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JAPANESE BANKS: TAIL RISK AND CAPITAL BUFFERS

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This paper applies quantile regression to a structural credit model to investigate the impact of extreme bank asset value fluctuations on capital adequacy and default probabilities (PD) of Japanese Banks. Quantile regression allows modelling of the extreme quantiles of a distribution which allows measurement of capital and PDs at the most extreme points of an economic downturn, when banks are most likely to fail. Outcomes are compared to traditional structural measures. We find highly significant variances in capital adequacy and default probabilities between quantiles, and show how these variances can assist banks and regulators in calculating capital buffers to sustain banks through volatile times.

Keywords: *quantile regression, Japanese banks, probability of default, capital adequacy*

I. INTRODUCTION

The global financial crisis (GFC) has highlighted the devastating effect that high credit risk can have on financial markets and economic stability. Whilst default probabilities of banks are generally low, even during a downturn of a normal business cycle, this can change during extreme downturns such as seen in the GFC. During this period, impaired assets (problem loans) of banks more than trebled in the US and UK. 161 banks failed in the US in the two years 2008 to 2009 as compared to three in 2007 and none in the prior two years (Federal Deposit Insurance Corporation, 2010). Bank capital shortages led to the need for government financial rescue packages for banks in the US, UK and many other countries. Share markets plunged, and economic stimulus packages and slashing of interest rates were required to shore up major world economies. In short, the subject of credit risk in extreme circumstances has become one of the most important and intensely scrutinised topics in finance today.

Japan is a particularly important market to study in a credit context, with Japanese banks having experienced a prolonged series of crises, commencing with the bursting of an asset price bubble (real estate and stock prices) in the early 1990s, followed by the Asian Crisis which commenced in the late 1990s, and then to top it off, the GFC from 2007 onwards. Japan is considered to have fared better than the US and European markets during the GFC, due to a lower exposure to sub-prime securities and higher credit standards. The latter was as a result of lessons learned during prior crises, resulting in substantially lower non-performing loans as compared to the situation in the early 2000s (see Section II for details). Against this background, using quantile regression, we show how despite having fared better than global peers, based

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on fluctuating asset values the default probabilities and capital adequacy of Japanese banks were severely impacted during the GFC.

Many prevailing credit models were designed to measure ‘average’ credit risks over a period, or credit risk at a specific point in time. The problem with these approaches is that they are not designed to measure extreme losses, i.e. the tail of the credit loss distribution. It is precisely during these extreme circumstances when firms are most likely to fail. Some examples of well-known models in this category include the z score (Altman, 1968, 2000) which uses five balance sheet ratios to predict bankruptcy; Moody’s KMV Company (2003) RiskCalc model, which uses 11 financial measures to provide an Estimated Default Frequency (EDF) for private firms; Ratings agencies which provide credit ratings based on customer creditworthiness, but which are not designed to ratchet up and down with changing market conditions; CreditMetrics (Gupton, Finger, & Bhatia, 1997) which incorporates credit ratings into a transition matrix that measures the probability of transitioning from one rating to another, including the probability of default; and the Basel Accord standardised approach which measures corporate credit risk for capital adequacy purposes by applying risk weightings to customers on the basis of their external credit rating.

Other models use Value at Risk (VaR), one of the most widely used approaches for measuring credit and market risk by banks, which measures risks falling below a pre-determined threshold at a selected level of confidence, such as 95% or 99%. A key shortfall of this approach is that it says nothing of risk beyond VaR and it is usually based on a normal distribution Gaussian approach which does not adequately capture tail risk. Critics have included Standard and Poor’s analysts (Samanta, Azarchs, & Hill, 2005) due to inconsistency of VaR application across institutions and lack of tail risk assessment. Artzner, Delbaen, Eber, & Heath (1999; 1997) found VaR to have undesirable mathematical properties (most notably lack of sub-additivity), whereas Pflug (2000) proved that Conditional Value at Risk (CvaR), which looks at losses beyond VaR, does not have these undesirable properties. In assessing why existing credit models failed in the credit crisis, Sy (2008) finds that most existing credit models are based on a reduced form linear approach which have typical reliance on having large amounts of statistical data coming from a quasi-equilibrium state, and that this approach is ineffective in making even short-term forecasts in rapidly changing environments such as in a credit crisis. The study finds that such inductive models have failed to predict what would happen just when they were most needed to. Hedge fund returns have also been found to deviate from the VaR Gaussian approach (Bali, Gokcan, & Liang, 2007; Gupta & Liang, 2005). Jackson, Maude & Perraudin (1998) found that VaR estimates based on a simulation approach outperformed VaR estimates based on a Gaussian approach. Ohran and Karaahmet (2009) found that VaR works well when the economy is functioning smoothly, but fails during times of economic stress, because VaR is ignorant of the extreme losses beyond VaR.

This study uses the Merton (1974) structural model with modifications made by Moody’s KMV (Crosbie & Bohn, 2003), which we hereafter refer to as the Merton/KMV model (described in Section III). This model does measure fluctuating risk over time using a combination of the structure of the customer’s balance sheet and movements in market asset values to calculate default probabilities. However, again this is based on an ‘average’ over the time period measured, and does not highlight the extreme quantiles within the measured period.

Credit models which do not adequately measure tail risk could lead to banks having under-provisions or capital shortages during extreme economic circumstances. During the GFC, many global banks were not adequately prepared to deal with the extent of defaults and impaired assets during this time, and were left scrambling for capital and funding just when it was most difficult to obtain. Per the International Monetary Fund (Caruana & Narain, 2008), “it (Basel) does emphasise that banks should address volatility in their capital allocation and define strategic plans for raising capital that take into account their needs, especially in a stressful economic environment”. The Basel Committee on Banking Supervision (2008) stated that capital adequacy requirements should include “introducing a series of measures to promote the build-up of capital buffers in good times that can be drawn upon in periods of stress. A countercyclical capital framework will contribute to a more stable banking system, which will help dampen, instead of amplify, economic and financial shocks”. Indeed, Basel III includes requirements for such capital buffers. Capital, as pointed out by the Bank of England (2008), reduces during a downturn period due to declining market based asset values and under these circumstances a mark-to-market approach provides a measure of how much capital needs to be raised to restore confidence in a bank’s market capitalisation. Inadequate focus on potential tail risk meant many banks were unprepared and undercapitalised to deal with the extreme events of the GFC.

This research addresses a major gap in existing credit models. Whereas existing models focus on ‘average risk’ or risk below a defined threshold, we use quantile regressions to divide the data into different tranches, enabling the researcher to isolate and model the most risky tranches. Quantile regression, as introduced by Koenker and Bassett (1978) has successfully measured extreme market risk (share prices) as it is more robust to the presence of outliers than other prediction methods such as Ordinary Least Squares. Quantile regression has been applied to a range of market risk models, notably by Nobel economics laureate Robert Engle, who together with Manganelli (Engle & Manganelli, 2004) applied them to a suite of CAViaR (Conditional Autoregressive Value at Risk) models. The authors make the point that modelling techniques must be responsive to financial disasters, and that existing VaR techniques are inadequate as they only focus on one particular quantile. By not properly estimating risk, financial institutions can underestimate (or overestimate) the risk, consequently maintaining excessively high (low) capital. Their CAViaR models are unique in that instead of modelling a single distribution, they can directly model different quantiles, including the tail of the distribution.

This project is unique and innovative in that it extends quantile regression techniques from market risk applications to structural credit risk models. The remainder of the paper is organised as follows. Section II will examine the Japanese banking industry. Sections III and IV will discuss key metrics used in this paper including the Merton/KMV model (and its associated Distance to Default and Probability of Default measures) and quantile regression. Section V includes Data and Methodology. Results are presented in Section VI, followed by Conclusions in Section VII.

II. THE JAPANESE BANKING INDUSTRY

The financial services industry in Japan has been undergoing a reorganisation since the 1990s, triggered by the Japanese asset price bubble bursting. This was the start of a decade-long recession (referred to as the lost decade). Aggressive economic

stimulation took place, including rate reductions which started in 1991 virtually reaching zero in 1995. The late 1990s heralded the Asian Financial Crisis followed by further economic stimulation and capital injections into undercapitalised financial institutions, together with outright purchase by the Bank of Japan of banks' asset backed commercial paper and asset backed securities (Shirakawa, 2010). Non-performing loans (NPLs) reached a peak of 8.5% in 2002, dropping steadily thereafter to 1.4% in 2007 (Bank of Japan, 2009a). Over the period of the Asian Financial Crisis, market values of stocks, particularly in the financial sector, fell dramatically. The Nikkei 500 Bank index, per Datastream, showed a drop of 78% from June 1996, bottoming in March 2003 with most of this drop (55%) taking place pre-2000.

