Comments on the Consultative Document: *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches*
issued by the Basel Committee on Banking Supervision

Japanese Bankers Association

We, the Japanese Bankers Association ("JBA"), are pleased to provide our comments on the consultative document: *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches*, issued by the Basel Committee on Banking Supervision ("BCBS") on March 24.

We sincerely hope that the following comments will aid the BCBS in its further consideration of this matter.

<<Executive Summary>>

General Comments

○ **Strong objection to the application of the standardised approach to certain asset classes**

The Internal Ratings-Based ("IRB") approaches are essential tools for the business management activities of banks. We fear that the application of the standardised approach to certain asset classes would lead to deterioration in the level of risk management at banks, and costs would be further passed on to clients with high credit quality. Furthermore, there is a concern that the application of a one-size-fits-all standardised approach would reduce the diversity of bank behaviour, and systemic risk would increase.

○ **Capital charges should be appropriately calibrated**

The Group of Governors and Heads of Supervision ("GHOS") agreed that the Basel Committee would focus on not significantly increasing overall capital requirements. Therefore, careful consideration should go into the level of capital charges in order to achieve and to be appropriate level for the overall financial industry. The Basel Committee should also ensure that at the same time, the level of capital charges for banks with specific business models or in specific jurisdictions do not end up with significantly higher increase.

○ **Objection to the introduction of a capital floor (output floors)**

Variation in risk-weighted assets could be addressed by the harmonisation of

parameter estimation methodologies and the introduction of parameter floors. The leverage ratio should be regarded as the sole backstop measure for the capital framework.

○ **Ample time should be taken for implementation and transitional arrangements**

The review should be stopped for those areas for which a sufficient review is not completed by the end of 2016. Sufficient time (5 years or more) and appropriate transitional arrangements should be provided for the implementation of the revised framework.

Specific Comments

○ **A more robust Advanced Internal Ratings-Based ("A-IRB") approach should be applied to exposures to corporates**

Given that the proposed revisions would give rise to issues such as (i) the risk weights assigned to exposures to large corporates (subject to the standardised approach) becoming higher than those assigned to exposures to medium-to-small sized corporate (subject to the IRB approach), and (ii) the difficulty of assessing risks in a consistent manner across portfolios through the co-existence of several risk measurement approaches within the portfolio, the Basel Committee should consider a combination of alternative solutions, such as the harmonisation of parameter estimation methodologies and the introduction of parameter floors. These alternatives would alleviate the problems in risk weighted asset variability, and at the same time, ensure a more robust A-IRB framework that should still be applied to corporate exposures.

○ **The A-IRB approach should continue to be applied to exposures to financial institutions**

The uniform application of the standardised approach to financial institutions would give rise to issues such as crowd behavior by banks subject to international standards, which could amplify shocks, and further destabilising financial systems. Therefore, the A-IRB approach, incorporating sufficient risk sensitivity, should continue to be applied to exposures to financial institutions. This would avoid substantial unintended consequences that could have potentially significant destabilising effects on the financial system. Furthermore, insurance companies, lease companies and moneylenders, subject to different regulations and legal

frameworks as of those to banks, should be treated as our proposed exposures to corporates.

○ **The PD/LGD approach should continue to be permitted to specialised lending**

As the PD/LGD approach best reflects the reduction in default and recovery risks inherent in the design of specialised lending schemes, the Basel Committee should consider retaining the usage of this approach. Additionally, the current risk measurement framework could be significantly improved through the increase in granularity of the slotting criteria, enhancing the risk sensitivity measurement for exposures that would not qualify for the PD/LGD approach.

○ **The application of the PD/LGD approach should be permitted for certain equity exposures**

For equities held for purposes of maintaining long-term relationships with clients, banks very often have access to undisclosed client information, and therefore have an "information advantage" over those that only have access to disclosed information. Therefore, for these exposures, the PD/LGD approach should continue to be permitted. Regardless of our proposal, if the Basel Committee considers that the application of the standardised approach to equity exposures is necessary, appropriate transitional arrangements over a sufficient period of time (at least 5 years after the introduction of the framework) should be provided in order to take in to account the need for banks to communicate with clients whilst ensuring that these important long term relationships are not hampered by these revisions.

○ **The values for CCFs should be calibrated according to the nature of commitments**

Commitment-related transactions should be classified into "general commitments", "unconditionally cancellable commitments" and "non-commitments" based on the three conditions: (i) possibility of unconditional cancellation by the bank; (ii) receipt of commitment fees; and (iii) the bank's approval before drawing commitments. Then, for "unconditionally cancellable commitments" that satisfy the above (i) and (ii) conditions, the CCF should be set at 0% or a sufficiently low level. "Non-commitments" that satisfy all of the three conditions should be excluded from the calculation of risk-weighted assets.

<<General Comments>>

1. Strong objection to the application of the standardised approach to certain asset classes

We strongly oppose the mandatory application of the standardised approach and constraints on the use of the A-IRB approach with respect to certain asset classes for the following four reasons. For the reasons mentioned hereafter, the scope of the usage of the IRB approaches should be kept as broad as possible.

(1) Risk-sensitive internal models are too important to be eliminated

The IRB approaches are more risk sensitive than the standardised approach, and enable banks to promptly respond to risk fluctuations and avoid losses. Therefore, the IRB approaches contribute to consistent, comprehensive and objective identification of credit risk by banks and form the foundation for ensuring sound business management. Furthermore, since the introduction of Basel II, the IRB approaches have been used by banks to autonomously and proactively enhance their credit risk management and internal management activities such as cost and profit analysis, hence they have become core essential tools for the business management activities of banks.

