March 13, 2008

Comments on the Consultative Documents for "Revisions to the Basel II Market Risk Framework" etc. issued by the Basel Committee on Banking Supervision

Japanese Bankers Association

The Japanese Bankers Association is thankful for the opportunity presented to comment on the consultative documents released by the Basel Committee on Banking Supervision on January 16, 2009. These documents include *"Revisions to the Basel II Market Risk Framework," "Guidelines for Computing Capital for Incremental Risk in the Trading Books"* and *"Proposed Enhancements to the Basel II Framework."*

It is our hope that the following comments will assist in the remaining work towards finalizing the rules of the Basel Committee in the examination of this subject.

General Comments

It is our understanding that the *"Revisions to the Basel II Market Risk Framework,"* (Market Risk Amendments), *"Guidelines for Computing Capital for Incremental Risk in the Trading Books"* (Guidelines) and *"Proposed Enhancements to the Basel II Framework"* (Framework Enhancements) presently attached to the consultative package, were established to enhance the framework of Basel II as measures to counteract the financial crisis that commenced in the summer two years ago. We are adequately aware of its importance and necessity.

The Market Risk Amendments seek to impose stable capital requirements against factors that could generate significant losses in a preventive manner. We also understand that from the perspective of international financial regulations and supervision in the G20 and other countries and regions, there is an urgent need to implement quick measures for the imposition of further capital.

The new proposal seeks for the calculation of stressed VaR for both specific risk and general market risk. It is our position that if the same objectives can be attained, there should be a review of methods other than the stressed VaR (for example, through

application of an additional multiplication factor) for general market risk due to the different risk attributes and practicability. We ask that the Basel Committee introduce new measures after the execution of an adequate impact studies in order to secure fairness with regards to the impact on financial institutions in each country and region as an integrated international rule.

Simultaneously, there is a need to leave room to review any newly established rule based of the fact that the method and level of desirable risk management is always evolving.

Specific Points

1. Calculation of Stressed VaR (Paragraph 718(Lxxvi) (i) (j)) of the Market Risk Amendments)

(1) Stressed VaR in the Case of General Market Risks

We understand the necessity of imposing additional capital charge and the necessity of seeking the imposition of stable capital requirements in a preventive manner to address factors that generate significant losses (addressed by "specific risk" charge including securitization products). In addition, we also understand that the Market Risk Amendments have been proposed because of the urgency for constructing measures for seeking to impose additional capital charge promptly, from the perspective of international financial regulations and supervision for the G20 and other countries.

Under these conditions, the present proposal seeks the calculation of stressed VaR for both specific risk and general market risk in light of the fact that "large unexpected losses in trading books have occurred" during the current financial turmoil.

Take a look at the developments regarding this issue. We understand that the Basel Committee's debate on incremental risk charge (or incremental default risk charge) has included a discussion on the imposition of additional capital requirements for specific risk.

However, this new proposal seeks to charge capital via a stressed VaR even for general market risk, despite the fact that additional capital charge for general market risk not being under discussion to date. It is our position that an adequate detailed examination is needed prior to any implementation of any additional capital charge for

general market risk.

This position is based on our understanding that specific risk and general market risk should not be calculated in the same way by a priori but should be calculated based on adequate consideration of their respective risk attributes. In other words, general market risk has less degree of uniqueness and fat tail characteristics compared to specific risk, which means that a certain degree of conservatism can be attained, for instance, by implementing a longer tail event than under the current rule.

In other words, this conservatism will be able to be achieved by adding adjustments such as through the application of an "additional multiplication factor" (i.e. the raising of the multiplication factor) since the confidence interval and holding period can be conservatively adjusted by multiplying some fixed numeric number under certain assumptions.

We believe the additional multiplication factor method is not an inferior approach to the stressed VaR method due to the following two reasons.