The GFC saw the NPL ratio increase for the first time in seven years to 1.7% at end 2008 and 1.9% at end 2009, still substantially lower than the figure in 2002. In 2008, both the major banks and the regional banks recorded net losses for the first time after 2003. A range of measures to address the crisis included cutting policy rates, introducing special fund supplying operations to facilitate corporate finance, and introducing measures to insure the stability of financial markets. In 2009, the Bank of Japan (BOJ) resumed its purchases of stocks (which had commenced in the 1990s) held by financial institutions. A 'policy package to address the economic crisis' was introduced in April 2009. This included encouragement (and extension) of the use of the measures which were already available in the Act on Special Measures for Strengthening Financial Functions. To support funding for small firms, additional emergency guarantee facilities were made available by the credit guarantee corporations. In 2009 BOJ expanded the range of eligible collateral for loans on deed to the government and those with government guarantees.

Currently, the banking industry is centralised into three Mega Banks; they are Mitsubishi UFJ Financial Group, Sumitomo Mitsui Financial Group and Mizuho Financial Group. These three banks came into being through various mergers of large banks to consolidate their standing capital ratios in the light of Bank of International Settlements (BIS) regulation regarding capital adequacy ratios for international banks. With the reforms, many regional and international banks have either merged or dissolved. There are many categories of banks in Japan including the Mega Banks, Regional Banks, Money Center Banks, On-line Banks and Trust Banks (see Table 1 for the 10 largest Banks). There are 47 prefectures in Japan and in each prefecture there are at least two banks operating. Overall the number of banks operating in Japan is over 150, with the three Mega Banks having assets totalling over \$US5 trillion representing over 50% of total assets of all Japanese banks.

The Japanese banking regulator is the Financial Services Agency (FSA). BOJ is not a regulator, but "contributes to the maintenance of an orderly financial system" (Tamaki, 2008), including on and off-site monitoring of banks. BOJ (2009b) recognises the importance of holding additional capital to sustain banks through downturn periods: "Japan's financial institutions should strengthen their capital bases. They need to be able to cope with the risks that might materialise due to the changes in economic and financial circumstances".

At March 2010, Japanese banks in this study had weighted average equity ratios just over 5% (see Table 1, which includes size and capital adequacy data). This compares to 2009 equity ratios (2010 not yet available) for banks in Australia of 6.2%, Canada 5.2%, Europe (excludes UK) 3.2%, UK 3.9%, and US 7.1% (Allen & Powell, 2010).

TABLE 1: DATA COMPARISON OF KEY JAPANESE BANKS IN OUR STUDY

| Banks | Market Capitalisation (USD \$bn) | Assets (USD \$bn) | Equity Ratio | Tier 1 Capital Ratio | Total Capital Ratio |
|-----------------------------|---|--------------------------|---------------------|-----------------------------|----------------------------|
| Mitsubishi Financial Group | 74.14 | 2,177.44 | 5.55% | 11.18% | 14.87% |
| Sumitomo Financial Group | 46.20 | 1,310.26 | 5.72% | 11.15% | 15.02% |
| Mizuho Financial Group | 30.66 | 1,666.53 | 3.75% | 9.09% | 13.46% |
| Resona Holdings | 14.56 | 433.39 | 5.61% | 10.81% | 13.81% |
| Sumitomo Trust & Banking | 9.82 | 219.09 | 7.08% | 9.88% | 14.17% |
| Bank of Yokohama | 6.67 | 127.60 | 6.39% | 9.85% | 12.20% |
| Chuo Mitsui Trust & Holding | 6.23 | 158.69 | 5.71% | 9.86% | 13.80% |
| Shizuoka Bank | 6.07 | 96.72 | 7.96% | 14.06% | 15.32% |
| Chiba Bank | 5.35 | 109.25 | 5.93% | 11.39% | 12.80% |
| Mizuho Trust & Banking | 5.05 | 63.02 | 5.32% | 10.07% | 15.73% |
| Others (average) | 1.21 | 37.80 | 5.08% | 9.04% | 11.12% |
| Total | 275.25 | 8,542.56 | 5.33% | 9.27% | 11.53% |

Market Capitalisation, Assets and Equity figures are obtained from DataStream at 30 March 2010. Tier 1, Total Capital, and Equity ratios were obtained from individual companies' financial reports for the year ending March 2010, with total ratios representing asset-weighted averages. The equity ratio is the book value (per March 2010 annual financial reports) of Equity to Total Assets.

III. DISTANCE TO DEFAULT AND PROBABILITY OF DEFAULT

The Merton/KMV approach (which we use in this study, but modify to incorporate quantiles) provides an estimate of distance to default (DD) and probability of default (PD). The model holds that there are three key determinants of default: the asset values of a firm, the risk of fluctuations in those asset values, and leverage (the extent to which the assets are funded by borrowings as opposed to equity). The firm defaults when debt exceeds assets, and DD measures how far away the firm is from this default event. KMV (Crosbie & Bohn, 2003), in modelling defaults using their extensive worldwide database, find that firms do not generally default when asset values reach liability book values, and many continue to service their debts at this point as the long-term nature of some liabilities provides some breathing space. KMV finds the default point to lie somewhere between total liabilities and current liabilities and therefore use current liabilities plus half of long term debt as the default point (we follow this debt definition in this study). It should also be noted that, while both Merton and KMV use the DD approach outlined below, Merton calculates PD per equation 2, whereas KMV instead align the DD with default probabilities obtained from their extensive database to produce Estimated Default Frequencies (EDFs). As we do not have access to the KMV database, we use equation 2 in our Merton/KMV model to obtain our PDs. This will have no impact on our capital buffer measurements as we obtain these from DD rather than PD.

$$DD = \frac{\ln(V/F) + (\mu - 0.5\sigma_v^2)T}{\sigma_v\sqrt{T}} \quad (1)$$

$$PD = N(-DD) \quad (2)$$

Where V = market value of firm's assets; F = face value of firm's debt (in line with KMV, defined as current liabilities plus one half of long-term debt); μ = an estimate of the annual return (drift) of the firm's assets (we measure μ as the mean of the change in $\ln V$ of the period being modelled as per Vassalou & Xing (2004); N = cumulative standard normal distribution function; T = time horizon (for which we use one year in line with usual practice); σ_V = volatility (standard deviation) of firms' asset values.

To estimate the σ_V component of equation 1, we follow the estimation, iteration and convergence procedure shown below, as outlined by studies such as Bharath & Shumway (2009), Vassalou & Xing (2009), and Allen and Powell (2009).

$$E = VN(d_1) - e^{-rT} FN(d_2) \quad (3)$$

Where E = market value of firms equity, and r = risk free rate.

$$d_1 = \frac{\ln(V/F) + (r + 0.5\sigma_V^2)T}{\sigma_V\sqrt{T}} \quad (4)$$

$$d_2 = d_1 - \sigma_V\sqrt{T} \quad (5)$$

Volatility and equity are related under the Merton model as follows:

$$\sigma_E = \left(\frac{V}{E}\right)N(d_1)\sigma_V \quad (6)$$

Per the approach of KMV (Crosbie & Bohn, 2003) and Bharath & Shumway (2008), initial asset returns are estimated from historical equity data using the formula:

$$\sigma_V = \sigma_E \left(\frac{E}{E+F}\right) \quad (7)$$

Daily log equity returns and their standard deviations are calculated for each asset for the historical period. These asset returns derived above are applied to equation 3 to estimate the market value of assets every day. The daily log asset return is calculated and new asset values estimated. Following KMV, this process is repeated until asset returns converge (repeated until difference in adjacent σ 's is less than 10^{-3}). These figures are then used to calculate DD per equation 1.

