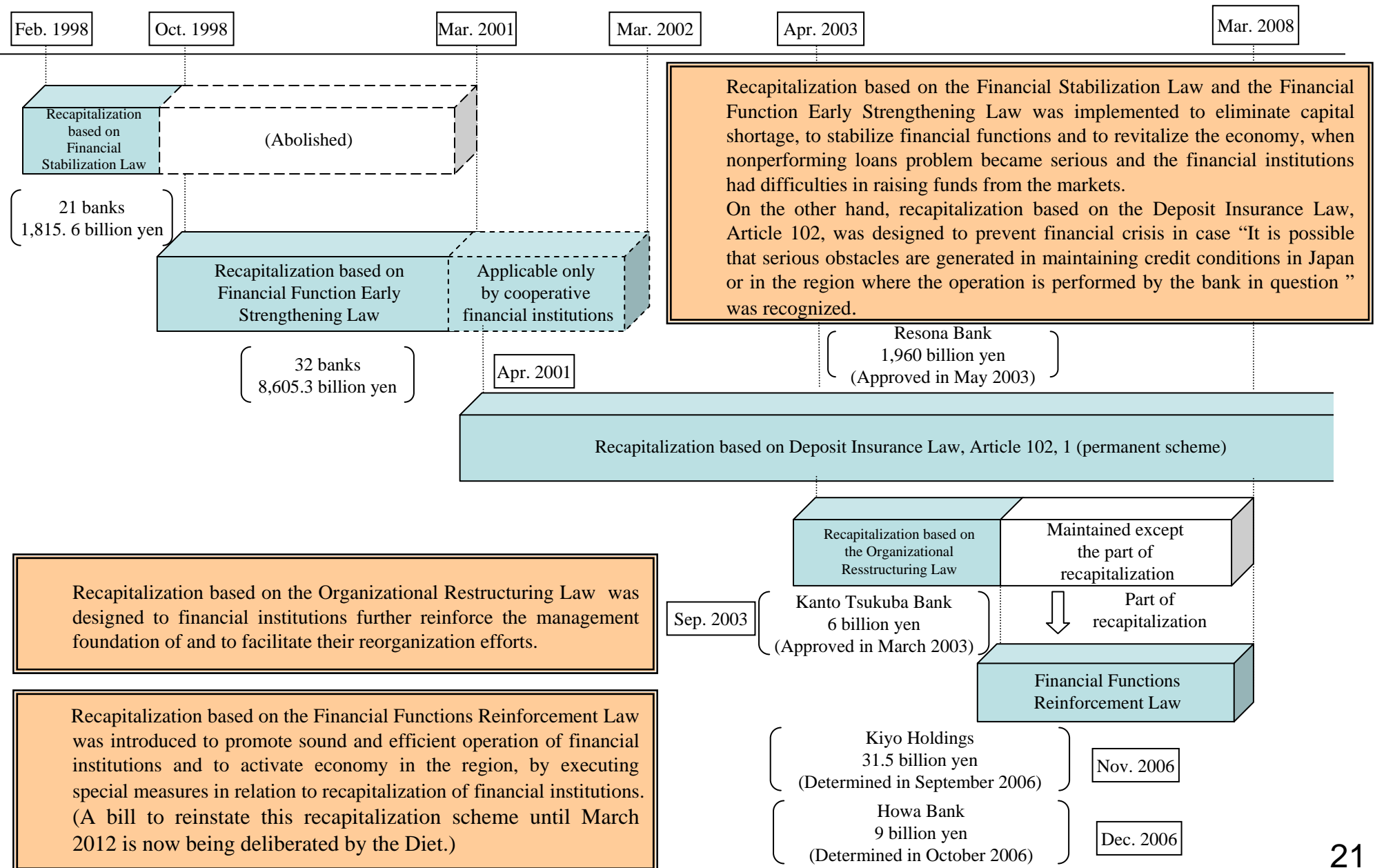
After a transitional period, the following revised deposit insurance system became effective from April 2005.

1.Payment and settlement deposits: non-interest-bearing deposits such as current deposits are protected in full.

2.Other deposits such time deposits, etc.: the principal up to the amount of 10 million yen and the accrued interest thereon are protected per person at each financial institution.

