Basel Committee
on Banking Supervision

Regulatory Consistency Assessment Programme (RCAP)

Assessment of Basel III G-SIB framework and review of D-SIB frameworks – Japan

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Glossary

AFS	Available-for-sale
C	Compliant (grade)
CET1	Common Equity Tier 1
D-SIB	Domestic systemically important bank
DAT	Data Analysis Team
EU	European Union
EUR	Euro
FSA	Financial Services Agency
FSB	Financial Stability Board
G-SIB	Global systemically important bank
JPY	Japanese yen
LC	Largely compliant (grade)
MDA	Maximum distributable amount
MNC	Materially non-compliant (grade)
MPG	Macroprudential Supervision Group
NC	Non-compliant (grade)
OTC	Over-the-counter
Q&As	Questions and answers
RCAP	Regulatory Consistency Assessment Programme
RWA	Risk-weighted assets
SIB	Systemically important bank

Executive summary

The Basel Committee on Banking Supervision (Basel Committee) sets a high priority on the implementation of regulatory standards underpinning the Basel III framework. The Committee established the Regulatory Consistency Assessment Programme (RCAP) to monitor, assess and evaluate its members' implementation of the Basel framework.

This report summarises the findings of the RCAP Assessment Team on the domestic adoption of the Basel global systemically important bank (G-SIB) framework in Japan. The focus of the assessment was on the consistency and completeness of the regulations with the Basel Committee's minimum requirements. Issues relating to prudential outcomes, the capital levels of individual banks or the supervisory effectiveness of the Japanese authorities were not in the scope of this assessment.

The report also presents a review of the Japanese domestic systemically important bank (D-SIB) framework. Unlike the G-SIB assessment, this review was not graded, consistent with the high-level, principles-based nature of the Committee's D-SIB framework.

The RCAP Assessment Team was led by Mr Wayne Byres, Chairman of the Australian Prudential Regulation Authority. The Assessment Team comprised four experts drawn from the Basel Committee Secretariat, Brazil, India and Singapore. The main counterpart for the assessment in Japan was the Financial Services Agency (FSA). The assessment and review of the Japanese SIB frameworks was conducted alongside assessments and reviews in the other four jurisdictions that are currently home to G-SIBs: China, the European Union, Switzerland and the United States.[1]

The Japanese G-SIB framework came into force on 31 March 2016 through an amendment to the FSA capital adequacy rules. Banks have been required to report and disclose information for the G-SIB identification methodology since March 2014. There are currently three G-SIBs based in Japan: Mitsubishi UFJ FG, Mizuho FG and Sumitomo Mitsui FG.[2]

The G-SIB framework in Japan is assessed as compliant with the Basel G-SIB framework. This is the highest overall grade. Both subcomponents of the G-SIB framework, higher loss absorbency and disclosure requirements, are assessed as compliant.

The assessment identified two issues where further guidance from the Basel Committee is sought. The Assessment Team considers that the Committee should clarify the timing and the reference metrics for the capital conservation standards that apply when a bank falls into its combined buffer. Also, the Committee should provide guidance to national supervisors on the inclusion or exclusion of non-internationally active banks in the G-SIB reporting and disclosure requirements and the Committee's G-SIB identification methodology.

The Assessment Team's review of the Japanese D-SIB framework found it to be broadly aligned with the Basel Committee's D-SIB principles. The framework was finalised in 2015 and uses the G-SIB methodology, supplemented by country-specific factors, to identify D-SIBs. The corresponding higher loss absorbency requirements are being phased in from 2016.

The RCAP Assessment Team acknowledges the professional cooperation received from the FSA during the assessment and review. The Assessment Team is hopeful that the RCAP exercise will contribute to the sound initiatives that have been undertaken in Japan and to strengthening further the prudential effectiveness and full implementation of these G-SIB and D-SIB frameworks.

1 The other reports are available on the BIS website at www.bis.org/bcbs/implementation/l2.htm.

2 As published by the Financial Stability Board (FSB) in November 2015. See www.fsb.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf.

Response from the Japanese authorities

The Japanese authorities express our sincere gratitude to Mr Wayne Byres and the Assessment Team for its great efforts on the draft finding report, and highly appreciate the professional and thorough way in which the detailed assessment was conducted in the process of RCAP.

We welcome the team's overall rating and subcomponent ratings to the effect that the G-SIB framework in Japan is assessed as compliant with the Basel G-SIB framework. We have made our utmost efforts for timely and proper incorporation of the G-SIB framework into the relevant Japanese regulations, and we believe that its effective implementation has contributed to ensuring a more robust G-SIB framework in Japan. In the G-SIB assessment process, we have had constructive dialogues with Japanese banks so that they would submit and disclose the relevant data in a proper manner, because timely and precise data submission is exceptionally challenging for them due to the difference from most other jurisdictions in terms of accounting standards and the fiscal year. We are delighted to have implemented the rules successfully through these banks' efforts as well as the help of Macroprudential Supervision Group (MPG) and Data Analysis Team (DAT) members.

We would like to comment on a suggestion by the team that the committee should provide guidance to national supervisors on the inclusion or exclusion of non-internationally active banks in the G-SIB reporting and disclosure requirements and the Committee's G-SIB identification methodology. We acknowledge that the G-SIB assessment methodology, in its document published in 2013, clearly focuses on the framework on cross-border spillovers and negative global externalities that arise from the failure of a globally active bank. In our view, the Japanese regime distinguishing internationally active banks from non-internationally active banks ensures consistency with the objectives of the Basel requirements to the extent which the rationale for adopting policy measures for G-SIBs is based on the cross-border negative externalities created by those banks.

We believe that the RCAP is a very useful and important instrument to ensure consistency and transparency among cross-jurisdictional regulatory frameworks. We also support and express our willingness to participate in the future exercise on an ongoing basis.