IV. QUANTILE REGRESSION

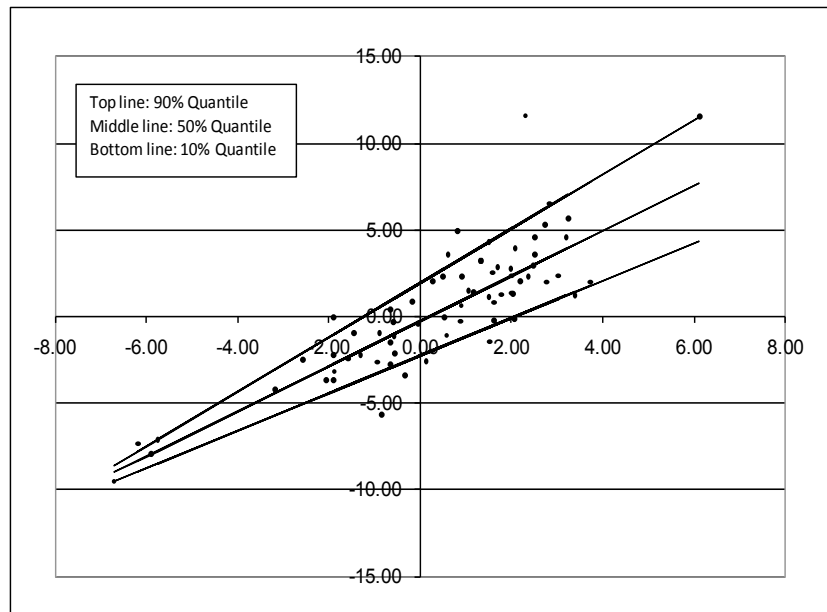
Quantile regression per Koenker & Basset (1978) and Koenker and Hallock (2001) divides a dataset into parts. Minimising the sum of symmetrically weighted absolute residuals yields the median where 50% of observations fall either side. Similarly, other quantile functions are yielded by minimising the sum of asymmetrically weighted residuals, where the weights are functions of the quantile in question per equation 8. This makes quantile regression robust to the presence of outliers.

$$\min_{\varepsilon \in R} \sum p_r(y_i - \varepsilon) \quad (8)$$

where $p_r(\cdot)$ is the absolute value function, providing the r^{th} sample quantile with its solution.

Figure 1 (Steiner, 2011) illustrates quantile regression. The x and y axes represent any two variables being compared (such as age and height; or market returns and individual asset returns). The 50% quantile (middle line) is the median, where 50% of observations fall below the line and 50% above. Similarly, the 90% quantile (top line) is where 10% of observations lie above the line, and the 10% quantile (bottom line) has 90% of observations above the line. The intercept and slope are obtained by minimising the sum of the asymmetrically weighted residuals for each line.

FIGURE 1: ILLUSTRATIVE QUANTILE REGRESSION EXAMPLE



The quantile regression technique allows direct modelling of the tails of a distribution rather than ‘average’ methods such as ordinary least squares or credit models which focus on ‘average’ losses over a period of time. The technique has enjoyed wide application such as investigations into wage structure (Buschinsky, 1994; Machado & Mata, 2005), production efficiency (Dimelis & Lowi, 2002), and educational attainment (Eide & Showalter, 1998). Financial applications include Engle & Manganelli (2004) and Taylor (2008) to VaR problems, and Barnes and Hughes (2002) who use quantile regression analysis to study CAPM in their work on stock market returns. In a stock market context, Beta measures the systematic risk of an individual security with CAPM predicting what a particular asset or portfolio’s expected return should be relative to its risk and the market return. The lower and upper extremes of the distribution are often not well fitted by OLS. Allen *et al.* (2009), using quantile regression, show large and significant differences between returns and beta, across quantiles and through time. These distribution extremes are especially important to credit risk measurement as it is at these times when failure is most likely. We expand these quantile techniques to credit risk by measuring Betas for fluctuating assets across time and quantiles, and the corresponding impact of these quantile measurements on DD, PD and capital, as outlined in the methodology section.

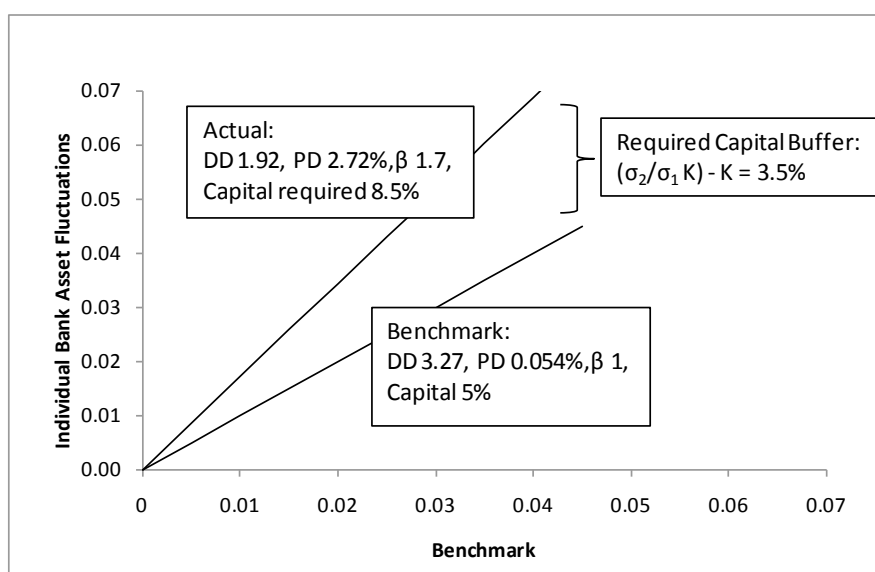
V. DATA AND METHODOLOGY

We use all banks listed on the Tokyo Stock Exchange for which data is available on Datastream (69 Banks in total as per Appendix 4). These banks have a market cap of USD\$275 billion and assets of \$8.5 trillion. Ten years data is used, split into two periods to compare how the banks were affected during the GFC as compared to pre-GFC. The GFC period includes the three years from January 2007 to December 2009. The pre-GFC period includes the seven years from January 2000 to December 2006. Seven years aligns with the Basel II advanced method for measuring credit risk. The early years of this period include the latter years of the Asian Financial Crisis as well as the ensuing recovery period. These are the seven years that banks, under the advanced model, would have used to measure credit risk (and determine capital requirements) going into the GFC, usually based on average risk over that period. By comparing this to actual GFC data, we can determine how adequate these capital requirements would have been. In addition to pre-GFC and GFC periods, we measure 2008 as a single year. This year was the height of the GFC, and as it is during the most extreme period that banks are likely to fail, it is important that we isolate and measure extreme periods.

We calculate DD and PD for each bank for each period using the methodology in Section III, with our “All Bank” figures being asset weighted averages. Quantiles for each period are calculated per Section IV, with two fundamental differences. Firstly, quantile Beta analysis is normally applied to share prices, whereas we use daily market asset values (per methodology in Section III). Secondly, share Betas are normally measured as individual share returns against the market. We instead compare risk measurements between two different periods (e.g. GFC v pre-GFC) and between different quantiles within those periods. Here we introduce the new concept of a benchmark DD (together with the associated PD and asset value standard deviation), to ascertain what buffer capital is needed when asset values fall below the benchmark. To explain this concept, assume a bank (or regulator) deems that the aggregate bank capital (leverage) ratio was adequate based on the seven year pre-GFC asset volatility, and sets this as the benchmark capital (K). For our example we will assume a benchmark ratio of 5% (which is approximately the weighted average pre-GFC equity ratios for Japanese Banks per Table 1). Let us assume the portfolio of banks in question has a theoretical DD of 3.276 for this period, which has an associated PD of 0.058%. In its simplest form the Merton/KMV model is essentially a measure of capital (assets – liabilities) divided by the standard deviation of asset values. As volatility increases, DD (and hence capital) reduces proportionately. As asset value volatility is the denominator of the Merton/KMV model, doubling of volatility ($\sigma_2/\sigma_1 = 2$) means that DD and capital (K) halve, and capital will have to be doubled (i.e. a capital buffer of 5% held) to restore the benchmark DD to its original value. Thus any asset fluctuations and increase in DD above the benchmark value require a corresponding percentage capital increase. We therefore measure capital buffers required to counter extreme fluctuations as:

$$\text{Required Capital Buffer} = (\sigma_2/\sigma_1 K) - K \quad (9)$$

The capital buffer will have a minimum of zero as capital should not fall below the benchmark. The benchmark is illustrated in Figure 2, which shows a situation where the capital benchmark is 5% and actual volatility (and hence DD) has increased by 1.7x benchmark ($\sigma_2/\sigma_1 = 1.7$).

