April 15, 2010

Comment on the Basel Committee's Consultative Documents: *"Strengthening the resilience of the banking sector,"* and *"International framework for liquidity risk measurement, standards and monitoring"*

Japanese Bankers Association

We, Japanese Bankers Association, would like to express our gratitude for this opportunity to comment on the Consultative Documents: "*Strengthening the resilience of the banking sector*" and "*International framework for liquidity risk measurement, standards and monitoring*" released by the Basel Committee on Banking Supervision named on December 17, 2009.

We understand that the proposals in the Consultative Documents are part of the Committee's comprehensive response to the lessons of the financial crisis which relates to regulation, supervision and risk management of global banks.

However, we believe that an appropriate consideration is required to introduce the proposed rules from views of macro-economic impact on the market and real economies, balance between uniform regulations and national regulations, diversity of business models, phased-in implementation and grandfathering measures, and appropriate consultation procedures.

Although our comments are attached separately, our key comments are as follows.

We hope that our comments will assist the Committee in formulating the new rules.

- Key comments -

Ⅰ. General Points

(1) Macro-economic Impact on the Market and Real Economy

- ✧ We believe the risk of financial system instability increases significantly with more proposed regulations. At the same time, imposing excessive capital surcharges on the banking sector will significantly impair the efficiency and financial intermediation functions of national financial systems.
- ✧ Ensuring the stability of financial systems and preventing a recurrence of the financial crisis will require an entire package of regulation and supervision, not merely stronger capital surcharges imposed on financial institutions.

- ✧ New regulations should not impair market soundness following the financial crisis. The introduction of regulations should be timed according to the environments of individual regions and markets and in consultation with the markets themselves. Regulations must also be acceptable to investors and other market participants.

(2) Uniform Regulations and National Regulations

- ✧ The Basel Committee′s debate concerning regulation must be consistent internationally from the perspective of balancing terms of competition, and may not be optimal for the financial and economic conditions of all G20 countries.
- ✧ We understand that globally-uniform regulations may be desirable, but business cycles are not uniform globally. New regulations should be timed and made in a manner that has sufficiently considered the premise that conditions in each country are different.

(3) Diversity of Business Models

- ✧ In Japan, which is notable for its stable propensity to save, banks generally operate based on retail deposits. Financial institution′s business models are varied and they reflect differences in each country′s economy as well as each institution′s organizational structure. Regulations should therefore work to ensure substantial fairness by addressing these differences.

(4) Phased-in Implementation and Grandfathering Measures

- ✧ Regulations should not be limited to strengthening the quality of capital; they should be phased-in over a sufficiently long period and grandfathering provisions should be included in order to mitigate any sudden upheavals.

(5) Appropriate Consultation Procedures

- ✧ Before any new rules not included in the consultation paper are added, appropriate dialogue between the public and private sector should take place.

Ⅱ. Detailed Points

(1) Liquidity Surcharge and/or Capital Surcharge

- ✧ The systemic risks of major financial institutions to financial system as a whole can be mitigated by enhancing bankruptcy regimes (deposit insurance schemes, etc.), supervisory authority inspections, early remedial measures, and other preventative measures.

- ✧ Additional capital charges should be studied in light of the degrees to which systems and schemes function in individual countries, and such charges should not be imposed in an internationally-uniform manner.

(2) Appropriate Transitional Measures (Grandfathering)

- ✧ Grandfathering provisions should be applied to any capital raisings under current standards up to the date when the new regulations are implemented.
- ✧ In making the transition to new regulations, appropriate transition measures should be introduced, including exclusions from application and phased-in transition measures in light of national financial and economic conditions.

(3) Additional Requirements for Tier1 and/or Tier2 Capital (contingent capital, write-down features)

- ✧ The roles of Tier 1 as going concern capital and Tier 2 as gone concern capital should be distinguished more clearly.
- ✧ Mandatory conversion and/or write-down features enhance ability to absorb losses and could be used as a capital buffer. However, there are concerns that these features may shrink debt capital market and weaken banks' ability to raise capital. These features should be considered from the perspectives of investors and markets.
- ✧ For mandatory conversion and write-down features, it is appropriate to establish a sufficient transition period adequately considering the needs and views of investors, until the funding market stabilizes.

(4) Regulatory Adjustments

- ➢ <u>Other Intangible Assets (Software, etc.)</u>
- ✧ Software and other intangible assets that produce cash flows should not be deducted.