1. G-SIB assessment

1.1 Context

Introduction to the Basel G-SIB framework

The Basel Committee published the G-SIB framework in 2011 and updated it in 2013. It comprises an assessment methodology for global systemic importance, the magnitude of additional loss absorbency that G-SIBs should have and arrangements for phasing in the requirements. Based on the Basel Committee's assessment methodology, the Financial Stability Board (FSB) published a list of G-SIBs in 2011 and has updated it annually since.

The Basel framework is set out in *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement*, July 2013.[3] This document was the basis of the RCAP assessment. The RCAP Assessment Team focused on the key requirements of the G-SIB framework, namely (i) the level and composition of the higher loss absorbency requirement and coordination with other regulatory requirements; and (ii) the reporting requirements for and public disclosure by banks.

In the Basel G-SIB framework, the higher loss absorbency requirements come into effect between 1 January 2016 and 31 December 2018, in parallel with the Basel III capital conservation and countercyclical buffers. Disclosure requirements apply from 2014. The assessed jurisdictions implemented G-SIB frameworks between 2012 and 2016, with the higher loss absorbency requirements being phased in by 2019.

Status of Japanese implementation

The FSA is responsible for implementing G-SIB regulations in Japan. The higher loss absorbency requirements for G-SIBs have been implemented by way of amendments to the *FSA Administrative Notice on Capital Adequacy Rules pursuant to Article 14-2 of the Banking Act* (the Pillar 1 Notice) and the *Order Specifying the Categories etc Prescribed in Article 26 Paragraph (2) of the Banking Act*, both revised in November 2015. These amendments took effect on 31 March 2016.

The FSA has implemented the disclosure requirements for G-SIBs by revising its *Notice on the Matters Separately Prescribed by the Commissioner of the Financial Services Agency Regarding Capital Adequacy Conditions pursuant to Article 19-2 Paragraph 1 Item 5 Sub-item (d) of the Ordinance for Enforcement of the Banking Act* (the Pillar 3 Notice). These revisions were made in February 2014 and took effect from March 2014. The FSA requires banks to report data each year for the G-SIB identification methodology using its powers under Article 52-31-1 of the *Banking Act*.

Regulatory system, model of supervision and binding nature of prudential regulations

The FSA was established in 1998. It is responsible for the regulation, inspection and supervision of banks, as well as other private sector financial institutions. It derives its legal authority from the *Banking Act*. This gives the FSA the power to issue business improvement orders, impose additional capital requirements and make rules.

The FSA issues FSA Notices, Q&As pertinent to FSA Notices, Supervisory Guidelines and Inspection Manuals. FSA Notices constitute legally binding formal rules for regulated entities. Supervisory

[3] See www.bis.org/publ/bcbs255.htm.

Guidelines and Inspection Manuals are meant for FSA staff, but are publicly available and banks are expected to follow them. The same is true for Q&As. More detail is given in Annex 2 and the Committee's RCAP assessment report of the implementation of the risk-based capital framework in Japan.[4] In line with the conclusions of the Committee's previous RCAP assessment of Japan, the Assessment Team considers all these instruments to be binding and hence eligible for the RCAP Assessment.

In implementing the G-SIB framework, the FSA also issues Designation Notices to individual banks deemed to be systemically important. These have the same status as FSA Notices and are also considered legally binding.

Structure of the banking sector

As of 31 March 2015, 123 banks were operating in Japan on a consolidated basis. The Japanese financial sector is large, relative to gross domestic product and is dominated by banks.

There are currently three G-SIBs based in Japan: Mitsubishi UFJ FG, Mizuho FG and Sumitomo Mitsui FG. These three major financial groups comprise around 44% of the total exposures of the Japanese banking system. As at 31 March 2015, the Japanese G-SIBs had average total capital and common equity tier 1 (CET1) ratios of 15.6% and 10.7%, respectively. Mitsubishi UFJ FG is in Bucket 2 of the November 2014 G-SIB list, attracting a CET1 higher loss absorbency requirement of 1.5%. Mizuho FG and Sumitomo Mitsui FG are in Bucket 1, which attracts a 1% higher loss absorbency requirement.[5]

1.2 Scope of the assessment

Scope

The RCAP Assessment Team has considered all binding documents that effectively implement the Basel G-SIB framework in Japan as of 1 April 2016 (the cut-off date for the assessment). The assessment had two dimensions:

- a comparison of domestic regulations with the Basel G-SIB framework, to ascertain that all the required provisions have been adopted (the *completeness* of Japanese domestic regulation); and
- whether there are any differences in substance between the domestic regulations and the Basel framework and, if so, their significance (the *consistency* of Japanese regulation).

Any identified deviation was assessed for its materiality (current and potential, or having an insignificant impact) by using both quantitative and qualitative information. In addition to the available data, the assessment relied on expert judgment as to whether the domestic regulations met the Basel framework in letter and spirit.

Importantly, the assessment did not evaluate the adequacy of capital or resilience of the banking system in Japan or of the Japanese G-SIBs or the supervisory effectiveness of the Japanese regulatory authorities.

Assessment methodology and grading

This cross-jurisdictional assessment followed the Committee's standard RCAP assessment process.[6] Before an assessment starts, the Committee agrees the principles and process for the type of assessment and the

4 Basel Committee on Banking Supervision, *RCAP Assessment of Basel III regulations – Japan*, October 2012, www.bis.org/bcbs/implementation/l2_jp.pdf.

5 See Financial Stability Board, *2015 update of list of global systemically important banks (G-SIBs)*, www.fsb.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf.

6 For more information on the RCAP, see www.bis.org/publ/bcbs264.htm.

Team Leader agrees the specific arrangements for the particular exercise with counterparts in the assessed jurisdictions. The assessment itself comprises three phases: (i) self-assessment by the relevant authorities; (ii) an assessment phase; and (iii) a post-assessment review phase.