FIGURE 2: ILLUSTRATION OF REQUIRED CAPITAL BUFFER USING A BENCHMARK

In this study, we measure the asset value fluctuations occurring in various quantiles of the GFC period against the pre-GFC benchmark. To allow measurement of the GFC period (or any other period within the 10 year sample period used) against the benchmark, we need a benchmark which covers the entire 10 years. We achieve this by bootstrapping the seven year pre-GFC returns and extending them to 2009. We use F tests to test for volatility between the benchmark and each quantile (results for these are discussed in Section VI and shown in Appendices tables 1b, 2b and 3b) for each selected period and bank, and between each quantile within each selected period (results discussed in Section VI and shown in Appendices tables 1c, 2c and 3c). F is σ_2^2/σ_1^2 , whereby a value of 1 shows no difference between the two samples measured (e.g. difference in variance between two quantiles) and a value of 3 shows variance of 3x higher for one of the two samples than the other. We use * to denote significance at the 95% level and ** at the 99% level. As per our example, we need to assume a benchmark capital level for which we will use 5%, which approximates the overall capital level of aggregated Japanese banks per Table 1.

When referring to “All Japanese Banks” or “All Banks” in this study we are referring to the 69 banks in our study. In addition to using the aggregated position for all 69 banks (for which we use asset weighted averages to obtain the total DD and PD for all banks), we select two banks to illustrate our model. These are Sumitomo Mitsui Financial Group (SMFG) which is a major bank and Shizuoka Regional Bank which is a regional bank. The reason we have chosen these banks is simply because they are very different in terms of size, product range and capital ratios, thus allowing us to illustrate the model across different bank profiles. A summary of the profile of these banks is given in Appendix 5.

VI. RESULTS

Table 2 shows how DD and PD differ from year to year in our 10 year sample period. 2001 and 2002 were periods of high volatility for Japanese banks, although as noted in the introduction section, much of the downturn in equity and asset values arising from the Asian Financial Crisis had already occurred prior to year 2000. The mid-2000s

were a period of low volatility and default probabilities, with 2008 (the height of the GFC) showing a substantial increase in risk as indicated by these measures, reducing again in 2009.

TABLE 2: ANNUAL DD AND PD FOR ALL JAPANESE BANKS FROM 2000-2009

| Year | DD | PD |
|------|------|--------|
| 2000 | 4.20 | <0.01% |
| 2001 | 2.07 | 1.93% |
| 2002 | 2.21 | 1.37% |
| 2003 | 6.99 | <0.01% |
| 2004 | 5.71 | <0.01% |
| 2005 | 8.36 | <0.01% |
| 2006 | 5.85 | <0.01% |
| 2007 | 2.78 | 0.27% |
| 2008 | 0.99 | 16.13% |
| 2009 | 2.77 | 0.28% |

Distance to Default (DD) and Probability of Default (PD) for each year is calculated per Section III. In summary, DD is the number of standard deviations that asset values are away from falling below debt values, based on asset value volatility. PD is calculated from DD and is the probability corresponding to the standard normal distribution. Figures are asset value weighted averages of all Japanese banks in our sample.

Table 3 provides a summary of outcomes for All Banks across all the periods measured, split into quantiles. Moving left to right within each of the segments in Table 3, the periods become more risky (the GFC period on its own being more risky than the entire period from 2000-2009, and 2008 being the most volatile of the GFC years). For example, the entire period DD at the 50% level is 2.53 (PD 0.57%), whereas GFC DD for the same quantile is 1.45 (PD 7.36%), and 2008 on its own has a DD of 1.03 (PD 15.27%).

TABLE 3: QUANTILE DISTRIBUTION OF KEY RISK INDICATORS

| Distance to Default | | | | Beta (β) | | | |
|---------------------|---------------|------|------|------------------|---------------|------|------|
| Quantile | Pre-GFC + GFC | GFC | 2008 | Quantile | Pre-GFC + GFC | GFC | 2008 |
| 5% | 2.60 | 1.69 | 1.11 | 5% | 1.01 | 1.54 | 2.00 |
| 10% | 2.57 | 1.62 | 1.09 | 10% | 1.02 | 1.61 | 2.04 |
| 50% | 2.53 | 1.45 | 1.03 | 50% | 1.07 | 1.80 | 2.16 |
| 90% | 2.50 | 1.35 | 0.88 | 90% | 1.11 | 1.93 | 2.50 |
| 95% | 2.49 | 1.34 | 0.87 | 95% | 1.12 | 1.95 | 2.56 |

| Probability of Default | | | |
|------------------------|---------------|-------|--------|
| Quantile | Pre-GFC + GFC | GFC | 2008 |
| 5% | 0.47% | 4.55% | 13.37% |
| 10% | 0.51% | 5.24% | 13.85% |
| 50% | 0.57% | 7.36% | 15.27% |
| 90% | 0.62% | 8.84% | 18.83% |
| 95% | 0.65% | 9.05% | 19.34% |

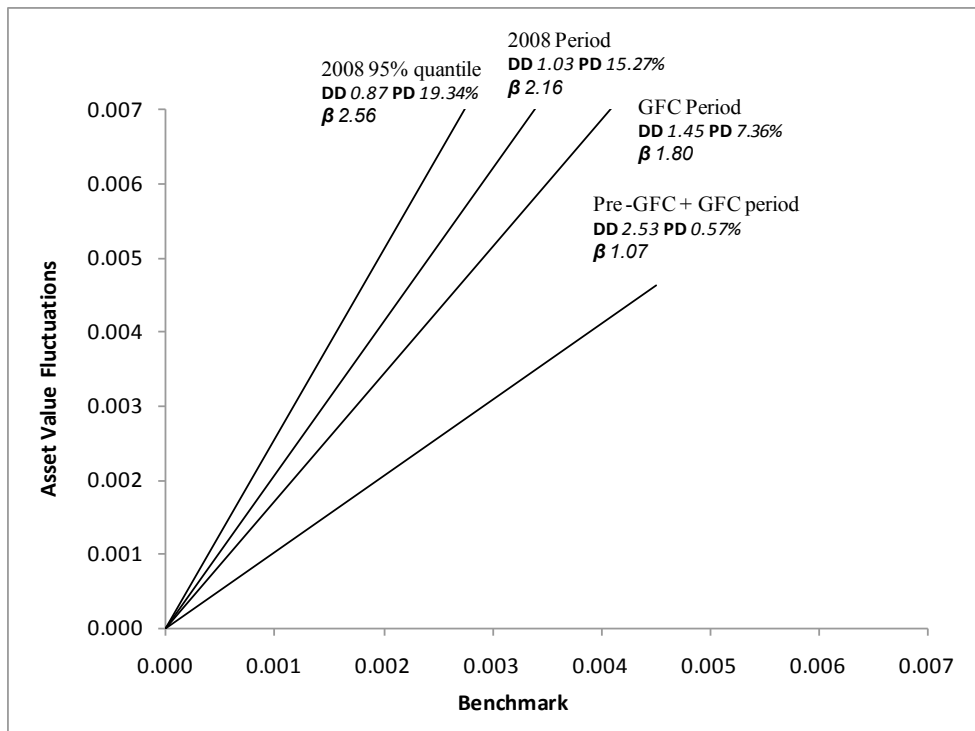
Figures are for All Banks. Distance to Default (DD), and Probability of Default (PD) are calculated per Section III. Beta (β) is the coefficient of the benchmark and quantile asset value fluctuations as discussed in Sections IV and V.

Thus there is a dramatic increase in PDs during more risky times. There is also a shift in outcomes for different quantiles within each period. For example, PD almost doubles during the GFC from 4.55% (5% quantile) to 9.05% (95% quantile). A typical ‘through the cycle’ OLS type approach using the Merton model, would produce

results around the 50% quantile level for the entire period (PD 0.57%), whereas we see that PDs in fact fluctuate from 0.47% at a lowest risk position (top left segment of the PD table) to 19.34% at a highest risk position (bottom right of the PD table) during the most extreme 5% of 2008. Given that firms are far more likely to fail during the most extreme segments than during an ‘average’ period, it is important for banks and regulators to understand the extent of these fluctuations to ensure adequate provisions and capital for these times. Using equation 9 and the standard deviation of asset values, we can estimate capital buffers (see Table 4) required to counter volatility.

