May 27, 2005

Comments on “The Application of Basel II to Trading Activities and the Treatment of Double Default Effects”

Japanese Bankers Association

The Japanese Bankers Association would like to express its gratitude for being given the opportunity to comment on the consultative document titled “The Application of Basel II to Trading Activities and the Treatment of Double Default Effects” published by the Basel Committee on Banking Supervision (Basel Committee) and the International Organization of Securities Commissions (IOSCO) on April 11. We hope that our comments may help the Basel Committee and the IOSCO to finalize this document.

(General remarks)

We highly appreciate that the consultative document will contribute to the further improvement of risk management.

Part 1, Part 2 and Part 3 of the consultative document provide financial institutions with further risk sensitive options that may reduce capital charge. Meanwhile, Part 4 and Part 5 may impose additional capital requirements. We understand that the Basel Committee basically intends to implement all parts of the consultative document as a package simultaneously to maintain overall required capital unchanged and ensure a level playing field among countries.

However, we perceive that it will be extremely difficult to implement these proposed rules when Basel II starts. Eleven months have already passed since the mid-year text was published and resources available to financial institutions for additional preparations are extremely limited. For example, it would be difficult to implement specific risk modeling and downward valuation adjustments / reserves in Part 4: Improvements to the current trading book regime, considering heavy burdens of modeling and different accounting practices in valuation adjustment among countries. Likewise, the proposed treatment for unsettled trades in Part 5 requires large preparatory burdens to develop IT systems and to build operational procedures so that the costs significantly outweigh the prudential benefits.

Therefore we would like to request the Basel Committee to reconsider the implementation timing of the proposed rules and to give national discretion for the implementation processes.

(Detailed discussion)

1. <u>The treatment of counterparty credit risk</u>

   Clarification of methods to recognize collateral as credit risk mitigation

   1) *Standardized method (Paragraphs 58, 158, 159)*

      In the standardized method, the consultative document does not show how to recognize the risk mitigation effects of collateral and it could be interpreted as not allowing such effects. Reasonably the standardized method should be allowed to recognize the risk mitigation effects of collateral. We would like to request the Basel Committee to state explicitly the method of recognizing collateral, for example, by adding to the text a statement that "it is possible to deduct collateral amount (after adjusting for collateral haircut) from the finally calculated EAD."

   2) *Current exposure method (Paragraph 54)*

      The formula in Paragraph 54 explicitly indicates that it is possible to offset "collateral held" and "positive replacement costs plus add-ons." However, it is not clear whether it is possible to offset negative replacement costs and collateral posted. We would like to request the Basel Committee to state explicitly that " it is possible to offset "posted collateral" and "negative current exposure" when the collateral contract is legally valid. "

      Furthermore, since the consultative document stipulates that it is not possible to offset "replacement cost" and "add-ons" in the mathematical formula, we would be most grateful if the Basel Committee would show us the theoretical background behind this for our reference.

2. <u>The treatment of double default (Paragraph 242 "307a")</u>

   Operational requirements concerning "forms of protection"

   We would like to request the Basel Committee to revise the operational requirements concerning "forms of protection" so that double default effects could be recognized if "multiple-name credit derivatives, multiple-name guarantees, synthetic securitizations and other tranched products” in Paragraph 224 (for simplification, referred to as “multiple-name credit derivatives etc.” below) meet certain operational requirements.

In order to avoid “wrong-way risk” when there is a high correlation between the credit of the protection provider and that of the obligor, the consultative document stipulates operational requirements of “forms of protection” in addition to the requirements for the eligible protection provider and the eligible obligor.

“Forms of protection”, one of the three eligibility requirements, precludes recognition of double default effects for multiple-name credit derivatives etc. because there is supposed to be “wrong-way risk” in all cases. However, we believe that double default effects should be recognized for multiple-name credit derivatives etc. as well as single-name credit default swaps (CDS) and guarantees, by demonstrating that “wrong-way risk” is negligible.

3. <u>Improvements to the current trading book regimes</u>

(1) Method of measuring specific risk under the internal models

1) Conditions for measuring default risk (Paragraphs 292, 312)

In measuring default risk included in specific risk under the internal model, the consultative document specifies the assumption of a “one-year” time horizon and a “99.9%” confidence interval. However, we believe that this treatment is unnecessarily conservative especially for highly-liquid positions since the holding period on trading books is generally much shorter and closing out highly-liquid positions is easy. We would like the Basel Committee to allow the utilization of the current regulatory presupposition (“10-days” holding period and “99%” confidence interval) for such positions.