During the assessment phase, the RCAP Assessment Team compared the domestic regulations with the corresponding Basel framework. The Assessment Team identified observations for discussion with the relevant authorities. Following feedback from the FSA, the list of observations was developed into a structured list of preliminary findings. The materiality of quantifiable deviations was assessed primarily in terms of their current or, where applicable, potential future impact (or non-impact) on the capital ratios of the Japanese G-SIBs. The non-quantifiable aspects of identified deviations were discussed and reviewed with the Japanese authorities in the context of the prevailing regulatory practices and processes. The Assessment Team also had regard to the impact of the deviations on the collective G-SIB scoring mechanism.

As per the RCAP methodology approved by the Basel Committee, the outcome of the assessment was summarised using a four-grade scale, both at the level of each of the two subcomponents of the Basel G-SIB framework and for the overall assessment of compliance: compliant, largely compliant, materially non-compliant and non-compliant.[7]

Ultimately, the assignment of the assessment grades was guided by the collective expert judgment of the assessment team. In doing so, the assessment team relied on the general principle that the burden of proof rests with the assessed jurisdiction to show that a finding is not material or not potentially material. A summary of the materiality analysis is given in Annex 4.

The Basel G-SIB framework builds on other parts of the Basel capital framework. For example, the higher loss absorbency requirements for G-SIBs are defined with reference to the Basel III definitions of CET1 and risk-weighted assets (RWA). All the assessed jurisdictions had previously been assessed on their implementation of the Basel risk-based capital standards. This assessment of G-SIB frameworks did not repeat previous assessments of the risk-based capital standards, nor did it penalise a jurisdiction a second time where the relevant part of the capital framework was found to be less than compliant in the risk-based capital assessment. Similarly, this assessment of G-SIB frameworks relied on the previous RCAP assessments of the bindingness of regulations in each jurisdiction.

1.3 Main findings

A summary of the main findings is given below.

Summary assessment grading — Table 1

Key components of the Basel G-SIB framework	Grade
Overall grade	C
Higher loss absorbency	C
Disclosure requirements	C

Compliance assessment scale: C (compliant), LC (largely compliant), MNC (materially non-compliant) and NC (non-compliant)

[7] 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 been adjusted to take into account the different nature of the two exercises. See www.bis.org/publ/bcbs264.htm for further details.

Main findings by component

Higher loss absorbency

The Japanese implementation of the G-SIB higher loss absorbency requirements is considered compliant.

Four deviations have been identified, none of which is deemed material. The designation of G-SIBs in Japan, the transitional period and certain supervisory actions on a breach of a bank's capital buffer are determined on an individual basis, rather than being explicit in the Japanese regulations. The Assessment Team has not identified any material deviations to date, but the structure of the framework could lead to differences in outcomes in the future.

The Assessment Team has two observations on the higher loss absorbency requirements in the Japanese G-SIB framework. First, having reviewed the Japanese implementation of the capital conservation standards that apply when a bank falls into its capital buffer, the Assessment Team considers that the Basel Committee should provide guidance to national supervisors on the timing and reference metrics for distribution restrictions. Second, the Japanese higher loss absorbency requirements are being implemented between 31 March 2016 and 31 March 2019, in line with the Japanese financial year. This difference in the timing of implementation has not been considered a deviation from the Basel framework.

Disclosure requirements

The Japanese implementation of the G-SIB disclosure requirements is considered compliant.

One deviation has been identified, relating to the application of disclosure requirements to banks designated as G-SIBs in the previous year but not meeting the EUR 200 billion threshold. This deviation is not considered material.

The Assessment Team has one observation on the application of the G-SIB reporting and disclosure requirements to banks that are not internationally active. The Assessment Team considers that the Basel Committee should provide guidance to national supervisors on the inclusion or exclusion of non-internationally active banks in the G-SIB disclosure requirements and the Committee's G-SIB identification methodology.

1.4 Detailed assessment findings

The component-by-component details of the assessment of compliance with the Basel Committee G-SIB framework are given below. The focus of this section is on findings that are assessed to be deviating from the Basel framework and their materiality. Section 1.5 lists observations and other findings specific to the implementation practices in Japan. Observations do not indicate sub-equivalence.

Higher loss absorbency

Section grade	Compliant
Summary	Four deviations have been identified, which relate to the structure of the higher loss absorbency requirements set out for G-SIBs in the Japanese legislation and the role of capital remediation plans. The deviations are not considered material.
Basel paragraph number	46
Reference in the domestic regulation	Article 2-2 of Pillar 1 Notice Designation Notice Comprehensive Guidelines for Supervision of Major Banks (Supervisory Guidelines)
Findings	It is not explicit in the Japanese regulations that the higher loss absorbency requirements for Japanese G-SIBs will be compliant with the Basel framework. However, it is implied in Article 2-2, paragraph (5) of the Pillar 1 Notice, which states that the