As risk increases, so too does β (as per the right-hand segment of Table 3) when comparing daily asset returns for each segment with the benchmark (which as per the methodology section, is based on the pre-GFC period). To illustrate this, we show selected β values (and corresponding DD and PD) in Figure 3. It is important to note that Figure 3 is not a quantile graph from any particular period, but is a β comparison across selected periods. We see that β of the entire 2000-2009 period against the benchmark is 1.07, increasing to 1.8 over the whole GFC period, then to 2.16 for 2008 only, and to 2.56 at the height of the GFC period in 2008 at the 95% quantile. The graph clearly shows how PDs shift dramatically with rising β , ranging from 0.57% to 19.5%. It should be noted, that as we are measuring volatility, there are no negative values in our graphs. Naturally, the standard deviations of the returns are calculated using both positive and negative returns.

FIGURE 3: BETA COMPARISONS DURING KEY PERIODS – ALL BANKS



Appendices 1 to 3 provide a graphical illustration of the quantile measures, together with summary statistical tables for our two example banks as compared to the aggregated values for All Banks, as well as the results for the F tests (as explained in Section V). Appendix 1 shows the entire 2000-2009 period, Appendix 2 shows the GFC years from 2007-2009 and Appendix 3 shows 2008 on its own. The values calculated per these appendices allow estimating and comparing of capital buffers

required to maintain capital at the benchmark value during extreme cycles for our sample banks as discussed in the next three paragraphs.

Consolidated All Banks had DD for the three-year GFC period ranging from 1.69 at the 5% quantile to 1.34 at the 95% level, dropping to 0.87 at the 95% quantile for the 2008 only period. The 95% GFC quantile asset value fluctuations exceed the benchmark by approximately 2x, requiring the average Japanese bank in our sample to double their existing equity ratio to maintain an adequate capital buffer to counter this. All of these GFC quantiles, even the lowest 5% quantile is significantly higher than the benchmark at a 99% confidence level using an F test.

For Shizuoka Regional Bank, all quantiles during the GFC (and even more so during 2008 only) had asset value standard deviations and DDs exceeding the benchmark at significant levels. Shizuoka's asset volatility during the GFC 95% was approximately 1.7x above the benchmark. However Shizuoka already has an equity ratio of 7.96% per table 1, which is 1.6x above the benchmark, so would only need a very small additional capital buffer to counter these fluctuations.

Sumitomo Financial Group had very high levels of asset volatility during the GFC, ranging from DD 0.80 at the 5% quantile to 0.63 at the 95% quantile. This fell to 0.18 at the most extreme quantile (95% in 2008). All of these GFC quantiles, even the lowest 5% quantile is significantly higher than the benchmark at a 99% confidence level using an F test. As the most extreme asset value fluctuations (at the GFC 95% quantile) are more than treble the benchmark, Sumitomo would need capital buffers significantly higher than the average Japanese bank to restore their capital and DD levels to the benchmark.

The abovementioned F tests compared the quantiles to the benchmark we set, which is based on pre-GFC volatility. We also tested for differences in volatility between the quantiles in each bank (e.g. is the 95% quantile asset volatility significantly different to asset volatility for all quantiles such as would be measured by an OLS approach?). Here we note some differences between the banks. For Sumitomo the differences in variances between the quantiles in the various periods tend to be significant at the 99% level, but for Shizuoka most quantile differences show lower significance, generally at the 95% level, showing that there is less extreme volatility (outliers) for Shizuoka as compared to Sumitomo. This is reflected in the quantile graphs for Shizuoka in the Appendices which show a narrower spread than the quantile graphs for All Banks and much narrower than Sumitomo.

Table 4 compares buffer requirement outcomes of traditional credit modelling (using the KMV/Merton model to which no quantiles have been applied) to our model which divides the dataset into quantiles and time periods. The standard model over the 10-year period is very similar to our 50% quantile model for this period, which as we saw in Figure 3 has β not much higher than 1, and results in very little additional capital being required for All Banks and Sumitomo, and none for Shizuoka who already has sufficient capital. To illustrate our model, we use the 95% GFC quantile, which shows significant capital buffers required at this point for All Banks and Sumitomo, with a small additional buffer required for Shizuoka. We could have used an even more extreme quantile (2008 95%) which would result in even higher required buffers at that point.

Shizuoka has been shown to have a higher DD (less risky) than All Banks, with Sumitomo having a lower DD (more risky). The DD calculation per equation 1 is essentially a measure of two key factors, being capital (the numerator being a measure of the distance between assets and liabilities) and asset volatility (the denominator). Thus it is necessary to identify which of these two factors is causing the variation in DD. Tables 1 and 4 show us that Shizuoka has a stronger capital position than Sumitomo. Shizuoka also has lower asset volatility than Sumitomo as evidenced by the lower F statistics in the Appendices for all of the periods. Thus Shizuoka’s lower risk is due to a combination of both higher capital and lower asset volatility.

TABLE 4: REQUIRED CAPITAL BUFFER

| | All Banks | Sumitomo | Shizuoka |
|------------------------------------|------------------|-----------------|-----------------|
| Benchmark capital | 5.00% | 5.00% | 5.00% |
| Traditional Modelling | | | |
| Capital required | 5.38% | 6.14% | 5.26% |
| Less: Existing capital | 5.33% | 5.72% | 7.96% |
| Additional capital buffer required | 0.05% | 0.42% | -2.70% |
| Our Extreme Modelling | | | |
| Capital required | 10.45% | 12.90% | 9.35% |
| Less: Existing capital | 5.33% | 5.72% | 7.96% |
| Additional capital buffer required | 5.12% | 7.18% | 1.39% |

Traditional modelling in the above table is based on a standard Merton/KMV approach with no quantiles. This approximates our 50% quantile entire period model as per Figure 3. The extreme modelling period shown is based on our 95% GFC period. Existing capital is taken from Table 1. Calculation of capital buffers is as outlined in Section V, with the benchmark representing the pre-GFC period.

Overall, our modelling approach measures fluctuations at extreme points, which the traditional modelling does not do. Fluctuations in asset values erode capital and our model, as per the methodology in Section V and results in Table 4, provides a method for measuring buffers required to maintain the capital position during extreme downturns.

VII. CONCLUSIONS

This study has examined a new approach to measuring credit risk through cycles. Using quantile regression, the study has shown how market asset values can substantially change at different points, resulting in a wide range of DD and PD values for banks depending on the time period and quantile. Calculating credit risk based on averages through a cycle, or using static models which calculate risk at a single point in time, could lead to insufficient provisions and capital buffers by banks. This can lead to the situation, such as happened during the GFC, where banks are left scrambling for capital just when it is most difficult to raise. Bank failure is most likely during extreme economic downturns, and loss provisions and capital need to account for these circumstances. Our approach provides a method to banks and regulators for estimating capital buffers to sustain banks during extreme economic downturns.

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APPENDIX 1: QUANTILE REGRESSION FOR SELECTED BANKS (2000-2009)

Figure 1a

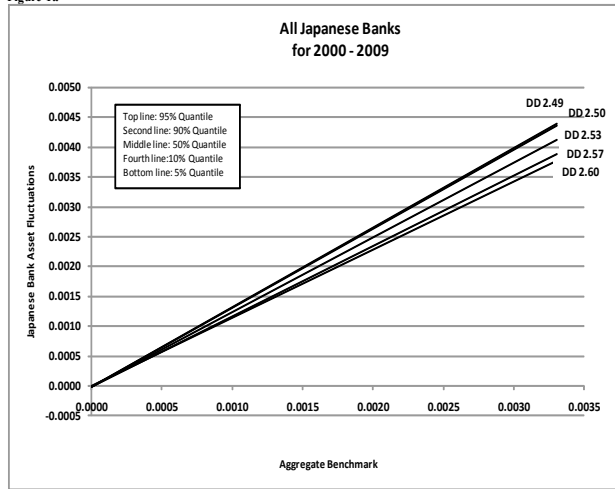


Table 1a Distance to Default

| Quantile | All Banks | Shizuoka | Sumitomo |
|----------|-----------|----------|----------|
| -5% | 2.60 | 3.22 | 1.44 |
| -10% | 2.57 | 3.19 | 1.37 |
| -50% | 2.53 | 3.10 | 1.25 |
| -90% | 2.50 | 3.04 | 1.10 |
| -95% | 2.49 | 3.02 | 1.06 |

Table 1b F Test - whole period quantile v benchmark

All Banks
Volatility Significance Testing: F Test:

| | 5% Quantile | 50% Quantile | 95% Quantile |
|--------------|-------------|--------------|--------------|
| | DD | DD | DD |
| F | 4.6764 | 4.9339 | 5.1163 |
| p | <0.0001 | <0.0001 | <0.0001 |
| Significance | ** | ** | ** |

