Golden opportunity?

Japanese banks have historically been well-capitalised, but implementation of the Basel output floors could change this. Against this backdrop, **Stelios Papadopoulos** investigates the prospects for capital relief trade issuance in the jurisdiction.

Japanese banks are expected to boost their issuance of significant risk transfer transactions as the implementation of the Basel output floors draws near. Issuance will likely remain restricted to foreign exposures, although the market is expected to broaden beyond corporate loans to project finance exposures.

Historically, Asia Pacific banking systems have been well-capitalised and generally profitable, so there has been no significant push – whether from shareholders or regulators – towards deleveraging. In fact, banks in Australia, Hong Kong, Japan and Singapore have strengthened their capital position since 2016. APAC banking systems are dominated by banks that use IRB models and are thus likely to report higher RWAs because of the implementation of the Basel 4 floor.

The key feature of the new Basel rules is the output floor, which sets a lower limit on the capital requirements that banks calculate when using their internal models. The main aim of the output floor is to address model risk and unwarranted variability, thereby enhancing the comparability of capital ratios.

Banks using internal models will now have to calculate RWAs using whichever model they are permitted to use. Lenders must then calculate RWAs using the standardised approach and then ▶

multiply the amount obtained by 72.5%. Banks must then compare the results from the last and first step and whichever figure is higher will be used to calculate the various capital requirements.

Overseas corporate loans have been the predominant asset class in the Japanese SRT market, with MUFG having been the most active SRT originator so far. According to Bank of Japan data, manufacturing makes up over 20% of the composition of overseas loans for the major Japanese banks, followed by electricity and gas. The same data note that North America and EMEA constitute the bulk of the overseas exposure of the major banks.

However, there could be a broadening into other asset classes and particularly project finance, where Japanese banks hold substantial portfolios. Nevertheless, it's quite idiosyncratic and the amount of exposure is lower compared to corporate loans. It would therefore be more challenging to keep sufficient diversification in the portfolio, according to local originators.

Yet from a regulatory and cost of capital relief standpoint, it's understandable why project finance would make sense, given the use of the slotting approach. Under the terms of the slotting approach, banks have to assign specialised lending assets into 'buckets' from 'strong' to 'default', with each bucket being associated with a risk weight.

"Yet the risk weight of the best category tends to be higher than the risk weight the bank would have been assigned by their traditional IRB model," an SRT investor explains. "Japanese banks have been historically well-capitalised, due to their low-risk business and lower capital intensity. However, Basel 4 clearly changes this, so they will need to act – which may involve selling loans or more SRT issuance."

Similarly, Martin Neisen, partner at PwC, comments: "The standardised approach is the basis for the calculation of the output floors of Basel 4, which leads to the increase of risk weights for specialised lending in the standardised approach and indirectly also to an increase for IRB positions. Along with the low margins of Japanese banks, the case for synthetic securitisations becomes more convincing."

He continues: "An additional reason is that banks can use in the IRB approach either their own PD/LGD estimates or the slotting approach. The latter is more conservative and more qualitative. Over the last years, many supervisors did not allow banks to use their own PD/LGD estimates anymore, especially when they were redeveloping their models for specialised lending."

The structuring and design of Japanese capital relief trades is very similar to European transactions, according to investors, other than Europe's STS framework. The application of the supervisory formula is the same in Europe and Japan. But the difference between STS and non-STS is that STS is more lenient, in the sense that the risk weight floor for the retained senior tranche is 10% rather than 15%.

Hence, banks can achieve a much lower attachment point. Placing a thinner tranche means cheaper pricing and more capital relief, given the lower risk weight for the senior piece.

Martin Neisen, PwC

Yet unlike Europe, Japanese SRT issuance will likely remain restricted to foreign exposures. The same investor states: "The low-rate environment in Japan for over 20 years means that domestic exposures are more tightly priced, so it is hard to execute an SRT trade that doesn't cost more than the carry on the portfolio. The only other option is a local pension fund or insurer, which could accept much tighter spreads on the SRT deal than international investors, but the universe of structured credit buyers in Japan is limited."

> "THE LOW-RATE ENVIRONMENT IN JAPAN FOR OVER 20 YEARS MEANS THAT DOMESTIC EXPOSURES ARE MORE TIGHTLY PRICED"