	Commissioner of the FSA would consider "the importance of such entities in the international financial system taking into account the agreement in Financial Stability Board". It is also implied in the Supervisory Guidelines, which indicate that the FSA designates G-SIBs following the identification framework of the FSB. The Assessment Team noted that the higher loss absorbency requirements in the Designation Notices for the Japanese G-SIBs were in line with the Basel framework at the time of the assessment.
Materiality	Not material
Basel paragraph number	47
Reference in the domestic regulation	Article 2-2 of Pillar 1 Notice Designation Notice Comprehensive Guidelines for Supervision of Major Banks ("Supervisory Guidelines")
Findings	The Basel framework adopted the bucketing approach for G-SIB higher loss absorbency requirements to provide incentives for banks to avoid becoming more systemically important. To this end, the bucket thresholds are set initially such that the top bucket (currently the fifth bucket) is empty, but should it be populated, a new bucket will be added. Each new bucket will be equal in size (in terms of scores) to each of the initially populated buckets and the minimum higher loss absorbency requirement for the new buckets will increase in increments of 1% of RWA. The bucketing approach and incentives for G-SIBs to avoid becoming more systemically important are not explicit in the Japanese regulations. However, it is implied in Article 2-2, paragraph (5) of the Pillar 1 Notice, which states that the Commissioner of the FSA would "take into account the agreement in the Financial Stability Board" when stipulating the list of G-SIBs and corresponding higher loss absorbency requirements in the Designation Notice. It is also implied in the Supervisory Guidelines which indicate that the FSA designates G-SIBs following identification by the FSB. The Assessment Team noted that the higher loss absorbency requirements for the Japanese G-SIBs in the Designation Notice were in line with Basel requirements at the time of the assessment.
Materiality	Not material
Basel paragraph number	57
Reference in the domestic regulation	Article 1, paragraph (2), item (ii) of Order Specifying the Categories, etc. Prescribed in Article 26, Paragraph (2) of the Banking Act
Findings	The Basel framework requires any G-SIB in breach of its combined buffer to agree a capital remediation plan over a time frame to be established by the supervisor. The FSA regulations prescribe a capital distribution constraint plan but do not require it to be established within a fixed time frame. It also does not explicitly mention that restrictions on distributions will remain in force until the capital remediation plan has been completed. The FSA has indicated that, in case of a breach of the combined buffer, it would set the time frame and establish appropriate actions individually so that the bank regains the trust of the market quickly, taking the condition of capital markets into account. In order to monitor the progress of the recovery plan, III-2-1-4-3 of the Supervisory Guidelines stipulates that the FSA may require the bank to report the progress situation to the FSA as necessary.
Materiality	Not material
Basel paragraph number	58
Reference in the domestic regulation	Article 1, paragraph (2), item (ii) of Order Specifying the Categories, etc. Prescribed in Article 26, Paragraph (2) of the Banking Act Designation Notice
Findings	The Basel framework grants a 12-month grace period for a G-SIB that migrates to a bucket requiring a higher loss absorbency requirement to meet that additional requirement. After this grace period, if the bank does not meet the higher loss absorbency requirement, then the capital conservation standards for the expanded capital conservation buffer will be applied.

	This transition period is not applied automatically in the Japanese G-SIB framework. The FSA indicated that, should a G-SIB progress to a higher bucket, higher loss absorbency requirements and their implementation date would be set on an individual basis by a Designation Notice. This difference is not considered to be material by the Assessment Team.
Materiality	Not material

Disclosure requirements

Section grade	Compliant
Summary	One deviation has been identified: there is no automatic requirement for banks classified as G-SIBs in the previous year but not meeting the disclosure threshold to publish G-SIB disclosures. However, this is not a material deviation.
Basel paragraph number	42
Reference in the domestic regulation	Pillar 3 Notice, article 7, paragraph 5
Findings	The Basel framework determines that banks below the EUR 200 billion threshold that have been classified as a G-SIB in the previous year would also be required to comply with the disclosure requirements. The FSA explained that a requirement in the Pillar 3 Notice, "the banks designated by the Commissioner of the FSA are required to disclose", was included in order to have flexibility to include G-SIBs from the previous year and other banks in the disclosure requirements. Although the banks classified as a G-SIB in the previous year are not automatically required to disclose information, the FSA has the power to require them to publish such disclosures.
Materiality	Not material

1.5 Observations specific to implementation practices in Japan

The following list describes the observations of the Assessment Team regarding Japan's implementation of the G-SIB framework. These observations are consistent with the Basel framework and are provided here for background information only.

Higher loss absorbency requirements

Basel paragraph number	56 and 57
Reference in the domestic regulation	Article 1, paragraph (2), item (ii) of Order Specifying the Categories, etc. Prescribed in Article 26, Paragraph (2) of the Banking Act
Findings	The Basel G-SIB framework implements the G-SIB higher loss absorbency requirement through an extension of the capital conservation buffer, maintaining the division of the buffer into four bands of equal size. Where a G-SIB fails to meet the combined buffer, the four bands correspond to different proportions of restrictions on distributions. A G-SIB that breaches its combined buffer is subject to distribution restrictions until the buffer is restored. Should a Japanese G-SIB breach its buffer, the FSA Regulation imposes constraints on capital distributions. Capital distributions are to be constrained "up to an amount obtained by deducting the amount of capital distribution which has already been paid in the relevant business year from the amount equivalent to 60% / 40% / 20% of the amount of adjusted profits after tax". 60%, 40% and 20% relate to the fourth, third and second bands of the buffer, with the fourth band corresponding to the highest quartile of capital ratios within the buffer and the first being the lowest.

	The FSA explained that the 60% (or 40%, or 20%) cited above becomes a cap on the maximum distributable amount for the relevant business year. The Japanese regulations define "maximum distributable amount" as the adjusted profits after tax for the previous business year to that in which capital conservation standards were imposed. For example, if the 60% restriction applies and 50% of the maximum distributable amount has already been paid out, then dividend distributions of the remainder of the year must not exceed 10% of the total maximum distributable amount. This means that 40% will be retained in the bank. Paragraph 131 of the Basel III standards states that earnings should be conserved in the subsequent financial year. In reviewing this issue, the Assessment Team identified that the conservation limit on "earnings in the subsequent financial year" could be interpreted in two ways, which could lead to different distribution restrictions in practice. Therefore, the Assessment Team recommends that the Basel Committee provide guidance to national supervisors on its intentions. This issue is discussed further in Annex 5.
Basel paragraph number	62
Reference in the domestic regulation	Designation Notice
Findings	The Basel framework requires that the higher loss absorbency requirement will be phased in alongside the capital conservation and countercyclical buffers, ie between 1 January 2016 and year-end 2018, becoming fully effective on 1 January 2019. The Japanese Designation Notices are structured so that they set out first the full requirement (100% of the higher loss absorbency requirement) and then transitional arrangements that apply only between 31 March 2016 and 31 March 2019. Thus, the requirements are effectively phased in between 31 March 2016 and 31 March 2019. The implementation of these requirements reflects the Japanese financial year, which starts on 1 April. As in the RCAP Capital assessment for Japan, this difference in the timing of implementation has not been considered a deviation from the Basel framework.

