June 18, 2009

Comments on the UK FSA "The Turner Review" and its Discussion Paper 09/2 (DP09/2)

Japanese Bankers Association

We, Japanese Bankers Association ('JBA'), would like to first express our gratitude for this opportunity to comment on the United Kingdom's Financial Services Authority (UK FSA) paper of The Turner Review and Discussion Paper 09/2 (DP09/2). JBA respects the UK FSA's leadership in regulatory response to the global banking crisis.

JBA also shares the severity of the current global financial crisis. The initiatives, proposed in The Turner Review and DP09/2 by UK FSA, are likely to have an important step for the future international banking regulations to respond to the current financial crisis. We view that the UK FSA's initiatives would have a significant influence on creating the future international regulatory framework under the current financial crisis.

We sincerely hope that the following comments will assist UK FSA in formulating the rules on this subject.

General Comments

JBA views that UK FSA' proposals will have an influence on the international discussions on strengthening international regulation framework because London is one of the largest international financial center in the world. Considering what are behind the current financial crisis, we believe that the priority should be placed on addressing the causes of such crisis. Upon the discussion of strengthening bank capital standards and introducing liquidity standards, we would like to request them to consider the following points.

1. We believe that further market turmoil caused by the hasty introduction of new regulations by some countries should be avoided. In response to the global financial market turmoil, a new global regulatory framework should be established under the discussion of international bodies such as the Basel Committee.

2. We would like to confirm that the discussions leading to tighter regulations should be conducted in a cautious manner, until an economic recovery is assured. Discussion over the quality and quantity of capital would significantly impact on the financial markets and therefore, any response should be made in a prudent manner. In particular, international consensus should be made with regard to the definition of "Core Tier1 ratio", which may require a minimum ratio of 4%, and other relevant issues raised in The Turner Review.

3. In case of introducing new measures such as "leverage ratio" and "core funding ratio", etc. as a new regulatory framework, regulators should take into consideration multiple effects that would incur on a comprehensive basis. We view that any regulation which aggravates procyclicality should be avoided. Therefore, deliberate quantitative impact studies before implementation are necessary to be conducted.

Specific Points

(1) Quantitative Measures for Liquidity Risk Management (para.4.17–4.21, 5.55–5.62, and Q15 in DP09/2)

Necessity for Quantitative Measures on Liquidity Risk Management

During the current crisis, the importance of being able to access adequate liquidity on an ongoing basis has been recognized again. We believe that the group-wide based "core funding ratio", which emphasize the importance of core deposits, is an effective liquidity risk management indicator.

However, in order to control excessive asset growth, rather than focusing on liabilities alone, we believe that it is more important to establish evaluation standards considering both assets and liabilities on the balance sheet, accompanied by the analysis of quality of assets held. Many financial institutions own large amounts of government bonds, which are high marketable or liquid assets on the asset side. In order to control business models which finance long term assets with short term liabilities, we believe that assessment should be made over the separation of short term sticky funding sources, and those that are not.

We are concerned that if liquidity regulation should be undertaken on a regional, individual currency, or individual entity basis, this would be detrimental to the optimal asset allocation in the world and would significantly undermine market efficiency. The regulation to control liquidity risk management should focus on enhancing liquidity in order to promote cross-border, cross-product and cross-currency transactions. In order

to ensure flexible liquidity for each financial institution, we urge regulations to be designed so as to be constructive regulatory supporting system in terms of currency swap accommodation provided by regulators or central banks.

(2) Leverage Ratio as a Supplemental Measure (para.4.22–4.25 and Q6–Q7 in DP09/2)

Addressing the Leveraged Businesses

Some of the largest factors behind the current financial crisis are considered to be the investment banking business with extremely high leverages as well as an imbalance of macrostructure, a skewed incentive structure, and the transmission of risk through financial transactions that were conducted on a global basis.

Therefore, it makes no sense that regulatory responses made to the above leveraged business are negatively affecting the commercial banking business, which is supported by core deposits. If leverage ratio, which ignores the nature of assets/liabilities of commercial banks, is implemented as a supplemental measure, there will also be a significant risk that commercial banks would not be able to fulfill their responsibilities, such as becoming restricted in increasing loans pertaining to the increase of deposits. Thus these issues must be analyzed prudently.