Next, we would like to point out that sudden default is an extreme case of ratings migration and thus default risk is deemed to be included in event risk (Paragraph 312, Footnote 52). Accordingly, default risk should not be modeled separately from event risk. We believe that it would be more appropriate to apply the “10-day” holding period and “99%” confidence interval for event risk as a whole.

Supposing default risk is to be separated from event risk, banks should be allowed to determine their own holding periods and confidence interval of internal models reflecting their own trading asset profiles.

We believe that it is excessively conservative to separate default risk and apply a one-year time horizon and a 99.9% confidence interval. Furthermore, the rule proposed by the Basel Committee is not consistent with common trading practices and might become the disincentive to sophisticate internal models in measuring default risk.

2) *Calculation of risk assets under the IRB approach (Paragraph 294, 311)*

The Market Risk Amendment stipulates that market risk asset is defined as the higher number of (i) the value-at-risk on the base date and (ii) last 60 days average of the daily value-at-risk, divided by 8%. In order to maintain consistency with the IRB approach to measure credit exposures in non-trading portfolio, we would like the Basel Committee to state explicitly that the risk asset multiplied by 8% under the IRB approach is recognized as the market risk equivalent to default risk.

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(2) Internal model validation standards

1) *Validation of market risk (Paragraph 309 "B.9 (b)")*

We do not believe that any additional regulatory model validation is necessary, since current market risk amendments set various constraints in the assumptions of the internal models. For example, the choice of historical observation period (sample period) for calculating value-at-risk will be constrained to a minimum length of one year. For banks that use a weighting scheme or other methods for the historical observation period, the effective observation period must be at least one year (this is, the weighted average time lag of the individual observations cannot be less than 6 months).

Even if the additional validations requirement is to be introduced, we would like to request the Basel Committee to give national discretion, if necessary, to financial institutions to adopt suitable validation methods in light of the characteristics of the each institution's internal model and the results of back testing, as permitted under the current regulatory framework. Moreover, for models subject to regulatory constraints in estimating losses, we hope that the Basel Committee deletes the list of additional tests found under Paragraph 309 "B.9 (b)", or at least clarifies these tests are not compulsory.

2) Definition of trading PLs used in back testing (Paragraph 310)

Regarding back testing, Paragraph 310 could be interpreted as allowing each financial supervisory authority to determine whether to use hypothetical PLs, actual PLs or both at national discretion. However, currently financial institutions are allowed to use either hypothetical PLs or actual PLs. We hope that the current regulatory framework is maintained, allowing financial institutions to choose either hypothetical PLs or actual PLs under national discretion.

4. <u>Unsettled and failed trades</u>

(1) Treatment of capital deductions (Paragraphs 326, 332)

The consultative document requires the deduction from capital as follows.

- If the payments have not yet taken place five business days after the settlement date, the positive current exposure will be deducted from a firm's capital.
- If two business days after the second contractual payment/delivery date (or two business days after the due date of the first contractual payment/delivery leg) the second leg has not yet effectively taken place, the bank that has made the first payment leg will deduct from capital the full amount of the value transferred plus replacement cost, if any.

This treatment cannot take into account recovery rates and thus is excessively conservative compared to the treatments of other exposures. We would therefore like to be allowed the capital deduction of expected losses (EL) adjusted for recovery rate.

Besides, we would like to confirm that LGD of 45% is allowed to be used in these cases as in Paragraph 324, even in the Advanced IRB (AIRB) approach.

(2) Treatment of "longer settlement dates" transactions as forward contracts (Paragraphs 327, 333)

1) Application of the principle of materiality

Other than foreign exchange trading (FX), there are few transactions with longer settlement lags, resulting in only the increase in costs compared with prudential benefits. We would therefore like to request the Basel Committee to give national discretion not to impose capital charges when there would be negligible impact on capital requirements. Alternatively, we would like to request the Basel Committee to add to Paragraph 324 the same wording as in Paragraph 331: “when exposures are not material, banks may choose to apply a 100 percent risk-weight to these exposures” for both DVP or non-DVP transactions.

2) *Consistency with capital charges for foreign exchange transactions*

Under the Current Accord, foreign exchange transactions with an original contract period of no more than 14 days are exempted from capital charges, and we understand that there will be no changes to this in Basel II. Although in the consultative document the settlement lag of five business days is a bifurcation point whether to impose capital charges, we would like to confirm that foreign exchange transactions with original contract periods of 14 days or less are excluded from capital charges in light of consistency with the Current Accord.