February 15, 2008

JBA’s Position Regarding "Guidelines for Computing Capital for Incremental Default Risk in the Trading Book"

Japanese Bankers Association

We, Japanese Bankers Association, would like to express our gratitude for giving us this opportunity to comment on "Guidelines for Computing Capital for Incremental Default Risk in the Trading Book" published by the Basel Committee on October 12 last year (the “Guidelines”).

We hope that the comments below will assist the Basel Committee in finalizing the Guidelines.

(General Comments)

We are basically in support of the content of the proposed Guidelines as they attempt to clarify the content of the Basel II Framework text.

Japan introduced the Basel II Framework at the end of March 2007 and has endeavored to use it in order to enhance risk management capabilities of banks. Our understanding is that this proposal refers to the Market Risk Amendment covered by Basel II, and more specifically, focuses on the use of internal models for specific risks within market risks.

We think it is necessary to ensure that the Guidelines clarify the content of the Basel II text and that the hurdles are not excessively high in light of the practice of trading business.

(Specific Points) (Comments on specific issues where feedback is sought)

Discussion Point 3: Frequency of calculation of incremental default risk

Currently, when calculation is made using analytical reports from ratings agencies concerning default rates, etc., the highest updating frequency is once per year. If the intention of the Guidelines is to require calculation on a daily basis, we would like to insist that there needs to be room for discretion with respect to the frequency of computation of incremental default risk so that it can be aligned with the actual internal risk management practices of the financial institution.

Discussion Point 5: Estimation of liquidity horizon

１． Clarification of "liquidity considerations"

At the end of Paragraph 20, it is stated that “it is appropriate that default risk capital charges for trading book positions reflect these liquidity considerations." But, it is extremely difficult to quantitatively measure liquidity for each individual instrument, and even if multipliers etc. are used, it is impossible to verify the validity of such multipliers.

We believe that it would be easier for us to understand the Guidelines if, to the extent possible, specifications or clear instructions with respect to the instrument categories and their liquidity horizons were provided, which would facilitate early implementation of the Guidelines.

２． Concept of liquidity horizon

In Paragraph 22, reference is made to "The time period consistent with the bank's actual trading experience and risk management process in rebalancing similar positions during stressed market conditions." There are, however, limitations to the number of samples to be used in estimating liquidity horizon for individual instruments. Especially, during stressed market conditions, it must be considered extremely difficult to collect data on liquidity horizons for actual positions in individual instruments. We would therefore like to request that the Guidelines provide specific liquidity horizons for individual instruments in case where sample numbers are limited.

３． Measurement of concentrated positions (issuer concentration)

In Paragraph 25, it is stated that “This longer liquidity horizon for concentrated positions is necessary to provide adequate capital against two types of concentration: issuer concentration and market concentration.” Since we think that “issuer concentration” has no relation to “liquidity horizon”, we would like to see a clearer explanation of the relationship between the two in the context of this paragraph.

Discussion Point 6: Estimation methods for incremental default risk of structured products

Paragraph 10 discusses "indirect losses that may arise from default events in (equity securities and) structured credit assets," which we interpret as losses from default events for" a part of the assets" included in the structured credit assets. In other words, it is difficult to conceive of defaults on all of the assets in a structured credit asset, in which case it would presumably be treated as a direct loss. In the case of direct loss, it is likely that there will also be credit migration such as downgrading or fluctuations in spread risks occurring simultaneously.

However, the Guidelines provide for capital charges for the former (indirect losses arising from default events) but not for the latter (credit migration or spread risks) (Paragraph 14), making a conceptual distinction between the two. We would like to see a clearer explanation of the difference between the "indirect losses arising from default events in structured credit assets" discussed in Paragraph 10 and the "credit migration or spread risks" discussed in Paragraph 14.