April 17, 2009

Comments on the Consultative Document for *"Proposed Enhancements to the Basel II Framework*" issued by the Basel Committee on Banking Supervision

Japanese Bankers Association

The Japanese Bankers Association would like to first express its gratitude for this opportunity to comment on the Consultative Document released by the Basel Committee on Banking Supervision named "*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 by the Basel Committee in the examination of this subject.

General Comments

The "*Proposed Enhancements to the Basel II Framework*," which is attached to the Consultative Document (hereafter called as *Framework Enhancements*) was established as a measure to counteract the financial crisis that commenced in the summer two years ago. In particular, it has sharply differentiated capital treatment between complicated structured products originated through off-balance sheet transactions or ABCP conduit transactions that triggered the so-called subprime financial crisis, with traditional structured products. It also specifies that appropriate treatment should be taken from a regulatory capital perspective. And, since the Japanese Bankers Association highly appreciates and would like to support the *Framework Enhancements*. We also fully understand that from the current 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 requiring additional capital requirement.

We would like to comment mainly on the "*definition of resecuritisations*" and "*operational criteria for credit analysis*" when using external ratings, from the

perspective of balanced regulations that take into account practical operational burdens.

Regarding the former, we request that the Basel Committee explicitly state "*economic substance*" is a basis in the "*definition of resecuritisations.*" Furthermore, based on a sufficient understanding of causes behind the origin of this financial crisis, we ask that a decision will be made on setting a threshold, including whether or not to establish such a setting, after giving sufficient consideration to whether or not this would achieve the desired result.

Regarding the latter, taking into consideration a practical response to securitisation exposure or resecuritisation exposure already held, we would like for implementation to start at the end of 2010, rather than at the end of 2009.

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

Specific Points

1. Definition of Resecuritisations (The First Paragraph in Page 2 of the Framework Enhancements)

(1) Clarification with respect to Judgment based on Economic Substance rather than the Legal Form in terms of Resecuritisation

We request that "*economic substance*" be placed as a basis in the definition of resecuritisations.

Securitisations have varying structures. For example, due to restricted by domestic law in Japan, structured products are produced so that underlying assets are to be transferred at first to a trust vehicle and then repackaging trust beneficiary rights to securities product such as corporate bonds is made. For such products, although it formally looks as though there are two securitisation transactions being carried out, in light of the relationship with the underlying assets, the risk of holding and becoming involved with the concerned product remains unchanged. Therefore, although there are formally two securitisation transactions being carried out, if you look at the economic substance of the transaction, then some of them can be deemed as first-level securitisations, not

resecuritisation

Furthermore, the basic idea of *the Basel II Framework Document (Paragraph 538)* regarding this topic is that "*Similarly, supervisors will look to the economic substance of a transaction to determine whether it should be subject to the securitisation framework for purposes of determining regulatory capital.*"

Moreover, we believe that differentiating between structured products that may lead to the incurring of losses, including credit risk, etc., and structured products that do not, is in line with the philosophy of Basel II, which aims for risk-sensitive regulations and that it is rational. We also believe that it would be effective to prevent regulatory capital arbitrage that is derived from a difference between rules regarding specialized lending and those regarding securitisations.

Therefore, from the view of promoting sound securitisation markets, we propose resecuritisation exposure should be judged on the basis of *"economic substance."*

(2) Definition of Resecuritisation Exposure

In the Consultative Document, it says, "*A resecuritisation exposure would be defined as a securitisation exposure where one or more of the underlying exposures meet the framework's definition of a securitisation exposure.*" However, we think that sufficient discussions need to be made before final determination due to the fact that there are mainly two views regarding this topic among Japanese financial institutions as mentioned below.

The first view is that setting a threshold is unnecessary, giving a second thought the fundamental cause of this crisis that the correlation between the so-called resecuritisations and systemic risk was higher than that between traditional securitisations and systemic risk.

Another view is that while in favor of the policies expressed in the Consultative Document, it is not rational to treat all the following three in the same manner: a) "one" securitization exposure that does not affect the entire resecuritised portfolio, b) "one" securitisation exposure that greatly affects the entire resecuritised portfolio and c) a resecuritised portfolio that mostly consists of securitisation exposures. Therefore, they believe that the establishment of a certain

low level threshold as the upper limit (the maximum being 5-10% of the entire resecuritised portfolio) and the treatment that any resecuritised portfolio that fall under that limit would be deemed as securitisation exposures rather than resecuritisation exposures are worthy of discussion as a rational approach.

Due to this, we ask that the Basel Committee make a decision regarding the definition of resecuritisation exposure, including whether or not to set a threshold, only after giving sufficient consideration to whether or not it would achieve the desired regulatory goals based on a sufficient understanding of the causes behind the financial crisis.

2. *Treatment of "Operational Criteria for Credit Analysis" When Using External Ratings (Paragraphs 565(i), (ii), (iii) and (iv) in Page 5 of the Framework Enhancements)*

The Consultative Document proposes that new criteria, i.e. *"operational criteria for credit analysis"* be added when using external ratings (*Paragraphs 565(i), (ii), (iii) and (iv)*). We understand that these criteria are necessary for banks as investors to understand securitisation risk without excessive reliance on external ratings. As such, we strongly request on the following two items.

First of all, there are disclosure restrictions in light of contracts for already held securitisation exposures. Therefore, in order to meet the criteria mentioned in the proposal, preparation time is required for gaining the understanding and cooperation of concerned parties in securitisation markets, including the time required for renewing the conditions of contracts. Therefore, taking into consideration the commensurate time for meeting required criteria, we propose that the implementation date be set at the end of 2010, rather than at the end of 2009.

Next, in order to fulfill the criteria presented in the Consultative Document, we ask that the Basel Committee and the relevant authorities promote the disclosure of the information mentioned under *Paragraphs 565(i), (ii), (iii) and (iv)* not only by banks who are the users, but also by originators, by securities companies who are the arrangers, and by ratings agencies, since obtaining their cooperation is indispensable.

3. Treatment of ICAAP in the Pillar 2 at the Branch Office or Overseas Subsidiary Level (Paragraph 4, Pages 9-10 of the Framework Enhancements)

Regarding the proposal concerning the Pillar 2, the Consultative Document says *"A financial institution's ICAAP should be conducted on a consolidated basis and, where appropriate, at the legal entity level" (Paragraph 4).* Since ICAAP is originally meant to be managed on a banking group level, we ask that the Basel Committee clearly states that ICAAP should not be unnecessarily imposed at the overseas subsidiary or branch office level.

Under the laws and regulations, etc. of each nation, if ICAAP is made mandatory at the overseas subsidiary or branch office level, then it would impede the independent and efficient capital management at the financial group level. Furthermore, since arrangement of supervisory colleges are internationally scheduled, we believe it would make little sense to require a single financial group to make separate capital management on a country-by-country basis. Not only that, we are afraid that significant confusion may arise since the treatment in each country varies. The basis should be a single ICAAP for each financial group and a separate management on a branch office and subsidiary basis in each country or region should be kept to a minimum.

Furthermore, even in light of the thinking of "*Home-Host Information Sharing for Effective Basel II Implementation*" announced by the Basel Committee on June 2006, we understand that information sharing among the authorities of the home country of an internationally active bank and those of the host countries would promote meeting the above mentioned criteria stated in *Paragraph 4.*