Therefore, when considering supplemental measure such as a leverage ratio, it is important to establish new measures taking into account a variety of business model of each financial institution. For example, it is noted that if the purpose is to control excessive leverage, deposit should be treated differently considering its nature apart from other liabilities, when designing supplemental measures for commercial banks where deposits are predominant financial sources.

Interconnectedness of Each Measure

Especially, we would like to request careful consideration to the interconnection of consequences from all of regulatory responses, recommended in The Turner Review.

For example, in terms of the proposed strengthening liquidity standards, high quality assets, such as government bonds, are required; on the other hand, leverage ratio may reduce the incentives to hold governmental debt, which would create a discrepancy between regulators' liquidity requirements and leverage standards. If both the quantitative liquidity and leverage standards are required to be met, increase in loans may be discouraged, as a result of which a new kind of procyclicality effect would be induced.

To address the issues of interconnected and new procyclicality caused by the new

regulations demands a holistic approach to regulation not a piecemeal approach, supported by thorough quantitative impact studies. We do request to maintain consistency as the entire effects of multiple regulations.

(3) Definition of Capital (para.4.7–4.9 and Q3 in DP09/2)

Discussion on the quality and quantity of capital will have a significant impact on the financial markets, thus careful responses are needed. We think it important both to maintain financial stability and to consider balance between efficiency and effectiveness. It is required to deliberately consider possible adverse effect brought by strict regulations.

In particular, although in fact UK banks are required to maintain minimum “Core Tier1” ratio of 4%, we are concerned that the definition is currently under discussion and international consensus has not been reached yet. New measures without international agreement, should not be adopted without careful consideration.

In addition, for financial institutions, in order to maintain stable capital planning, rapid rule changes are not favorable. When introducing new rules, at least, sufficient transitional periods should be assured.

Discussion among the Quality and Quantity of Capital

In terms of regulatory capital, we respect fully the importance of common equity as the most high quality capital with predominant roles. It is very meaningful to accurately evaluate the quality of capital for the purpose of strengthening resilience in case of financial crisis.

On the other hand, we understand that diversification of capital raising instruments itself is not a cause for the current financial turmoil. We view that the intention of investors coincides with the needs of financial institutions with respect to capital raising in a free, competitive market mechanism, which would produce benefits for certain extent. There is the fact that some capital instruments other than common stocks have also a shock absorptive function.

We are afraid that the current discussion is based on the assumption that common stock financing market seems to continue to be stable, however, this assumption is not fully examined. We are also concerned that the argument for sophisticating more appropriate capital assessment would turn out to be overly sought to common stock in the regulatory capital. In any case, if funding market for common stock turns unstable, there is a risk of losing a shock absorption function of common stock in Tier 1 capital.

In terms of procyclicality, the possibility that capital instruments without

diversification would produce adverse effect has to be reconsidered. So we urge not to over-emphasize common stocks from simple and excessively conservative perspective, but to evaluate the common stock in terms of adequate capital assessment so that financial stability should be maintained.

Furthermore, while we recognize the necessity of the quality of capital in light of “going concern capital,” the quantity of capital, especially, what percentage of regulatory capital is required, is a separate issue. We understand that quality and quantity of capital should be discussed comprehensively, considering possible combination of instruments used in capital build up as well as depositor protection, bank resolution at each jurisdiction and size of each capital market.

Necessity of Tier 2 Capital

The Turner Review proposed that “Core Tier 1” requirement is no less than 4% and Tier 1 requirement is no less than 8%. We are concerned that the significance of Tier 2 capital, as qualified regulatory capital, is less focused.

For commercial banks, depositor protection is important for the theme of bank’s management. In order to ensure stable financing through deposits, it is indispensable to establish a depositor protection system in preparation for bank bankruptcies. In this respect, for commercial banks which have large portion of deposits for their liabilities, Tier 2 capital still plays a significant role, from the perspectives of ensuring depositor protection and stable means of financing. In addition to common stock as a buffer to absorb losses before insolvent, a lower quality capital such as subordinated loans and debts are to be combined with common stock. This will enable regulators to respond to and take precautionary measures toward the financial crisis in a timely manner.