Shizuoka Regional Bank
Volatility Significance Testing: F Test:

| | 5% Quantile | 50% Quantile | 95% Quantile |
|--------------|-------------|--------------|--------------|
| | DD | DD | DD |
| F | 5.1527 | 5.5777 | 5.8452 |
| p | <0.0001 | <0.0001 | <0.0001 |
| Significance | ** | ** | ** |

Sumitomo Financial Group
Volatility Significance Testing: F Test:

| | 5% Quantile | 50% Quantile | 95% Quantile |
|--------------|-------------|--------------|--------------|
| | DD | DD | DD |
| F | 10.0833 | 13.5415 | 18.5508 |
| p | <0.0001 | <0.0001 | <0.0001 |
| Significance | ** | ** | ** |

Figure 1b

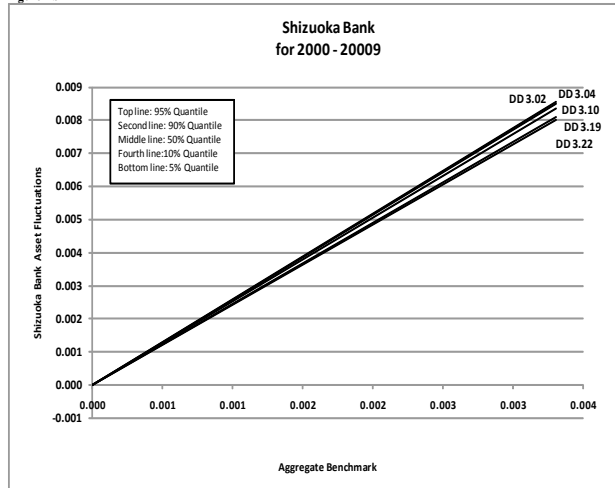


Table 1c F Test - whole period quantile v whole period stdev

All Banks
Volatility Significance Testing: F Test:

| | 5% Quantile | 10% Quantile |
|--------------|-------------|--------------|
| | DD | DD |
| F | 1.0916 | 1.0632 |
| p | 0.0127 | 0.0589 |
| Significance | * | - |

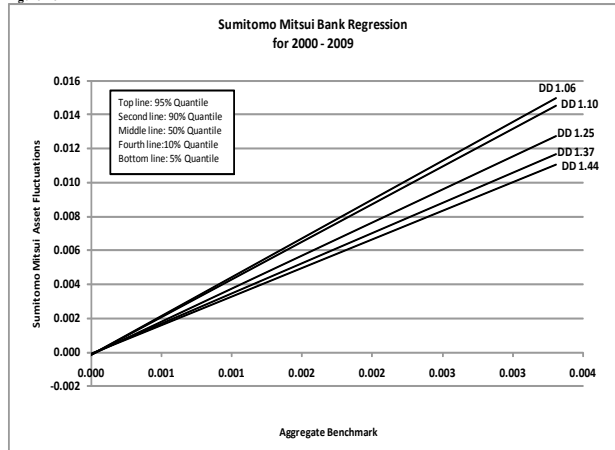
| | 90% Quantile | 95% Quantile |
|--------------|--------------|--------------|
| | DD | DD |
| F | 0.9976 | 1.0023 |
| p | 0.5246 | 0.4769 |
| Significance | - | - |

Shizuoka Regional Bank
Volatility Significance Testing: F Test:

| | 5% Quantile | 10% Quantile |
|--------------|-------------|--------------|
| | DD | DD |
| F | 1.0853 | 1.0657 |
| p | 0.0183 | 0.0522 |
| Significance | * | - |

| | 90% Quantile | 95% Quantile |
|--------------|--------------|--------------|
| | DD | DD |
| F | 1.0342 | 1.2200 |
| p | 0.1950 | <0.0001 |
| Significance | - | ** |

Figure 1c



Sumitomo Financial Group
Volatility Significance Testing: F Test:

| | 5% Quantile | 10% Quantile |
|--------------|-------------|--------------|
| | DD | DD |
| F | 1.4238 | 1.2766 |
| p | <0.0001 | <0.0001 |
| Significance | ** | ** |

| | 90% Quantile | 95% Quantile |
|--------------|--------------|--------------|
| | DD | DD |
| F | 1.2200 | 1.2921 |
| p | <0.0001 | <0.0001 |
| Significance | ** | ** |

The y axis in each graph represents the individual bank daily asset fluctuations. The x axis is the pre-GFC benchmark, calculated as discussed in Section V. The F test in table 1b tests for differences in volatility between the benchmark and each quantile for each selected bank. F is σ_1^2/σ_2^2 , whereby a value of 1 shows no difference between the benchmark and the selected quantile and a value of 3 shows variance of 3x higher for the selected quantile as compared to the benchmark. * denotes significance at the 95% level and ** at the 99% level. Table 1c performs a similar F test to test for volatility differences between the selected quantile as compared to all quantiles.

APPENDIX 2: QUANTILE REGRESSION FOR SELECTED BANKS (2007-2009)

Figure 2a

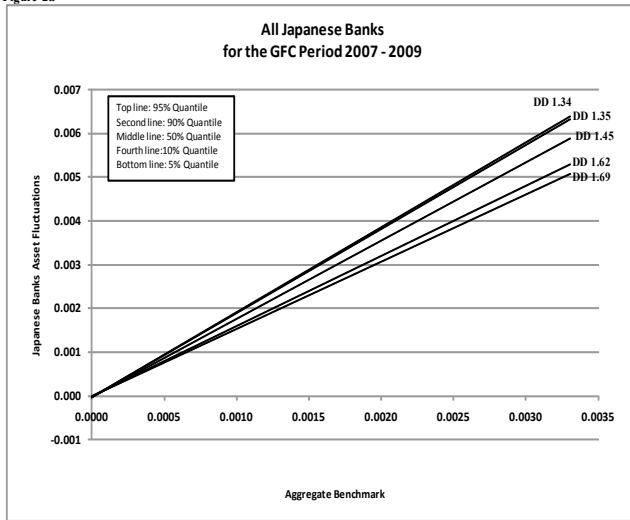


Figure 2b

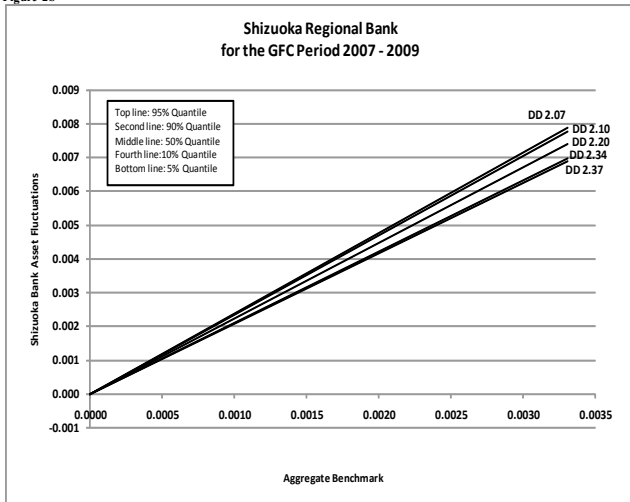


Figure 2c

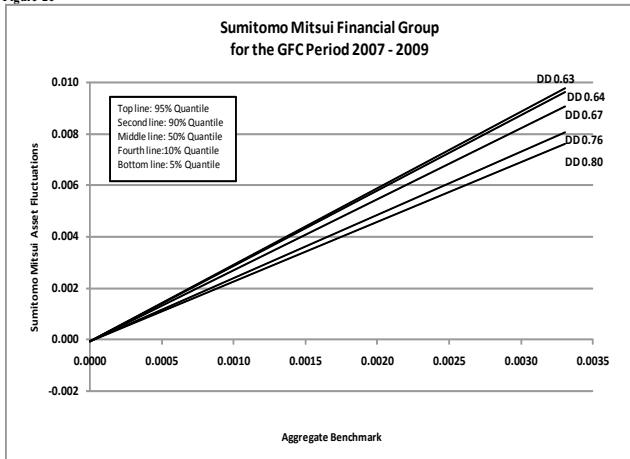


Table 2a Distance to Default

| Quantile | All Banks | Shizuoka | Sumitomo |
|----------|-----------|----------|----------|
| -5% | 1.69 | 2.37 | 0.80 |
| -10% | 1.62 | 2.34 | 0.76 |
| -50% | 1.45 | 2.20 | 0.67 |
| -90% | 1.35 | 2.10 | 0.64 |
| -95% | 1.34 | 2.07 | 0.63 |