- ➢ <u>Deferred Tax Assets</u>
- ✧ With respect to deferred tax assets, a certain portion of, for example, 20% of Tier1 capital should be allowed for inclusion in common equity in order to ensure international comparability based on the differences in accounting standard and tax regime of each country.

- ➢ <u>Double Gearing Rules</u>
- ✧ When double gearing adjustments are applied broadly to investments in financial institutions, international alliances through minor currencies in Asian countries

will become more difficult. This may have the effect of impairing healthy incentives to financial institutions to expand their businesses.

- ✧ Capital injections across countries and regions can somehow limit the impact of bankruptcies and these capital injections would stimulate global money during normal times while helping to stabilize the financial system overall during times of crisis.
- ✧ We therefore advocate a cautious approach that takes into account national and regional financial system structures by, for example, limiting the scope of regulatory adjustment to investments in certain economic regions or investments in domestic financial institutions.

➢ Defined Benefit Pension Fund Assets

- ✧ Retirement benefit accounting systems differ across countries and regions, and the rules should be adapted to the regime of each country. Some grandfathering treatments should be allowed for countries in which International Financial Reporting Standards (IFRS) are scheduled to be introduced.

2. Enhancing Risk Coverage

- ✧ With regard to the capital charge for CVA, treatments for hedging transactions on real demand (for example, international trade by business customers) should be different from those for speculative transactions.
- ✧ These transactions on real demand of business customers are diversified, thereby little potential for systemic risk. We think that any consideration of this topic must take account of the adverse impact on the facilitation of corporate finance activities.
- ✧ In measuring CVA risk, the effect of the higher asset value correlations for large financial institutions and the wrong-way add-on risks should be carefully examined considering the QIS findings to avoid excessive capital charge of those risks.

3. Leverage Ratio

- ✧ Japanese banks hold deposits well in excess of loans, and these abundant surplus funds support government bonds. Balance sheets of this nature that have sound asset/liability structures should not be treated the same as exposures that have increased as a result of leveraged transactions.
- ✧ In addition, current monitoring indicator ratios are inconsistent with liquidity regulations for highly-liquid assets like government bonds. We therefore encourage financial officials in different countries to define leverage ratio as

monitoring indicators as appropriate to conditions in their respective countries under Pillar 2, not regulatory ratios under Pillar 1.

4. Limiting Procyclicality

- ✧ The current risk weight function adopts a probability approach to calculate 99.9 percentile PD from average values for PDs. Applying further stress to the input PD would be a double application of stress and thus not rational. We propose using long-term average PDs that include financial crises.
- ✧ There are ways other than amortization to withdraw reserves to proactively cover losses—for example, by selling assets, collateral covering, and risk hedging. We view that loss absorbency should be allowed for going concern basis. In order to encourage provisioning, expected loss shortfall as well as excess reserves should be counted toward common equity.
- ✧ Minimum capital requirements and capital buffers should be managed clearly, and thus capital buffers should be managed under the Pillar 2 as appropriate to each country′s financial systems and economic conditions.
- ✧ Restrictions on distribution will not only effectively lead to raising minimum capital adequacy, but should also be reviewed from a legal perspective (restrictions of shareholder rights) in regard to the impact on corporate laws in different countries.

5. Liquidity Regulations

- ➢ Liquidity Coverage Ratio (LCR)(*1)
- ✧ Factors such as cash outflow and inflow are excessively conservative and should be reviewed.
- ✧ Run-off rates covering highly ′sticky′ deposits should be lowered.

- ➢ Net Stable Funding Ratio (NSFR)(*2)
- ✧ Together with a leverage ratio regulation that limits increases in banks′ own balance sheets, the NSFR will reduce long-term lending. Furthermore, it will reduce credit supply by decreasing lending and result in a large adverse effect on the real economy.
- ✧ The objective of NSFR is to encourage structural changes in liquidity risk profiles as a supplementary measure to LCR, and they should therefore be addressed under the Pillar 2 as part of the framework to be administered according to national circumstances as supplementary indicators to LCR.
- ✧ We propose the Core Funding Ratio, which is calculated more simply and would therefore be expected to be more stable, be considered from a regulatory

perspective.

(*1) LCR is the metric that requires banks to hold a stock of high quality liquid assets which is clearly sufficient to cover cumulative net cash outflows over a 30-day period under the prescribed stress scenario.

(*2) NSFR is the metric that requires banks to have stable funding (for example, deposit, long-term debt, capital or others) against less liquid assets which can not be liquidated within one year.