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Bank of Japan

The Current Situation in Japan's Financial System and Macroprudential Policy

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Introduction

It is a great honor to have this opportunity to speak before the Paris Europlace Financial Forum today. Before I begin, I would like to offer my deepest condolences to the victims of the recent terrorist attacks in Paris.

Since the global financial crisis, the "macroprudential" perspective has become widely recognized. Underlying the macroprudential framework is the view that, to ensure financial stability, it is necessary to devise institutional designs and policy measures to prevent systemic risk from materializing, based on analyses and assessments of risks in the financial system as a whole, taking into account the interconnectedness of the real economy, financial markets, and financial institutions' behavior.

Today, I will start by providing an assessment of the current situation in Japan's financial system from a macroprudential perspective. I will then share with you my views on some of the issues regarding macroprudential policy.

Assessment of the Current Situation in Japan's Financial System

Let me begin with an overview of the current situation in Japan's financial system. The Bank of Japan has been pursuing quantitative and qualitative monetary easing (QQE) since April 2013, and the policy has been steadily exerting its intended effects toward achieving the price stability target of 2 percent. It goes without saying that the financial system serves as an important transmission channel through which QQE produces its effects. Indeed, the following positive financial effects have been observed in the past two and a half years: (1) stability of long-term interest rates at low levels and declines in credit risk premiums; (2) progress in portfolio rebalancing among financial institutions and institutional investors; and (3) a positive spillover to asset prices. Looking ahead, further enhancement of the financial intermediation function continues to be expected as financial institutions have secured robust capital bases.

As such, the effects of QQE are gradually becoming evident on the financial front as well. From a macroprudential perspective, however, the more financial activity increases, the more important it becomes to be vigilant as to whether such effects of QQE would lead to financial excesses or imbalances. Under the current framework for the conduct of monetary policy, the Bank examines financial imbalances -- from a longer-term perspective -- as a risk that will significantly affect economic activity and prices. As part of the examination process, the Bank releases semiannually its *Financial System Report*. In this report, it makes a forward-looking assessment of the stability of the financial system from various angles -- including analyses of the balance between financial institutions' risks and financial bases, macro stress testing, and the monitoring of risk indicators that suggest signs of financial imbalances -- and presents tasks and challenges toward achieving financial stability. Taking the latest findings into account, significant financial imbalances are not observed at present. That said, the Bank will continue to examine developments without presumption.

Macroprudential Policy

I will now turn to macroprudential policy. In recent years, this area has seen various international discussions conducted and measures implemented worldwide. First, "structural measures" for enhancing the resilience of the financial system, including implementation of the Basel III requirements and responses to the "Too Big to Fail" problem, have been proceeding steadily. Second, many countries have been making use of macroprudential measures aimed at containing excessive financial cycles and the accumulation of imbalances. These are sometimes referred to as "time-varying macroprudential policy," thereby distinguishing them from structural measures. In what follows, I will touch upon some of the issues regarding macroprudential policy.

First, let me discuss the selection and application of "time-varying" macroprudential tools. Many of the measures that have been adopted recently in various countries are ones with which to lean against financial cycles, by utilizing regulatory ratios such as the countercyclical capital buffer (CCB) and the loan-to-value (LTV) ratio. The introduction of the CCB regime is scheduled for 2016 in countries worldwide, including Japan. Among countries that already have proceeded with the activation of these measures, some have noted that the measures have been exerting their intended effects on such sectors as the housing market, where overheating has been observed. At the same time, some point to the considerable uncertainty surrounding the measures' effects and to difficulties that accompany their application, including the following. First, there is a lag after activation before the measures begin producing effects. Second, leakages of policy effects to unregulated sectors, such as shadow banking institutions, as well as to overseas, may well occur. And third, measures intended for specific sectors, such as housing, give rise to the issue of conflict with other governmental measures. In fact, the inability to employ these macroprudential tools in a timely fashion entails the risk of accelerating financial cycles. "Hard" measures, which involve the adjustment of regulatory ratios in a countercyclical manner, are relatively new. Given this, the ultimate challenge, including responses to the various others I have just mentioned, is how to carry out these measures in an accountable manner.