Considering the above, the mandatory application of the standardised approach to certain asset classes would not only be at odds with these enhancements but would disincentivise banks from enhancing their risk management practices and could lead ultimately to deterioration in the level of risk management at banks. In reviewing the regulatory framework, the BCBS appears to excessively focus on comparability and simplicity and does not sufficiently consider risk sensitivity. An important point to be mentioned is that, the current proposals, addressing the issue of risk weighted asset variability, revert to the standardised approach, instead of trying to review the risk sensitive foundations of the current IRB framework. Unlike the standardised approach, which should rightly focus on simplicity and comparability because a wide range of banks, including small-sized banks, use the approach, the IRB approach were initially developed as advanced techniques receiving the necessary approval by relevant national regulators. Given this, when reviewing the IRB approach, the BCBS should particularly place weight on “building” and not “destroying” the current risk sensitive framework.

(2) Increasing divergences between regulatory capital management and internal risk management would lead to a decrease in capital efficiency

Through the usage of risk sensitive IRB approach for calculating regulatory capital requirements, banks are currently able to manage their regulatory capital in a way that is

consistent with the actual risks in the portfolio. In turn, banks have realised appropriate risk management while providing the function of financial intermediation through the appropriate and efficient use of capital. Indeed, banks have been developing their capital plans by reflecting the results of stress testing, enhancing capital management taking into account their internal risk management, and continuously striving to achieve risk-sensitive, global financial accounting. However, this consultative document proposes to apply a "one-size-fits-all" standardised approach to certain asset classes, which runs counter to what the regulatory framework after the introduction of Basel II has been seeking; i.e., to integrate regulatory capital management and internal risk management. The increasing divergence between regulatory capital management and internal risk management raises the significant concern that these revisions would result in a reduction in capital efficiency.

Furthermore, with respect to corporate exposures, applying different measurement approaches depending on the size of the business is incompatible with banks' credit management practice, which is based on companies' inherent credit quality, and thus would give rise to significant confusion.

(3) Unintentional encouragement for banks to hold high-risk assets

Applying the standardised approach to certain asset classes could lead to excessively conservative capital charges for low-risk assets compared to the actual risks, and hence risk weights for such assets could be higher than those eligible for the application of IRB approaches. Consequently, banks could concentrate their credit on those asset classes assigned with a relatively low regulatory risk weight under the IRB approach, but where the inherent associated risks are quite high. Eventually, there is the danger that banks would be incentivised to focus on more high-risk assets. Furthermore, the proposed approach imposes an excessively conservative regulatory capital requirement on blue-chip clients with high credit quality, which may adversely affect the funding activities of such clients. According to an estimation by a Japanese bank, at most a cost of 97 bps (this is the average of major banks) would need to be passed on to its lending to large corporations, in order to maintain the current level of profitability. Higher funding costs or a possible decline in credit demand, would ultimately undermine banks' financial intermediary function, having potential adverse effects on large corporations and financial institutions, and furthermore, on sustainable economic growth.

(4) Alternative solutions, such as harmonizing parameter estimation methodologies would lead to a substantial reduction in excessive variation in credit risk-weighted assets

Variation in credit risk-weighted assets, arise from differences in stress periods across jurisdictions, characteristics of banks' borrowers (e.g., region and industry) and recovery-related behaviour (e.g., support for the cure of non-performing loans, and recovery and disposal). These are "justifiable" risk weighted asset variability, attributable to the respective banks' risk characteristics and business strategies. It stands to reason that such variation should be permitted.

On the other hand, excessive variation in credit risk-weighted assets arising from differences in internal model measurement approaches, considered to be "un-justifiable", could be addressed through the harmonisation of parameter estimation methodologies. The Regulatory Consistency Assessment Program ("RCAP") reports issued by the BCBS in July 2013 and April 2016 indicated that variation in risk weights with respect to the banking book was primarily due to LGD and EAD estimates. Unlike LGD and EAD estimates, which rely on the number of default cases, the appropriateness of PD estimates relies on whether there is a sufficient population of borrowers to be used as a denominator in the PD estimation. Therefore, where there is sufficient denominator data, the outcome of PD estimation should be sufficiently reliable, even if there is only a small number of default data. Furthermore, since the introduction of Basel II, banks have accumulated internal data regarding non-disclosed client information for risk management purposes and have enhanced modelling techniques and validation methods utilising such information, under the appropriate supervision of national regulators. In particular, in Japan, the major funding tool for corporates is borrowing from financial institutions. Consequently, Japanese banks have retained and accumulated information – information that is not available from market data sources – for earnings forecasts of corporates and the recoverability of claims (including the appropriate valuation of collateral values). The consultative document sets out criteria for assessing modellability, which are: (i) data availability; (ii) information advantage; and (iii) modelling techniques and validation. Therefore, it should be noted that, at least for some jurisdictions, banks are able to satisfy all of these criteria even for low-default portfolios ("LDPs"). In light of this, for LDPs, the Basel Committee should consider to retain the usage of IRB approaches, but at the same time consider a policy mix of harmonising LGD and EAD parameter estimation methodologies, and introducing parameter floors, instead of requiring the application of the standardised approach.

Furthermore, excessive variation in credit risk-weighted assets can be reduced by,

for example, establishing a guideline regarding management of IRB approaches that can be referenced by the public and private sectors based on best practice of industry, such as model validation using external ratings (e.g., review on rank-ordering, comparison of probability of default), and by enhancing disclosures of parameter estimation methodologies under the IRB approaches.

If the "one-size-fits-all" standardised approach is applied to material asset classes, our concern is that the diversity of bank behaviour would be substantially reduced, and economic pro-cyclicality and systemic risk arising from crowd behaviour (including the suspension of providing funds to low-rating clients) would increase. In addition, removing the IRB approaches and using external ratings within the standardised approach framework may weaken banks' risk assessment capabilities.