From the perspective of depositor protection, minimum regulatory capital ratio (based on a sum of Tier 1 and Tier 2 capital) should continue to play an important role for commercial banks. Based on this view, discussions then need to be made regarding “Core Tier 1” capital as sustainable measures that lead to balanced regulations where risk management is highly advanced and as quality and quantity of capital are strengthened for the purpose of protecting depositors, etc. and absorbing losses. When doing so, we think that it is meaningful to use the concepts of “going concern capital” and “gone concern capital” indicated by the UK FSA as starting points for global discussion.

Constituents of Predominant Capital

In discussing the important qualitative elements of predominant capital, it is important that they should absorb realized losses and should not trigger insolvency. For instance, it should be possible for noncumulative perpetual preferred stocks to be equivalent to common stock, so we think these preferred stocks should be eligible for inclusion as a part of predominant capital.

(4) Procyclicality (para.5.30–5.44 and Q12 in DP09/2)

We view that regulations to financial institutions should not be designed to encourage them to reduce their credits when the economy is deteriorating, and we believe it meaningful to discuss over capital buffers as a means of mitigating procyclicality.

Before such discussion, it should be recognized that the economic structure of each nation is different, and that the resulting economic cycle and fluctuations are also various. Furthermore, we urge regulators to be aware that the timing of recovery from the current and future financial crises and public authorities' involvement will likely differ from country to country.

Concept of Capital Buffers

At first, based on this view, government authorities should employ frameworks that are aligned with the international regulation, as they seek to mitigate the impact of the procyclicality of the capital framework and its impact on their countries and/or regions. Subject to this, we believe it would be valuable to discuss further the concept of capital buffers.

Next, as a preposition for discussion on the capital buffers, the maximum level of required capital imposed on each financial institution under the stress scenarios should be clarified. This means that the capital requirement above the maximum level set by regulators should be addressed at regulators' risk. The proposed Pillar 2 framework in DP Paragraph 5.66 should be carefully discussed between authorities and industry participants in order to avoid unnecessary discussions on additional Pillar 2 capital requirement resulting from Pillar 2 stress testing. In addition, new regulatory measures such as capital insurance or reduction of minimum required capital level should be considered.

Furthermore, with the current financial crisis, connecting this discussion for capital buffers for reducing procyclicality with the increase in minimum capital requirement

would most likely impede economic recovery. Therefore, we oppose to this kind of treatment. In terms of capital buffer, we understand high loss absorption of common stock is needed. However, we do not think it necessary to assume a reversal of capital reserve in considering increase in capital ratios. Combining both capital as a numerator and risk capture of assets as a denominator, we request that some measures that would contribute to financial stability on a long term should be considered.

Relation between Quality of Capital and Capital Buffers

Some aspects of the argument that focusing on predominant capital, referred as "Core Tier 1" capital, in The Turner Review as a buffer for absorbing losses borne by large internationally active banks is understandable. We think that evaluating the soundness of banks based on predominant capital while the concept has not been finalized, and applying it to the market raises grave concerns and risks.

We understand the debate that high quality capital, accumulated in good times of the economic cycles, should be allowed to be reversed when the downturn materialized. However, we request that, in order to make consideration with the method of how the accumulated capital will be reversed in the economic downturn, the practicable applicability, which could be achieved, should be fully considered. We also urge regulators to consider including capital instruments, other than predominant capital, into qualified regulatory capital in times of economic downturn.

(5) Enforcement of External Ratings (para.10.26–10.48 and Q29–Q31 in DP09/2)

Basel II allows the usage of ratings of external credit assessment institutions (ECAI) and it also points out the need for fully grasping the product content at the time of each use.

In Japan, provisions have been made with regard to the "public requirements of a qualifying grade when rating securitization transactions" mentioned in the Basel II regulations. These are specific provisions (i.e. "ratings are publicly announced and included in the ECAI's transition matrix") so as to secure appropriate ratings of securitization exposure through market discipline, since market disciplines do not cover ratings of securitization exposure much. We view that it is worthy to consider enforcing such requirements in the Basel II securitization framework as a general rating requirement aside from securitization risk exposure, based on the perspective of enhancing market discipline.