*** Uninsured amounts will be paid upon liquidation of the failed institution, in accordance with the state of remaining assets .**

Recapitalization Scheme

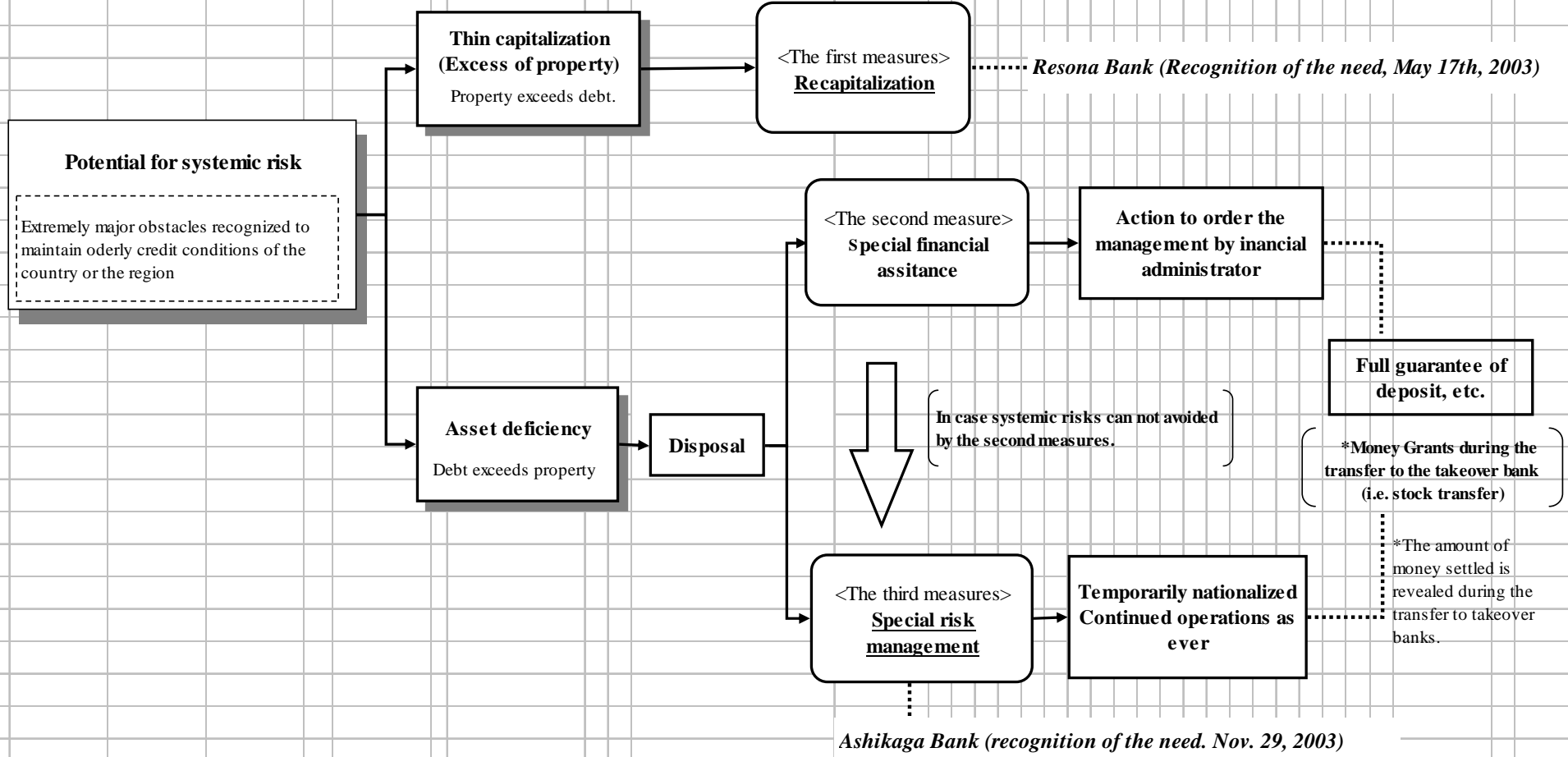


Scheme of Article 102 of Deposit Insurance Law

Financial crisis readiness

In case that the extremely major obstacles are reconized to maintain orderly credit conditions of the country or the region, treat the failure by recapitalization or full guarantee of deposite etc.