2. Calibration of capital charges

A deliberate consideration should be made to ensure that the level of capital charges after the review of the regulatory framework would be the same as the level under the current framework. The press release issued by the GHOS and the BCBS states that the objective of this review is to address excessive variation in credit risk-weighted assets calculated using the internal models, and not to significantly increase the level of overall capital requirements. However, the proposals in this consultative document would result in a significant increase in the level of capital charges. Such proposals include requiring the application of the standardised approach to certain asset classes, and imposing additional capital charges to unconditionally cancellable commitments. The level of capital charges after the review of the regulatory framework should be calibrated in a manner to achieve an appropriate level for the overall financial industry and at the same time should be carefully considered to ensure that the capital charges for banks with specific business models or in specific jurisdictions should not increase significantly, also taking into account the impacts of other regulatory reviews currently being carried out (such as the review on sovereign risk and step-in risk). In particular, during this consultation, parameter floors and regulatory parameters for the IRB approaches, and risk weights under the standardised approach, should be appropriately calibrated. In addition, the scaling factor (1.06) applied under the current regulatory framework should be reviewed and revised as necessary. With regards to credit risk, our proposal would be to introduce (i) a scaling factor to be applied to the difference between risk-weighted assets under the current IRB and revised IRB for those asset classes applying IRB approaches, and (ii) a scaling factor to be applied to the difference between risk-weighted assets under the current standardised approach and revised standardised approach. This would ensure that the new capital requirements would be in line with current level of capital requirements for the respective asset classes applying the IRB and standardised approaches.

We understand that specific calibrations would be made based on data collected in the Quantitative Impact Study (QIS) currently being undertaken. In this exercise, data should be sufficiently reviewed. Specifically, a QIS timeline that enables banks to submit appropriate data should be considered, and a sufficient period should be set aside for data analysis by the BCBS, in particular, for the analysis of the impact on the real economy and markets. For this purpose, an additional QIS should be conducted, where necessary, with a different timeline from the review of this framework in order to consider the appropriate overall calibration.

3. Introduction of a capital floor (output floors)

We strongly oppose the introduction of a capital floor based on the standardised approach. Excessive variation in credit risk-weighted assets can be reduced by establishing parameter floors (input floors) and the use of supervisory parameters, rather than introducing a capital floor based on the standardised approach (output floors).

The current capital floor was initially designed under Basel II as a means of alleviating upheaval, and was not intended to control variation in credit risk-weighted assets. Furthermore, the introduction of permanent capital floors based on the standardised approach has demerits, such as increasing capital costs, undermining the accuracy of risk identification at financial institutions, and a negative impact on bank management practices. We believe that this demerit has a greater impact than the capital floor's merits of enhancing financial institutions' soundness through an increase in capital charges.

Moreover, given that the leverage ratio requirements are already scheduled to be introduced, there is a clear overlap between the regulatory role of the leverage ratio and the proposed capital floor, as a backstop to the risk-based capital framework. In order to avoid unnecessary complexity, and consistent with the Basel Committee's stance on enhancing the simplicity of the regulatory framework, the leverage ratio should be regarded as the single backstop measure under the framework, while the risk-based capital framework itself should retain its high level of risk-sensitivity.

If the Basel Committee introduces a capital floor based on the standardised approach, the objective of such a floor should be to prevent under-estimation of risk-weighted assets calculated using internal models. This means that the level of the floor should be calibrated in a manner only binding to certain banks that calculate "un-justifiable" risk-weighted assets based on inappropriate internal models, through the global benchmark survey on internal models. The standardised approach is a simplified approach used by banks which do not have sufficient resources for data accumulation, model development and validation, and other activities. Hence, the application of this approach should not be required for banks that on the contrary, have the above-mentioned resources. If a capital floor is set at a high level and consequently risk-weighted assets under the standardised approach become larger than those calculated under the internal models for most banks, banks would be disincentivised from undertaking risk-sensitive management based on the internal models. This may lead to the deterioration in the level of risk management.

4. Implementation timing and transitional arrangements

The consultative document states that this review should be finalised by the end of 2016. However, as noted above, the proposals in this consultative document would have very significant impacts on the real economy. Therefore, in order to establish an appropriate framework, the revisions should fully reflect the comments from industry. However, this should not lead to a longer period of regulatory uncertainty. Therefore, we would propose that the revisions to the current framework should be finalized in 2016, and the current framework should be retained for areas where the Basel Committee has not reached a definitive agreement by the end of the year.

If a capital floor based on the standardised approach is introduced, and the application of the standardised approach is required for certain asset classes, IRB banks would need to overhaul their current risk-weighted asset calculation process so as to, for example, make possible the calculation of risk-weighted assets based on the standardised approach along with the IRB approaches. The burden of calculation under the revised framework would be considerably heavy, and therefore sufficient time would be required to undertake IT system developments and other preparations. This should be considered on a separate timeframe from that of regulatory reviews of other risk categories, and five years or more should be given before the implementation of the framework.

The revisions proposed in the consultative document may give rise to a concern that the level of capital charges for certain asset classes (such as exposures to large corporates, financial institutions, specialised lending and equity exposures) would increase considerably. Most importantly, the issue should be addressed through an appropriate calibration. However, in order to avoid a potentially drastic increase in risk-weighted assets for some banks, appropriate transitional arrangements (for example, the exemption of existing assets) or phase-in arrangements similar to those under Basel III should also be considered.