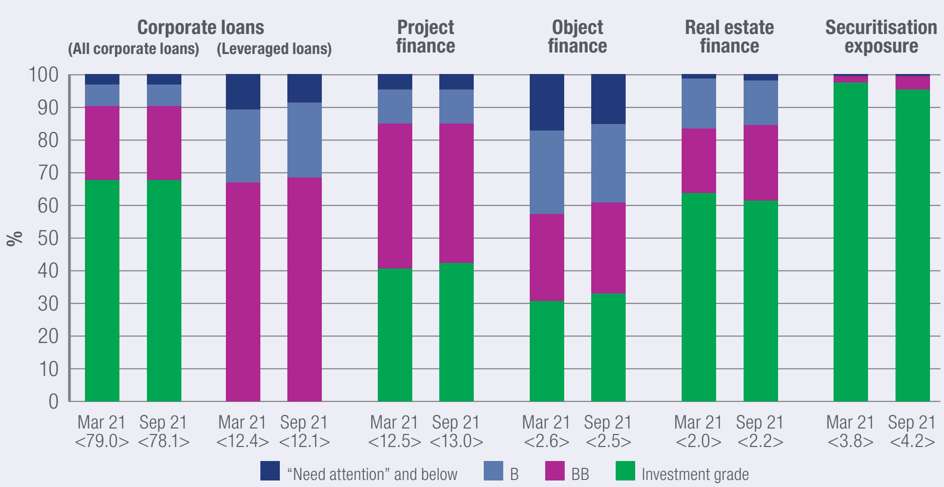
Indeed, the long-standing low yields in the domestic loan market have forced Japanese banks into portfolio acquisitions abroad. "Low rates and deflation meant that portfolio loan acquisitions made sense as a diversification play for Japanese banks, along with a strong yen," comments another SRT investor.

Mizuho's acquisition of an RBS North American loan portfolio in 2015 is a case in point. The low rate environment began in the late 1990s and it involved a decline in both funding and lending rates, resulting in reduced net interest income.

Loan demand stagnated during that time, so banks were not able to compensate for declining interest margins by boosting volumes. Lenders made up for the contraction of their core business by expanding into Japanese government bonds and by finding new sources of revenue other than domestic lending.

The large banks were able to build on their existing foreign branches and representations to

Figure 1: Overseas exposures of major Japanese banks – April 2022



Source: BOJ

Shunsako Sato, Moody's

expand their cross-border business – expanding primarily in the US and Europe. The major banks increasingly focused on corporate clients from the export-oriented industries. Those clients were expected to have above-average financing needs, as they were growing faster in comparison to those relying on domestic markets only.

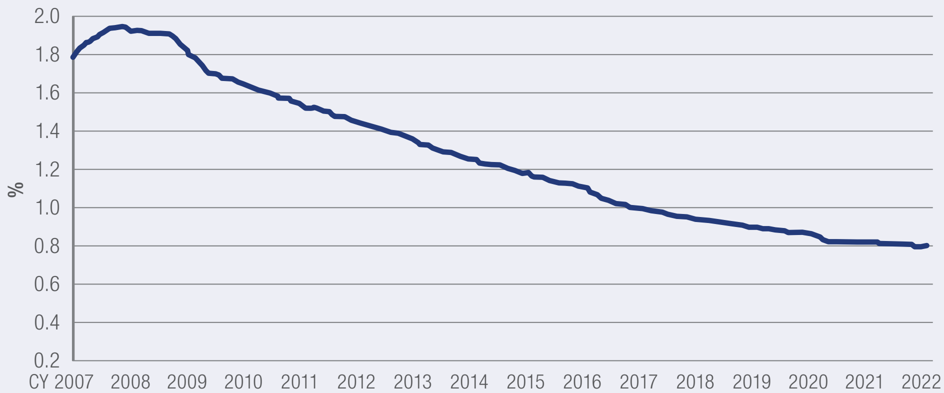
Portfolio acquisitions and more broadly the existence of the 'originate to hold' model is important for SRT issuance, since synthetic technology is a capital management tool that is utilised for transferring risk on core bank lending books that are originated to hold.

Kenji Matsumoto, director, credit portfolio management at MUFG, comments: ''Japanese banks have historically used an originate-to-hold model. However, this depends on each bank's strategy and market situation. Our understanding is that many banks are promoting an 'originate to distribute' model these days for non-Japanese Yen loans.''

Shunsako Sato, svp at Moody's, concurs: ''The drivers of a shift to originate-to-distribute are global regulatory changes and macro trends in the US financial system. Japanese banks are shifting to it, but also US and other banks as well. Non-blue chip US loans have higher risk weights and therefore require higher capital allocation, which is expensive for all banks.''

Japanese bank non-Yen exposures are mostly wholesale funded. By distributing the loans originated, Japanese banks can reduce reliance on market funding and free up capital.

Figure 2: Average contract interest rates – Japan



Source: BOJ

> "LARGE BANKS IN JAPAN AND OTHER DEVELOPED ECONOMIES GENERALLY DO NOT NEED TO RAISE EQUITY TO GROW THEIR LOAN BOOK"

Sato continues: ''Originate to distribute works better in the US, where the practice of originate to distribute has been developed over the years – including the development of an institutional loan market.''

Looking ahead, if a recession were to occur, then this could perhaps constitute another driver of higher SRT issuance – along with Basel 4 – since raising equity will become expensive. However, Japanese banks have a track record of raising equity when needed.

Sato notes: ''Large banks in Japan and other developed economies generally do not need to raise equity to grow their loan book, as they typically generate sufficient capital through profits. Nevertheless, large banks globally have raised equity when they need to replenish it after incurring heavy losses.''

He concludes: ''A recession would make it more expensive for banks to raise equity in any country, not just Japan. Synthetic securitisation could be one way to work around capital constraints, but the Japanese banks have a track record of raising equity when needed; for example, during and after the 2008 global financial crisis.''

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