Disclosure requirements

Basel paragraph number	42
Reference in the domestic regulation	Supervisory Guideline – III-3-2-4-4-(3)-vii
Findings	The Basel G-SIB framework requires all banks with a leverage ratio measure exceeding EUR 200 billion to make the indicators of the G-SIB identification methodology publicly available. The Basel framework generally only applies to internationally active banks. The Japanese Supervisory Guidelines state that an internationally active bank holding company with a leverage ratio exposure measure exceeding EUR 200 billion must disclose the quantitative items appropriately in accordance with the Basel Committee instructions for the G-SIB assessment exercise. However, these Guidelines do not state that all banks meeting the leverage ratio exposure threshold should report such data to the Japanese FSA or another relevant authority. There is a small number of Japanese banks that have a leverage ratio exposure measure exceeding EUR 200 billion (one of these materially so) and that are not considered internationally active. These banks are not subject to the G-SIB reporting and disclosure requirements and are not included in the Basel Committee's G-SIB identification and assessment methodology. Were these institutions to be included, this could affect the G-SIB scores of other institutions. This issue is discussed further in Annex 5.

2. D-SIB review

2.1 Context

Introduction to the Basel D-SIB framework

The Basel Committee published its D-SIB framework in 2012.[8] The D-SIB framework comprises a set of principles on the assessment methodology and the higher loss absorbency requirement for D-SIBs. These principles allow appropriate national discretion to accommodate structural characteristics of domestic financial systems, including the possibility for countries to go beyond the minimum D-SIB framework. The Committee considers that it would be appropriate if banks identified as D-SIBs by their national authorities are required by those authorities to comply with the principles from January 2016 (in line with the phase-in arrangements for the G-SIB framework).

Status of Japanese implementation

The Japanese D-SIB framework was finalised in November 2015 by way of revisions to the Pillar 1 Notice and the *Order Specifying the Categories etc Prescribed in Article 26 Paragraph (2) of the Banking Act*. The Designation Notices to designate individual D-SIBs were finalised in December 2015. The provisions of the D-SIB framework took effect on 31 March 2016.[9]

Significance of D-SIBs in the banking sector

There are currently four designated D-SIBs in Japan, in addition to the three G-SIBs listed in Section 1.1: Daiwa Securities Group, Nomura Holdings, Norinchukin Bank and Sumitomo Mitsui Trust Holdings. These comprise around 15% of Japanese total banking system exposures and are all internationally active.

2.2 Scope and methodology of the review

The review of the D-SIB framework was done in parallel with the G-SIB assessment, but was not performed on a graded basis. Instead, the Assessment Team collected information on the implementation of the D-SIB framework in Japan (as well as China, the EU, Switzerland and the United States) and developed a qualitative narrative. This approach is consistent with the Basel Committee's objectives: valuable information is collected on implementation, while respecting the high-level, principles-based nature of the D-SIB framework.

The RCAP Assessment Team has considered all binding documents that effectively implement the Basel D-SIB framework in Japan as of 1 April 2016 (the cut-off date for the assessment and review). These documents were compared to the Basel Committee's D-SIB principles.[10]

Differences between the principles and the Japanese framework were considered and discussed with FSA. The Assessment Team did not assess the materiality of these differences.

As for the G-SIB assessment, the D-SIB review did not evaluate the adequacy of capital or resilience of the banking system in Japan or of the Japanese D-SIBs or the supervisory effectiveness of the Japanese regulatory authorities.

[8] See Basel Committee on Banking Supervision, *A framework for dealing with domestic systemically important banks*, October 2012, www.bis.org/publ/bcbs233.pdf.

[9] This deadline reflects the Japanese fiscal year-end, and thus is equivalent to calendar year-end 2017.

[10] Basel Committee on Banking Supervision, *A framework for dealing with domestic systemically important banks*, October 2012, www.bis.org/publ/bcbs233.htm.

2.3 Results of the review

Assessment methodology

The Japanese authorities issue Designation Notices to all designated D-SIBs. These Designation Notices highlight, amongst other provisions, that the requirements will be phased in between 31 March 2016 and 31 March 2018.

Japanese regulations highlight that, at a high level, designation as a D-SIB relates to a bank's importance to the Japanese financial system. However, it is worth noting that the D-SIB framework only applies to internationally active banks. Further details of how "importance" is interpreted is provided in the assessment methodology.

The Pillar 1 Notice stipulates that minimum capital requirements, including SIB buffers, apply to internationally active banks that are consolidated subsidiaries of bank holding companies. Foreign subsidiaries are considered "domestic banks" and, thus, included in the assessment.

The Japanese assessment methodology is broadly consistent with the D-SIB framework. It is based on the G-SIB assessment methodology's categories and indicators, supplemented with prescribed indicators and differentiated weightings to reflect country-specific characteristics. The four categories assessed are: (i) size; (ii) interconnectedness; (iii) substitutability/financial institution infrastructure; and (iv) complexity. Many of the indicators within each category mirror those in the G-SIB methodology, supplemented with others that reflect Japan's financial system.

Japan's D-SIB assessment methodology — Table 2

Category	Weighting	Individual indicator
Size	25%	Total exposures as defined for use in the Basel III leverage ratio
Interconnectedness	5%	Intra-financial system assets
	5%	Intra-financial system liabilities
	5%	Securities outstanding
	5%	Market price of equities categorised as available-for-sale
	5%	Total amounts of deposits that exceed the 10 million yen maximum guarantee (uninsured deposits)
Substitutability/Financial institutions infrastructure	8.33%	Payment activities in Japanese yen
	8.33%	Assets under custody held on behalf of Japanese clients
	8.33%	Underwritten transactions in debt and equity market
Complexity	8.33%	Notional amount of over-the-counter (OTC) derivatives
	8.33%	Cross-jurisdictional claims
	8.33%	Cross-jurisdictional liabilities

Source: FSA.