<<Specific Comments>>

1.Exposures to corporates

(1) Strong opposition to the application of the standardised approach to exposures to large corporates

Credit risk to corporates is not a risk that is dependent solely on the level of size-based indicators, such as consolidated total assets and revenues, and would not fluctuate significantly around a certain threshold level of these size based indicators. Thus, it is far from reasonable to draw a simple conclusion that large-sized corporates have a low default exposure and are not suitable for modelling, and therefore apply a different calculation approach to that of other types of corporates. As an alternative, a consistent approach should be applied to the same asset class. From a risk management perspective, it is more appropriate to thoroughly assess the credit quality of individual corporates and centrally manage exposures to them, irrespective of the size of corporates.

In addition to the above, the application of the standardised approach to exposures to large corporates may give rise to a concern that risk weights assigned to exposures to small-and-medium-sized corporates, to which the IRB approaches are applicable, would be lower than those assigned to large corporates. Specifically, the standardised approach may have adverse effects from the perspectives of banks' clients and internal risk management, as discussed below. Consequently, we strongly oppose the application of the standardised approach, in particular, to exposures to large corporates.

(i) For example, the risk weight under the standardised approach is 100% for exposures to large corporates with a BBB-rating. This is considered to be a punitive level since the risk weight assigned is double or triple the average risk weight (with a maturity of 2.5 years) estimated under the foundation internal ratings-based (F-IRB) approach for same-rating exposures. Therefore, the application of the standardised approach may result in an inappropriate framework in that the capital cost would inconsistently and significantly increase as a result of an increase in risk-weighted assets related to loans, even though the credit quality of corporates has improved due to, for example, growth or business expansion. This may discourage banks from providing appropriate business growth support.

(ii) If an asset class to which the IRB approaches are applied is guaranteed by a guarantor to which the standardised approach is applied, the risk weight would increase since a conservative risk weight would be assigned under the standardised approach. This may disincentivise banks from obtaining guarantees which is surely

not the intention of the proposed revisions.

(iii) As a result of applying multiple risk measurement approaches to the same asset class, outcomes of capital cost and the level of profitability related to transactions for each company may vary depending on the size of the company. This may raise the concern that the risk assessment may not be being consistently carried out across portfolios. (For example, risk-weighted assets may differ by corporate size, even though the same rating is assigned.) Ultimately, this may have an adverse impact on the real economy since the cost would be passed on primarily to clients with high credit quality.

We understand that this review does not intend to increase capital charges for exposures to large corporates. Given the negative effects listed in (i), (ii) and (iii) above, instead of applying the standardised approach, we would propose the alternative solution of having the A-IRB approach, but subject to, for example, parameter floors with reference to the probability of default published by external rating agencies.

As discussed above, we are of the view that the A-IRB approaches should be applied to exposures to large corporates in consideration of the introduction of parameter floors. However, if the Committee still believes that the application of A-IRB approaches should still not be permitted, we would propose to place large corporate exposures under the F-IRB approach, where LGD and EAD, which are the primary cause of variation in credit risk-weighted assets, are based on supervisory fixed values.

Despite our comments expressing our strong opposition to apply the standardised approach to exposures to large corporates, if the Basel Committee considers that even the F-IRB approach should not be pursued, and still believe the application of the standardised approach as the optimal solution, the scope of the standardised approach should be limited to borrowers with an external rating of AA or higher and with evidently limited default cases based on historical data provided by external credit rating agencies, such as S&P and Moody's. Alternatively, as stated in our comments to the second consultative document on *Revisions to the standardised approach for credit risk*, the Basel Committee could consider to increase the granularity of the risk weight table, partly addressing the shortcomings of the standardised approach (for example, the same risk weight (100%) is assigned to both BBB-rated claims (investment grade) and BB-rated claims (non-investment grade)) and partially mitigate the cliff effects coming from these risk weightings. Specifically, excessively conservative risk weights assigned to BBB and higher-ratings should be reduced as indicated in Table 1 below.

[Table 1] Proposed risk weight table for exposures to corporates

	AAA rating	AA rating	A rating	BBB rating	BB rating	B rating	CCC rating and below
Exposures to corporates	20%	20%	30%	50%	100%	125%	150%

(2) Treatment of exposures to medium-sized corporates

As discussed above, credit risk to corporates is not a risk which is dependent on the level of size-based indicators such as consolidated total assets and revenues. Corporates with revenue of over €0.2 billion may face default to a certain extent (e.g. a typical Japanese major bank faces more than 25 cases of default per year on average), and banks undertake very similar recovery efforts for both exposures to medium-sized corporates and exposures to other types of corporates. Consequently, the credit loss rate is not necessarily dependent on the amount of sales. Therefore, the application of the F-IRB approaches should not be required for corporates above a certain threshold amount of revenue. We would propose to have the A-IRB approach even for exposures to medium-sized corporates.

If the constraint is imposed on the use of A-IRB approach, the application of the F-IRB approach should be mandated for exposures to large corporates having a relatively small number of defaults, while LGD and EAD floors should be applied to exposures to non-large-sized corporates.

(3) Treatment of exposures to subsidiaries within the group

As discussed above, we strongly oppose the application of the standardised approach to exposures to large corporates.

If the standardised approach is applied to exposures to large corporates, the applicability of the IRB approaches should be determined according to the size of the company on a non-consolidated basis, instead of a consolidated basis.

2. Exposures to financial institutions

We strongly oppose the application of the standardised approach to exposures to financial institutions. When Basel III was introduced, the level of capital charges for exposures to financial institutions had been sufficiently raised by setting the asset correlation at 1.25. Moreover, the standardised approach only defines four risk-weight buckets (i.e., 20%, 50%, 100% and 150%), and hence has low risk sensitivity. This may

cause the cliff effect and crowd behaviour in transactions between financial institutions including cross-border transactions, and may act as a de-stabilising factor to the financial system since financial institutions with relatively low ratings would find it difficult to raise funds. Taking into account these issues, for exposures to financial institutions, we would propose for the reduction in variability through the harmonisation of parameter estimation methodologies for LGD and EAD, instead of requiring the application of the standardised approach.