First, within the regulatory supervision by the authorities of each country, many financial institutions have sought to upgrade and sophisticate their own risk management using VaR. If despite these efforts a theoretically very rough method like stressed VaR is used to calculate additional capital charge, the motivation to upgrade risk management using VaR at the respective banks may decrease. In other words, there is the concern that the incentive to upgrade risk management in the future will decrease. The fact is that when analyzed under the light of consistency with the original purpose for using VaR (i.e. retaining a capital buffer against possible losses), the utilization of a logically inconsistent concept would leave potential problems regarding upgrading risk management in the future.

Second, while admitting that the "additional multiplication factor" method does have the possibility of slightly amplifying pro-cyclicality, we see that the method also has the merits of being able to adapt to larger events in the future without complexity and of not requiring the review of various parameters that stressed VaR calculations require.

Further, we would like the concrete "multiplication factor" number to be set after considering the results of the impact study to be conducted hereafter. We think that considering the results of the impact study conducted based on market fluctuations of

2007 and 2008 will enable the setting of appropriate "multiplication factor" numbers and the goal of stable capital charges might be achieved.

(2) Observation Period for Stressed VaR (Paragraph (Lxxvi)(i) of the Market Risk Amendments)

As described above, we recommend and propose the use of a method that differs from stressed VaR, but we would like to specify the following points in the event that the stressed VaR framework is introduced.

First, Paragraph 718(Lxxvi)(i) states that the Basel Committee on Banking Supervision stipulates that the 24 month period from 2007 through 2008 was a stress period for almost all portfolios. Based on this view, it states that 12 months should be selected from that period. We would like to confirm that this period is a continuous period specified by the concerned bank.

Additionally, globally active financial institutions would suffer from swelling costs to implement different systems and in complying with each country's rules on a global basis, if the authorities of each country define these differently. Therefore, we would like to confirm that the regular reports submitted to the authorities of each country may use the observation period utilized in the institution's home country as an integrated period on a global basis.

Finally, it is our understanding that the concept of "stress" in the proposed "stressed VaR" differs from that used in the Pillar 2 of the Basel II Framework and in the internal risk management concept. We believe that practical confusion could be avoided if at least a term other than "stress" were used so that it is clear that the concept differs from these.

2. Securitization Products in Trading Books (Paragraph 712(iii) (iv) of Market Risk Amendments and Paragraph 565 of Framework Enhancements)

The proposal calls for the almost identical treatment of banking books for the measurement method of specific risk related to securitization exposure in trading books. We would like to make the following three requests and/or confirmations regarding this.

The documents state that the risk weight table of Paragraph 712(iii) in the Market

Risk Amendments will be used by banks applying the Standardized Approach for credit risk method or the Standardized Approach for market risk, and that Paragraph 712(iv) will be applied to banks using the IRB approach for credit risk along with the internal models approach for market risk.

First, we would like Paragraph 712(iv) to be applied to banks using the IRB approach, regardless of whether or not they are subject to the market risk requirement, in order to maintain consistency with internal risk management. This treatment is consistent with the intent of applying the same capital charge as banking books to the securitization exposure of trading books that is intended by this Market Risk Amendments proposal.

Second, in the event that the above is not accepted, we would like to confirm that if the rules of Paragraph 712(iv) are applied to banks using the IRB approach along with the internal models approach for market risk, they will also be applied to banks that only use the internal models approach for general market risks from among market risks.

Finally, Paragraph 609 (Hierarchy of Approaches) related to the securitization exposure in the Basel II Framework document recognizes the Ratings-Based Approach (RBA), Supervisory Formula (SF) and the Internal Assessment Approach (IAA) (targeting the ABCP (asset-backed commercial paper) program). Therefore, we would like to make it possible to apply the Internal Assessment Approach (IAA) to ABCP held in the trading book based on the precondition that approval of the IRB approach for credit risk is obtained, in light of Paragraph 609, with regards to the regulations of Paragraph 712(v) that are proposed in the Market Risk Amendments.