The main differences between the indicators in the Japanese D-SIB framework and those in the Basel G-SIB framework are:

- "total amounts of deposits" and "market price of equities categorised as available-for-sale" have been added to the interconnectedness category;
- "trading and available-for-sale (AFS) securities" and "Level 3 assets" were excluded from the complexity category; and

- "cross-jurisdictional claims" and "cross-jurisdictional liabilities", that formed the cross-jurisdictional activity category in the G-SIB framework, were added to the complexity category.

The Japanese Supervisory Guidelines further elaborate definitions for each indicator. Moreover, the Supervisory Guidelines note that the D-SIB designation relies not only on indicator scores, but is complemented with a comprehensive assessment of systemic importance, including activities in specific markets, portfolio composition and qualitative assessment. All domestic banks with JPY 15 trillion (approximately EUR 115 billion, as of end-2015) or more in consolidated assets are included in the scope of assessment.

While there is no explicit requirement for the frequency of assessment, banks are required to complete and report data templates annually; the authorities use these data to perform scoring calculations. Similarly, there is no requirement to re-assess banks after structural changes. However, the authorities can require banks to re-submit data, eg following a merger.

The Japanese assessment methodology is publicly disclosed in the Supervisory Guidelines.

Higher loss absorbency

A high-level view of how the authorities set the D-SIB capital buffer is set out in the Supervisory Guidelines, and specific capital buffer requirements are presented in the Designation Notices. However, there is no publicly available description of a methodology for linking results of the assessment methodology to higher loss absorbency requirements. In practice, higher loss absorbency requirements are based on a combination of the indicator scores and qualitative assessments.

The Supervisory Guidelines state that the minimum capital buffer for each bank shall be determined by their systemic importance and specified by the Designation Notice. The higher loss absorbency requirements set in the Designation Notices provide evidence that there are differentiated requirements linked to the results of the assessment of domestic systemic importance. Individual bank scores are not publicly disclosed.

As noted above, the scope of the assessment includes foreign subsidiaries domiciled in Japan as "domestic banks". Both the Pillar 1 Notice and Designation Notices highlight that designation as a SIB may be the sole decision of the FSA but also influenced by the decision of the FSB. The Pillar 1 Notice states that, if an institution is designated as both a G-SIB and a D-SIB, the higher of the higher loss absorbency requirement related to each designation shall be applied.

Home-host issues related to SIB buffers for large Japanese banks are discussed as part the Japanese authorities' participation supervisory colleges and crisis management groups.

The Pillar 1 Notice, the *Banking Act*, and Designation Notices stipulate the D-SIB buffer must be met entirely with CET1 capital, as an extension of the capital conservation buffer. Further, D-SIBs are subject to compliance with other heightened prudential requirements, such as the Basel Committee's *Principles for effective risk data aggregation and risk reporting*.[11] Any Pillar 2 capital requirements, based on bank-specific risk profiles, are in addition to D-SIB higher loss absorbency requirements.

[11] Basel Committee on Banking Supervision, *Principles for effective risk data aggregation and risk reporting*, January 2013, www.bis.org/publ/bcbs239.htm.

Annexes

Annex 1: RCAP Assessment Team, Review Team and Peer Review Board

Assessment Team Leader

Mr Wayne Byres	Australian Prudential Regulation Authority

Assessment Team Members

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Review Team

Ms Valeria Salomao Garcia	World Bank
Mr Brad Shinn	Office of the Superintendent of Financial Institutions, Canada
Mr Rob Urry	South African Reserve Bank
Mr Sunny Yung	Hong Kong Monetary Authority

Peer Review Board

Mr Pascual O'Dogherty	Bank of Mexico
Mr Arthur Yuen	Hong Kong Monetary Authority
Mr Aditya Narain	International Monetary Fund

Annex 2: Local regulations issued by the Japanese authorities to implement the Basel G-SIB framework

Overview of G-SIB rules and issuance dates — Table A.1

Domestic regulations	Version and date
Banking Act	Implemented in June 1981 and revised subsequently (most recently in June 2014)
FSA Administrative Notice on Capital Adequacy Rules pursuant to Article 14-2 of the Banking Act (the Pillar 1 Notice)	Revised in December 2015
Order Specifying the Categories etc Prescribed in Article 26 Paragraph (2) of the Banking Act	Revised in December 2015
Notice on the Matters Separately Prescribed by the Commissioner of the Financial Services Agency Regarding Capital Adequacy Conditions pursuant to Article 19-2 Paragraph 1 Item 5 Sub-item (d) of the Ordinance for Enforcement of the Banking Act	Revised in March 2014
Designation Notices	Issued in December 2015
Supervisory Guidelines	Revised in December 2015

Source: FSA.

Hierarchy of Japanese laws and regulatory instruments — Table A.2

Level of rules (in legal terms)	Type
Laws	Enacted by the Diet
Notices	Issued by the FSA
Regulatory documents	Issued by the FSA

Sources: *RCAP Assessment of Basel III regulations – Japan*, October 2012, www.bis.org/bcbs/implementation/l2_jp.pdf.

The RCAP assessment of Japan's implementation of the Basel capital standards considered the binding nature of regulatory documents in Japan. The findings of that assessment are given in Annex 7 of the previous RCAP assessment report.[12] This RCAP Assessment Team did not repeat that assessment, but instead relied on the previous RCAP findings.