If the application of the A-IRB approach to exposures to financial institutions is not permitted, the Basel Committee should consider the alternative solution of applying the F-IRB approach to financial institutions.

Moreover, other financial organisations (such as insurance companies, leasing companies, and moneylenders) should be excluded from the scope of financial institutions. Their regulations and legal systems are distinctly different from those for banks and securities firms. Hence, it is not reasonable to collectively include all exposures with different risk profiles in exposures to financial institutions and apply the same standardised approach. Consistent with the treatment under the current framework, exposures to other financial institutions should be treated as corporate exposures.

3. Specialised lending

(1) The use of the PD/LGD approach should be permitted

Since the risk profile of specialised lending schemes differ significantly by the features of a project, such as industry, geographical location, parties involved in the project, the form of contract and other factors, banks examine various risks related to the business and reflect the result in their internal ratings for credit examination purposes.

However, the standardised approach applies the same risk weight to specialised lending (except for real estate non-recourse finance). Such treatment does not reflect risk weight reduction effects of collateral such as aircraft and vessels and differences in risks across project finance deals (e.g., low-risk projects to which the public sector is expected to provide credit enhancement, such as the construction of a hospital or a railway project), and thus lacks risk sensitivity.

On the other hand, within real estate non-recourse finance in specialised lending, the risk weights are assigned according to the LTV. However, this framework only considers the LGD under the PD/LGD approach, and does not reflect PDs in the risk weights. Therefore, the risk sensitivity must be considered as being low.

Such a “one-size-fits-all” measurement approach for specialised lending may cause

overstatement or understatement of risk-weighted assets, and may disincentivise banks from undertaking efforts to construct a business and finance structure that ensures appropriate risk-taking and securing of loans.

Furthermore, the current supervisory slotting criteria are not a sufficiently risk-sensitive approach, since this approach has only five buckets.

If the standardised approach or the supervisory slotting criteria are applied to specialised lending, risk-weighted assets would increase to inappropriate levels. It is highly likely that this could lead to a reduction in lending by banks and an increase in interest rates on loans. In particular, a demand for vast infrastructure development is expected in emerging countries, and the G20 also sets the promotion of infrastructure investment as one of its policy agendas. The proposals in this review are at odds with these high-level policy objectives.

For specialised lending, it is crucial to reflect the effect of default risk-reduction and recovery risk-reduction through various structures. In this regard, the most appropriate risk measurement approach would be the PD/LGD approach. Moreover, in light of the following, the data necessary for the parameter estimation could be obtained. Based on this, excessive variation in credit risk-weighted assets could be addressed through the harmonisation of parameter estimation methodologies and the introduction of parameter floors.

(i) Project finance

Banks have a considerable degree of control over assets and income generated from such assets because, under project finance, all assets are generally acquired as collateral, and additional funding activities are prohibited unless consent from a lender is obtained. Additionally, since creditors are limited, even if a default event has occurred, the business can be continued or losses can be avoided through means such as restructuring or changing the operator by the borrower(s) and the creditor(s). Therefore, risks can be controlled. As covered by the Moody's analysis, there are about 6,000 cases of project finance across the world, and this population is sufficient to accumulate data for the purposes of parameter estimation.

(ii) Real estate non-recourse finance and object finance

Common schemes are generally structured for real estate non-recourse finance or object finance (aircraft finance and shipping finance), and a number of transactions exist. Real estate, aircraft and vessels that are pledged as collateral have objective market prices and historical transactions, and hence their LGD can be modelled using these data.

In addition, external data is also available which can be used for the verification of internally estimated parameters. External credit rating agencies publish the levels of PDs and LGDs for real estate non-recourse finance, which are the underlying assets of CMBS, and the level of long-term average PD of CMBS.

(2) Increasing the granularity of the slotting criteria

As discussed above, we consider that it is appropriate to continue to apply the PD/LGD approach to specialised lending. However, we understand that, for those portfolios to which the PD/LGD approach is not applicable, for reasons such as shortage of data, the slotting criteria would be applied. In applying the slotting criteria, the granularity should be increased in order to address issues associated with the current slotting criteria (i.e., the granularity of the current slotting criteria is too low and hence the risks of specialised lending cannot be fully reflected). This is because, while specialised lending has lower risk relative to the risks associated with exposures to corporates due to the design of its structure (for example, collateral or guarantee is required), risk weights under the current supervisory slotting criteria are often determined at a conservative level in comparison to exposures to corporates. In addition, since the supervisory slotting criteria have only five categories, cliff effects may arise, which may act as a barrier to the sound development of financial markets related to specialised lending. Therefore, the granularity of the slotting criteria (currently five categories) should be increased. In particular, the risk weight assigned to the category for high credit quality should be considerably reduced. Specifically, we propose the following risk weight table based on the probability of default and the average recovery rate related to project finance, as published by S&P. (See Appendix 1 for details.)

The proposed changes to the slotting criteria shown below are based on actual data from cases of project finance that are generally secured by illiquid assets. Therefore, for exposures that are secured by highly liquid assets and thus with higher recoverability (object finance and some of project finance), the introduction of a framework to apply lower risk weights should be considered.

