July 28, 2003

Financial Services Agency

Progress Report

Working Group on Regulation of Capital Adequacy Ratio

[Provisional Translation]

In the “Program for Financial Revival” (October, 2002) and the “Work Schedule” (November, 2002), it was determined that proper calculation of deferred tax assets and review of the issues on capital adequacy of banks were to be examined promptly in the Financial System Council.
Based upon the Program and the Work Schedule, nine meetings of the Working Group (WG) on the Regulation concerning the Capital Adequacy Ratio have been held since February 2003.

The progress report is an account of the content of the discussions of the WG, laying down the points of broad agreement and disagreement.

The outline of the progress report is in the attachment.

(Attachment)

1. Regulation regarding the Capital Adequacy Ratio

- Points to be noted in the examination of regulation regarding the capital adequacy ratio were discussed, such as its relation with the economic environment, the impact on bank management, the fact that it is a minimum requirement, etc.
- The recognition that the definition of the regulatory capital adequacy ratio should be proactively determined from the viewpoint of supervisory policy, while ensuring transparency was broadly agreed.
- There was broad agreement over the recognition that financial institutions should make efforts to enhance their capital adequacy so that each financial institution secures a proper level of capital adequacy in light of its management strategy.

2. Deferred Tax Assets

Cause of deferred tax assets

The following recognition was broadly agreed;

- While the scope of provisioning which is recognized as tax-deductible losses is limited, the amount of deferred tax assets increased because financial institutions accelerated the disposal of Non-Performing Loans (NPLs) and tightened provisioning practices.
- Deferred tax assets have the following vulnerabilities.
  ① The characteristics as an asset depends on the future taxable income.
  ② If financial institutions failed, they would become valueless.
- The ratio of deferred tax assets against capital has become higher.
- It is necessary for the quality of capital to improve in some way.

Treatment in business accounting

- There was no objection regarding the accounting method for income taxes itself.
- There were some differing views on the accounting of deferred tax assets such as;
  ① Deferred tax assets should be evaluated more rigorously
  ② Deferred tax assets are already being booked rigorously
  ③ Audits by the auditors have inherent limitations
- There was broad agreement over the recognition that it is important to enhance the credibility of deferred tax assets.

- There was a strong view that reasonable calculation and efforts to disclose information are necessary in the accounting of deferred tax assets.

Supervisory measures

- There were various views on the issues to be noted in discussing supervisory measures with regard to deferred tax assets, such as the relation with macroeconomic policies or policies regarding the disposal of NPLs, importance of improving the substance rather than the numerical outcome.
- There were also various views regarding the methodology for implementing measures to improve the situation, such as the efforts of banks, pressure by the Government, market pressure through disclosure.
- Regarding the review of current rules concerning the treatment of deferred tax assets, there were views that insist the advantages of reviewing the rules aggressively, and those that were cautious from the viewpoint of ensuring the stability of the system and promoting the disposal of NPLs.
- The following views were emphasized;
  ① Each bank should first make efforts to strengthen profitability.
  ② Each bank should enhance transparency by disclosing information.
- There was broad agreement over the recognition that the ratio of deferred tax assets against capital should be reduced in the future. On the other hand, views were divided with regard to the method and sequence in implementing such measures.

Relation with tax system

- In relation to the discussion over a possible review of rules concerning deferred tax assets, there were the following views;
  ① It should be examined separately from the amendment of tax system.
  ② It is not appropriate to examine it separately from the tax system because they are indivisible as issues.

3. Double-Gearing

- With regard to the question of double-gearing, there were the following views;
  ① Regulations should be strengthened.
  ② No more regulation is needed because sufficient countermeasures have already been taken
  ③ Information disclosure should be further enhanced.

Conclusion

- There was broad agreement over the recognition that the ratio of deferred tax assets against capital should be reduced in the future.
- The Working Group requests the banking community that banks themselves develop a reasonable capital adequacy policy, make efforts to strengthen profitability and make utmost efforts to enhance their capital base. The Working Group also asks the authorities to take active measures such as to monitor and promote the efforts of the financial institutions.
- The Working Group requests the authorities to promptly examine an enhancement of information disclosure with regard to the basis and procedures for the calculation of deferred tax assets, and to implement effective measures.
- Based on the progress report, the Working Group will further examine these issues.