One point I want to stress in relation to this is that, in dealing with financial imbalances, what is important and effective is supervisory guidance by central banks and financial authorities -- namely, their "soft" approach, by which they issue advance warnings while providing guidance and advice to financial institutions based on assessments of financial system stability. Supervisory guidance for financial institutions is primarily regarded as a microprudential measure. By carrying them out from a macroprudential perspective in an industry-wide and collective manner, however, the soft approach is capable of producing effects as a form of macroprudential policy. Moreover, compared with hard approaches like the CCB, this approach allows for more forward-looking and flexible responses. Based on such understanding, the Bank's disclosure of the challenges and risks involved in ensuring financial stability, through the publication of the *Financial System Report*, and its responses to these issues, through on-site examinations and off-site monitoring, are considered part of macroprudential policy.

Second, let me shift my focus to international financial regulations as a form of "structural" macroprudential policy. Reform of international financial regulation is entering its final stages. Basel III and responses to the issue of "Too Big to Fail," such as TLAC (Total Loss-Absorbing Capacity), are measures designed to substantially strengthen the resilience of the global financial system. Furthermore, it is important to acknowledge the fact that financial authorities and the financial industry worldwide have developed a common understanding on international regulation, overcoming differences in their views. This indicates a major step forward, in that we have created a foundation for international cooperation to tackle many issues and crises that could arise in the future.

Having said this, I would like to mention several points with regard to the finalization and gradual implementation of the Basel III regulatory reforms.

The first point is the importance of a comprehensive calibration of the framework in its finalization. Several of the remaining issues involve quite a number of calibrations based on the accumulation of very technical and expert considerations, such as the measurement of risk-weighted assets. The outcome of these considerations would have a significant impact on the determination of required macro capital and the risk-taking behavior of financial institutions. I would like to emphasize that the calibration should be finalized in such a way that the amount of risk-weighted assets and required capital as a whole would be maintained at an appropriate level, while taking a holistic approach in examining effects on the institutions.

The second point is the necessity of a review of the effects and impacts of these regulatory reforms after their implementation. Reforms of international financial regulations to date have been drastic enough that it is no exaggeration to refer to them as a "fundamental re-design." Looking at individual countries, large-scale financial and structural reforms are underway, as typified by the Volcker rule in the U.S. The extent of the effects and impacts of these regulatory reforms on international financial intermediation and flow of funds in the financial sector as a whole remains unknown, and therefore requires close monitoring. From a long-term perspective, in order for the financial system to ensure stability and in turn contribute to sustainable economic growth, financial institutions need to be sufficiently profitable through active and innovative financial intermediation. In this regard, it is important to remove any regulatory excess, inconsistency among regulations, and uncertainty regarding the regulatory environment.

Concluding Remarks

That brings me toward the end of my speech. Topics for discussion regarding macroprudential policy go beyond those I have raised today. One such topic regards the effective institutional arrangements for macroprudential policy. Needless to say, there is no such thing as a universally optimal set of arrangements, as financial and economic structures as well as legal frameworks differ from country to country. Moreover, the desirable form of arrangements would vary depending on the kind of macroprudential measures each country intends to utilize. Looking at the recent developments in countries with multiple regulatory and supervisory authorities, there has been quite a number of movements to establish new bodies or councils in charge of macroprudential policy. In Japan, the Financial Services Agency (FSA) -- which is legally authorized to conduct industry-wide supervision and inspections -- and the Bank -- which contributes to financial system stability, such as through the "lender of last resort" function -- are making joint efforts in carrying out macroprudential policy, fulfilling their respective functions. Furthermore, in June 2014, the two entities together established a task force with the aim of holding regular joint meetings, and they have been fostering further coordination. The Bank is determined to continue with its efforts to contribute to ensuring the stability of the financial system, making use of these arrangements.

Thank you.