[Table 2] Proposed changes to the slotting criteria

Risk Weight (%)		External ratings (S&P) (Benchmark)
Slot 1	20	AAA
		AA+
		AA
		AA-
Slot 2	30	A+
		A
		A-
Slot 3	50	BBB+
		BBB
		BBB-
Slot 4	70	BB+
		BB
		BB-
Slot 5	100	B+
Slot 6	120	B
Slot 7	150	B-
Slot 8	200	CCC/C

[Table 3] Risk weight based on the probability of default and average recovery rate related to project finance, published by S&P

Project Finance	Risk Weight (%) by period (year)						
	1	2	3	4	5	8	10
S&P A	13	18	23	27	32	46	55
S&P BBB	22	28	34	40	46	64	76
S&P BB	40	48	55	62	70	91	106

4. Equity exposures

The standardised approach for credit risk proposes to apply a uniform risk weight (250%) to equity exposures. This approach does not appropriately consider the risks associated with issuers, and thus lacks risk-sensitivity. On the other hand, the PD/LGD approach under the current framework calculates risk weights by taking into account

risks associated with issuers, and thus is a highly risk-sensitive approach.

The consultative document raises the difficulty for banks of obtaining sufficient data about issuers as one of the reasons for requiring the application of the standardised approach. In this respect, for equities held for purposes of maintaining long-term relationships with clients, banks generally have client information (including non-public information) – even with respect to listed companies – in addition to publicly-available information, and the PD can be estimated along with normal borrowers (it is considered that the LGD would be fixed at 90%). Therefore, such equity exposures should be excluded from the scope of the standardised approach, and the PD/LGD approach should continue to be permitted.

Regardless of our proposal, if the Basel Committee still considers that the application of the standardised approach is necessary, banks may need to consider whether to sell the equities that they hold, where necessary, since the capital charges for equity exposures would increase significantly. If the purpose of holding equities is to maintain long-term relationships with their clients, considerable time would be needed for banks to negotiate with their clients to reach a mutual agreement on selling shares, and for clients of banks to review its capital policy, such as by searching for stable and alternative shareholders to replace the banks. Additionally, if banks sell shares at the same time, this would have adverse impacts on the real economy through a decline in share prices. Taking these factors into account, if the application of the standardised approach is required, appropriate transitional arrangements (at least five years after the introduction of the revised framework) should be provided.

Furthermore, if the application of the standardised approach is required, a framework should be established that allows the standardised approach to take into account the offsetting of hedges set out in paragraph 345 of the current Basel II text (which states that short cash positions are permitted to offset long positions in the same individual stocks provided that these instruments have been explicitly designated as hedges and that they have remaining maturities of at least one year). It would be inappropriate if this type of measure is not provided, as the effect of risk reduction would not be appropriately reflected in the measurement of risk-weighted assets, and this may cause a further increase in the level of capital charges.

5. Parameter floors

(1) We agree to a 0% LGD floor to be applied to financial asset collateral.

Given that financial asset collateral has a low possibility of value fluctuation, it would be appropriate to apply a 0% LGD floor to secured exposures, as proposed in the

consultative document.

(2) LGD floor for secured exposures under the A-IRB approach

We understand the Basel Committee's proposal to introduce a floor to achieve a reduction in credit risk-weighted assets for the LGD used for non-secured exposures, since the LGD estimation methodology under internal models varies across banks for such exposures.

However, for secured exposures, it is not considered appropriate to introduce a uniform LGD floor because collateral valuation practice and actual implementation of collateral disposal differ across jurisdictions. When setting the LGD floor for secured exposures, the LGD floor should be calibrated in a manner so as to apply to very optimistic estimations. In addition, in determining the level of the floor, exposures which cannot be recovered by disposing of collateral should be deemed to be recoverable as unsecured exposures. Specifically, the level of a floor for collateral assets other than financial assets should be assigned to 10% or lower. Alternatively, given differences in laws and regulations and practices established in respective jurisdictions, national supervisors should have the discretion to determine the level of a floor.

In addition, for credits provided primarily through arrangers (for example, bank loans in U.S. and Europe purchased in the secondary market (leverage loans) and secured bonds), if collateral pledged by the borrowers is difficult to evaluate on a collateral-by-collateral basis, A-IRB banks should be allowed to use the LGD floor for secured exposures, instead of the LGD floor for unsecured exposures, provided that the effectiveness of collateral is ensured based on historical credit loss data.

(3) Eligible collateral requirement under the F-IRB approach

As mentioned below, collateral valuation and management at banks are performed centrally, irrespective of measurement approaches. In view of this, the eligible collateral requirement applicable to the asset classes subject to the F-IRB approach should be consistent with the requirement for the A-IRB approach.

(i) The size and the number of defaults (regardless of whether they are LDP or not) are unrelated to the collateral valuation and management methods. Therefore, differing the type of collateral that can be recognised in accordance with the size based indicators is clearly inappropriate.

(ii) The method for recognising collateral would be inconsistent according to the size of companies. Such a framework is inappropriate since, for example, if a

corporate is in a growth process, and its total assets or revenues exceed the threshold, this would result in a significant increase in the capital cost associated with loans.

(4) Collateral haircuts

Collateral haircuts should not be increased and, instead, the current level should be retained. For example, under the current framework, IRB banks are required to re-evaluate real estate collateral at least once a year. As such, the decline rate of real estate prices would be an appropriate benchmark in determining haircuts. The trend of real estate indicators for five years, assuming that there are five years from the period of normality to the period in which a bank disposes of real estate after the default of its client, was observed. As a result, the decline rate of real estate price was found to be approximately 30%, at the largest. Given this analysis, we consider the proposed collateral haircut (50%) in this consultative document to be overly conservative.

Since collateral valuation practice and actual collateral disposal differ across jurisdictions, it is difficult to establish uniform haircuts and thus collateral haircuts should be set at the discretion of national supervisors.

Moreover, since current A-IRB banks verify the appropriateness of collateral haircuts based on historical data, it is appropriate to apply a collateral haircut lower than that applied to F-IRB banks.