- Resona Bank Recapitalization
- Ashikaga Bank Special risk management (Temporarily nationalized)



IV. Discussions in international forums and actions to be taken

Main recommendations of the FSF WG (April 2008)

- **Further enhancement of risk management practices at financial institutions**
- **Revisions to Basel II capital rules**
- **Improving transparency and valuation of complex financial products**
- **Improving the supervisory monitoring system and stress-testing**
- **Further international supervisory cooperation, particularly in information exchange and cross-border supervisory oversight**
- **Establish rules for the proper role and conduct of rating agencies, and encourage proper use of the ratings by investors.**

Statement by G-7 Finance Ministers and Central Bank Governors on Global Financial Market Turmoil

September 22, 2008

- **We reaffirm our strong and shared commitment to protect the integrity of the international financial system and facilitate liquid, smooth functioning markets, which are essential for supporting the health of the world economy.**
- **We strongly welcome the extraordinary actions taken by the United States to enhance the stability of financial markets and address credit concerns, especially through its plan to implement a program to remove illiquid assets that are destabilizing financial institutions. We also strongly welcome the measures taken by other G-7 countries. Major central banks have been coordinating to address liquidity pressures in funding markets, which has been critical in addressing disruptions in global financial markets. Several regulators have taken decisive actions to combat market manipulation and stabilize financial markets, including a temporary ban on short selling of financial stocks.**

Statement by G-7 Finance Ministers and Central Bank Governors on Global Financial Market Turmoil (cont.)

- We recognize the importance of making regulation more effective and bringing investors back into a liquid and stable marketplace. **We remain committed to full and rapid implementation of the Financial Stability Forum (FSF) recommendations to enhance the resilience of the global financial system for the longer term.** We look forward to the FSF report this fall on progress made in strengthening prudential supervision and regulation, improving firms' risk management practices, enhancing disclosure and transparency, and strengthening accounting frameworks.
- We pledge to enhance international cooperation to address the ongoing challenges in the global economy and world markets and maintain heightened close cooperation between Finance Ministries, Central Banks and regulators. **We are ready to take whatever actions may be necessary, individually and collectively, to ensure the stability of the international financial system.**

Declaration of the Summit on Financial Markets and the World Economy

November 15, 2008

Root Causes of the Current Crisis

- ***Market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence.***
- ***Weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system.***

Root Causes of the Current Crisis (cont.)

- ***Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.***
- ***Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes.***

Actions Taken and to Be Taken

- ***Continue our vigorous efforts and take whatever further actions are necessary to stabilize the financial system.***
- ***Recognize the importance of monetary policy support, as deemed appropriate to domestic conditions.***
- ***Use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability.***

Actions Taken and to Be Taken (cont.)

- *Help emerging and developing economies gain access to finance in current difficult financial conditions, including through liquidity facilities and program support.*
- *We stress the International Monetary Fund's (IMF) important role in crisis response, welcome its new short-term liquidity facility, and urge the ongoing review of its instruments and facilities to ensure flexibility.*

Common Principles for Reform of Financial Markets

- ***Strengthening Transparency and Accountability***
- ***Enhancing Sound Regulation***
- ***Promoting Integrity in Financial Markets***
- ***Reinforcing International Cooperation***
- ***Reforming International Financial Institutions***

Action Plan to Implement Principles for Reform

References:

- ***Declaration of the Summit on Financial Markets and the World Economy, 15 November 2008, G20***

<http://www.whitehouse.gov/news/releases/2008/11/20081115-1.html>

- ***Global Financial Stability Report
Financial Stress and Deleveraging - Macro-Financial
Implications and Policy***

October 2008, International Monetary Fund

<http://www.imf.org/external/pubs/ft/gfsr/2008/02/index.html>

References (cont.)

- ***Financial Stability Report 24***

October 2008, Bank of England

<http://www.bankofengland.co.uk/publications/fsr/2008/index.html>

Global financial crisis and Japan's experience in the 1990s, Keynote speech by Dr. Takafumi Sato, Commissioner, Financial Services Agency, at the Symposium on Building the Financial System of the 21st Century, Hakone, 25 October, 2008.

<http://www.fsa.go.jp/en/announce/state/20081025.html>

Thank You