Table 2b F Test - GFC Quantile v benchmark

All Banks
Volatility Significance Testing: F Test:

| | 5% Quantile | 50% Quantile | 95% Quantile |
|--------------|-------------|--------------|--------------|
| DD | DD | DD | DD |
| F | 2.3769 | 3.2292 | 3.7918 |
| p | <0.0001 | <0.0001 | <0.0001 |
| Significance | ** | ** | ** |

Shizuoka Regional Bank
Volatility Significance Testing: F Test:

| | 5% Quantile | 50% Quantile | 95% Quantile |
|--------------|-------------|--------------|--------------|
| DD | DD | DD | DD |
| F | 4.3616 | 5.0440 | 5.7094 |
| p | <0.0001 | <0.0001 | <0.0001 |
| Significance | ** | ** | ** |

Sumitomo Financial Group
Volatility Significance Testing: F Test:

| | 5% Quantile | 50% Quantile | 95% Quantile |
|--------------|-------------|--------------|--------------|
| DD | DD | DD | DD |
| F | 5.4652 | 7.7680 | 8.9920 |
| p | <0.0001 | <0.0001 | <0.0001 |
| Significance | ** | ** | ** |

Table 2c F Test - GFC Quantile v GFC Stdev

All Banks
Volatility Significance Testing: F Test:

| | 5% Quantile | 10% Quantile |
|--------------|-------------|--------------|
| DD | DD | DD |
| F | 1.2521 | 1.1536 |
| p | 0.0008 | 0.0229 |
| Significance | ** | * |

| | 90% Quantile | 95% Quantile |
|--------------|--------------|--------------|
| DD | DD | DD |
| F | 1.2493 | 1.2740 |
| p | 0.0009 | 0.0004 |
| Significance | ** | ** |

Shizuoka Regional Bank
Volatility Significance Testing: F Test:

| | 5% Quantile | 10% Quantile |
|--------------|-------------|--------------|
| DD | DD | DD |
| F | 1.1267 | 1.0997 |
| p | 0.0477 | 0.0919 |
| Significance | * | - |

| | 90% Quantile | 95% Quantile |
|--------------|--------------|--------------|
| DD | DD | DD |
| F | 1.1266 | 1.2444 |
| p | 0.0478 | 0.0011 |
| Significance | * | ** |

Sumitomo Financial Group
Volatility Significance Testing: F Test:

| | 5% Quantile | 10% Quantile |
|--------------|-------------|--------------|
| DD | DD | DD |
| F | 1.2813 | 1.1451 |
| p | 0.0003 | 0.0291 |
| Significance | ** | * |

| | 90% Quantile | 95% Quantile |
|--------------|--------------|--------------|
| DD | DD | DD |
| F | 1.2444 | 1.2841 |
| p | 0.0011 | 0.0002 |
| Significance | ** | ** |

The y axis in each graph represents the individual bank daily asset fluctuations. The x axis is the pre-GFC benchmark, calculated as discussed in Section V. The F test in table 2b tests for differences in volatility between the benchmark and each quantile for each selected bank. F is σ_1^2/σ_2^2 , whereby a value of 1 shows no difference between the benchmark and the selected quantile and a value of 3 shows variance of 3x higher for the selected quantile as compared to the benchmark. * denotes significance at the 95% level and ** at the 99% level. Table 2c performs a similar F test to test for volatility differences between the selected quantile as compared to all quantiles.

APPENDIX 3: QUANTILE REGRESSION FOR SELECTED BANKS (2008)

Figure 3a

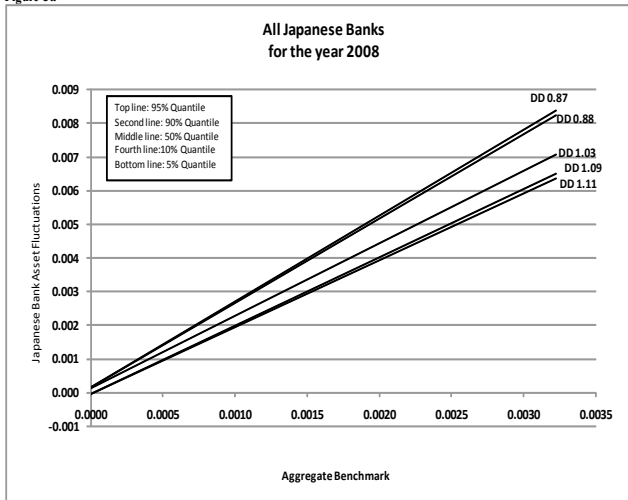


Table 3a Distance to Default

| Quantile | All Banks | Shizuoka | Sumitomo |
|----------|-----------|----------|----------|
| -5% | 1.11 | 1.60 | 0.24 |
| -10% | 1.09 | 1.54 | 0.24 |
| -50% | 1.03 | 1.38 | 0.21 |
| -90% | 0.88 | 1.26 | 0.19 |
| -95% | 0.87 | 1.26 | 0.18 |

Table 3b F Test - 2008 quantile against benchmark

All Banks
Volatility Significance Testing: F Test:

| | 5% Quantile | 50% Quantile | 95% Quantile |
|--------------|-------------|--------------|--------------|
| | DD | DD | DD |
| F | 4.8672 | 5.6985 | 7.9977 |
| p | <0.0001 | <0.0001 | <0.0001 |
| Significance | ** | ** | ** |

Shizuoka Regional Bank
Volatility Significance Testing: F Test:

| | 5% Quantile | 50% Quantile | 95% Quantile |
|--------------|-------------|--------------|--------------|
| | DD | DD | DD |
| F | 7.7182 | 10.4101 | 12.4431 |
| p | <0.0001 | <0.0001 | <0.0001 |
| Significance | ** | ** | ** |

Sumitomo Financial Group
Volatility Significance Testing: F Test:

| | 5% Quantile | 50% Quantile | 95% Quantile |
|--------------|-------------|--------------|--------------|
| | DD | DD | DD |
| F | 10.5001 | 14.1287 | 19.5344 |
| p | <0.0001 | <0.0001 | <0.0001 |
| Significance | ** | ** | ** |

Figure 3b

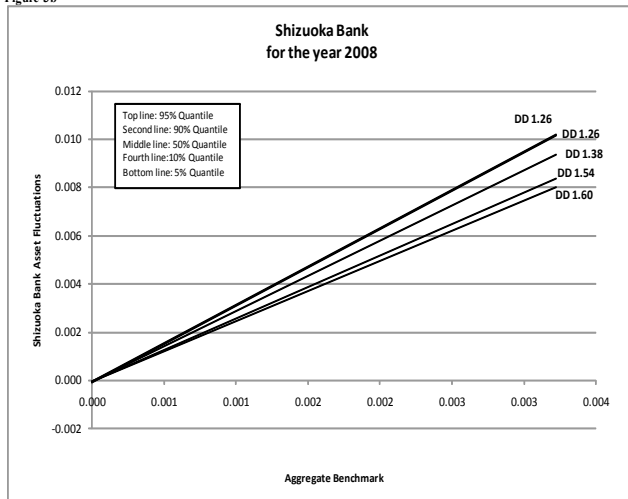


Table 3c F Test - 2008 quantile against 2008 stdev

All Banks
Volatility Significance Testing: F Test:

| | 5% Quantile | 10% Quantile |
|--------------|-------------|--------------|
| | DD | DD |
| F | 1.2538 | 1.2045 |
| p | 0.0339 | 0.0664 |
| Significance | * | - |

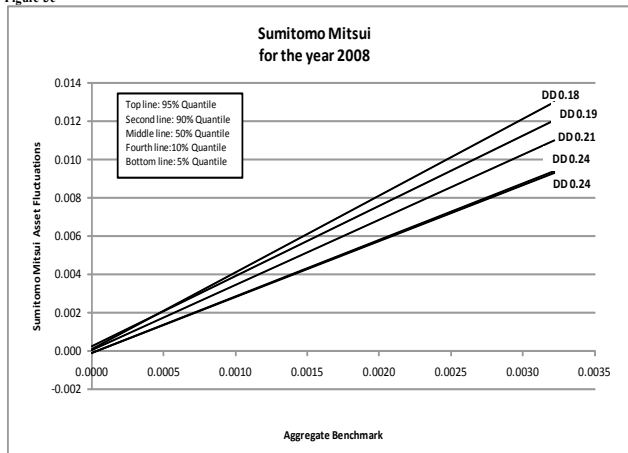
| | 90% Quantile | 95% Quantile |
|--------------|--------------|--------------|
| | DD | DD |
| F | 1.2548 | 1.3106 |
| p | 0.0334 | 0.0145 |
| Significance | * | * |