6. Parameter estimation methodologies

(1) PD estimation methodology for retail exposures

The consultative document explains that seasoning effects should be taken into account as a risk factor in the estimation of PDs for retail exposures. Given that seasoning effects can be reflected by directly adjusting PD estimates, such an approach should be permitted according to the bank's portfolio characteristics.

(2) LGD estimation methodology for unsecured exposures

The consultative document proposes that banks should separately estimate and then aggregate: (i) a long-run average LGD and (ii) an add-on to reflect the impact of downturn conditions; to derive an LGD for unsecured exposures. For the reasons mentioned below, the Basel Committee should permit banks to directly estimate their downturn LGD, consistent with the estimation of LGD for secured exposures.

(i) Since impacts arising during the economic downturn would vary across

jurisdictions, it would not be appropriate to apply a consistent floor to the downturn add-on or to introduce regulatory add-ons for the downturn component. The Basel Committee should instead apply a floor to the overall LGD.

(ii) If the estimation approach of LGD differs between unsecured exposures and secured exposures, it is likely that LGD for unsecured exposures and LGD for those secured exposures with approximately a 0% coverage ratio (i.e., "the amount of collateral received"/"the amount of the exposure") would be inconsistent (i.e., there would be divergences between the two). In such cases, even if the amount of collateral posted is extremely small, LGD estimates may decline sharply compared to the case of unsecured exposures. Therefore, this may mistakenly incentivise banks to collect a small amount of collateral in order to apply a lower LGD.

(iii) The level of LGD for secured exposures would heavily rely on LGD for unsecured exposures if the estimation methodology of LGD for secured exposures is designed under the assumption that consistency between LGD for unsecured exposures and LGD for those secured exposures with approximately a 0% coverage ratio is ensured in order to prevent the situation stated in (ii) above. This contradicts the Basel Committee's proposal to permit banks to directly estimate their downturn LGDs for fully and partially secured exposures.

(3) CCF estimation approach

Taking into account the following, the CCF estimation approach should not be limited to the fixed-horizon estimation approach, and the use of the cohort approach, which is used by many IRB banks in Japan, should continue to be permitted.

(i) The cohort approach that observes the drawdown rate from the base date reflects actual drawdown in measuring capital requirements for the next one year.

(ii) The Basel Committee proposes to introduce a CCF floor based on the standardised approach. Therefore, it is excessively restrictive to designate the estimation approach and at the same time introduce a CCF floor as a means to reduce variation in the level of CCF.

(iii) The cohort approach is not deemed to be excessively non-conservative in comparison to the fixed-horizon estimation approach.

If the fixed-horizon estimation approach is introduced, the BCBS should provide a sufficient period of time for transition because banks would need to establish a data collection framework (including IT system development).

(4) Maturity

The benefit of time for individual claims is only available up to the maturity of the individual claims. Therefore, it is overly conservative to apply the maturity parameter based on the expiry date of a facility and thus this proposal should be reconsidered.

7. Off-balance sheet exposures

(1) Definition of commitments

Banks fulfill an efficient and flexible credit-granting function for clients through the usage of off-balance sheet exposures. Therefore, if the framework of off-balance sheet exposures is changed considerably and, in particular, unconditionally cancellable commitments are treated in a similar way as general commitments, the banks' function of extending credit to clients could be undermined, thus adversely affecting the real economy. We particularly oppose a simple definition of commitments which is categorised solely by the existence or not of a contractual arrangement with clients. Since the product characteristics of commitments differ across jurisdictions and banks, appropriate treatment should be determined according to categories that reflect the actual risks. Furthermore, the scope of off-balance sheet exposures should be limited to those that are subject to the calculation of risk-weighted assets under the current framework.

(2) Level of CCFs

The estimation of the level of CCFs for off-balance sheet exposures according to characteristics of exposures should be permitted. In particular, commitment-related transactions should be classified into "general commitments", "unconditionally cancellable commitments" and "non-commitments" based on the three conditions as specified in Table 4: (i) possibility of unconditional cancellation by the bank; (ii) receipt of commitment fees; and (iii) the bank's approval before drawing commitments. Then, for "unconditionally cancellable commitments" that satisfy the above (i) and (ii) conditions, it is appropriate to set the CCF at 0% or a sufficiently low level. Whereas, "non-commitments" that satisfy all of the three conditions should be excluded from the calculation of risk-weighted assets.

With respect to those contracts satisfying all of the three conditions above, since banks do not have any obligations to extend credit to clients, it would be inappropriate to treat such arrangements as commitments simply by virtue of the existence of contracts. Under these arrangements, clients apply to the bank for loans before drawing and the bank determines whether the application for drawing could be accepted. As with

the case of general new loan arrangements, the bank may decline the drawing for whatever reason.

In Japan, the purpose of the use of unconditionally cancellable commitments for corporates is mainly to provide funds for their settlement purposes. Under such commitments, the bank permits an overdraft to the client's current account (i.e., the use of a credit line) to satisfy the temporal mismatch of client's cash supply and demand needs. However, this product generally serves as a backstop, and the bank does not receive any commitment fees from clients and could reduce, suspend or terminate the credit line at its discretion when, for example, the client's creditworthiness deteriorates. In practice, the bank has in place a process where it restricts withdrawal, reduces or cancels the credit line and considers and demands additional collateral to be posted before the client defaults when there is any indication of deterioration in the client's creditworthiness, and shifts to normal loans (e.g., loan on deeds) if the use of the commitment line continues for a long time. As this process is the same as unconditionally cancellable commitments for retail clients, it is not reasonable to differentiate the treatment of commitments for corporate clients and those for retail clients. Rather, for corporate clients, it is easier for banks to capture the situation of individual clients in detail and a timely manner, and to promptly identify deterioration in their creditworthiness. Therefore, risks associated with corporate clients are mitigated relative to those for retail clients.