In implementing the G-SIB framework, the FSA also issues Designation Notices to individual banks deemed to be systemically important. These were not assessed in the previous RCAP assessment. Designation Notices have the same status as FSA Notices and so are also considered legally binding.

[12] Basel Committee on Banking Supervision, *RCAP Assessment of Basel III regulations – Japan*, October 2012, www.bis.org/bcbs/implementation/l2_jp.pdf.

Annex 3: Financial indicators of the Japanese banking system, G-SIBs and D-SIBs

Overview of the Japanese banking system and systemically important banks

As of 31 March 2015 Table A.3

Size of banking system (at consolidated level, EUR billions)	
Total assets all banks operating in the jurisdiction (including off-balance sheet exposures)	11,109
Total assets of all G-SIBs	5,127
Total assets of all designated D-SIBs	1,698
Number of banks	
Number of banks operating in Japan	123
Number of G-SIBs	3
Number of designated D-SIBs	4
Capital adequacy of G-SIBs (EUR billions, per cent)	
Total regulatory capital	262
Total CET1 capital	180
Total RWA	1,675
Capital adequacy ratio (weighted average)	15.6%
CET1 ratio (weighted average)	10.7%
CET1 ratio (minimum in sample)	9.4%
CET1 ratio (maximum in sample)	11.3%
Capital adequacy of D-SIBs (EUR billions, per cent)	
Total regulatory capital	104
Total CET1 capital	78
Total RWA	532
Capital adequacy ratio (weighted average)	19.6%
CET1 ratio (weighted average)	14.7%
CET1 ratio (minimum amongst sample)	10.3%
CET1 ratio (maximum amongst sample)	19.8%

Entries for D-SIBs exclude designated G-SIBs where these are also considered D-SIBs at the consolidated level in the jurisdiction where they are subject to consolidated supervision.

The definition of total assets is slightly different for the different categories of banks.

- "Total assets for all banks operating in the jurisdiction (including off-balance sheet exposures)" is total on-balance and off-balance sheet exposures before the application of credit risk mitigation. It does not include the numbers for Nomura Holdings and Daiwa Securities Group, as these are securities companies instead of banks and not required to report the same data as banks.
- For G-SIBs, the total assets measure is based on the size indicator in the G-SIB methodology (December 2012 version).
- For D-SIBs, the total assets measure is the leverage ratio definition. This measure does include Nomura Holdings and Daiwa Securities Group.

Indicators of systemic importance

As of 31 March 2015, in EUR billions and per cent of global totals — Table A.4

Total exposures	6,674	9.0%
Intra-financial system assets	671	8.5%
Intra-financial system liabilities	659	7.4%
Securities outstanding	844	6.9%
Total payments	153,664	7.2%
Assets under custody	4,493	3.9%
Underwriting activity	255	4.8%
Notional amount of OTC derivatives	43,424	6.8%
Trading and AFS securities	399	12.2%
Level 3 assets	45	6.8%
Cross-jurisdictional claims	1,768	10.3%
Cross-jurisdictional liabilities	1,092	7.0%

The indicators of systemic importance are based on the total sample of banks in Japan used for the Basel Committee and FSB's G-SIB identification data collection exercise. This comprises all banks with a leverage ratio exposure measure exceeding EUR 200 billion or which were designated as G-SIBs in the previous year's G-SIB assessment.

Annex 4: Materiality assessment

The assessment of materiality distinguished between quantifiable and non-quantifiable gaps. The Assessment Team attempted to quantify the impact of all quantifiable gaps for each G-SIB. In total, five gaps were assessed based on information provided by the Japanese authorities. The Assessment Team also had regard to the impact of the deviations on the collective G-SIB scoring mechanism.

In cases where the computation of the impact was not straightforward, the computation erred on the conservative side. Where no data were available to quantify gaps, the Assessment Team relied on expert judgment. Following this approach, the Assessment Team determined whether gaps were likely to be "not material", "potentially material" or "material".

Number of gaps by component

Table A.5

Component	Not material	Potentially material	Material
Higher loss absorbency	4	0	0
Disclosure requirements	1	0	0

Annex 5: Areas for further guidance from the Basel Committee

Capital conservation standards

The Basel G-SIB framework implements the G-SIB higher loss absorbency requirement through an extension of the capital conservation buffer, maintaining the division of the buffer into four bands of equal size. Where a G-SIB fails to meet the combined buffer, the four bands correspond to different proportions of restrictions on distributions. A G-SIB that breaches its combined buffer is subject to distribution restrictions until the buffer is restored. The distribution restrictions are described in paragraph 131 of the Basel III standards as follows:

"The table [below paragraph 131] shows the minimum capital conservation ratios a bank must meet at various levels of the [CET1] capital ratios. For example, a bank with a CET1 ratio in the range of 5.125% to 5.75% is required to conserve 80% of its earnings in the subsequent financial year (ie payout no more than 20% in terms of dividends, share buybacks and discretionary bonus payments)."

The Assessment Team identified that the conservation limit on "earnings in the subsequent financial year" could be interpreted in two ways (illustrated using the same example as in paragraph 131):

1. When a bank falls into the buffer range, it is required to conserve 80% of its earnings (ie 80% of this year's earnings) in the subsequent financial year; or
2. When a bank falls into the buffer range, it is required to conserve 80% of its earnings in the subsequent financial year (ie 80% of next year's earnings).

The difference in interpretations can produce materially different outcomes.

Also, the requirement in the Basel standards to conserve earnings "in the subsequent financial year" may suggest that distribution restrictions should not apply until the financial year after that in which the bank has fallen into the buffer range. A third, less literal, interpretation would impose restrictions from the point at which the bank enters the buffer, and that any earnings subsequent to the breach (including interim earnings during the current financial year) would be subject to the restrictions. Under this interpretation, a G-SIB would not wait until the next financial year to commence compliance with the restrictions.