Shizuoka Regional Bank
Volatility Significance Testing: F Test:

| | 5% Quantile | 10% Quantile |
|--------------|-------------|--------------|
| | DD | DD |
| F | 1.2196 | 1.2196 |
| p | 0.0543 | 0.0543 |
| Significance | - | - |

| | 90% Quantile | 95% Quantile |
|--------------|--------------|--------------|
| | DD | DD |
| F | 1.3218 | 1.3218 |
| p | 0.0121 | 0.0121 |
| Significance | * | * |

Figure 3c



Sumitomo Financial Group
Volatility Significance Testing: F Test:

| | 5% Quantile | 10% Quantile |
|--------------|-------------|--------------|
| | DD | DD |
| F | 1.3232 | 1.3083 |
| p | 0.0119 | 0.0150 |
| Significance | * | * |

| | 90% Quantile | 95% Quantile |
|--------------|--------------|--------------|
| | DD | DD |
| F | 1.1739 | 1.4059 |
| p | 0.0976 | 0.0030 |
| Significance | - | ** |

The y axis in each graph represents the individual bank daily asset fluctuations. The x axis is the pre-GFC benchmark, calculated as discussed in Section V. The F test in table 3b tests for differences in volatility between the benchmark and each quantile for each selected bank. F is σ_1^2/σ_2^2 , whereby a value of 1 shows no difference between the benchmark and the selected quantile and a value of 3 shows variance of 3x higher for the selected quantile as compared to the benchmark. * denotes significance at the 95% level and ** at the 99% level. Table 3c performs a similar F test to test for volatility differences between the selected quantile as compared to all quantiles.

APPENDIX 4: ALL JAPANESE BANKS USED IN THIS STUDY

| Bank | Market Capitalisation (US \$m) | Total Assets (US \$m) | Bank | Market Capitalisation (US \$m) | Total Assets (US \$m) |
|--------------------------|--------------------------------|-----------------------|----------------------------|--------------------------------|-----------------------|
| 77 Bank | 2,167.6 | 62,938.6 | Kagoshima Bank | 1,476.4 | 35,879.3 |
| Aichi Bank | 880.2 | 27,895.1 | Kansai Urban Banking | 1,140.8 | 46,008.2 |
| Akita Bank | 777.7 | 25,629.5 | Keiyo Bank | 1,349.2 | 36,396.1 |
| Aomori Bank | 494.2 | 23,702.1 | Kita-Nippon Bank | 239.9 | 12,799.7 |
| A WA Bank | 1,399.8 | 28,512.3 | Kiyo Holdings | 969.2 | 38,952.6 |
| Bank of Iwate | 1,071.2 | 27,039.6 | Michinoku Bank | 293.2 | 19,840.0 |
| Bank of Kyoto | 3,482.0 | 76,114.7 | Mie Bank | 373.5 | 17,517.7 |
| Bank of Nagoya | 832.7 | 32,433.7 | Minato Bank | 535.9 | 31,311.7 |
| Bank of Okinawa | 853.3 | 17,204.0 | Mitsubishi UFJ Fin. Group | 74,143.0 | 2,177,444.0 |
| Bank of Saga | 488.9 | 21,489.3 | Miyazaki Bank | 533.5 | 20,705.1 |
| Bank of the Ryukyus | 442.4 | 17,493.0 | Mizuho Financial Goup | 30,658.4 | 1,666,529.0 |
| Bank of Yokohama | 6,665.5 | 127,602.2 | Mizuho Trust & Banking | 5,054.6 | 63,021.2 |
| Chiba Bank | 5,346.8 | 109,248.9 | Musashino bank | 974.1 | 37,998.7 |
| Chiba Kogyo Bank | 396.9 | 23,451.1 | Nagano Bank | 177.0 | 9,522.9 |
| Chugoku Bank | 3,122.8 | 64,670.8 | Nanto Bank | 1,546.2 | 48,528.3 |
| Chukyo Bank | 661.5 | 17,603.9 | Nishi-Nippon City Bank | 2,348.9 | 77,515.1 |
| Chuo Mitsui Holdings | 6,228.4 | 158,686.5 | Ogaki Kyoritsu Bank | 1,218.8 | 42,917.5 |
| Daisan Bank | 512.2 | 18,892.4 | Oita Bank | 631.0 | 28,959.9 |
| Daishi Bank | 1,280.3 | 48,062.0 | Resona Holdings | 14,557.3 | 433,391.6 |
| Daito Bank | 89.0 | 7,024.3 | San-In Godo Bank | 1,412.0 | 41,606.3 |
| Ehime Bank | 499.0 | 19,026.1 | Sapporo Hokuyo Holdings | 1,412.0 | 41,606.3 |
| Eighteenth Bank | 533.5 | 24,902.6 | Shiga Bank | 1,676.1 | 46,029.7 |
| Fukui Bank | 773.8 | 23,268.7 | Shikoku Bank | 723.5 | 27,095.7 |
| Fukushima Bank | 123.0 | 6,440.7 | Shimizu Bank | 384.0 | 14,421.7 |
| Gunma Bank | 2,730.9 | 65,974.8 | Shinsei Bank | 2,375.0 | 121,551.7 |
| Hachijuni bank | 2,988.6 | 65,859.9 | Shizuoka bank | 6,070.3 | 96,719.3 |
| Hiroshima Bank | 2,610.4 | 67,668.8 | Sumitomo Mitsui Fin. Group | 46,197.4 | 1,310,262.0 |
| Hokkoku Bank | 1,257.2 | 34,193.3 | Sumitomo Trust & Bank | 9,820.9 | 219,091.5 |
| Hokuetsu Bank | 415.8 | 23,738.6 | Suruga Bank | 2,206.1 | 34,910.1 |
| Hokuhoku Financial Group | 3,053.1 | 107,366.2 | Tochigi Bank | 496.6 | 25,597.5 |
| Hyakugo Bank | 1,222.0 | 45,447.9 | Toho Bank | 813.5 | 33,650.9 |
| Hyakujushi Bank | 1,199.7 | 41,076.7 | Tohoku Bank | 148.1 | 7,093.5 |
| Iyo Bank | 3,036.1 | 55,753.7 | Tokyo Tomin Bank | 521.8 | 26,331.8 |
| Joyo Bank | 3,449.1 | 79,141.7 | Tomato Bank | 242.6 | 9,259.1 |
| Juroku Bank | 1,445.3 | 46,543.1 | | | |

Total Market Capitalisation 275,251.9

Total Assets 8,542,562.0

APPENDIX 5: PROFILE OF OUR TWO SELECTED BANKS

Sumitomo Mitsui Financial Group

Sumitomo Mitsui Financial Group (SMFG) is the holding company for Sumitomo Mitsui Banking, which is one of Japan's largest banks (along with Mitsubishi UFJ and Mizuho). The bank's operations include retail, corporate, and investment banking; asset management; securities trading; and lending. Sumitomo Mitsui Banking has some 500 domestic branches and another 20 branches abroad. Other units of SMFG include credit card company Sumitomo Mitsui Card, brokerage SMBC Friend Securities, management consulting firm Japan Research Institute, and Sumitomo Mitsui Finance and Leasing. In the US it operates the California-based Manufacturer's Bank. The bank had total assets of US\$1.3 trillion at March 2010 financial year end, a total capital ratio of 15.02% and a tier I ratio of 11.15%. Out of the three mega Japanese banks, Sumitomo Mitsui has the highest total capital adequacy ratio.

Shizuoka Regional Bank

Shizuoka Regional Bank is headquartered in Shizuoka, Shizuoka Prefecture. It has 187 domestic branches, primarily concentrated in the Tokai region between Tokyo and Osaka and overseas offices in Los Angeles, New York, Brussels, Hong Kong, Shanghai, and Singapore. Shizuoka Bank's total assets stood at US\$96.7 billion at March 2010 with loans and bills discounted of US\$64.6 billion. The bank's capital adequacy ratio at the same time was 15.32%, one of the highest ratios among Japanese banks, and its Tier I ratio was 14.06%, substantially higher than the BIS standard of 8%.

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