As discussed above, it is not reasonable to treat unconditionally cancellable commitments in a way similar to general commitments, and A-IRB banks should also be permitted to apply CCF estimation approaches to unconditionally cancellable commitments that are different from those used for general commitments. Specifically, for example, banks should be permitted to include in estimation samples those cases where the unused portion is cancelled before default to prevent additional use of the commitment, or to extend the observation period beyond one year in order to take into account in estimation the cancellation of contracts or the reduction of credit lines that were undertaken more than one year before default.

Furthermore, the level of CCFs for off-balance sheet exposures based on the standardised approach should also be set according to characteristics of exposures.

[Table 4] Classification of commitments and proposed CCFs

Classification of transactions	Conditions			Proposed CCF (under the standardised approach)	(Reference) Applicable products in Japan
	Unconditionally cancellable?	Receipt of any commitment fees?	Is the bank's approval required whenever using a credit line?		
General commitments	Not possible	Yes	Not required	50%	Commitment line
Unconditionally cancellable commitments	Possible	No	Not required	Decrease the CCF level for corporates at least to the same level or below as the CCF for retail	General bank overdraft
Non-commitments	Possible	No	Required	Out of scope	Special bank overdraft

8. Others

(1) CVA

Capital charges based on the SA-CVA and BA-CVA should be calibrated appropriately taking into account the fact that the IMA-CVA would be removed. In particular, the BA-CVA is expected to be adopted by most financial institutions that do not have in place advanced CVA calculation system infrastructures and the necessary organisational structure (e.g., CVA desks). Therefore, if capital charges under the BA-CVA become excessively conservative and associated capital costs increase, the high costs would be passed on to those derivatives transactions used by corporates to hedge their business risks. As a result, it would become difficult for corporates to continue their hedging activity based on actual demand, which may have negative effects on the real economy. Given these situations, the Basel Committee should calibrate the level of capital charges for the BA-CVA carefully and appropriately.

(2) Introduction of an SA-CCR floor to the IMM

The IMM, which is based on historical data, is capable of identifying the remaining amount of counterparty credit risk more precisely than the SA-CCR. This advantage of internal models of precisely identifying remaining amounts should be highly regarded, and measurement outcomes based on the IMM should not be undermined by applying a floor based on the SA-CCR. Even if a floor is to be set, it should be set at a sufficiently low level.

(3) Category of qualifying revolving retail exposures

The consultative document proposes to include qualifying revolving retail exposures in the categories of "transactors" and "revolvers". Since these buckets are not commonly used in Japan and many products are difficult to classify into these categories, we oppose the introduction of such a framework.

In particular, as a general practice in Japan, a credit card has a cashing quota in addition to a shopping quota and hence the credit line is used for both quotas. Therefore, it is operationally very difficult to separate an unused portion into the "transactors" and "revolvers". Given that such products are commonly used, these categories should be removed.

Regardless of our comments above, if the Basel Committee decides that such categorization is appropriate, in light of the differences in product characteristics and jurisdictional practices, we believe that "transactors" and "revolvers" should be defined with a certain degree of flexibility for its implementation and interpretation.

(Appendix 1) Increasing granularity of slotting criteria for specialised lending exposures

According to the "Annual Global Project Finance Default and Recovery Study" and the "Project Finance Default And Recovery: Shale Gas Fuels Rise In U.S. Defaults" published by S&P, the probabilities of default for project finance rated A, BBB and BB by S&P were 0.14%, 0.30% and 0.90%, respectively. Furthermore, according to S&P project finance consortium data, the average recovery rate of project finance was 74%-76%, including the periods of economic downturn.

Based on the calculation of risk weights using the above data over a five-year period (with LGD = 26%), risk weights for ratings A, BBB and BB were 32%, 46% and 70%, respectively. Given this result, it is reasonable to make the risk weights more granular and to reduce the risk weights assigned to higher rating categories.

[Table 5] Risk weight based on the probability of default and average recovery rate related to project finance, published by S&P

Project Finance	Risk Weight (%) by period (year)						
	1	2	3	4	5	8	10
S&P A	13	18	23	27	32	46	55
S&P BBB	22	28	34	40	46	64	76
S&P BB	40	48	55	62	70	91	106

The average probability of default in the project finance consortium data was 1.39%, which is mostly consistent with the average probability of default of corporate exposures published by S&P and Moody's, i.e., 1.5% and 1.615%, respectively. In addition, it is confirmed that the recovery rate is higher than unsecured corporate exposures. Therefore, it would be inappropriate if risk weights assigned to project finance are higher than risk weights assigned to corporate exposures.

[Table 6] Average risk weight by period for project finance and corporates

	Risk Weight (%) by period (year)				
	1	2	3	4	5
Overall Project Finance	48	56	63	71	78
Moody's C&I	59	68	76	85	93
S&P C&I	58	66	75	83	92

Based on the above, we propose the following risk weight table for the slotting criteria approach:

[Table 7] Proposed changes to the slotting criteria

Risk Weight (%)		External ratings (S&P) (Benchmark)
Slot1	20	AAA
		AA+
		AA
		AA-
Slot2	30	A+
		A
		A-
Slot3	50	BBB+
		BBB
		BBB-
Slot4	70	BB+
		BB
		BB-
Slot5	100	B+
Slot6	120	B
Slot7	150	B-
Slot8	200	CCC/C

The proposed changes to the slotting criteria shown above are based on actual data from cases of project finance that are generally secured by illiquid assets. Therefore, for exposures that are secured by highly liquid assets and thus with higher recoverability (such as for object finance and some project finance schemes), the introduction of a framework to apply lower risk weights should be considered.