When defining the basis for distribution restrictions in the subsequent financial year, Japan has based its approach on the first interpretation above, ie this year's earnings is used as the basis for distribution restrictions in the subsequent financial year. However, the Japanese framework also imposes distribution restrictions for the remainder of the financial year in which the breach occurs. The allowable distributions in the subsequent financial years also take into account the distributions made in the year of the breach.

As the Assessment Team considers that there are reasonable alternative interpretations of the Basel standards, it recommends that the Basel Committee provides additional guidance to national supervisors on this requirement.

Inclusion of domestic banks in the G-SIB identification, reporting and disclosure requirements

In general, the Basel standards only apply to internationally active banks. However, the Basel G-SIB framework requires:

- The 75 largest banks in the world to be included in the sample on which the G-SIB scores are based; and
- all banks with a leverage ratio measure exceeding EUR 200 billion to make the indicators of the G-SIB identification methodology publicly available.

The Japanese Supervisory Guidelines state that an internationally active bank holding company with a leverage ratio exposure measure exceeding EUR 200 billion must disclose the quantitative items appropriately in accordance with the Basel Committee instructions for the G-SIB assessment exercise. This is founded on the general premise that the Basel framework only applies to internationally active banks and that, as such, if the bank is not considered to be internationally active, then it would not be required to disclose the G-SIB indicators or to report such data to the Japanese FSA or another relevant authority.

Also, such a bank would not submit information to the Basel Committee as part of its G-SIB identification and assessment methodology. The Assessment Team understands that this has not necessarily been the approach adopted uniformly in all other jurisdictions. This could affect the G-SIB scores of other institutions, particularly in situations where a very large but domestically focused bank is excluded from reporting to the Committee's G-SIB identification exercise.

There is a small number of Japanese banks that are not considered internationally active and that have a leverage ratio exposure measure exceeding EUR 200 billion. The exclusion of such banks from the G-SIB identification, reporting and disclosure requirements is, for the reasons noted above, listed as an observation and is not considered to affect the compliance of the Japanese rules with the Basel framework. However, the Assessment Team considers that it would be beneficial for the Basel Committee to provide guidance to national supervisors on the inclusion or exclusion of non-internationally active banks in the G-SIB reporting and disclosure requirements and, in particular, the Committee's G-SIB sample. Different interpretations on this issue could have an impact on the G-SIB list and the indicator scores of G-SIB sample banks.

Annex 6: FSA summary of its Pillar 2 supervisory review process, as applied to G-SIBs and D-SIBs

The higher loss absorbency requirement for G-SIBs incorporates elements of both Pillar 1 and Pillar 2. The indicator-based measurement approach, the pre-specified requirements for banks within each bucket and the fixed consequences of not meeting the requirements can be considered close to Pillar 1. However, the use of supervisory judgment to finalise the allocation of individual banks to buckets can be considered close to Pillar 2. In some jurisdictions, Pillar 2 may adapt to accommodate the existence of the G-SIB higher loss absorbency requirements, but capital meeting the G-SIB higher loss absorbency requirement should not be used simultaneously to meet Pillar 2 requirements relating to other risks.

As described in the RCAP assessment of Japan's implementation of the Basel capital standards,[13] the FSA and the Bank of Japan have established a comprehensive Pillar 2 framework. These rules are generally stipulated as secondary legislation, underpinned by the general powers in the *Banking Act* that enable the authorities to impose additional capital charges. In general legal terms, the authorities are in a position to take action and have done so in the past.

In Japan, higher loss absorbency requirements for G-SIBs and D-SIBs are considered Pillar 1 requirements. In addition, under Pillar 2, the FSA strongly encourages SIBs to maintain enough capital to withstand severe shocks considering their systemic importance. Any such Pillar 2 requirements are in addition to the SIB higher loss absorbency requirements.

Under Pillar 2, the FSA requires banks to establish a robust governance and risk management framework through a sufficient two-way dialogue.

More precisely, based on the "Comprehensive Guidelines for Supervision of Major Banks", the FSA reviews whether major banks have a process for evaluating the level of their overall capital adequacy in light of the risk characteristics and implement appropriate measures to maintain a sufficient level of capital in terms of both quality and quantity.

Especially for SIBs, the FSA reviews whether the directors and the board of directors have sufficiently established capital plans considering the higher loss absorbency, and how institutions are prepared for stresses in the market and the economy. A solid financial footing is essential for banks to increase the resilience to future shock and continue to function as effective intermediaries. The FSA encourages banks to maintain adequate capital through solid income and a proper capital plan taking into account the phased-in higher loss absorbency implementation.

As for G-SIBs, the FSA reviews whether they develop more robust governance according to their size, complexity, international activities, and systemic interconnectedness by, for example, requiring the main subsidiaries of the bank holding company to appoint independent outside directors even though the subsidiaries are unlisted.

The FSA published Strategic Directions and Priorities,[14] which indicate what goals the FSA aims to attain during the period from July 2015 to June 2016 and how. Based on the Strategic Directions and Priorities, the FSA pays attention to the following points for the review of SIBs:

[13] Basel Committee on Banking Supervision, *RCAP Assessment of Basel III regulations – Japan*, October 2012, www.bis.org/bcbs/implementation/l2_jp.pdf.

[14] Financial Services Agency, *Highlights of the Financial Monitoring Report for 2014-2015*, 2015, www.fsa.go.jp/en/news/2015/20150909-1.html.

- Whether they strengthen their risk governance by establishing the risk appetite framework, and whether they manage their profitability closely and review their business strategy and capital plans flexibly based on the outlook for the economy and potential stresses in the market.
- Whether they establish a robust stress-testing framework, whether the board of directors and management committees discuss the results of the stress testing and contingency plan, and whether the results are reflected in the business strategy and their capital policy.
- Especially for large securities companies, whether they set target levels for risk indicators according to their size and risk profile to enable the front offices to manage and monitor the risks.