JAPAN (as of April 2014)

Action plan for reducing reliance on credit rating agencies' ratings by financial institutions

The recent financial crisis brought about a concern that the public use of CRA ratings has caused excessive use of CRA ratings by investors. Against such background, Japanese authorities have taken measures to reduce reliance on CRA ratings in advance of the publishing of the FSB principles. Major measures taken are as follows:

- Added supervisory and inspectional viewpoint on risk management (Revision of the supervisory guidelines and inspection manuals on August 2008, June 2009, and February and November 2011)
    - ✓ Added provisions to check whether the systems to reduce excessive reliance on external ratings are developed with regard the investment in securities products, etc.

- Reviewed the eligibility to use the bonds issuance registration system (Amendment of the Cabinet Order; became effective on April 2010)
    - ✓ Deleted the following requirement for eligibility to use the bond issuance registration system: acquisition of single-A or higher ratings from two different designated rating agencies

- Reviewed a statement regarding credit ratings on the format of the Securities Registration Statement (Amendment of Cabinet Order; became effective on October 2010)
    - ✓ Deleted the entry column for credit ratings from the format of the Securities Registration Statement

Although immediate actions required for the regulatory reforms were taken by 2011, we will closely continue monitoring the appropriateness of each financial institution's risk management process and its operation in place, such as the internal credit assessment process. In addition, as a member of the international organizations such as the FSB, BCBS and IOSCO, the Japan FSA will actively participate in the international discussions and review domestic actions according to the discussions.

Concrete plans for each sector are as mentioned below.

I. Banking

There is a provision that refers to a credit rating by a CRA which has been confirmed by the authority as an eligible CRA for use in calculating the capital adequacy ratio of banks. However, this provision is provided in order to implement the standardized approach of the Basel regulation. The other rules related to banks have no reference to external ratings. Therefore, regarding banks' use of CRA ratings in risk management, the Japan FSA will participate in the discussion at the Task Force on Standardized Approach under the Basel Committee, in particular, considering the possibility of (i) providing additional requirement(s) and/or discretion for using credit ratings and (ii) developing alternative approaches to calculate risk assets which do not use credit ratings, etc., and consider further reformative actions in response to the respective progress if necessary. For reference, around 100 Japanese banking sectors (accounting for about 30% in total risk assets in Japan) are using a standardized approach.

II. Central Bank

The BOJ conducts its own internal assessments to judge the eligibility of assets such as corporate bonds, both for collateral and asset purchasing. The BOJ started conducting its own internal credit assessment long before the FSB Principles were issued.

The BOJ uses CRA ratings as one of the elements to be reviewed for some asset categories, specifically, as a minimum requirement. Currently, around 6% of the aggregate collateral accepted by the BOJ is subject to such CRA rating requirement. The rest consists mainly of Japanese Government Securities and loans on deeds to the Japanese Government, which are not subject to the CRA rating requirement.

The Policy Board of the BOJ decides the basic eligibility criteria both for collateral and for assets purchasing as stipulated in Article 15 of the Bank of Japan Act. How the BOJ utilizes CRA ratings, including the range of assets for which CRA ratings are required as well as the level of required CRA ratings, can be altered at its sole discretion. For example, the BOJ set temporary rules regarding the eligibility standards for corporate bonds and loans on deeds to companies from Dec. 2008 to Oct. 2010. The BOJ currently applies temporary rules for the debt of companies in disaster areas.

The BOJ reviews its frameworks as necessary to ensure that the usage of CRA ratings in the eligibility criteria remains appropriate, giving due consideration to the FSB Principles.

III. CCPs

In Japan, CCPs do not mechanistically rely on external CRA ratings in membership criteria, margin requirements and investment policies.

In membership criteria, a CCP is required to have a certain extent of financial bases, appropriate management and a business operation system. "Certain extent of financial bases" includes having sufficient creditworthiness, and one of the elements to judge whether the CCP has the sufficient creditworthiness is whether the external rating of the CCP is higher than single-A or other equivalent ratings When judging creditworthiness, comprehensive decisions are made by taking into account adequate types of information, for example, whether there exists a recent sudden fluctuation of the market information on the CCP such as spread of its corporate bonds and CDS, and its stock price, and whether there exists an extreme reduction in financial information such as liquidity on hand.

Regarding margin requirements, in Japan, one of the considerable criteria prescribed in the internal rules of the Japanese CCPs (Japan Securities and Clearing Corporation (JSCC), etc.) regarding the judgement of the eligibility of corporate bonds etc. (namely, special securities, corporate bonds and yen-dominated foreign bonds) as collateral securities is whether all ratings assigned by eligible rating agencies are single-A or higher. However, variety of products are accepted as collateral securities such as Japanese government bonds, US government bonds, local government bonds, convertible bonds with equity-purchase warrants and stocks. Consequently, corporate bonds etc. are limitedly used when all these other products are difficult to use as collateral. In addition, when using corporate bonds etc. as collateral securities, overall assessment of the issuing company should be made by considering factors other than CRA ratings. Therefore, these internal rules of the Japanese CCPs are not mechanistically relying on external ratings. In addition, in case the rating of the collateral securities deposited has downgraded and CCP participants decided to withdraw the securities and sell in the market, considering the size of the market, corporate bonds etc. account for only 1% of the total collateral securities in appraised amount and there will be no cliff effect that causes a significant impact on the market.

Regarding investment policies, article 156-6 (2) of the Financial Instruments and Exchange Act prescribes that the Financial Instruments Clearing Organization may not conduct subsidiary business, therefore, CCPs are not allowed to conduct an investment management business in Japan. Moreover, CCPs are permitted to invest in limited types of products such as money trust when managing collateral deposited top them as their original business. In addition, we are currently considering adding a new supervisory viewpoint in the Guidance for Supervision of the FMIs, namely, whether collateral etc. are only managed by using products which have high liquidity and credibility. Therefore, there is no mechanistic reliance on external CRA ratings in investment policies.

We will continue to appropriately monitor and supervise CCPs in accordance to the Guidelines for Supervision of the FMIs.

IV. Investment Funds

In Japan, in relation to investment funds management, there are no rules that mechanistically rely on external CRA ratings. The Japan FSA will actively participate in the international discussion at IOSCO etc. and consider further actions in response to the progress if necessary.

V. Securities firms

Please refer to I. Banking. (Financial Instruments Business Operators in Japan are required to calculate their RWA in a similar way as the Basel regulations.)

VI. Insurance Companies

Please refer to I. Banking. (Insurance Companies in Japan are required to calculate their RWA in a similar way as the Basel regulations.)